On 29 August 2007, amidst growing concern about the perceived lack of transparency in the South African hedge fund industry, the FSB published its long-awaited regulations (the ‘Hedge Fund Regulations’) governing South Africa’s hedge fund industry. Broadly speaking, the Hedge Fund Regulations established certain ‘fit and proper requirements’ for hedge fund managers, introduced the procedures which hedge fund managers are required to follow in order to obtain authorisation to act as such and the created of a Code of Conduct for hedge fund managers.

The Fit and Proper Requirements made it obligatory for anyone managing a hedge fund to apply to the FSB for a Category IIA financial services provider licence. Category IIA financial services providers are required to have a track record of managing particular hedge fund strategies and are required to adequately demonstrate knowledge, skill and competency in managing all instruments and asset classes comprising a hedge fund portfolio as optimised by and in conjunction with the requisite hedge fund strategies employed from time to time. In addition, an applicant for a licence to act as a Category IIA financial service provider, as well as any key individual of such applicant, is required to display certain character qualities such as honesty and integrity and to meet certain academic requirements. The Code of Conduct is significant in that, for the first time in South African law, the definition of a hedge fund was provided as hedge fund means a portfolio which uses any strategy or
“The most prominent change is the introduction of two types of hedge funds, being the Retail Investor Hedge Fund (RIHF) and the Qualified Investor Hedge Fund (QIF).”

The most prominent change is the introduction of two types of hedge funds, being the Retail Investor Hedge Fund (RIHF) and the Qualified Investor Hedge Fund (QIF). A qualified investor will be an investor that commits a minimum of R 1 million and that has illustrated that he understands the workings and risks of hedge funds. The New Regulations make South Africa the first country in the world to regulate hedge funds (as a product) to such a large extent. Europe’s Undertaking for Collective Investment of Transferable Securities (UCITS) is also a very comprehensive European Commission framework but the difference is that UCITS applies to mutual funds generally and not just to hedge funds. That is ironic considering that, in my view, South African hedge funds have been the most self-regulated funds in the world and have largely employed the adequate risk management processes and checks and balances that a lot of international hedge funds did not have prior to the financial crisis.

Although hedge funds are now collective investment schemes, they are given distinct treatment from other unit trusts regulated by CISCA in that as a designated scheme they are permitted to enter into certain transactions and employ certain strategies that unit trust may not enter into. Although there are marked differences between hedge funds and unit trusts, the fact that hedge funds are now regulated under CISCA has given investors greater confidence in that CISCA has a long history of regulating unit trusts in South Africa and various CISCA provisions are now applicable in the enforcement of hedge funds. To note a few:

- The marketing and solicitation rules that apply to unit trusts, as set out in Board Notice 92 of 2014 apply to hedge funds. While previously the Association of Savings Investment South Africa (ASISA) monitored advertising of collective investment scheme investments through the code of conduct applicable to their members (“ASISA Code”), all advertising material, fund fact sheets, application forms and minimum disclosure documents (the equivalent of the KID document under UCITS) must now be submitted to the FSB for review.

- Whereas previously, hedge funds enjoyed freedom of contract to agree most issues contractually with investors, going forward an array of matters will be regulated. These include repurchase/redemption obligations; requirements around the posting and receipt of collateral; requirements in relation to derivative instrument counterparties; requirements in relation to valuation and pricing; disclosure and reporting requirements to investors; and prudential investment requirements for retail hedge funds;

- operators of foreign hedge funds can market their hedge funds to South African clients by obtaining authorisation through Section 65 of CISCA;
any contravention of the New Regulations shall be punishable or enforced in terms of CISCA, with the maximum liability being a fine not exceeding R10 million or to imprisonment for period not exceeding 10 years, or to both.

Hedge funds may be structured as trust arrangements formed under CISCA or as limited liability partnerships. Hedge funds housed in other structures, such as bewind or vesting trusts had to be restructured before 31 March 2016.

