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Hedge funds can also be low risk

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There are many popular misconceptions around hedge funds, one of the most common being that they are high risk, says Edwin Schultz, co-head of absolute returns at Coronation Fund Managers. This is not necessarily the case. Investors across all risk profiles should not ignore a sector of funds that could potentially benefit their investment portfolios significantly.

"At times the perception of hedge funds as risky is justified, judging by the high profile losses of some funds over the years and of late," says Schultz. "But there are many well-run hedge funds with sound long-term philosophies, managed within prudent risk frameworks – and that comply with low risk mandates."

He says low risk hedge funds can demonstrate low levels of volatility and defensiveness in declining market conditions. "Clients with conservative, cautious or moderate risk profiles can thus include hedge funds in a balanced portfolio without taking on undue risk."

There are several ways in which to determine the level of risk posed by a hedge fund, says Schultz. The hedge fund's mandate is one such indicator.

"Hedge fund managers have a greater opportunity set of investment tools at their disposal and are able to short sell shares and use derivatives more freely than long-only funds," says Schultz. "How these tools are used, and the limits on measures including gearing, credit and downside deviation, is specified in the mandate. These together determine how much risk a fund can assume."

He acknowledges a hedge fund's track record is also a good indicator of risk and suggests that investors check returns relative to indices and in relation to market conditions, drawdowns (the percentage decline from peak to trough) and the number of months of negative returns. A hedge fund with consistent, favourable returns can indicate low risk.

Institutional investors have already grasped the benefits of hedge funds and experienced how their wider opportunity set provides the potential to produce better risk-adjusted returns than conventional funds, says Schultz. Harvard Management Company in the US, which manages in excess of $22 billion in endowment assets, for instance, has a 12% allocation to hedge funds. It has achieved an annual return of 15.9% over the past 10 years (inflation averaged at 2.5% over this period).

"Hedge funds can play an important part in any portfolio, however, they need to be included within a framework of a sound philosophy and prudent risk management," says Schultz. "Hedge funds are only suitable for informed investors who have sought the input of properly qualified financial advisors."

He continues, "there is no substitute for doing the homework and conducting a proper due diligence on any recommended hedge fund. Investors need to thoroughly understand the philosophy and risk management process of a fund, just as they would any equity investment or conventional fund, to really know the capacity of the risk involved before investing in this asset class."