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Opalesque Roundtable Series '19

SOUTH AFRICA

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Editor's Note

Since about 2014, many institutional investors have turned their attention toward private markets, and so over time the conversation has moved from, *"There are not enough asset classes to generate a real return!" to a now pro-active "What else is outside the traditional box?"* sentiment, and alternatives begin to stand out. These discussions have changed from a type of intellectual curiosity about potentially diversifying through considering asset classes with low correlations, to a rather direct *"You have to go and understand this asset class because you have to* ***generate a real return in the long run.****"* It's now about really looking outside the box and putting those strategies on the table.

In addition, the South Africa regulator has been very pro-active regarding private markets, allowing a maximum allocation of up to 15% in alternatives for pension funds. But the reality is that of the 4 trillion rand available, only 2% sits in alternatives. So the runway is seven times bigger, for everyone that decides to take advantage and go up to the regulatory limit.

Impact investing & how millennials are changing the investment business

Globally and also in South Africa, impact investing is gaining traction. Institutions are now looking at the concept of making financial and social returns.

This Roundtable also discusses how millennials are further changing the investment industry, starting with changes in information flow and the presentation of data, virtual fact sheets, increased use of technology, to the point of **disrupting intermediary partners' business models.** The group also gives recommendations how to deal with the resulting reduced attention span of investors and intermediaries.

The Opalesque 2019 South Africa Roundtable, sponsored by SANNE, took place in the Cape Town office of SANNE with:

1. Craig French, Visio Capital
2. Graeme Rate, SANNE
3. Herman Sandrock, Fairtree Capital
4. Michael Denenga, Webber Wentzel
5. Monei Pudmo-Roos, Ngwedi Investment Managers
6. Pawan Singh, Sanlam Alternative Investments
7. Raphael Nkomo, Ngwedi Investment Managers
8. San-Marie Greeff, SANNE

The group also discussed:

- The appeal of private market portfolios (page 7). New structures for private equity investment (page 10, 16-17), Venture Capital Corporations (page 12-13)

- The growth of private debt (page 7, 17). Operational challenges (page 8)

- More hurdles for hedge funds in South Africa (page 8-9), but whey they will also come back (page 10)

- Do asset managers generally overstate their true skill in generating pure alpha? (page 10)

- Are retail hedge funds the big growth opportunity? (page 11-14). How to cope with fee and cost pressure. Disclosing transaction costs (page 14-16)

- Education: Why working with asset consultants and trustees has now become an imperative (page 12)

- Opportunities in: Constructive engagement and activism (page 18), portable alpha (page 19), artificial intelligence, machine learning, data science, crowdfunding (page 20-21), big data (page 22).

Enjoy!

Matthias Knab
Knab@Opalesque.com

Participant Profiles

(LEFT TO RIGHT):

Raphael Nkomo, Herman Sandrock, Craig French, Pawan Singh, Matthias Knab

Michael Denenga, Monei Pudumo-Roos, San-Marie Greeff, Graeme Rate

Introduction

Craig French
Visio Capital

I'm Craig French from Visio Capital. Our firm was started in 2003 as a South African equity long/short manager, so we are probably the third oldest South African long/short fund behind Decillion and the Peregrine Capital Team. We still manage equity long/short equities and also a number of long-only mandates, pension, sovereign type mandates. We also have Africa ex-South Africa long-only equity mandates. My role is that of a product specialist where I am also in charge of client relations and also work with a number of different offshore platforms in Cayman, US, Europe where our funds can be accessed.

Raphael Nkomo
Ngwedi Investment Managers

I'm Raphael Nkomo from Ngwedi Investment Managers. Ngwedi is a newly established investment manager in South Africa. Before that I was Chief Investment Officer at Prescient. And before Prescient, I was in London working for a hedge fund. I have a background in computational finance and have been in the industry for more than 17 years.

Pawan Singh
Sanlam Investments

My name is Pawan Singh, I'm from Sanlam Investments where I run the alternatives multi-strategy capability; a diversified portfolio of private market strategies, encompassing private debt, private equity, real assets (real estate and infrastructure) and hedge fund strategies. Before that I was at Sanlam Multi Manager, through which I know some of the people around this table – together we did fund of funds allocations in long-only strategies. Prior to that, I was at Capitec Bank and before that at Deloitte New York, in structured finance. I studied a B.Com in accounting in India and have over ten years of experience in financial services.

Herman Sandrock
Fairtree Capital

My name is Herman Sandrock from Fairtree Capital. Fairtree's first fund was launched in 2003, which incidentally was also the first market neutral fund in South Africa.

Over time our range of hedge funds have expanded to include a comprehensive range of asset classes and strategies. Following investor feedback after the global financial crisis, we realized there is also an opportunity to add long-only funds to the business and we launched our first such fund in 2011. In recent years we have also added private equity strategies, for example, hospitality real estate in SA and in Europe. Fairtree's asset under management is now more than 50 billion Rand with the alternative business still being one of the larger and more diversified hedge fund businesses in South Africa. I'm an actuary by training and at Fairtree I'm the Head of Distribution.

Michael Denenga
Webber Wentzel

I am a Partner at Webber Wentzel specializing in investment funds. By way of quick background, I completed my articles at Webber Wentzel and subsequently had a stint in the treasury departments of Standard Bank and Investec. I returned to Webber Wentzel and was a Partner from 2006 to 2009 before I founded a boutique law firm specializing in investment funds. I returned to Webber Wentzel in April 2018.

We act for general partners, investors, management teams and portfolio companies advising them on all aspects of investment fund formation and transactional arrangements. We have advised collective investment scheme management companies on structuring as well as regulatory and licensing requirements. We also advise the management companies and banks on treasury documentation entered into with the banks, including prime brokerage, securities lending Agreements and international swaps and derivatives association documentation. We have consistently been involved in high profile transactions in South Africa and have extensive experience in the rest of Africa. Through the alliance between Linklaters and Webber Wentzel, our clients have an access to an integrated, seamless and flexible offering.

Monei Pudumo-Roos
Ngwedi Investment Managers

My name is Monei Pudumo-Roos, I work with Raphael at Ngwedi Investment Managers. The company was established in August 2018, with most of us, if not all, coming from Prescient Investment Managers. We have a very strong skill-set in the fixed income space which we also use to port alpha to other asset classes, so we have fixed income mandates, equity mandates, and multi-asset class mandates. We are positioning ourselves in the market as that core manager that you can't afford to do without, aiming for small but consistent incremental returns over time.

San-Marie Greeff
SANNE

San-Marie Greeff, Director of Business Solutions at SANNE's South African Business. As an alternative asset and corporate administration provider, SANNE offer fund administration and corporate solutions across asset classes to a global client base. Being a FTSE 250 business we leverage our global expertise and provide solutions to clients across the alternatives spectrum. In South Africa, we provide hedge, private debt, real estate and private equity fund administration and are further looking at infrastructure solutions. We have our own Management Company who provide a hosting solution to hedge funds as well as long-only managers.

