Regulation is the key to growth prospects

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Football frenzy gripped South Africa in the months of June and July but the real flurry lies in the aftermath of the World Cup. It is clear that the tournament raised the entire continent's profile in a crescendo that not even the embattled vuvuzelas could reach. And now the country, with its many resources, talents and capabilities, is poised for a greater level of interest from foreign investors.

Political leaders and financial gurus have already pegged Africa as a catalyst to lead global economic growth and investors have been encouraged to look at this continent for its huge potential. Undoubtedly, the majority of interest would be in the assets relating to the oil and gas and mining sectors. This, in addition to interest from the private sector, could also see governments and public enterprises rallying to invest in order to secure energy production capabilities and mineral requirements for the future.

In its role as hub to the continent, South Africa will, in turn, see a boost to its consumer economy, ranging from infrastructure, communication, transport and banking – and even the fund industry. Indeed South Africa is the new land of opportunity.

Here comes the hedge

Attractive propositions and lucrative geographies would normally have hedge fund managers running around in a tizzy, but the South African market faces some challenges to keep up with the strong growth witnessed in recent years.

In South Africa hedge funds as an investment class have really only come to prominence in the last few years. In terms of investment, the asset class is relatively still small. Six years ago the market was around R3bn (USD 200 million) spread across 15 funds. The latest estimate is that there are now 140-plus single strategy funds totaling about R30bn (USD 4 billion). Assets in funds of hedge funds are around R20bn (USD 2.6 billion). “This level of assets was reached two years ago ahead of the international financial crisis and has remained static since with no new inflows because of the reliance on the domestic market and certain local restrictions,” according to Ian Hamilton, Director of Lions of Africa.

In essence, there are a few issues surrounding the immediate growth prospects of the hedge fund industry despite the rosy garden that is its front porch. These can be intrinsically classified in the areas of regulation, tax legislation, exchange controls and domestic restrictions.

Growth destroyers

While the South African investment market is a sophisticated market in terms of financial services legislation and regulation, the country has not enacted specific regulations to provide hedge fund structures. Regulatory uncertainty is therefore a significant hurdle to growth.

Hamilton says, “What the South African hedge fund industry lacks are regulated collective investment vehicles that can be used for alternative investments. At present the South African Collective Investment Schemes Control Act only caters for long only daily priced unit trusts. There is a glimmer of light that the authorities may consider extending the act.”

Bert Chanetsa, Deputy Executive Officer of Investment Institutions of the Financial Services Board, confirms that the regulation of hedge funds is being investigated. “The objectives that the regulation of hedge fund will achieve are reduction of systemic risk and protection of investors. To a larger extent, the regulation should ensure compliance with IOSCO principles,” he states.

Sean Morris, fund manager with Coronation Fund Managers adds that progress has been very slow in terms of the development of a regulatory framework. “The risk to regulation is overregulation, which will significantly reduce the tool set available to hedge fund managers,” he warns.

Another hindrance is the South African tax legislation. A direct investment into a South African domestic fund, such as a partnership, may subject the foreign investor to South African income tax or capital gains tax, as domestic structures are not recognised instruments that can be held by foreign investors. “This does not help because investment in local funds creates tax risks for foreign investors in certain circumstances. While these can generally be circumvented I suspect it is a turn-off for some investors,” says Dale Lippstreu, director of Maitland Fund Services.

So, foreign investment in local funds has been restricted due to domestic tax issues. This leaves the industry with domestic investors, which are mainly institutional and coming from the retirement fund industry. But there is an additional issue with domestic investment, with uncertainty over retirement fund legislation.

The retirement fund industry in South Africa is estimated to be around USD 200 billion in assets under management. Current regulatory restrictions have allowed retirement funds to invest in only up to 2.5% of total assets in an investment class such as hedge funds. Hamilton adds that the retirement fund investment restrictions are under review, but it is unlikely that any major beneficial change will take place in the next twelve to eighteen months.

The main source of capital for hedge funds is from the retirement fund industry and pension funds, and their investment horizon tends to be longer and less volatile. This in turn makes it harder for funds to examine ‘exotic’ approaches.

Morris sums it up: “The industry does not have access to as many ‘exotic’ investment instruments and the largest part of the industry remains equity long-short. The primary source of capital for many hedge funds has been the retirement fund industry and consequently there has been a lot of self-regulation which also prevented many funds from making very risky investments.”

Last but not least is the issue of exchange controls. Investment capacity is an issue in the South African market. While South African managers are able to invest outside of South Africa, investing a South African citizen’s money triggers exchange control restrictions on the amount of capital that can be externalised. Due to this, hedge funds mainly invest in the South African market.

A way out!

On the face of it the market looks a bit of a minefield with lots of factors to consider. But look a little bit deeper and one finds that there are ways out for investors and managers with open minds. Take the regulation aspect for example. While there is no formal regulatory framework for hedge funds, it would be wrong to say that the hedge fund market is totally unregulated. All hedge fund managers are currently regulated under the Financial and Intermediaries Services Act. Both prime brokers (who execute the investment transactions) and independent third party administrators also fall under the authority of the Financial Services Board.

While the industry has operated on a more conservative and sounder basis, hedge fund managers, perhaps, need to think outside of the box and find out ways to make the most of the current situation. This, in turn, will increase the appetite for risk – and this should certainly be the way forward, considering the obstacles surrounding the industry.

A number of moves are taking place to make it easier for the foreign investor. There are a growing number of single strategy South African hedge funds domiciled off-shore. Some of these are in fact multi-strategy and are close to fund of funds in terms of structure. These funds are foreign domiciled US dollar priced funds that are advised by South African fund managers with the overall objective of replicating the domestic fund. The objective of the “parallel fund” is to provide a structure that is easily understood and accessible to the foreign investor. The fund is managed alongside the South African entity.

Hamilton, a veteran in the industry, believes that South African hedge fund managers need to set up, or partake in, these structures outside of South Africa. “This is the only way they will be able to still invest in South Africa, i.e. use their local expertise for international investors,” he says. “There is nothing to stop South African hedge fund managers going the same route that many of their international counterparts have gone and that is setting up foreign domiciled funds investing into South African and African markets. This can be done despite certain limitations when it comes to investment strategies that are difficult to replicate through international markets such as London,” he explains.

In terms of existing investment strategies, the fixed interest funds have been the place to be. “On a 12 month view the long/short equity funds with a positive market bias have done well but on the year to date basis the market neutral funds have been better,” says Lippstreu.

It is clear that the World Cup has triggered many prospects for the country and South African fund managers should take the opportunities that it has created. “This includes publicity for the country and a great image that flattened many unfounded rumours. The country works, it is dynamic, it has a lot going for it and investment opportunities are good,” Hamilton adds.

Lippstreu emphasises that regulation is the key to the long term growth of the industry. “Regulation will afford the industry a form of official recognition and bring it into the investable universe for a broader investor community.”

The reality is that South African hedge funds offer an entry into Africa and not just South Africa as many of the South African listed entities are companies with considerable business across the continent. The positives are there for enlightened investors to take advantage of.

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