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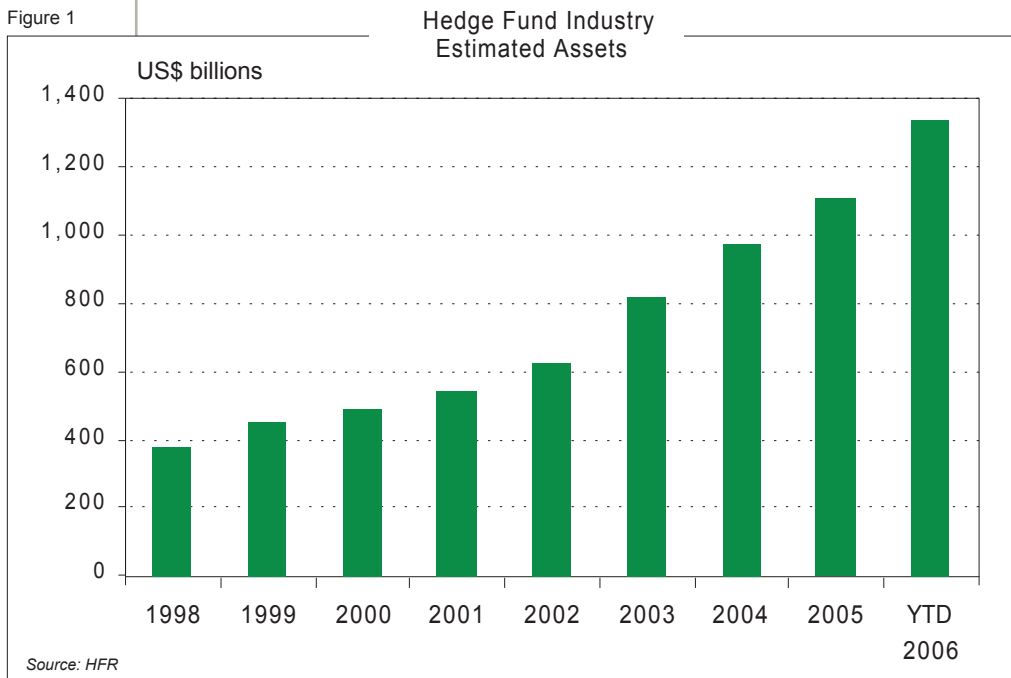
## Funds of Hedge Funds: Excellent global portfolio diversifiers

**Hedge funds, pooled investments that adopt unconventional but sophisticated investment strategies to generate returns - usually at a lower risk than general equity markets - are gaining wider acceptance internationally. Locally, hedge funds are being increasingly recommended by financial consultants as an important part of a well-diversified investment portfolio.**

Hedge funds aim to produce some level of positive returns in any market conditions. They therefore avoid large, direct exposures to traditional asset classes like equities and bonds. Instead, they use short-selling and derivatives like futures and options, among other investment tools, to reduce their market exposure and effectively 'hedge' their positions. They can also invest in less common assets like commodities and private markets.

As illustrated in figure 1, the global hedge fund industry has almost doubled in the past three years, with

Figure 1



assets of around US\$1.3 trillion as of September 2006, according to Hedge Fund Research Inc. of the US. The South African hedge fund industry is small by comparison, but is also growing quickly.

Why are these largely unregulated funds making such inroads among global investors? Many funds can now boast track records of 10 years or more, and have proved that they can protect capital even in falling markets, thereby helping to inspire confidence in what has come to be regarded as a separate asset class.

At the same time, most of the money is going into funds of

hedge funds, which are "umbrella" funds structured by asset managers who invest across a number of hedge funds.

The growth in funds of hedge funds has been the asset management industry's response to the unregulated, complicated and opaque nature of the hedge fund industry. They have helped to overcome concerns around hedge funds in several ways:

First, fund of hedge fund managers combine various funds in ways that lower the risk associated with any one hedge fund. This means that the unexpected collapse of a single hedge fund – like the well-publicised example of Long Term Capital Management – would have a limited impact on investors in funds of hedge funds.

Funds of hedge fund managers also closely monitor the credentials of the underlying managers, their particular investment strategies and, of course, each fund's performance. This way the many types of risk – such as market and manager risk – can be reduced. This has resulted in very low volatility for funds of hedge funds historically.

Global funds of hedge funds have a low correlation with other asset classes, proving to be an excellent diversifier in a portfolio, in many cases lowering its risk. They can also offer exposure to many different types of assets not available in South Africa. This means they can provide even better offshore diversification benefits than foreign money market, bond or equity investments.

To illustrate the diversification that a fund of hedge funds achieves, OMAM's global funds of hedge funds typically invest in 15 to 30 different underlying hedge funds across a range of geographies, investment styles and strategies.

The underlying hedge fund managers have very specialised knowledge and aim to generate returns using their expertise, rather than relying on overall market movement. Often any market exposure is virtually eliminated in order to provide consistent returns at low risk. There have been very few years when funds of hedge funds have posted negative returns.

At the same time, the advent of global fund of hedge funds has allowed more individual investors access to the hedge fund market. Historically this has been restricted by high minimum investment amounts (typically around US\$1 million), but because funds of hedge funds pool many individual investments together, these minimum requirements are more easily met.

Global funds of hedge funds can also allow investors access to top-performing international single hedge funds that may have been closed to new investment as a result of their historic success. Although it may seem counter-intuitive, many investment strategies employed by hedge funds work best when they have smaller amounts of money under management. As a result, their fund managers can opt to close them to new investors at relatively low levels. Yet fund of hedge fund managers may have a special relationship with the single hedge fund, which permits them to continue to invest, regardless of their closure, thus giving their clients special access to top-performing funds and star managers.

Global funds of hedge funds are likely to attract even more assets in the future. Globally, regulators are making strides towards creating an environment that would allow individuals greater access to hedge funds.

Investors looking to invest some of their portfolio offshore would do well to consider including a global fund of hedge funds in their asset allocation mix. Given its low correlation to equities and bonds, such an allocation could either lower risk without sacrificing returns, or increase returns without raising risk.

However, investors must seek advice from an authorised financial services advisor regarding any amounts to be allocated to a global fund of hedge funds. Like any investment, these funds come with associated risks, even though they may be aimed at lowering overall portfolio risk.