My role oversees all business solutions in South Africa across multi-strategy and multi-asset class solutions. Prior to SANNE, I worked at Sanlam Collective Investments in the regulated environment responsible for the unit trust business, and at Satrix, which is a traditional beta index tracking product.

Graeme Rate
SANNE

Graeme Rate, Country Head - South Africa and Malta at SANNE. Having more than 19 years in the South African alternatives fund industry I've seen many interesting developments in the industry, starting with setting up one of the first hedge fund managers in South Africa. I also managed my own business providing broking and middle office services to hedge funds, and for the last four and a half years in alternative fund administration with SANNE. I'm a qualified Chartered Accountant and a qualified Stock Broker.

Matthias Knab What are some of the trends and developments you see in the South African and then also in the Pan-African investment markets?

Monei Pudumo-Roos: We have experienced a fair amount of market volatility of late and this has somehow destabilized the overall market. Investors are now seeking some form of stability in their returns and less likely to take on more risk at this stage. In the institutional space, we have certainly seen interest and more allocation towards income type solutions as well as alternative investments such as renewables and private debt with the view of obtaining better and more predictable returns

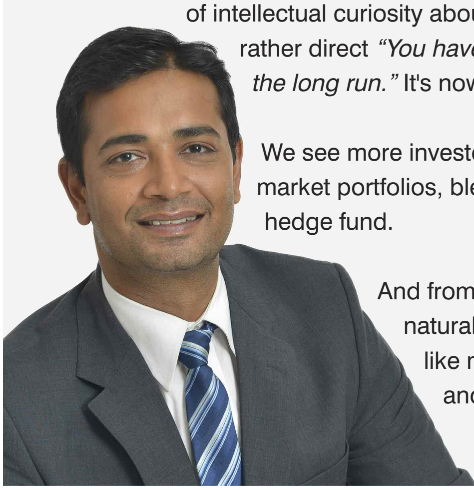
We have seen funds and asset aggregators taking tactical views and upweighting their allocations towards fixed income solutions, looking mostly at short-dated type of credit and not necessarily wanting to take on duration risk.

The allocations to alternative assets are currently still small as the limits are strictly controlled. The impact of the allocations is therefore questionable, especially when it come to the big funds.

Pawan Singh: I work in private markets, and given that my focus is on multi-strategy, I will share with you some of the things that we have seen from a capital allocation perspective.

The early adopters of the private market space, whether investing in private equity, private debt or infrastructure, have been pension funds, (both public and private), and also high net-worth individuals. I would say that until 2014, the listed environment was giving investors a healthy return and so there was little reason for many institutional investors to move into an asset classes like private markets or alternatives which in general can be very opaque. Transparency is limited and illiquidity is high. But since 2014, with the lowered growth from traditional asset classes that Monei alluded to, there has been a bigger drive towards private markets. So over time the conversation has moved from, "There are not enough asset classes to generate a real return!" to a now pro-active "What else is outside the traditional box?" sentiment, and alternatives begin to stand out.

The types of conversations investors are having have fundamentally changed. These conversations have changed from a type of intellectual curiosity about potentially diversifying through considering asset classes with low correlations, to a rather direct *"You have to go and understand this asset class because you have to generate a real return in the long run."* It's now about really looking outside the box and putting those strategies on the table.



We see more investors opening-up to the idea of having **private market portfolios** alongside their public market portfolios, blending liquid and illiquid assets. An example of transcending these two buckets is a hedge fund.

And from a yield perspective, a lot of our pension funds are trying to match liabilities, so naturally long-dated private debt assets fill that bucket. But in many cases some strategies like mezzanine debt or distressed debt tend to do well in a rising interest rate environment and so they potentially offer risk mitigation along with a real return.

I would say that the interest seen will be sustained to the point that, even if at some point in the future the environment turns and listed markets come back in vogue, there will already be sufficient adoption from investors in South Africa of the unlisted space such that those two strategies can coexist, just like active and passive strategies coexist.

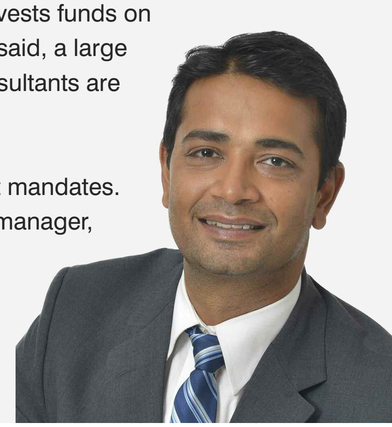
Michael Denenga: So from your perspective, do you see investors allocating more to those alternative investments?

Pawan Singh: Yes, in 2017 we received an allocation from one of the large pension funds in South Africa and we grew those assets significantly during 2018. We actually put commensurate risk-adjusted returns on the table, to the point where this pension fund is liquidating some of their listed assets and putting more money into unlisted assets.

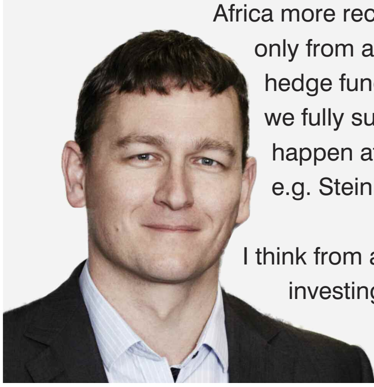
<u>Bear in mind that the South Africa regulator has been very pro-active regarding private markets, allowing a maximum allocation of up to 15% in alternatives for pension funds</u>. But the reality is that of the 4 trillion rand available, only 2% sits in alternatives. So the runway is seven times bigger, for everyone that decides to take advantage and go up to the regulatory limit. Globally, that number is at 30%.

Coming back to your question, Michael, some of the bigger pension funds, like Eskom, our public South African electricity utility, and the PIC (Public Investment Corporation, a South African state owned entity that invests funds on behalf of government employees) have been early adopters of alternatives. In our case, as I said, a large pension fund has given us a mandate and on the back of that some of the smaller asset consultants are also beginning to have conversations.

There is interest in private debt and we are having several conversations around private debt mandates. For this we have been engaging with SANNE – whether through a multimanager or a single manager, there are **operational challenges** when it comes to things like reporting, administration, and how to best deal with the current lack of transparency due to poor information flow. We have found that with a partner like SANNE, it becomes a lot easier.



Herman Sandrock: At Fairtree we have certainly seen greater interest in niche strategies in the alternative space in South Africa more recently. But by and large, it has been a very difficult period for the hedge fund industry here, not only from a performance perspective but also because of the **massive regulatory change** of regulating hedge fund products, and a lot of time a high opportunity cost was absorbed by that transition. Although we fully support the regulation, timing wise it was almost the perfect storm because the transition had to happen at a very challenging time for investment markets. In addition, we had our own local scandals e.g. Steinhoff and it was and a very challenging political environment over the last two years.



