Hedge fund risk disclosure

Investments

Investment in a hedge fund portfolio carries a high degree of risk, and is only suitable for sophisticated or professional investors, who fully understand the risk of investing in a hedge fund portfolio, and are capable of sustaining a substantial loss of their investment. You should carefully consider the risks listed below, before investing in a hedge fund portfolio. The list of risks listed below does not cover all risks that may arise from investing in a particular hedge fund portfolio, as there are various hedge funds strategies, existing strategies may change, and new strategies may be developed over time. Furthermore not all the risks set out below apply to all hedge funds, and many hedge funds operate in a well-controlled environment.

We advise that you consult with your own legal, tax and financial advisers, to ensure that you understand these risks.

1. Some of the main risks of hedge funds

1.1 Investment strategies may be inherently risky

Hedge fund strategies may include leverage, short-selling and short term investments. In addition, hedge funds often invest in unlisted instruments, low-grade debt, foreign currency and other exotic instruments. All of these expose investors to additional risk. However, not all hedge funds employ any or all of these strategies and it is recommended that investors consult their adviser in order to determine which strategies are being employed by the relevant fund and which consequent risks arise.

1.2 Leverage usually means higher volatility

Hedge funds may use leverage. This means that the hedge fund manager borrows additional funds, or trades on margin, in order to amplify his investment decisions. This means that the volatility of the hedge fund can be many times that of the underlying investments.

The interest expense and other costs incurred in connection with leverage or borrowing may not be recovered by an increase in your investments. Gains realised with leveraged investments may cause the underlying fund's net asset value to increase at a faster rate than would be the case without leverage. If, however, investment results fail to cover the cost of leverage or borrowings, the portfolio's net asset value could also decrease faster than if there had been no leverage or borrowings. Because of the leveraged nature of certain of the investments, a relatively small movement in the market price of traded instruments may result in a disproportionately large profit or loss.

The degree to which leverage may be employed in any given hedge fund will be limited by the mandate of the fund. The limits laid down by the fund mandate should be carefully reviewed in making an investment decision.

1.3 Short-selling can lead to significant losses

Hedge funds may borrow securities in order to sell them short, in the hope that the price of the underlying instrument will fall. Where the price of the underlying instrument rises, the fund can be exposed to significant losses, given that the manager is forced to buy securities (to deliver to the purchaser under the short sale) at high prices.

1.4 Unlisted instruments might be valued incorrectly

Hedge funds may invest in unlisted instruments where a market value is not determined by willing buyers and sellers. The hedge fund manager may have to estimate the value of such instruments, and these estimates may be inaccurate, leading to an incorrect impression of the fund's value. Potential investors should ensure that objective valuations are performed for all instruments in a fund and that the fund has a competent administrator.

1.5 Fixed Income instruments may be low-grade

Hedge funds may invest in low-grade bonds and other fixed interest investments. These investments are more likely to suffer from defaults on interest or capital. They are also more likely to have volatile valuations when the market changes its view on credit risk. The fund mandate should also limit the extent (i.e. the lowest acceptable rating and maximum percentage exposure) to which low grade debt can be acquired by the fund. Investors should review the mandate to gain an appreciation of the maximum possible exposure applicable to the relevant fund.

1.6 Exchange rates could turn against the fund

Hedge funds might invest in currencies other than the base currency. For example, a South African hedge fund might invest in UK or US shares. The fund is therefore exposed to the risk of the rand strengthening or the foreign currency weakening.

1.7 Other complex investments might be misunderstood

In addition to the above, hedge funds might invest in complex instruments such as but not limited to futures, forwards, swaps, options and contracts for difference. Many of these will be derivatives which could increase volatility. Many will be "over the counter" which could increase counterparty risk. Many exotic instruments may also be challenging for the manager to administer and account for properly. Investors should enquire into how these instruments are objectively and independently valued.

1.7.1 Derivatives

Hedge funds may use derivative instruments for investment and hedging purposes. Many derivative instruments may be challenging for the manager to administer and account for properly. All instruments are objectively and independently valued. Some of the risks associated with derivative instruments include the following:

a. **Tracking:** When derivatives are used for hedging purposes, an imperfect or variable degree of correlation between price movements of the derivative instrument and the underlying investment sought to be hedged may prevent the portfolio from achieving the intended hedging effect or expose the portfolio to the risk of loss.

b. **Liquidity:** Derivative instruments, especially when traded in large amounts, may not be liquid in all circumstances, so that in volatile markets the portfolio may not be able to close out a position without incurring a loss. In addition, daily limits on price fluctuations and speculative position limits on exchanges on which the portfolio may conduct its transactions in derivative instruments may prevent prompt liquidation of positions, subjecting the portfolio to the potential of greater losses.

c. **Leverage:** Trading in derivative instruments can result in large amounts of leverage. Thus, the leverage offered by trading in derivative instruments will magnify the gains and losses experienced by the portfolio and could cause the portfolio's net asset value to be subject to wider fluctuations than would be the case if the portfolio did not use the leverage feature in derivative instruments.

