Breaking out of the domino effect

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The hedge fund industry in South Africa is at the crossroads. Hampered by obstacles such as the lack of a formal regulatory framework and exchange controls, the industry is being urged to think out of the box in order to spur growth.

One thing is for sure – the next few steps made by the industry, which includes managers, service providers, regulators and government bodies – will determine the future of the hedge fund industry in South Africa for years to come.

To put matters into perspective, the industry is facing a 'domino effect' precipitated by several issues. These include a lack of a formal regulatory framework, tax legislation issues, exchange control restrictions and domestic investment obstacles amongst others. Some of these directly contribute to the industry being small is size, which, in turn, hampers new investors and other market entrants.

Driven by the above-mentioned issues, the majority of funds are currently deploying risk-averse strategies. Local trading strategies are conservative because of the nature of the investor mandate i.e. institutional money, and also due to a lack of opportunity for more esoteric themes. This is restricting growth, which in turn, is slowing interest from foreign investors in the local market.

The small size and vulnerability of the domestic industry have no doubt contributed to the conservatism of the industry. Dale Lippstreu, Director of Maitland Fund Services makes his point very clearly. “The value of a sound approach has been illustrated over the past three years and I don’t see this changing. The appetite for risk increases with confidence in the markets and this seems to be some way off at this point.”

One of the biggest worries in this situation is that due to this domino effect – where every issue is affecting another and vice versa – stagnation could set in. Ian Hamilton, Director of Lions of Africa, explains: “At present it seems that we have a finite pool of money and therefore it is difficult for new funds to attract money, unless it is away from existing fund managers. There is investor caution now that performances are sedate. International investors most probably have a far higher appetite for risk than the local institutions. Many of the South African fund managers are very inwardly focused and in a becalmed comfort zone. Interestingly they are “risk avoidant” when it comes to spending their own money to establish new portfolios.”

In the mix of all this, one must not forget the service provider, an important cog in the hedge fund machine. The South African hedge fund industry at the outset in 2002 adopted the best international practices espoused by the international body the Alternative Investment Managers Association (AIMA).

The South African hedge fund industry is well supported by a host of service providers that include prime brokers, third party administrators, central scrip depository participants (scrip lending and custody), third party risk reporting and software providers.

Third party administration and valuation is insisted upon by most institutional investors. There is custody for both single strategy and funds of funds. Reporting is regular; generally monthly but can be weekly and more recently, daily. Independent risk management and reporting is also provided by most of the managers. Large global investment banks are well represented in South Africa in a brokerage capacity.

Prime Brokers are strict in their granting of credit. “For an unregulated industry it is gratifying to see the self imposition of the best of European practices. International investors are usually impressed and taken aback as to the level of sophistication and self regulated control there is in the South

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African market," Hamilton says.

Despite all of this, there are problems, the root of which spring from the existing issues in the hedge fund industry itself. The small size of the industry again comes into the picture. Service providers, especially, require larger volumes of business inflows to ease the burden of rising costs. But with South African hedge fund inflows slowing over the last two years, growth has been sluggish, in turn increasing the load for many service providers. "The problems of the domestic service industry arise from the small size of the industry, agrees Lippstreu. "Increasingly complex investment strategies and securities, the rapidly evolving operational environment, demands for more frequent valuations and better reporting etc. are driving up the cost of systems which can only be mitigated by volume."

Sean Morris, fund manager with Coronation Fund Managers sums up the situation. "The prime broking market has sufficient participants given the size of the market. It is only in the fixed interest market that one participant dominates, but there are only a very small number of fixed interest funds presently. Administration is dominated by two participants and business may be marginal for another market participant."

While all service providers are well-integrated to provide strong support for hedge fund managers, the market opportunities for newcomers are limited. Hamilton clarifies, "Some big names have tried to enter the market in the field of prime broking and administration but have found it difficult to convince local players that there is a need to move. Given the lack of growth at present in the market it is more likely that we could see amalgamations or withdrawals."

Indeed, the market will have to grow quite considerably to make it attractive for new market entrants.

Still, there are discernable trends in the service provider industry that can help pick it up and heave it into the path of future growth. The main initiative is the increased use of managed account platforms. A managed account platform immediately gives the user a sense of comfort, as it provides a solution for servicing an enhanced list of products including multi-discipline accounts, separate accounts, variable reporting portfolios and other programmes. Indeed, this seems to be the way forward in order to offer independent and comprehensive hedge fund investment services, and solutions to large institutions to provide timely redemptions.

Jean-Pierre Matthews, Managing Director of PSG Absolute Investments, is looking forward to the growth prospects of the first South African open architecture hedge fund managed account platform, called the Momentum Managed Account Platform. "The platform provides investors with a host of compliance and governance services that include all assets being held in safe custody in the name of the platform and centralised risk management and mandate compliance."

Hamilton adds that the major platform is run by Momentum (a South African insurance group) and discussions are underway to launch this platform through the Johannesburg Stock Exchange.

"But that's not all," says Matthews, explaining that qualified prime brokers may be chosen by the hedge fund manager, but are appointed by the managed account platforms – thereby ensuring the ability of the managed account platforms to close manager positions that are outside the scope of the investment management agreement. "We are particularly excited about the ability of such platforms to provide financial services regulators a governance and compliance framework – especially within the ambit of possible CISCA (Collective Investment Schemes Control Act) inclusion down the line," he states.

Another initiative, which can only be to the benefit of the hedge fund industry, is the gradual move to daily NAVs for funds. As is becoming commonplace in the industry worldwide, daily NAV reporting is increasingly important as it helps investors keep a closer eye on exposures and how it might impact operational risk and liquidity of the fund. Hedge funds will need service providers with a middle-office function to ensure daily reporting is automated and the right risk management data is available.

With renewed inflows into the global hedge fund industry as well as renewed interest in emerging

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markets, South African hedge funds have something special to offer the global hedge fund investor, including top class governance and world class markets. “Great liquidity, cheap leverage and the ability to shortsell, along with solid and uncorrelated returns make this a great investment destination,” Matthews suggests.

For a continent which was for many years mainly considered difficult to conduct business in, Africa has turned over a new leaf and is seeing a sudden increase of interest that looks set to continue.

Undoubtedly, regulation will afford the industry a form of official recognition and bring it into the investable universe for a broader investor community. This is certainly the key to the long term growth of the industry. A lot can be done to establish South Africa as a major emerging markets hedge fund destination, and it is hoped that the industry will dedicate much of its efforts to grow in this direction.

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