I think from a pension fund perspective, we have also not seen a large number of institutional investors investing into regulated hedge funds and accessing the diversification benefits that hedge funds provide to their traditional portfolios. And perhaps as an industry we haven't been able to launch compelling solutions for them to do so. The reality is also that whereas the hedge fund industry was a very entrepreneurial industry in the past which could adapt and capitalize on opportunities quickly, we are now confronted with more hurdles and it takes longer to launch solutions and products within the regulated environment.

Craig French: The key clients that allocate to hedge funds in South Africa are largely the multi-managers or fund of hedge funds. Many of them are benchmarked against indices like the SWIX Index. When that was up 21 percent in 2017 and hedge funds were lagging that number, there was a lot of explaining to do, especially when in tricky environments hedge funds are supposed to generate returns or absolute returns.

I am not making excuses but the reality was many managers here were also challenged almost to act as political analysts as well starting with the removal of Finance Minister Nene in December 2015 to Pravin Gordhan's removal in 2017 – if a manager had a negative view on the currency through the raging 2017 EM bull market, you could try as hard as you like, but the reality is the key flows offshore into emerging markets is via ETFs, 3% of that goes into Naspers, 6% of that goes into Tencent – that's already a close to 10% allocation effectively to South Africa, and to fight that was near impossible.

Hedge funds here are still a relatively young asset class in South Africa if you compare it to the US, where they started in the '50s, but here only in the late '90s.

What you can also often observe is that a lot of the **fund of funds tend to redeem pretty much near the bottom,** and what you have seen this year is the market, looking at the the FTSE/JSE Top 40 Index, is down 18%. I don't have aggregate hedge number, but many are sort of in the 5-10% range, so there's **20% alpha there versus the market.**

Hopefully this will get investors and multi-managers to really look at the asset class again from an absolute return point of view, and, of course it just takes time to educate people on the benefits of the asset class. I think it has been an anomaly of an investment period given all the political headwinds, but we certainly are excited about some opportunities in sectors like healthcare and education, so we see great opportunities in listed hospitals as well as some of the education groups.

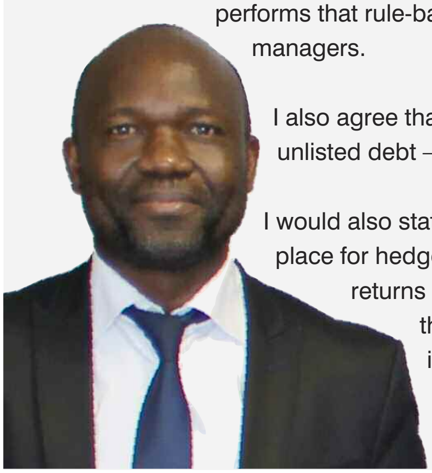
I think with the slow growth environment, obviously the consumer is under pressure and people buying down, so this benefits more the discount retailers as well as DIY. If we closely look at corporate balance sheets, those with solid balance sheets have clearly survived and are now able to gobble up their smaller competitors. It's a bit of a cleansing environment.

And obviously there are lots of plans afoot to try and stimulate growth, but there certainly are opportunities for alpha. But let me also add that, certainly for our hedge funds, our alpha has all been primarily driven year-to-date through the **short book,** and I would imagine this is a fairly similar pattern across the industry from an equity point of view.

Raphael Nkomo: My sense is that **asset managers – in South Africa and Globally – generally overstate their true skill in generating pure alpha.**

It is now an established fact that true alpha is very difficult to generate and that what most active managers call alpha is actually smart beta or simply beta in disguise. After accounting for most of the underlying risk factors or premia, true alpha is at worst nonexistent and at best statistically insignificant. My view is that as pension sponsors become more aware of these subtleties, the true investment conversation will focus on building client portfolios that have explicit exposures to known risk factors (like value, quality, momentum, etc.) and getting a fair compensation for that exposure over the business cycle.

Investment is always and everywhere a tradeoff between risk and reward. If we look at Europe for example, it has become far easier, cheaper and more transparent to get access to the value factor payoff via a rule-based portfolio than finding a value manager. And with the rule-based portfolio you know what you're getting, there is no option for the manager to style drift. Of course, this doesn't mean that value will always perform, but you know you are getting true exposure to value and when value performs that rule-based portfolio will perform as well as any portfolio managed by the so-called value managers.

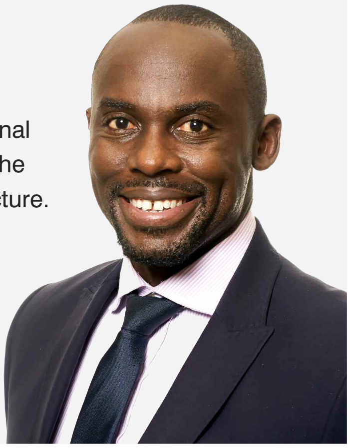


I also agree that we will see significant growth in alternatives, so things like private equity, private / unlisted debt – that's a given.

I would also state that **hedge funds are certainly going to come back.** There's no doubt that there is a place for hedge funds in traditional forms of investment and that properly constructed hedge provide returns that most traditional portfolios cannot achieve due to their ability to go short. Having said that, I think the plain vanilla equity long/short that has dominated the hedge fund industry in South Africa is probably dead for good.

San Marie Greeff: In respect of the regulatory the framework in South Africa, can the industry better position alternative assets to a broader investor base? Do we need to create a vehicle or solution for the retail market to have access to the alternative asset class?

Michael Denenga: Due to the new regulations we now have more restrictions for hedge funds. In private equity there is less regulation and more flexibility around structuring, therefore it is possible to attract different types of investors into your structures.



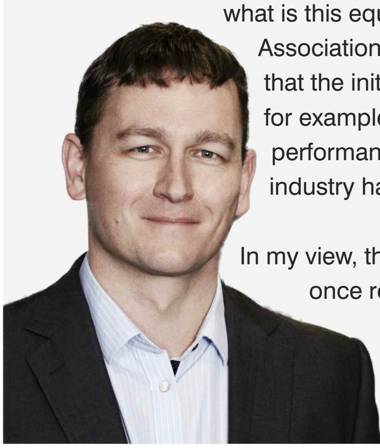
You will find that over the last year or two we have created **new structures for private equity investment,** the objective being to attract capital from diverse investors in addition to the institutional investors. For example, we have implemented structures that have a listed company ("Listco") as the only limited partner in a partnership. The Listco then contributes all of its assets into the fund structure. That means the fund structure will attract public funds with different check sizes to pension funds.

An option also exists to establish a feeder listed fund in Mauritius and in London, and that attracts a completely different type of investor to traditional pension funds. The feeder fund will then be the only limited partner to the local private equity fund. This is made possible because regulation is not that onerous and in the partnership structure you have freedom to contract with your investors in different ways. Contrast this with the hedge fund environment where regulation makes it a lot more difficult.

