

# THRIVE

STRIVING TO PRESERVE CAPITAL AND CREATE WEALTH YEAR ON YEAR

## MARKET REPORT

### EQUITY MARKETS SURGE, BUT DOWNSIDE RISKS REMAIN

March was one of those months when one started to wonder if there was a rule imposed, stating that markets were not allowed to go down, even for one day. Equity markets around the world rose by between 6% and 10% on very low volatility, with the biggest daily drawdown on the S&P500 being a mere -0.55%. South African equities joined in the global party, rising 7.87% on the month, also on low volatility and with little daily downside.

A couple of key events dominated the month and allowed markets to grind upwards. Firstly, the US Fed made it clear that they are not planning to raise rates in the US any time soon. Low rates have been at the centre of the equity rally since last March, encouraging investors to take risks by offering little reward to invest in interest-bearing instruments. As a result there has been plenty of liquidity chasing risky assets with a corresponding price rise. With this seemingly set to continue, it becomes very difficult to take a contrarian view as the risks seem too high. Under such circumstances being long beta is the place to be. That is, of course, assuming you get out before the music stops! The second major global event that helped to drive equity markets higher was the European Union and the International Monetary Fund seemingly providing the

assurance that Greece would effectively be bailed out of its problems. While there are still a lot of unanswered questions here, the markets seem to be treating Greece as a bit of a non-event! Not even a downgrade of Portugal's credit rating created much of a stir.

Locally, the key news was the surprise rate cut by the MPC at its March meeting. Most economists had forecast no change, but the lower than expected CPI numbers gave the MPC the scope to reduce rates once more. This saw some pretty drastic changes in the short end of the yield curve, which created excellent opportunities for fixed interest players who profit from those sort of movements. Going forward there do seem to be numerous headwinds for another rate cut, but the current consensus appears that rates will now remain on hold for a while before beginning to increase towards 2011.

For investors, it is easy to become complacent when markets behave in the manner they did in March. However, this is often the time at which you need to be at your most wary. Investors would be well served by exercising caution at this stage of the market rally and ensuring that they only enter an investment that carries a good margin of safety, much in the manner of a Benjamin Graham or Warren Buffett. ■

### Dear Clients



In this issue of Thrive, Kevin Ewer explains the various types of hedging strategies that fund managers use in the management of assets.

Over the past ten years, the South African hedge fund industry has grown in size as well as in the various strategies offered. At Blue Ink Investments we categorise the managers as follows: market neutral, long/short equity non-directional, long/short equity directional, fixed interest and others which include structured finance strategies.

While it is important to choose the correct manager in each category, it is equally important to have the correct weighting or allocation to each category. The process is similar to that of a traditional asset allocation model. The least risky portfolio (i.e. Evergreen) will have a higher fixed interest allocation, while the more volatile portfolio (i.e. Blue Sky) will have a larger weighting to equity strategies. The allocation process is not only influenced by the risk / return characteristics of the portfolio, but also by a macro view of markets and the economy in general.

The investment team was recently strengthened by the appointment of two trainees, Grant Hogan and Tatenda Chapinduka. They both recently graduated from UCT and we are confident that their specific skills will reinforce our award winning investment team.

Until next month!

**Esmarie Strydom**  
Chief Executive Officer, Blue Ink Investments

#### The Blue Ink funds produced the following performance to 31 March 2010

	1 Month	3 Months	6 Months	12 Months	2 Years	3 Years
Big Oak	0.06%	3.35%	7.56%	28.88%	9.08%	22.61%
Blue Ink-ubator	1.24%	4.09%	8.52%	16.84%	37.03%	-
Blue Sky	0.69%	1.45%	3.84%	10.98%	-2.95%	6.94%
Evergreen	1.33%	3.22%	6.87%	12.94%	21.24%	30.77%
Redwood	1.00%	2.55%	5.55%	11.69%	7.94%	17.69%
ALSI	7.87%	4.48%	16.44%	44.10%	2.97%	14.43%

## HEDGING: HOW, WHY AND WHICH WAY

Opinion piece by Kevin Ewer, Portfolio Manager at Blue Ink Investments



Understanding the science and art of hedging is critical to the success of a hedge fund manager's portfolio. Hedging is effectively a risk management tool that enables a manager to position his portfolio for a desired risk/return payoff.

Because the term hedge fund covers a broad range of strategies, it is important to understand that not all strategies follow the same process when looking for ways to hedge the portfolio. Some strategies, such as market neutral strategies, are always hedged against market movements, while others, such as trend following strategies, employ minimal hedging techniques.

