South African hedge funds poised for next stage of growth

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It has been a difficult year for all involved in the financial services sector, but recovery, albeit slow, seems to be on the horizon. For South Africa, the impact of the crisis has been much less than that experienced in other counties such as the US and the UK, and its alternative investment sector has also withstood the slump.

Many industry members believe that the reliance by the country's hedge fund managers on traditional yet well thought through investment strategies, as opposed to experimental and risky approaches, has been an important reason for the industry's relatively robust performance. It has also vindicated South Africa's embrace of first self-regulation and, since the beginning of last year, closer oversight of the industry by the country's supervisory authorities.

'What probably shielded the local industry from the worst of the crisis was the already high level of self-regulation and the limited proliferation of asset-backed securities in our market,' says Sean Morris, a manager for institutional business at Coronation Fund Managers. 'Investors did not lose significant amounts of capital resulting from the sudden departure of many international funds or write-downs of more than 50 per cent of fund assets.'

Exchange control legislation that regulates capital flows in and out of South Africa also has been a blessing in disguise amid the international financial and economic crisis, but Ian Hamilton, chief executive of hedge fund administrator Investment Data Services Group and former chairman of the South African chapter of the Alternative Investment Management Association, argues that other factors also underlie the country's resilience amid the global downturn.

'First, the banking system has come through with integrity as it was not exposed to poor investment products like sub-prime mortgages or lending to Eastern Europe,' he says. 'Secondly, South African hedge funds were domestically focused with relatively few foreign investors that might have made panic withdrawals. Thirdly, the country's hedge funds also had modest levels of leverage.'

Says Brett Thornton-Dibb, head of prime finance for South Africa at Deutsche Bank: 'The events of 2008 brought home to the investing community the value of a carefully selected hedge fund, particularly when you consider their capital protection capability. The global tide of redemptions certainly reached the shores of South Africa last year, but unlike in the international arena, no South African funds raised their gates.'

Industry members also cite regulatory standards that have given the country and its hedge fund industry a high degree of protective cover. Managers are regulated under the Financial Advisory and Intermediary Services Act, while providers of advice and intermediary services to South Africans must be registered with the industry regulator, the Financial Services Board, and meet certain fit and proper requirements.

Hedge fund managers must possess appropriate qualifications, be able to show the FSB that they have a suitable track record in the management of the hedge fund strategies they offer, and demonstrate knowledge, skills and competency in managing the instruments making up the fund portfolio. This registration process, which was launched in early 2008, has been completed over the past year and is seen by industry professionals as an important step forward for the local hedge fund industry.

The FSB created a special category of licence for hedge fund managers, which hitherto had been regulated in the same way as managers of long-only retail funds, in late 2007. The new rules, which included more demanding fit and proper requirements for managers of alternative funds, had been negotiated with the industry over the previous couple of years.

'All existing hedge fund managers were approved,' Hamilton says. 'The FSB was complimentary about the standard of application and the process of licensing 130 fund managers went smoothly - generally as a result of the industry being self-regulated and adhering to best practice for a number of years.'

South Africa also stood out last year for its reluctance to make a knee-jerk response to the slump in share prices of banks and other financial sector firms. At a time when regulators elsewhere rushed to impose blanket bans on short selling, their South Africa counterparts were comfortable that the existing ban on naked short selling was sufficient.

Carla de Waal, a portfolio manager at funds of hedge funds manager Novare Investments and the board member for media and education for Aima South Africa, says: 'South Africa has a sophisticated and well-regulated financial industry. The Johannesburg Stock Exchange doesn't allow naked short selling and, as a result, did not implement any short-selling restrictions last year as some other jurisdictions have done.'

As the dust settles globally on the financial services sector, industry players are preparing to embrace a new era in which forward-thinking hedge fund managers are looking not only to extract value in an opportune market environment but to deliver alpha to their clients while keeping risk to the minimum.

Certainly the industry has benefited from the dominance of traditional investment styles among hedge fund managers. With the industry still heavily weighted toward equity hedge strategies such as long/short and market neutral, as well as fixed-income approaches, these funds significantly outperformed the local equity market last year while highlighting to investors their strong capital preservation qualities.

'Equity market neutral and fixed-income strategies on average managed to post positive - and in most cases even cash-beating - returns in 2008,' de Waal says. 'We've had a strong rally in local equities over the past few months, with local hedge funds keeping up well.'

This stability amid a highly volatile global environment is highly welcome in a domestic market that prizes consistency over extremes of performance. Says Hamilton: 'Most of the South African investor class is institutional, such as domestic pension funds, and they have made long-term investment decisions based upon portfolio diversification and not short-term speculation.'

De Waal notes that funds of hedge funds remain the preferred route of investment for most investors. 'Funds of hedge funds are also very actively involved in developing a regulated hedge fund product for the South African market through industry representative channels, Aima South Africa and the Association for Savings and Investment South Africa,' she says.

'Aima and ASISA have been driving the process of interaction with the local regulatory bodies, the FSB and the Treasury, in establishing a regulated product environment for local hedge funds. This collaboration has already involved several fruitful meetings with the regulators so far this year.'

The extension of regulation from managers to their products will also be welcomed by investors, according to Morris. 'Moves afoot to increase the ambit of industry regulation to the hedge funds themselves would give investors a welcome comfort,' he says.

Hamilton says the transparency offered by regulated structures could allow greater investment in hedge funds by the country's pension fund industry. According to the latest figures from Aima, only 1.3 per cent of South African pension fund capital is currently invested in hedge funds, even less than 2.5 per cent limit imposed by Regulation 28 of the Pension Funds Act on investment in 'other assets', principally alternative funds.

The South African hedge fund industry remains small in global terms but its early embrace of regulation and ability to deliver impressive returns is raising its profile both at home and abroad.

This rising level of investor interest, however, is set to present its own challenges.

One of the biggest is ensuring the hiring and retention of the right talent in order to ensure that managers maintain the highest investment quality standards - something that the FSB's new experience and expertise criteria for the licensing of hedge fund managers is designed to promote.

Another important challenge is for managers to diversify their client base to avoid being left vulnerable by the exit of one or more cornerstone investors. Industry professionals believe that this will be best approached by gaining more investment from abroad as well as offering products that appeal to a wider range of investors.

But like managers elsewhere, South Africa's hedge fund industry will face an environment that lacks the sparkle of the final overheated years of the credit boom - not least because regulators are now more ready to save investors from their own over-excitement. Even if they are not twice shy, regulators may prevent them from being bitten again, according to Chantal Valentine, an economic and fixed-interest strategist at Coronation Fund Managers.

'The medium-term growth trend will probably be less exciting than what it was a few years ago, but it will also probably be more sustainable,' she says. 'Boring isn't always a bad thing.'

In a global environment where other countries are now looking to follow South Africa's example of strong but pragmatic regulation developed in close consultation with members of the industry, the ability of the country's hedge fund managers to thrive despite the constraints of oversight and transparency leaves them well placed in the future to win over more conservative investors both at home and abroad.

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