d. **Over-the-counter trading:** Derivative instruments that may be purchased or sold by the portfolio may include instruments not traded on an exchange. The risk of non-performance by the obligor on such an instrument may be greater and the ease with which the portfolio can dispose of or enter into closing transactions with respect to such an instrument may be less than in the case of an exchange traded instrument. In addition, significant disparities may exist between "bid" and "asked" prices for derivative instruments that are not traded on an exchange. Derivative instruments not traded on exchanges are also not subject to the same type of government regulation as exchange traded instruments, and many of the protections afforded to participants in a regulated environment may not be available in connection with such transactions. Heavy reliance on "over-the-counter" derivatives could result in an increase in counterparty risk

1.7.2 Counterparty risk

The ability of any counterparty to meet its obligations in terms of its contractual arrangements with the investment manager and the investment manager's ability to enforce any claim that it may have in respect of any defaulting counterparty will be subject to matters relating to, inter alia, solvency of the defaulting counterparty, the nature of the contractual arrangements between the parties, whether the defaulting counterparty has tendered any security for its obligations to the investment manager and practical and substantive risks associated with the South African judicial system.

1.8 The fund may be caught in a liquidity squeeze

Given their often short term nature, hedge funds need to be able to disinvest from or close certain positions quickly and efficiently. But market liquidity is not always stable, and if liquidity were to decrease suddenly, the hedge fund might be unable to disinvest from or close such positions rapidly or at a good price, which may lead to losses.

1.9 The prime broker may default

Hedge fund managers often have special relationships with so-called "prime" brokers. These are stock brokers that provide the required leveraging and shorting facilities. Prime brokers usually require collateral for these facilities, which collateral is typically provided using assets of the relevant client, and consequently such collateral might be at risk if the prime broker were to default in some way.

1.10 Custodian risk

The assets of a hedge fund that are held in custody may be lost in the event of the custodian or a subcustodian's insolvency, negligence or fraud.

1.11 Regulations could change

Legal, tax and regulatory changes could occur during the term of your investment in a hedge fund. The effect of any future legal, tax and regulatory change or any future court decision on a hedge fund could be substantial and adverse.

1.12 Past performance might be theoretical

Hedge funds are on occasion marketed using theoretical or paper track records. Past performance is seldom a reliable indicator of future performance. Theoretical past performance is often an even less reliable indicator, and investors should place lower significance on these.

1.13 The manager may be conflicted

The hedge fund manager might be managing other hedge funds or other traditional investment funds. The investor should ensure that sufficient controls are in place to manage any conflicts of interest between the different funds.

2. Some of the main characteristics of hedge funds

2.1 Hedge fund structures are often complex

Hedge fund portfolios and hedge fund portfolio managers are fully regulated by the FSB under the CIS Act and the FAIS act respectively. Investors must ensure that person/s they engage with hold the appropriate licence. Investors need to ensure that any structure is robust enough to contain any unlimited losses.

2.2 Manager accountability may be vague

Hedge funds are often managed by specific individuals and investors should ensure that sufficient controls are in place for the times when the manager is being covered for by colleagues. In addition, a hedge fund (for example a fund of funds) and its managers or advisers may rely on the trading and/or expertise and experience of third-party managers or advisers, the identity of which may not be disclosed to investors. This constitutes an additional risk for investors, which they must take into account.

2.3 Fees might be high

Hedge fund fees may be significantly higher than the fees charged on traditional investment funds. Investments should be made only where the potential returns justify the higher fees.

2.4 Fees might be performance-based

Hedge fund fees are usually performance-based. This means that the managers typically get a higher fee when their funds outperform specified performance targets, which might lead to riskier positions being taken. Investors need to ensure that performance fees allow for a fair sharing of both the good and the bad.

2.5 Transaction costs might be high

Given the often short term nature of investment positions, hedge funds are often traded more aggressively. This implies more stockbroking commission and charges being paid from the fund, which is ultimately for the investor's account. Investments should be made only where the potential returns make up for the costs.

2.6 Transparency might be low

Hedge fund performance is often the result of unique proprietary strategies or contrarian investment positions. For obvious reasons, managers will want to keep these confidential. Managers are therefore less likely to disclose trades to their investors, and holdings might be disclosed only in part or with a significant delay.

2.7 Monthly liquidity

As mentioned above, the frequency of withdrawals is limited to monthly dates. In addition, the manager may impose notice periods or lock-ins in due to lack of liquidity in the market to facilitate a repurchase of units. In this instance the Financial Sector Conduct Authority will be made aware of such lock-ups.

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The Manager and Trustee are registered and approved under the *Collective Investment Schemes Control Act* (No. 45 of 2002). Alexander Forbes Group Holdings Limited is a member of the Association for Savings and Investment South Africa (ASISA).

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