Herman Sandrock: *I think on the of biggest challenges or missed opportunities faced by the industry is that as an individual I can invest in a retail hedge fund in South Africa with 50,000 Rand, but I'm not allowed to invest in a hedge fund through unit trusts.*

Now, the long-only unit trust industry is estimated at 2.4 trillion Rand while the local hedge fund industry is 60-100 billion Rand, so that long-only unit trusts being able to invest in hedge funds is an important potential source of flows for the hedge fund industry.

I think there are other challenges as well such as fund classification. Retail investors like to have clear boxes – for example what is this equity long/short, where does it fit in, how risky is it compared to other hedge funds? Asisa (The Association for Savings and Investment South Africa) has been working on this classification and I expect that the initial proposal will be implemented early this year. And then a third potential challenge is fees – for example, fund of funds and discretionary fund managers prefer fixed fees as they don't want performance fees or a variability of costs whereas the predominant fee structure within hedge fund industry has been performance fees.



In my view, the next growth phase will be from discretionary fund managers investing in retail hedge funds once regulations allow it. It is helping that the industry is slowly converting their Qualified Investor Hedge Funds (QIHF) track records to Retail Investor Hedge Fund (RIHFs), which I think is also quite key because daily pricing and liquidity will be crucial in the collective world.

Craig French: *I think it's always helpful to look at how things developed offshore, particularly the UCITS industry in Europe which experienced an explosive growth with the institutional money flowing into UCITS products because of the more frequent pricing and improved transparency. I think we'll see exactly the same happening in South Africa over time.*

Herman mentioned fees, and certainly I also think we will see further fee compression, particularly on the multi manager side. We had US fund of hedge funds who invested with us, they used to charge one and ten, and what did their largest client do? An insurance group then took the money away from the fund of hedge funds and gave it to a consultant charging 40 basis points.

So this fee compression will eventually also trickle down here and also benefit the firms who are able to offer investors a multi-strat approach. The core building blocks for large institutions offshore in terms of alternatives is multi-strategy with its dynamic allocation with no additional fee. I would imagine that multi-strat funds will eventually eat all the fund of funds capital in South Africa, it's just a matter of time. Pension funds which historically only allocated via fund of hedge funds are also here starting to make direct allocations with the help of consultants as gatekeepers.

Regarding San Marie's question around access for the retail investors, I think that business is unlikely to grow dramatically.

Graeme Rate: As a fund administrator we see market effects on a slightly delayed basis. For those who have been in the industry for some time, you can agree that we still face the struggle of new product acceptance. *South African investors lack the correct information regarding the benefits of alternative products. We have moved from educating institutional investors and allocators to now needing to educate IFAs that are going to be allocating retail investors' money into retail products.*

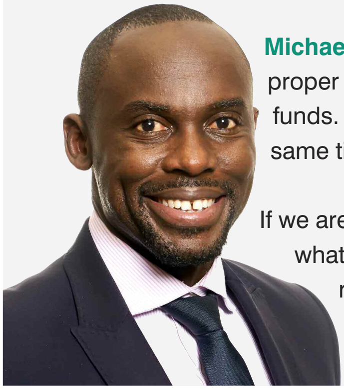
As Pawan mentioned earlier, there is a relatively low take-up of pension funds as direct investors into alternative asset products. <u>Working with asset consultants and trustees has now become an imperative.</u> As an industry we lack a collective educational push to the broader market.

Institutional investors are pressured to generate returns for investors. Also from our side, we are now seeing a movement from liquid alternatives strategies to private equity, private debt and real estate funds where there is an asset underpin.

The South African market has been through a lot of regulatory changes in the last few years and I agree with Herman that these changes are for the better. We have now improved risk reporting and investor disclosure. The self-regulated hedge funds product that traded on the fringes of the market in the past have now been swept away or amalgamated into the regulated framework.

Apart from the changes in legislation for alternative collective investments scheme products, there have also been changes to the qualification and experience of advisors who wish to invest client funds into alternate strategies.

What other significant regulatory changes might happen which improve access to products?



Michael Denenga: Most of the changes that we have seen so far are really more around the fit and proper requirements and around operational requirements, and these will not improve access to hedge funds. A lot of what the regulator is trying to do is to prevent systemic risk within the industry, but at the same time, this is also increasing the compliance headache for hedge funds.

If we are going to talk about increasing access to hedge funds generally it then really comes down to what Herman mentioned earlier that individuals should be permitted to invest in hedge funds through retail unit trusts.

Pawan Singh: The biggest reason for institutional investors or pension funds to adopt alternatives is their long-term investment horizon that allows them to match long-term liabilities with long-term assets.

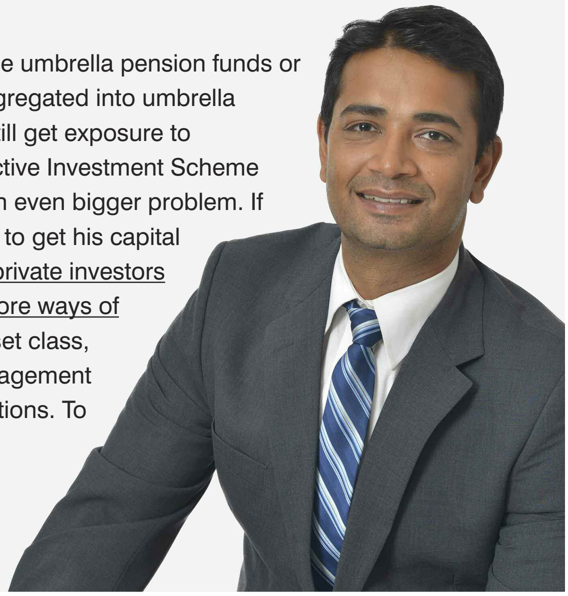
While the **principle of longevity** also applies to retail investors, at some point they need to retire, and so there is a tendency to think that they need liquidity. We also know that one of the biggest drivers of returns in private markets is the illiquidity premium, where a higher compensation is expected for putting your capital away for longer periods.

In 2009 South Africa introduced the Section 12J Investment to fast track smaller check sizes, from 25,000 Rand and upwards, into what they call VCC companies; **Venture Capital Corporations** that have a maximum size in the economy worth 50 million per transaction, and that number is growing. That vehicle has been created to target money from the retail investor who can also get tax back if he/she holds an investment for a minimum of a five-year period. And on the back of that, a handful of companies have sprung up, but it's also a very narrow space with a narrow framework for sector allocation.

When I speak to venture capital investors in the South African space, they find the Section 12J size to be very limiting for them to have an unconstrained mandate and to really do venture capital in a meaningful way. And from the regulatory prospective, globally at least, the advent of publicly listed close-ended funds that actually invest in unlisted assets has gotten a lot of traction. In the UK there were some teething issues in the beginning. The liquidity dried up and assets traded at a substantial discount to NAV, but over the long run, a lot of infrastructure assets, renewable energy and direct property have actually been included into these close-ended listed entities and they trade close to NAV. Sanlam UK has a real assets fund targeting a return of CPI + 4%, with exposure to sectors such as schools, renewable energy, transport, housing and healthcare. The overall portfolio trades close to NAV and generates an income yield close to 4%.

