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SHORT ARTICLE SERIES

Our purpose at Atleha-edu is to help ordinary South Africans save and invest for a better tomorrow.

We do this through Financial Sector Code (FSC)-compliant awareness and interactive education programmes focused on retirement fund trustee, management committee member; and fund member awareness and education initiatives, such as this short article.

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HEDGE FUND STRATEGIES: IT'S NOT JUST ABOUT SHORT SELLING

The stigma that hedge funds are simply short sellers that feed on bad news in order to push a stock's price down – or simply short poor or bad stocks – is one that has tended to stick. Hedge funds can, in fact, employ a wide range of investment strategies to realise returns for investors.

Before we dive into the various types of hedge fund strategies that can be employed, it's important to note that hedge funds provide diversification through exposure to different asset classes, thereby providing an additional and differentiated risk-return profile to portfolios that are not available to traditional long-only equity portfolios.

Different types of hedge fund strategies

Long and short equity: Funds aim to generate positive returns by being simultaneously long and short in the equity market. The objective is to reduce market risk and retain company-specific risk. The majority of local equity long-short funds tend to be long biased. An investment strategy is to take long positions in stocks that are expected to increase in value and short positions in stocks that are expected to decline in value. A long-short equity strategy seeks to minimise market exposure, while profiting from stock gains in the long positions and price declines in the short positions.

The prevalent hedge fund strategy in SA is this long-short strategy. It requires hedge funds to research the entire market in order to identify both outperforming and underperforming shares. This allows investors to position their portfolios to be long the outperforming shares and short the underperforming shares.

An example would be the concept of "pairing", whereby two shares in the same industry are identified and classified based on a number of key factors to determine which is thought to be able to outperform the other. The fund manager would then buy the share they expect to outperform, and short the share they expect to underperform.

Market neutral: In a market-neutral equity strategy, funds take similar-sized long and short positions in related equity sectors with the effect that directional market risk is offset. The aim is to profit from both increasing and decreasing prices. Market-neutral strategies are often attained by taking matching long and short positions in different stocks to benefit from mispricing and delivering positive returns from both the long and short stock selections and reducing risk from movements in the broad market.

The market-neutral approach is more conservative, whereby long positions are equally offset by short positions, resulting in zero-net market exposure. These strategies require a deep understanding of the markets and is not a case of directional speculation.

Fixed income: An investment strategy that attempts to profit from arbitrage opportunities in interest rate securities. When using a fixed-income arbitrage strategy, the investor assumes opposing positions in the market to take advantage of small price discrepancies while limiting interest rate risk. This general strategy type includes basis (e.g. cash vs. futures), yield-curve and credit spread trading, as well as volatility arbitrage.

Statistical arbitrage: Quantitative models are used to identify market opportunities and establish short-term positions involving a large number of securities.

Volatility arbitrage: Funds aim to exploit mispricing between similar instruments where the mispricing is the result of different volatility assumptions by price makers.

Multi-strategy: An investment philosophy allocating investment capital to a variety of investment strategies and potentially across several asset classes.

Commodities: Funds that predominantly invest in soft or hard commodities. These funds can follow a number of different strategies to obtain alpha from this asset class, including trend following or non-directional market neutral strategies.

GLOSSARY

Alpha: A measure of excess return generated by an investment (security) relative to a benchmark index
Arbitrage: The exploitation of pricing anomalies in financial markets to generate risk-free or low-risk profits
Derivatives: Financial instruments that derive their value from underlying securities and other variables, such as indexes or reference rates, have either no or small initial investment and allow firms to speculate or hedge risks that arise from factors outside their control, such as foreign currency rates.
Fixed-income market: The money and bond markets and their derivatives. Also called the **interest-bearing market.**
Futures: An exchange-traded contract for delivery of a standard equity of a specific underlying asset at a predetermined price and date in future
Long hedge: Buying a futures contract (e.g. by a commodity consumer) to hedge against a rise in the price of the underlying asset
Long position: A dealer that has purchased a security is said to be "long" that security
Net exposure: Net exposure is the difference between a hedge fund's long positions and its short positions. Expressed as a percentage, this number is a measure of the extent to which a fund's trading book is exposed to market fluctuations. Net exposure can be contrasted with a fund's gross exposure. A fund has a **net long exposure** if the percentage amount invested in long positions exceeds the percentage amount invested in short positions, and has a **net short position** if short positions exceed long positions. If the percentage invested in long positions equals the amount invested in short positions, the **net exposure is zero.**
Option: A contract that gives the holder the right, but not the obligation, to buy or sell an underlying instrument at an agreed price
Put option: An option that permits the holder the right, but not the obligation, to sell an underlying asset at an agreed price

The next article in this series will provide an overview of how hedge fund managers employ their investment strategies to realise returns for investors.

Do you have a question that you would like us to address in a subsequent article?
If so, please send your questions or suggestions for article topics by email to:

info@atleha-edu.org