The New Regulations also make it permissible for MANCOS to establish platforms that host different portfolios which are administered independently of each other. Most hedge fund managers have opted for platforms as opposed to establishing and licensing their own MANCOS due to the cost of establishing a MANCO under the New Regulations. One of the more practical consequences of the new Regulations is that it has become expensive and administratively burdensome for hedge fund managers to incorporate a MANCO. By way of example, the board of directors of the MANCO must be comprised of at least four directors, of which 50% must be non-executive directors and the majority of the non-executive directors must be independent. The pool of these independent directors is limited considering that the board must be comprised of individuals who can demonstrate collective investment scheme, legal and accounting expertise.

The MANCO will need to submit its memorandum of incorporation to the CIS Registrar. The CIS Registrar requires that such memorandum of incorporation contain restrictive conditions and that the MANCO be a “ring-fenced” company. More critically, the MANCO will have to meet certain capital requirements and must provide annual financial statements in respect of the previous three years. The MANCO will be required to have necessary control, compliance and risk management procedures in place, including, for example, documentation relating to business processes, policies and controls, a complaint resolution procedure and a business continuity plan.

Under the platform structure, the hedge fund manager will be appointed as a discretionary financial services provider by the MANCO in terms of an Investment Management Agreement between the parties. Most of the MANCOS that have been appointed have chosen the trust structure because this is the structure that housed traditional collective investment schemes and from a system and operational perspective it is more efficient for the platforms to maintain this structure.

The hedge fund managers still require the Category II Licence. In addition it is important to remember that hedge funds are regulated by other pieces of legislation that affects their business operations. A hedge fund is a complex creature that comprises of the hedge fund manager, the MANCO, the administrators, prime brokers, risk managers and compliance officers. Legislation that regulates the prime brokers such as the Financial Markets Act and the Rules of the JSE Limited must also be taken into account in determining the full spectrum of hedge fund compliance.

In summary
The hedge fund industry is hoping that the increased transparency and governance requirements will lead to increased investor confidence in the hedge fund industry as the New Regulations become more settled and better understood.
A unique alpha opportunity

Shortly after the global financial crisis of 2008, many prominent market commentators were forecasting a transition to a new low return world. With hindsight, it appears that these predictions were premature, with risk assets rallying significantly from their March 2009 lows.

The S&P500 has produced an annualised return of 15.1% from those lows and its price earnings ratio has more than doubled over the same period, despite anaemic global growth. However, with that “re-rating equity rally” largely behind us, it would appear that the sages of 2009 may now be more correct than they were back then, as global earnings growth looks set to align with global economic growth.

As a result investors have re-calibrated their return expectations which has led to a massive focus on the value of active investment management. This scrutiny is epitomised by the discussions around global hedge fund fees, as nominal returns from global hedge funds have fallen. The challenge for active management, is an increasingly competitive landscape, leading to an ever greater reliance on market beta as.

Key topics

+ What are the results now global earnings growth is set to align with global economic growth?
+ How are South African Asset Managers benefiting from structural inefficiencies?
+ Will alpha opportunities ever become a reality?
the primary driver of returns. This may well also be the case for hedge funds which are focussed on highly developed and competitive markets. Funds which are able to benefit from structural inefficiencies in emerging markets, do not face the same challenges, but then investors typically have to accept a trade-off of potentially higher alpha, at the expense of institutional soundness, regulatory certainty and financial market maturity.

Against this backdrop South Africa presents an appealing potential investment destination. According to the World Economic Forum’s Global Competitiveness Study, South Africa ranks exceptionally high in the categories which are of most importance to a financial market investors. With regard to its institutions, South Africa ranks first globally in relation to the strength of its auditing and financial reporting standards. It ranks in the top 3 for the efficacy and accountability of corporate boards, as well as the protection of minority shareholders’ rights. From a financial markets perspective, it ranks number one and two respectively for the ability to finance through the local equity market and the regulation of the securities exchange. It also ranks in the top 12 with regards to the soundness of its banks and the financial market development. Therefore, notwithstanding South Africa’s overall ranking of 49th amongst 140 countries in the study, it ranks higher than most developed nations, including the USA in a number of the subcategories which relate to investing in listed securities.