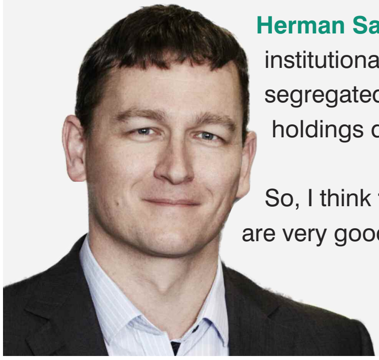
In South Africa we have Ethos Capital, which is the listed counterpart of Ethos Private Equity, one of the biggest private equity firms. You would expect that this fund would trade close to NAV or at a premium because of their reputation. But since inception, it has been trading in a 40% discount in NAV, and remember, that's the most premium brand. On the other hand there is Brian Joffe with Long4Life, trading at 20% premium. I just want to point out that there are a lot of discrepancies here.

Whilst one can be clever and create structures that give retail investors access to illiquid assets, you still have the conundrum of what happens when an asset trades at a significant discount in NAV and investors try and sell down their exposure. That's the difficulty.



There is another avenue for these retail investors. In South Africa, you have the umbrella pension funds or superannuation funds in Europe, where a lot of smaller pension funds are aggregated into umbrella platforms. Through such an umbrella, a small company's pension fund can still get exposure to alternatives or unlisted assets. The problem that remains is a regulated Collective Investment Scheme (CIS) investing in private markets. A CIS needs to provide liquidity, which is an even bigger problem. If you have a very small allocation to private markets and a retail investor wants to get his capital back, the asset manager has to make the capital easily available. So to help private investors or retail investors participate in this asset class, I guess we will have to find more ways of providing liquidity in a meaningful manner. Investor education around this asset class, alternatives, is definitely a focus area to achieve this and the entire asset management industry within private markets must work together towards finding more solutions. To address use of private market strategies for retail investors, we are working at launching a blend of a pooled and cost-effective, passive and alternatives product very soon, through Sanlam's umbrella platform.

Monei Pudumo-Roos: I think we also need to remember that in the retail space, flows are driven by performance, whereas on the institutional side, the funds and asset consultants / aggregators buy the manager based on the philosophy and investment strategy and as a result the investments tend to be more long-term as opposed to just chasing performance. The retail clients tend to want to know that they can quickly go in and out of an investment and therefore liquidity is crucial in the retail segment.



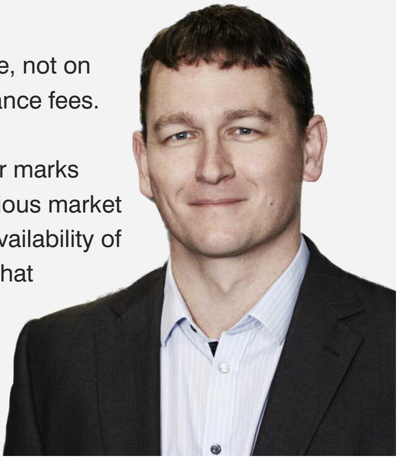
Herman Sandrock: You are certainly right, Monei, and interestingly we see something similar on the institutional long-only side where quite a few of our local institutional clients have decided not to go with a segregated mandate but actually invested in our unit trust because they want to be able to exit those holdings quickly and easily, which in a segregated mandate can be more complex.

So, I think **the move to the greatest possible liquidity solution is an overarching trend,** unless there are very good investment reasons such as harvesting that illiquidity premium not to do so.

Graeme Rate: As alternative asset managers, are you are still under pressure in terms of fees and total portfolio costs, especially with the move of funds into the regulated environment with more onerous disclosures?

Herman Sandrock: There is no doubt that there is fee pressure on active managers and a discussion in general about where fund management is heading. More and more of alpha can be explained or harvested through factor investing while the unique alpha or unexplained alpha is getting perhaps smaller or more difficult to harvest. And also, as we have discussed, as a hedge fund industry we have gone through a period where performance has been lackluster and poor compared to some of the previous standards and other asset classes.

Generally, our experience is that the challenge is perhaps more on the fixed element of the fee, not on the performance fee participation as well. Our institutional clients typically still prefer performance fees.



Investors are also focusing a lot more on clearly defining benchmarks, hurdles and high water marks and then analyzing a manager trying to figure out how performance was delivered across various market cycles. This focus makes sense due to lower expected real returns as well as the increased availability of cheaper alternatives being offered through factor investments and passives – I don't foresee that trend to stop. However, if a manager can still produce alpha, has a strong brand and operational support, I believe you will still have more pricing power. If not, such a firm will struggle.

Raphael Nkomo: As a trustee, I think I'll be more comfortable with performance fee, and I would probably try to lower the upfront or the ongoing base fee as low as I can, and then put the manager on the line and earn the fee when he delivers.

However, the big problem we've encountered with performance fees is the administrative burden. The largest multi managers in South Africa wouldn't even discuss performance fees anymore. It's always flat fee. They will probably continue to put pressure on the flat fee to come down.

Monei Pudumo-Roos: Herman on the contrary, what I have experienced from the institutional side is that clients are now moving away from performance fees. Especially in the long only space. The investors are revising their portfolio management agreements and negotiating for flat fees. That way they have control on cost and this is what Treasury is also pushing for.

Herman Sandrock: That could be right because some of the quality institutions you or Raphael might be referring to may ultimately have retail clients or advisors that advise retail clients, and then a performance fee may be difficult to explain to a client.

I had also mentioned that we increasingly see institutions investing in unit trusts, but in our experience pension fund institutional clients still very much go with segregated mandates with a performance fee structure to align our interest with theirs.

Monei Pudumo-Roos: Absolutely, and regulation in fact is calling for us managers to do away with performance fees. There's a call for more transparent and flat fees and the large retirement funds and multi managers are also putting pressure on us to reduce fees.

Craig French: We always had a 1 and 20 structure and I believe newer hedge fund launches are kind of 75 basis points and maybe 10% to 15% performance fee.

All our hedge fund clients have a performance fee structure in place, and then, from a long-only perspective, it's a split between some having a lower type of performance fee and then others having a flat fee which is slightly higher. So, it is mixed, but I think for the normal hedge fund in South Africa, I think 1 and 20 is acceptable above some cash hurdle.

Pawan Singh: I agree, fixed fees have come down. The 20 is still 20, but the 2 has become the 1.

Graeme Rate: The topology of just the flat performance fee has now gone. As other panelists have said, there is more complexity around the calculation of the performance fee, with this often linked to a hurdle rate and how that is calculated, whether that's a static hurdle or rolled on an annual basis.