As a rule of thumb, strategies that exhibit lower returns with minimal drawdown and lower volatility tend to use hedging as an active part of their strategy, far more than a strategy which has higher return targets but exhibits higher volatility and greater drawdown.

The most basic form of a hedge would be to move one's entire portfolio into cash by selling out of all positions. A hedge fund manager could do this under extreme conditions of uncertainty, however, it is seldom that one sees this in practice as many investors would frown upon paying investment fees on a portfolio comprised entirely of cash. If a manager was to take

this extreme positioning, it would tend to be a short-term condition as he looks for ways to profit from the market uncertainty.

More typically one would see a manager looking for an instrument in the market that can protect his current positions from adverse market movements. For example, if a manager holds a long equity position in Impala Platinum and feels there is short-term risk to a pull back in the share price, there are a number of techniques he can use to hedge the position without selling out.

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Firstly he may look to buy a put option on Impala Platinum. By doing this he will be perfectly hedged from any losses below a certain price (known as the strike price of the option), but will still be able to profit if the share rises in price. In order to put this hedge in place, he will be charged a fee (known as the option premium) to purchase the put option. This premium is affected by volatility and if volatility is high it can be extremely expensive to put such a hedge in place, which may force the manager to look for a less perfect hedge.

If the cost of purchasing a put option is too high, a manager may choose to sell short a similar company against the Impala position. Ideally the company will be in the same industry as the long position. In this case Anglo Platinum may be a suitable candidate. By shorting Anglo against the Impala position the hedge fund manager is expecting that if

the price of Impala falls, his losses will be offset by profits from a falling Anglo price.

This is an imperfect hedge, however, because if the price of Impala falls by more than Anglo, the portfolio will suffer a loss (though less than the unhedged position would have lost). In an extreme case, if Impala falls in price while Anglo rises, the portfolio may be worse off than if there was no hedge at all. The other downside to this hedging technique is that you only benefit from upside in Impala if the share rises by more than that of Anglo. However, it is cheaper and easier to put in place than a put option and if a manager finds the right share to use as the hedge, it can function very effectively in protecting the portfolio.

Another way to hedge the Impala position may be to understand what the underlying drivers of the company's earnings are and take a position in these. On Impala, clearly one of the main drivers would be the spot price of platinum, so taking a short position in platinum would enable one to profit from a falling platinum price to offset a drop in the Impala share price, which would be expected to drop at the same time.

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Hedging – be it shorting, a put option, or a market neutral strategy – may be employed across the asset management spectrum but it remains a crucial component of a hedge fund's investment strategy and an essential part of a managing a successful portfolio. ■



### HEDGE FUNDS: SEPARATING FACT FROM FICTION

Often maligned and misunderstood, hedge funds are a bit like the Batman of the financial world. But like the dark knight comic hero, most of the myths surrounding hedge funds are unfounded. Over the next few months *Thrive* is featuring a series on myths versus realities, tackling some of the more common misconceptions surrounding hedge funds.

**MYTH: Hedge funds are expensive to invest in**

**REALITY**

As with any investment product a fee is charged by the investment manager, but it is not of the level that conventional

wisdom states it is. The 2008 Novare survey indicates that 50% of hedge funds charge a 1% management fee and only 22% charge the 2% fee that conventional wisdom says is standard. Institutional rates are also negotiable for investors with bulk and many institutional investors are paying less than 1% management fee. Most funds do also charge a performance fee. This is typically 20%, though it is important to note that 83% of funds make use of a hurdle (often cash) before any performance fee is taken. The high watermark may also be practiced whereby a fund may be exceeding previous highs to charge performance fees in a fee crystallisation period. This means that in order for the hedge fund manager to charge a performance fee the

returns must be positive and must exceed a certain minimum return.

In comparison to unit trusts, the management fee charged is in line with most of the equity unit trusts, which typically charge between 1% and 1.7% management fees.

Hedge funds, unlike many other investment products, report their returns net of all fees as an industry standard. This is important as when assessing the level of return versus their costs, as potential investors often make the mistake of taking fees off again when analyzing the products as potential investments, thereby understating the level of return. ■

### FUND MANAGER PROFILE: KEVIN WILLIAMS - BATELEUR CAPITAL



#### Do you have a strategy or motto for investing?

We stick to what we understand and stay clear of the hype. As fundamental investors we also spend a lot of time visiting companies and talking to management, which provides additional insight.