Further to this context, South African asset managers have the benefit of structural inefficiencies within the domestic savings pool. The South African stock market capitalisation is over 2.5 times the size of its GDP, as compared to the USA which has a combined stock market capitalisation of 1.5 times GDP, and most other emerging economies at well less than 1 times GDP”.

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economies at well less than 1 times GDP. Interestingly, only roughly 35% of the revenue of stocks listed in South Africa is derived from the local economy, with the balance of revenues derived from a combination of global resources (25%), global developed market defensive (15%) and global consumer growth (25%) stocks. This structure means that investors in the South African market have the ability to access many global macro themes in a range of South African listed stocks trading in a very well-regulated and mature financial markets infrastructure. The question should then be asked, “are there any structural impediments which result in inefficiencies from which alpha can be sustainably derived”. The answer once again is a resounding “yes”. Of the approximately $850 billion in savings assets (pension, insurance and mutual funds, according to the SA Reserve Bank), roughly 90% is managed by the seven largest institutional money managers. This leads to a degree of lethargy in the market as these large pools of capital fight portfolio inertia due to their inability to move quickly as the market environment changes. Furthermore, just under 1% of that entire asset pool is currently invested in hedge funds in South Africa, creating an environment in which flexible and nimble hedge fund managers are still able to consistently produce alpha for their investors.

This story is borne out in the both the nominal returns achieved and the returns relative to the S&P500 and global hedge fund peers. According to Bloomberg, the HFRX Macro Multi Strategy Index has exhibited an annualised return of 2.38%, on volatility of 4.07% (Sharpe ratio of 0.5) with a Beta to the S&P500 of 0.13, which compares favourably to both the HFRX Macro Multi Strategy Index and the S&P500. Another Equity Long Short strategy returned 19.94% annualised, on volatility of 13.61% (Sharpe ratio of 1.44), with a Beta to the market of 0.02, which compares very favourably to the HFRX Equity Hedge Index and the S&P500.

The search for elusive alpha is becoming increasingly harder, and as expected nominal returns from equity markets adjust lower, the ability to produce differentiated alpha will become more sought after. Investors’ attention on the value-add of active management and reticence to pay active fund management fees to hedge fund managers who essentially provide beta returns is understandable. Structural inefficiencies in the South African hedge fund market mean that South African hedge fund managers have managed a range of different hedge fund strategies focussed on the South Africa market. In order to provide a flavour of the success in doing so, I’ve selected two strategies to compare to the global universe, with returns fully hedged to ensure that US Dollar investors have zero local currency exposure (roughly negating the interest rate differential). These strategies have not been the top performing hedge fund strategies, but represent an above median return relative to the entire universe. The returns have been substantially better than the global indices. One Multi Strategy Fund produced the following returns in US Dollars; an annualised return of 18.5% on volatility of 14.49% (Sharpe ratio of 1.25) with a Beta to the S&P500 of 0.13, which compares favourably to both the HFRX Macro Multi Strategy Index and the S&P500. Another Equity Long Short strategy returned 19.94% annualised, on volatility of 13.61% (Sharpe ratio of 1.44), with a Beta to the market of 0.02, which compares very favourably to the HFRX Equity Hedge Index and the S&P500.

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South Africa now has a regulated setting for hedge funds – both at manager and product level, giving it one of the world’s most advanced operating environments. The industry is hopeful that this will bring an increase in assets after a multi-year period where growth has been largely organic, rather than as a result of new inflows. With current assets under management in hedge fund strategies at around R70 billion (US$5 billion), the hope is that new types of investors will be attracted by regulated products.

The industry has in 2016 been transitioning portfolios into regulated structures. Qualified investor funds (QIFs) are very much the same type of product that the industry has always offered – but with greater oversight. Designed for sophisticated investors or institutions, they can use higher leverage limits and more unconstrained mandates in pursuit of higher returns. Retail investor funds (RIFs) are designed to cater to a wider set of investors, with some similarities to UCITS hedge funds in Europe. They can be accessed via smaller monthly contributions rather than big lump sums, and they have various other mandate constraints including lower levels of leverage.

Yes, funds must now meet the requirements of a complex and arduous operating environment. But it is one that the industry has largely welcomed as it legitimises the efforts of talented managers before a much wider audience, putting them on an equal footing with the long-only world.