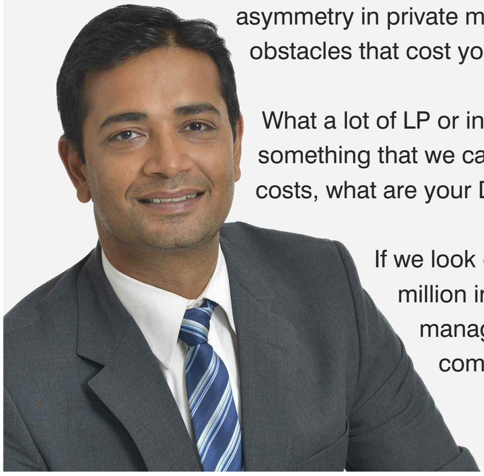
There's a lot more sophistication around the calculation of fees and these are now more closely aligned to the alpha generated. The days have passed of taking a performance fee on your total performance.

Herman Sandrock: On the RIHF or retail hedge fund side, our practice has actually been to adopt more the long-only performance fee methodology and not the traditional hedge fund fee methodology because this potentially positions these products for inclusion in unit trusts.

Pawan Singh: Fees in private markets vary. In some cases the 2 and 20 model for private equity still exists and there are valid reasons for this, but of course we have to look at it strategy by strategy.

So, if you're doing private debt, specifically unlisted private senior debt, you can't charge 1%. Most clients will be loath to pay anything more than 50 to 60 basis points, depending on the strategy and structure of the transaction. Regarding mezzanine, there's upside in those strategies and so there it's managed a lot like private equity where the 2% management fee isn't used to flying around the world in expensive cars, but really to keep the lights on. In a private equity fund, you're managing about 8-10 investments, over a period of 10 years. Your upside is only going to come five to six years after the first investment and as a manager and as an investment team, you are locked into the carry mechanism. So that 20% carry with the catch up, after reaching a hurdle rate between 10% to 12%, is still the norm and is equitable.

But in terms of explaining away the 2% management fee: if it is committed capital or invested capital, things start to get a bit more complicated. This is where we like to break it down and explain the detailed cost. *The reality is that at the time you are looking at a transaction and start doing the initial due diligence, already you'll be paying away fees when you haven't even put a deal on the table. Then when it comes to the investment committee, the deal may get rejected but you still paid fees for the vetting process in order to make sure you don't get poor quality assets in your portfolio.* There is also information asymmetry in private markets, where the seller knows more than the buyer, which can also be seen as obstacles that cost you to avoid losing money at a future date.

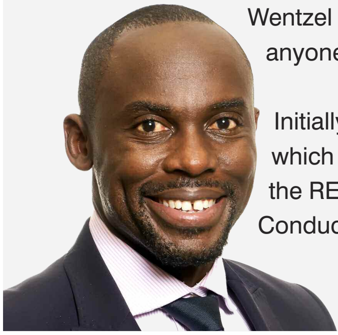


What a lot of LP or investors are doing now is asking for a **breakdown of transaction costs,** and that's something that we can do and actually encourage investors to ask for – for example, what are your legal costs, what are your DD costs, what are your financial costs? What are your travel costs and so on.

If we look globally at the larger private equity houses, we're talking about funds with over $500 million in assets. That's where the management fees starts to come down. But otherwise, the management fee is literally there to cover your operating costs, and your upside really comes from the performance fee which is much later in the cycle.

Graeme Rate: Most mangers around the table have first-hand experience with the increased regulatory framework for both managers as well as products. The private equity market is significantly larger in size than the hedge fund market, yet we have not seen the development of a **regulated private equity product** or regulations specially governing private equity fund managers.

My question is to Michael, will we see steps being made in terms of promulgation of a code of conduct for private equity mangers as well as regulations either defining or constraining of what assets can be constituted as a private equity portfolio?



Michael Denenga: In fact, there is a discussion taking place around this new category for private equity funds. It's supposedly going to be a Category VI FSP for private equity. This has been under discussion for a long time. As Webber Wentzel we have provided some comments to the FSCA on the initial drafts they have produced but it is anyone's guess when these codes of conduct will be finalized

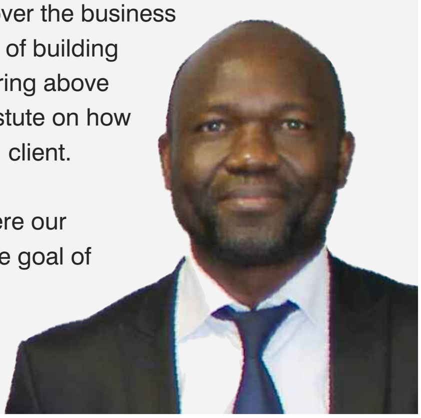
Initially, when the first document came through, it was supposed to be within a period of six months, which is why the exemption for private equity managers came through, where they were exempted from the RE exams. We have seen that the exemption has been renewed in June each year as the Codes of Conduct have not been finalized.

Matthias Knab Let's talk about the opportunities you see as asset managers in your respective strategies.

Raphael Nkomo: We are setting up a long-only investment manager offering standard cash, income, balance and equity solutions. I think the only avenue that we see is to be a little more creative in terms of the alpha or beta that we offer, especially for asset classes outside conventional equities.

We have a very strong, incredibly talented fixed-income and derivatives team that has won many awards in the country, especially in the short duration and fixed-income space. Our opportunity is to leverage our strong fixed income and derivatives skill sets and offer equity and ultimately balanced solutions that perform more predictably over the business cycles. Although we don't have bottom-up, stock picking skill sets – and have no intentions of building any – we intend offering equity and balanced solutions that display more certainty of delivering above benchmark return than competing solutions in the market place. To do so, we have to be astute on how to engineer these solutions in a way that satisfies the excess return requirements of the end client.

I believe the biggest opportunity at Ngwedi is to build something that looks like PIMCO where our signature short duration fixed income skill set is transportable to other asset classes with the goal of delivering a predictable excess return irrespective of the performance of the primitive asset classes.



Pawan Singh: The one space where we've seen a lot of growth in private markets is **private debt.** That's of course a global phenomenon with record amounts of assets being raised. The main catalyst increasing the flow of capital in private markets has been the regulatory impact of Basel III for the banks. *While banks used to be the primary funders for private and public markets, these stringent capital requirements limit them. This has created a massive funding gap on the African continent including South Africa. The IFC has estimated that the gap for SMEs in Sub-Saharan Africa exceeds USD70bn per annum – and Africa has the lowest levels of credit extended to the private sector by banks (32% of GDP according to 2017 World Bank figures).*

With spread compression evident in higher quality debt in developed markets, lower quality debt comes into play – but, with the lending opportunity that exists in Africa and with similar high yields available in Africa for senior, secured exposure in high quality counters, we have had a significant increase in appetite from investors regarding our African private debt fund.

To give some numbers from our economy, we have around 400 listed companies and then some 4,000 private mid-market companies that are unlisted. If you then go further down in the SME space, the numbers get even larger, and a lot of these firms are not bankable. A lot of them don't have long track records. While we are not saying that we invest in upstarts all the time, there are quality businesses in which we were the first institutional investor, wherein bigger houses are now buying equity stakes. But those firms were primarily funded out of the SRI fund that we run in private debt. A good example is Retail Capital, a SME financing business. So the demand for well managed private debt opportunities is there and growing.