We learnt a lot from the global economic crisis in 2008/2009, most notably how the earnings of cyclical companies can swiftly erode and the dangers of over-extended balance sheets. Consequently we have a bias towards cash generative businesses with predictable earnings and high dividend payout ratios. We tend to avoid companies with high capital expenditure requirements (both maintenance and expansionary). We prefer investing in companies with established management teams that have proven themselves through tough business cycles. Finally, we favour investing in companies with either stable or below trend operating margins.

#### Would you invest your own money in the hedge fund industry?

We believe strongly in the investment merits of hedge funds, and all of the investment professionals at Bateleur have a sizable portion of their liquid assets invested in our funds. I would also have no hesitation in recommending hedge funds as an important component of any diversified portfolio. However, because of the multitude of strategies available, potential investors need to do their homework on managers before investing.

#### What is your view on possible hedge fund regulation?

We are generally supportive of regulation as long as it does not significantly impede on investment flexibility. On the positive front, progressive regulation will provide greater comfort and security to investors and potentially widen the investor net. It may also enhance the image of hedge funds, which remain somewhat misunderstood.

#### How does the SA hedge fund industry compare with offshore peers?

From a self regulation perspective, the SA hedge fund industry is perhaps more advanced than its overseas peers. It has grown up with strong involvement from independent administrators, independent prime brokers and independent risk managers. For example it is common for investors in SA hedge funds to have daily access to the fund's underlying holdings and NAV. This is more the exception than the norm overseas.

From an investment perspective, SA hedge funds are somewhat more vanilla and conservative than their overseas peers. This is partly due to SA being a relatively small economy with fewer investment opportunities and (outside of the major exchanges), lower liquidity.

#### The SA hedge fund industry is now 10 years old; do you believe it has come of age?

As an industry, it has matured in terms of self regulation and delivering on its objectives (i.e. protecting capital in periods of market stress). However, it is still in infancy in terms of growth potential. At present the institutional market dominates the investor base. The sophisticated private client market is virtually untapped and provides a potential growth source.

#### What advice do you have for investors right now?

Right now capital markets are looking extended. We are negative on sovereign bonds, while cash offers muted returns. Selective high yield corporate bonds and selective high yield equities still offer reasonable returns. Our advice to investors is to be patient and back your fund manager. Opportunities will always present themselves irrespective of market direction. ■

#### How long have you been in the investment/hedge fund industry?

I started my investment career in 1996 as a sell side analyst at UBS Securities (Union Bank of Switzerland). In 2004 I left the sales side to set up Bateleur Capital. We have been managing hedge funds since 2005.

#### What do you like about the hedge fund industry?

The main attraction of the hedge fund industry is the investment flexibility that it offers. Our investment universe is not as restrictive as traditional investment vehicles. For example, some of our best returns historically have come from investing in large reputable companies that were not listed on a recognised exchange such as the JSE, but did nevertheless trade actively on the OTC market. The Rupert family-controlled company, Venfin, was one example of this. These opportunities would not be readily available in traditional investment vehicles.



**Pam Taioe, Receptionist at Blue Ink Investments**

**Tell us about your position at Blue Ink Investments**

I have been the receptionist at Blue Ink Investments for the past 10 years.

**Run us through some of your daily responsibilities and tasks**

I operate the switchboard, manage the dispatching and receiving of documents, packages and other correspondence. I also give support to the admin staff, prepare month-end statements and assist with the preparation of presentation packs, amongst many other things.

**What are the challenges you face?**

The challenge in my position is definitely to maintain balance on handling different types of people in a professional and wise manner.

**What do you enjoy most about your job?**

I really enjoy getting positive feedback from clients once I have assisted them.

**Tell us about your working environment at Blue Ink Investments**

The team spirit is what I enjoy most about working at Blue Ink. We are a close-knit team that work very well together.

**What are your key life learnings?**

I have learnt that in life determination, perseverance and patience will lead me to my destination if I don't lose focus.

**How do you spend your time on weekends?**

Most Saturday mornings I do evangelist work and in the afternoons I spend time with my family.

**What are your favourite activities outside of work?**

I love to play basketball and tennis. I also enjoy choral music.

**What other interests do you enjoy?**

I like to read my favourite book, The Secret, and watch comedies on TV. ■

**BLUE INK IN THE MEDIA**

Media highlights in April included coverage of our latest award-winning success - the Blue Ink-ubator fund being named the best Fund of Hedge Funds at the 2010 HedgeNews Africa awards.



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