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Racing the odds: Why hedge funds belong in South African portfolios

South Africans understand risk better than most. Our markets tend to swing with every domestic political event, commodity price move, every budget speech, and every global tremor. As a small but open emerging market economy, we are increasingly at the mercy of global macro and geopolitical news flow. Too often, investors respond by clinging to yesterday's favourites, only to discover that the odds have already shifted. Hedge funds offer something different: the flexibility to tilt the odds in your favour and to manage risk more dynamically.

Steven Crist, in his seminal writing on value, likened investing to betting on horse racing: "The issue is not which horse in the race is the most likely winner, but which horse or horses are offering odds that exceed their actual chances of victory." A horse at 2-to-1 with only a 25% chance of winning is a poor wager. A less fancied runner at 10-to-1, if its true odds are 20%, represents value. In investing, the same holds true. Too often, buy or sell decisions are made without a clear understanding of the expectations embedded in a share price.

Performance-chasing without weighing risk against reward is a common trap. Hedge funds are built to think differently. A highly rated company or sector that has performed well recently is by no means guaranteed to continue that trend, especially if exceptional results are already priced into the stock. A blue-chip company might still be the 'favourite', but that doesn't make it the best investment when the risk-adjusted return no longer justifies the bet.

Unlike traditional funds chained to benchmarks, hedge funds can go where the value is – and avoid where it isn't. Hedge funds ignore benchmark weightings, and they don't need to remain fully invested when markets look overhyped. They can hold cash, hedge exposures, or even short crowd favourites when valuations defy logic. Just as importantly, hedge funds are not trying to 'shoot the lights out'. Their goal is steady, risk-adjusted returns that may lag when a narrow set of shares surges, but which compound more reliably over time.

Crist made another observation that resonates with investing: "You are only playing against the other bettors at the track, not against the game or the house." In South Africa's volatile, sentiment-driven market, nimbleness is an edge that size alone cannot buy. With a market dominated by a handful of shares and a currency that swings with every headline, investors need more than buy-and-hold. They need tools that balance risk and reward, allowing for multiple, nuanced positions rather than all-or-nothing punts on a concentrated index. Hedge funds provide exactly that.

Scale also matters. The South African hedge fund industry remains small compared with the vast pools of capital managed by traditional firms. This relative agility allows hedge funds to move capital quickly, to enter and exit positions efficiently, and to exploit opportunities beyond the large liquid names. Crist's advice applies here too: "Recognise the difference between picking horses and making wagers in which you have an edge."

Investors should see an investment in a hedge fund not as an isolated 'bet'. Rather, they need to appreciate how they can increase their overall risk-adjusted return by adding hedge funds to their existing portfolio. There is very compelling evidence that the addition of a hedge fund to a traditional Reg 28 fund reduces risk and increases returns.

In the short term, it is difficult to separate skill from luck in both racing and investing. But the considered investor – who places bets only when confident the odds are in their favour – will, over time, enjoy a far greater chance of success.