What also helps us is that our parent company Sanlam Life is not a bank; it's a life insurance company. So, a lot of times we speak to first grade banking clients looking for funding, but the check size is too small or the mandate doesn't allow it. So, instead of a bank sending their client to a competitor, they would rather send them to us because we don't have a bank and don't compete with them. They keep the banking relationship and we can add to the pipeline of our products.

We expect private debt to continue to grow. Again, the benefit is that yield is being generated at the loan interest rate which can be passed as coupons to investors. It's not that attractive for investors to put in their capital for two years and not see any money back, <u>but in private debt you can have interest payments arranged on a quarterly basis, with the option of providing liquidity to the investor on a 12 month notice.</u>

Another space where we see a lot of interest is in the **Impact space** which is gaining traction globally. In South Africa, institutions are now looking at the concept of making financial and social returns, which I believe is very much manageable and possible. We have a stake in Climate Fund Managers, which is scheduled to close its capital raise in its first fund "Climate Investor One" in the coming months at over USD800m. This interest in the fund, which seeks to provide positive climate outcomes through investment in renewable energy projects in developing countries, is a reflection of the growing global appetite for investment in projects that make a positive environmental impact.

So those are the two areas where we see large opportunity sets for South Africa and the continent.

Craig French: Apart from the opportunities I mentioned before in healthcare and education where we believe that people will pay up for those services, they won't compromise, there are also opportunities within the transportation space in South Africa given the lack of infrastructure and the limited ability for government to satisfy demand.

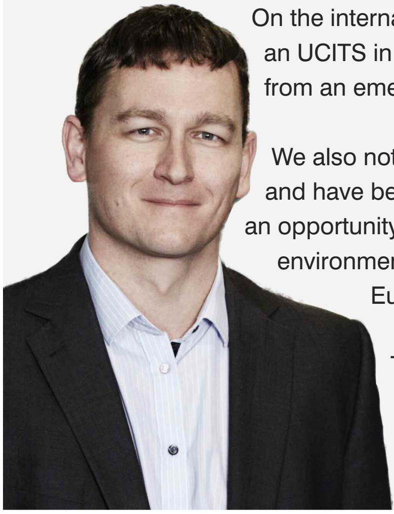
Another field where we are quite involved with is the **constructive engagement and activism** point of view, largely challenging boards on things like corporate governance, management incentivization and unlocking value. One of those opportunities of this as recently played out has been the breakup of Old Mutual, spin off of Quilter and unbundling of their one-third Nedbank bank stake.

The other opportunities are created through the tough economic environment when people are kind of buying down, so the low-end retail space, as well as cash DIY. In addition, the kind of low hanging fruits in South Africa tend to include hospitality, hotel, gaming space or the weak currency and the kind of infrastructure and virtual commerce from gamers to golf courses, to hotel, casinos and so forth.

Herman Sandrock: Coming back to hedge funds, I believe that this transition from QIHFs to RIHFs is quite important i.e. Qualified Investor Hedge funds to retail rnvestor hedge funds, as increasingly RIHFs will become the shopping window for alpha skill in the hedge fund space.

In addition to that, I'm excited about **portable alpha,** offering clients solutions where they can "port" alpha onto cost effective beta/passive type products. Now, it might be a bespoke solution that we offer as an asset manager or they might just execute or buy the index themselves and actually just invest a portion with us to obtain the uncorrelated alpha stream.

I also believe when hedge funds have a better year from a risk/return perspective, interest will pick up again. I think the dust has now settled in terms of our new regulation, which provides a good foundation for future growth.



On the international side, we see a lot of opportunity in the credit space and as a result we are launching an UCITS in January 2019 in that space. We believe there's a lot of opportunities, especially if you come from an emerging market, which is almost a junk bond environment, you look differently at credit risk.

We also noted that lot of our clients that have moved money out of South Africa have just stayed in cash and have been unsure when to invest in offshore markets given their high recent valuations. So there is an opportunity for alternatives and investments that potentially can offer a higher return in a low-yielding environment. Some of the things we're doing is in the real estate and hospitality space in the UK and Europe is to buy real quality hospitality assets offering an attractive annual yield.

There are of course also other opportunities in real assets and for us our focus has been to try and identify niches where we can compete with the large global competitors.

Graeme Rate: A trend we see in this new era of **millennials** involves information flow. Clients are pushing more requests asking to provide improved and faster reporting of more relevant and detailed information.

How do you perceive the change in the way the younger to middle-class generation are accessing and utilizing data? Have you experienced this as managers, and is that in some way changing your business model? For example, crowdfunding has become quite an interesting strategy in the US and Europe, especially for real estate funds, where the investors are buying a small slices of funds, generating rental yield's with the underpin of the physical property assets, obtaining exposure to real estate in this manner as opposed to ownership of physical property themselves.

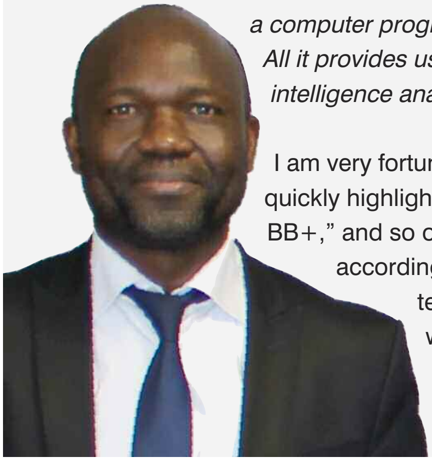
And my second question is then how you see technology enabling portfolio decision-making. Is it improving or changing the investment process?

Craig French: We are certainly aware of developments and changes in the industry and keep a close eye on those, but also, our clients are primarily institutional, and surely whatever they demand in terms of information we are able to deliver, with the help of our service providers and fund administration companies.

Raphael Nkomo: We are probably in the same position as we target primarily institutional clients.

As a new firm, technology was the biggest challenge we had to look at, and from that perspective we are quite fortunate that we are building out from scratch. We can do everything we always wanted to do in terms of technology, and we push ourselves hard to make sure that our systems are best in class of technology systems available out there.

When it comes to the investment process itself, we cannot ignore the avenue of ***artificial intelligence, machine learning, data science,*** *and those sorts of things. For example, in the credit space we have the official credit ratings, but you also must generate your own rating system in-house, and there is no better way to do than through machine learning algorithms. So, we can train a machine to rate companies quickly and unemotionally, but always recognizing that the output from a computer program doesn't necessarily mean we need to invest in those machine-preferred companies. All it provides us with is a quicker output of a reduced number of rated companies for further due intelligence analysis.*



I am very fortunate that I have a background in machine learning and that I can build algorithms that can quickly highlight certain key features for a very quick output such as, "This company could be AAA or BB+," and so on. Then myself and other analysts can take a look at this output and do the next steps according to our investment process. So, Graeme, I think that is undeniable that these technologies are coming, and the quicker you embrace them, the better it is. On our side we are certainly have the required mathematical background and we are putting substantial effort in that space.