Investors in South African hedge funds can be assured of the highest levels of oversight, coupled with talented and skilled managers who have strong track records.

International allocators have hailed the new regulatory environment. For investors sitting in Europe or the US, the due diligence...
process for an African allocation is geographically complicated, and therefore also expensive. Yet investors are attracted to the consistent, risk-adjusted returns that South African hedge funds are generating. Hedge funds make sense for them – these managers have in-depth knowledge of, and unparalleled access to, some of the best companies operating across the burgeoning African continent, and also the flexibility to generate returns even in economically and politically complicated times.

In the new environment, domestic investors are also expected to increase their allocations to hedge funds. South African pension funds have until now had very little exposure to alternative strategies, but regulated product structures mean they can no longer be ignored for investors seeking superior risk-adjusted returns. Many individual allocators have also not had access to these types of funds, and those who did faced tax uncertainty in the past.

Performance over time will always be the main criteria for any investor allocating to any asset class, and here South African hedge funds have built a track record of which they can be pleased, with returns consistently exceeding their global peers.

The HedgeNews Africa South African Single Manager Composite, a median return of all funds in our database which includes long/short equity, market-neutral and quantitative, fixed income and multi-strategy mandates, has returned a net annualised 10.61% (with an annualised standard deviation of 1.98%) since our records began in January 2007 to the end of September 2016. This is in line with the returns from the Johannesburg All Share Index on a total return basis, but with substantially less volatility (the index has added an annualised 11.03%, with a standard deviation of 15.21%).

The country’s hedge fund industry has grown steadily since the first fund launched more than 20 years ago, yet assets are still just a fraction of the long-only investment management industry.

While the country can be proud of a skilled group of managers whose strategies have stood the test of time, performance and innovation will remain key areas in the years to come.

Going forward, it will be interesting to see how retail (RIF) hedge funds perform compared with QIF hedge funds. As of mid-2016, around two-thirds of hedge funds had chosen to be regulated as QIFs, according to data from Novare. This can largely be attributed to relationships with existing investors, with domestic fund of funds the largest allocators to the industry. But as a new breed of investor emerges, attracted by regulated products, this could well change.

Many South African hedge fund mandates would fit into the retail space, given their relatively conservative nature and lower levels of leverage compared with their global peers. Yet over time RIF funds can be expected to offer slightly lower returns than QIF products, as offshore experience suggests, yet bring vital diversification benefits to broader investment portfolios.

“In the new environment, domestic investors are also expected to increase their allocations to hedge funds.”

Regulatory changes should bring growth for the industry and, in time, many existing funds may not have capacity for new allocations. One important challenge then is to bring new managers to market, despite a tougher environment for startups. So far, the signs are good that this is happening, as the industry looks forward to a period of expansion on the back of a solid foundation.
SANNE established its Hedge business division following the acquisition of IDS Fund Services (IDS) on 1 June 2016.

Founded in South Africa in 2002, IDS was established to provide an outsourced administration capability in the Hedge Fund industry, both locally in South Africa but also internationally. With the acquisition of IDS came operations, at scale, in Malta and Cape Town, which engaged more than 150 people and administers 230 funds totalling in excess of US$7bn.

Leading innovative technology platforms, like PAXUS, play an important role in our hedge offering to clients and we utilise the latest industry applications to administer alternative assets.

As a regulated business in South Africa and Malta, we operate at the highest level of standards in terms of our processes and procedures. We administer a wide range of structures that include Cayman, BVI, Maltese and Mauritian funds, as well as onshore South African regulated and unregulated portfolios. Other areas of focus include managed accounts, single and funds of funds, master feeder funds and umbrella funds. Our dedicated hedge professional have extensive expertise in the administration of most investment strategies, including equity L/S, equity M/N, managed futures/CTA, global macro, multi strategy, fixed income and commodity.

With the addition of Hedge to our areas of alternative assets expertise, we provide our global client base with a complete suite of alternative asset focused administration and reporting services. Should you wish to find out more about our services and operations in the Americas, EMEA or Asia-Pacific, please speak to us, we would be delighted to hear from you.