

Compounding without the cracks: The role of hedge funds in volatile markets



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The purpose of a hedge fund is often misunderstood. It does not attempt to outperform equities in a raging bull market, but to capture more upside in a bull

market than downside in a bear market. If done well, hedge funds provide a smoother journey and greater portfolio diversification.

Data from Hedge Fund Research (HFR) shows that broad hedge fund indices have historically delivered equity-like long-term returns with materially lower volatility than global equity markets. Lower correlation and lower drawdowns are not academic concepts; they are the building blocks of improved compounding. For pension funds managing long-dated liabilities, smoothing the journey can be just as important as maximising the destination.

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Behavioural research has consistently found that the average equity fund investor underperforms the funds they invest in – often by several percentage points per annum – largely due to adding exposure after strong returns and reducing allocations after drawdowns. They thus become victims of volatility.

Hedge funds are designed to interrupt that cycle. They do not rely on a rising index to generate returns. Instead, they seek to exploit mispricing between securities, to monetise dispersion, and to hedge out broad market risk. When volatility spikes and correlations break down, opportunities increase. By aiming for steadier, risk-adjusted returns, hedge funds seek to keep investors invested. The

greatest destroyer of long-term wealth is not volatility per se, but abandoning a strategy at precisely the wrong time.

This argument carries particular weight in South Africa, where the structure of the FTSE/JSE All Share Index has evolved markedly over the past decade. The index is increasingly concentrated. That concentration creates an illusion of diversification while embedding significant single-stock and thematic risk. Buying the index at higher levels in such an environment may feel prudent – after all, one is 'owning the market'. But if index performance is driven by a narrow leadership group or a single sector trading at elevated valuations, risk quietly accumulates beneath the surface.

One of the advantages of a hedge fund is that it is not compelled to own risk in benchmark proportions. It can hold exposure to a sector like gold when the risk-reward is compelling – without automatically inheriting a double-digit percentage weight simply because the index dictates it. Equally, it can reduce or hedge that exposure if valuations become stretched. Flexibility is not about being contrarian for its own sake; it is about weighing the odds.

The mathematics reinforce the philosophy. A 30% drawdown requires a subsequent 43% gain merely to break even. Avoiding large losses is disproportionately powerful in a compounding framework. By not chasing an equity benchmark, and by focusing instead on preserving capital during downturns, a hedge fund aims to improve the investor's realised return – the return actually experienced over time, not the headline figure of a single calendar year.

Hedge funds are not equity replacements. They do reduce portfolio volatility, mitigate index concentration risk, and dampen the impulse to add and withdraw capital at the wrong times. In more concentrated and sentiment-driven markets, the objective is not to win every race. It is to stay in the race – compounding steadily, avoiding the deep drawdowns, and ensuring that clients remain invested long enough for probability to work in their favour.