Monei Pudumo-Roos: And Graeme, regarding the millennials and how they could shape business going forward, what I personally think is that the simpler, quicker and easily accessible you can make the processes, the better. They want solutions that are easy to understand, liquid and the investment into these solutions can be easily activated. It is all about convenience to them.

For example, I was recently speaking with group of students in Johannesburg that were saying the following; "We don't have a lot of money, but we've got some money and would want to be able to invest. What's your minimum investment?" And you tell them, "Our minimum investment is like 1000 Rand a month or a lump sum of whatever, 50,000," they are not interested in that.

FinTech-enabled vehicles such as crowdfunding are now allowing the millennials and such types of investors to contribute whatever size they have, and it gets pooled and invested with investment managers. That's the way to go as these types of investors want a simpler and easier entry.

Pawan Singh: Crowdfunding has definitely become an important and effective way of attracting small check sizes in a more democratized matter and includes retail investors with varying cheque sizes. In our business, we haven't implemented a crowdfunding model, but that's something we have looked at and discussed, and maybe at some point we will have one.

An example of a South African provider using that model in a way that I think is relevant and important is Fedgroup. Fedgroup is a life insurance company that has three strategies **using crowdfunding along with institutional funding** to raise money for several debt tranches which are directed at an organic bee honey farm, a blueberry farm, and solar energy. Investors can put in as little as 500 Rand or as much as 10,000 Rand and will then own blueberries in a specific farm that you can actually see and follow from farm to table, which is great.

Fedgroup is talking about an IRR of between 10 and 12% which is based on their back tests, so we know that in the real world, it may not be the same. But the concept is built on transparency and accountability. You have the same thing with organic honey farming and for solar you can literally see where your panels are sitting, on which installation and in which part of the country.

I found that an interesting model as millennials are increasingly becoming adopters of conscious capitalism, popularized by John Mackey of Whole Foods. If you look at the other side of the spectrum you see mega deals in this space with Amazon buying Whole Foods for $13 billion. That makes you realize that there is space for doing good and making a profit.

Leapfrog investments is Africa's first $1billion impact business with a global reach. We see these approaches becoming more and more mainstream, including in the institutional space where a lot of the investors are looking for impact-driven strategies. An example of that is Truck Stops, initiated by Joe Letswalo of the Transport Sector Retirement fund (TSRF) to increase safety and wellness of truck drivers and improving the infrastructure around servicing long haul trucks. The returns on this model is close to 15%, which makes a very compelling case for inclusion of such models in retirement portfolios.

Regarding Graeme's second question about technology and how we can use it and its benefits, in the private markets space where I operate, technology definitely helps to address things like the lack of information available, exposure to risk factors and allows for better reporting. That then also helps clients to become more comfortable with the investment strategies and what we are trying to do, so technology therefore also enables better discussions.

At a portfolio level, Sanlam Capital Markets has a large debt origination team based in Johannesburg, and they use a credit model to rate private assets. They give internal ratings, which are more appropriate to South Africa. Here technology becomes very relevant, allowing us to push stuff through the machine, as Ray Dalio likes to call it. The more repeatable and robust your process is, the more it helps your screening and final process. If we could leverage that into other strategies like private equity, then you could also make due diligence a lot more streamlined. It could help you know where not to focus your efforts to ensure better conservation of time, energy and resources for doing what is really relevant.

Raphael Nkomo: In terms of technology, I've seen, especially overseas, several very impressive applications in various businesses. For example, in the legal domain, thousands of legal contracts or documentation can go into a machine, the machine reads it and summarizes it, and that is fantastic.

You don't have to go to hundreds and hundreds of pages of legal documents yourself if you have a well-trained machine does that for you. It is easy to see how similar programs could be deployed in the private equity space where we also have a lot of legal documents to read. So I think it's almost a no-brainer to have a tech infrastructure like that and hopefully that would be available in the not too distant future.

Herman Sandrock: We primarily work through intermediaries with their millennial clients. The reality is we are seeing that *some of our intermediary partners' business models are being disrupted,* and as a fund manager and product provider, you actually have to ensure you build relationships with the right intermediary partners, not only for today, but more so for tomorrow.

On the practical side, for us as managers providing instant information such as today's performance is of course a challenge because some of our strategies and pricing mechanisms tend to be complex and take longer to finalize pricing. Things like **virtual fact sheets** are also coming into play because people are interested in dynamic and not static data and information. Again, what this means on the practical side is that people don't like to look at the regular PDF but want a performance graph that they can play around with by moving a finger on a screen.

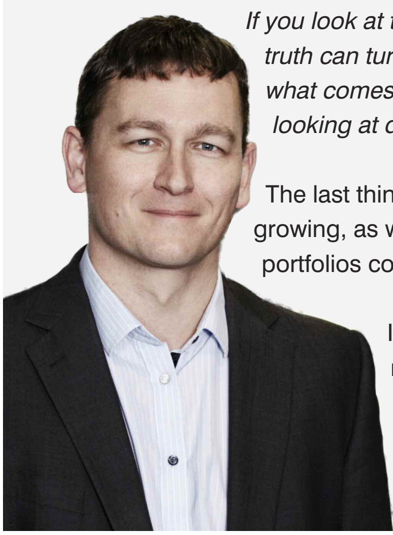
There is also far more emphasis from our investors on transparency, which is a challenge as it requires the client to have an in depth understanding of investment strategies, markets and instruments. It is certainly not tolerated anymore to repeat the patronizing response of the past – "It's too complex," or "It's difficult to explain, trust us we are experts," – that simply doesn't fly anymore.

On the other hand, we are also grappling with the ***reduced attention span*** *of our investors and intermediaries. I think a lot of people just lose interest a lot quicker. Even a two-minute video nowadays – which was shortened from thirty minutes only two years ago – is too long! People aren't interested in a two minute video anymore, they don't even watch half of it.*

By the way, is anyone still listening? My two minutes are up anyway....

[Laughter]

On the technology side there is no doubt that **big data** is the future, and we are also positioning ourselves accordingly. We are doing this on a solution basis for example multi-factor models and quantitative credit. What I find interesting is that we haven't really seen the merging of technology and human skill in respect to AI making an active decision or being a substantial help for a manager to make the call.



If you look at the Steinhoff scandal, there are a couple of lessons related to data. Taking audited reports as truth can turn out to be wrong. So maybe our mindset in how we deal with data will change, we will see what comes out of that. Certainly data screening AI tools which are trying to pick up inconsistencies by looking at different data sources, might become more and more important.

The last thing I wanted to comment on is the **active-passive** discussion. Factor investing is certainly growing, as we have said. We have noted that international clients seem to prefer a hybrid of passive portfolios complemented by high conviction active managers when investing in South Africa.

I think some investors might reconsider their exposure to pure passives in the South African market following the eventful 2017 and 2018 and might have an increased preference to manage the stock specific risk very tightly, which is where the active managers should have their moment.

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