

SOUTH AFRICA



"Outsized Alpha" from South Africa

Jan van Niekerk, Peregrine Ballast Fund

South Africa is an exciting opportunity, politically, economically and financially

South Africa is an example to the rest of the world in the way that it has transformed its political landscape over the last thirteen years. From an oppressive regime the country has emerged as one of the most progressive democracies. Political stability, a free market economy, firm entrenchment of property rights, and a healthy respect for law and the judicial system, provide investors with significant opportunities.

In the process of building the country's infrastructure and improving on social spending, education and health, government has been employing sensible fiscal policy, complimented by competent, market-orientated monetary policy. The country runs a small budget surplus at a time when corporate profits and commodity prices have been very strong.

South Africa has traditionally been known as a commodity based economy. The country is richly endowed with resources of gold, platinum, diamonds, iron, copper and coal. However, non-mining sectors these days comprise as much as 94% of the economy. South Africa has produced average economic growth rates in excess of 4.5% over the last

five years and the economy has doubled in nominal terms over the last six years.

The South African financial system is highly developed and compares well with first world standards. Not only does the central bank play a major role, but the economy is served by a multitude of national and international financial institutions and vibrant capital markets for companies to raise capital (equity and debt) in various forms.

The South African financial system is highly developed and compares well with first world standards

As the South African economy has opened up, global financial markets have forced inflationary discipline. The inflation target range for the central bank is 3% to 6%. Lower interest rates have stimulated the local economy.

The one weakness of the economy is its heavy reliance on foreign capital. South Africa runs a current account deficit of about 6% of GDP. Historically it has been more than

sufficiently funded through capital flowing into the local financial markets. This has mainly been in the form of portfolio flows, as net direct fixed investment remains low in an emerging markets context, which leaves the local currency in a vulnerable position.

The South African economy has entrenched its positive perception in the view of the world. Government debt carries an A2 long term rating from Moody's and A+ from S&P. Spreads on government paper are at about 1% and many foreign countries use South Africa as the base from which to expand their operations into Africa. Witness the investment of Barclays plc into local bank ABSA, and Vodafone into the local mobile phone operator, Vodacom.

SA Hedge fund industry is well developed and growing at a rapid pace with historical outsized alpha

The hedge fund industry in South Africa has developed significantly since the inception of the first stand-alone hedge funds almost ten years ago. Today more than 115 hedge funds operate in the country, with total estimated capital in excess of \$3.5bn. These comprise an array of stand-alone operations and institutional and "incubator" platforms, but exclude activities of foreign hedge funds in local markets. While most of

the original hedge fund managers originated out of the institutional fund management environment and banks, more and more hedge fund managers these days come out of other areas such as trading desks of banks and other financial institutions. The industry also has a number of funds that have spun out of other hedge funds.

A healthy fund of funds industry has developed. In line with global experience, institutional investors have taken longer than individuals in allocating assets to hedge funds, but this part of the market is also developing at a fast pace, with many of the major local pension funds, banks and insurance companies having made allocations.

The industry is well supported by an expanding infrastructure of prime brokers (both foreign and local), fund administrators, banks, and product providers.

The regulatory framework for the South African hedge fund industry is still evolving with the local industry body, under the auspices of AIMA (established in September 2003) working very closely with the authorities in this regard. Current practice is for the fund manager to be regulated by the Financial Services Board, while the structure is governed either by company law, trust law or common law in the case of partnerships.

Today more than 115
hedge funds operate
in the country

The SA hedge fund industry suffers from a style bias as the majority of the funds are equity based, mostly with a long/short mandate. This is a result of the very well developed stock market, which measures at 200% of GDP. Apart from India, South Africa has one of the largest single-stock futures markets in the

world. A well developed public derivatives market (SAFEX), and a very liquid OTC derivatives market, with significant participation by foreign banks, provides hedge fund managers efficient pricing and proper execution. Contracts-for-difference is a recent addition to this list of tools and the use of these instruments is growing rapidly. The tools necessary to develop other strategies are available. Some fixed income, equity market neutral, trading, arbitrage and trend following funds now also operate successfully in the market.

The one outstanding feature of the local hedge fund market has been the relatively large amounts of alpha that have been generated by hedge fund managers. A recent survey of hedge fund performance by Africa Hedge (<http://www.hedgefundintelligence.com/sa>) shows returns in excess of cash of 9.4% over one year, and 41.6% over three years. These are significant numbers in any context. All of these numbers are measured in local currency (ZAR) terms. This source of alpha is also becoming accessible to foreign investors, as some of the fund managers have already set up offshore structures that invest into South Africa. Most of these are available on a currency hedged basis. The costs of hedging out currency risk in many instances are surprisingly small.

The local industry can grow in size, with estimates of available capacity between double and four times the current size. This includes existing capacity with current managers as well as new capacity being created by new entrants and the development of other financial markets. The relaxation of exchange controls, a rapid growth in the credit markets and growth in financial products have been significant improvements.

Fees in the local industry are comparable to global standards with most funds charging between 1% and 2% annual management fees and 20% performance fees, with lifetime high water marks. Hurdle rates are common, although some of the larger, successful funds do not have hurdle rates in place.

Share in this outsized alpha

As with most hedge fund industries, the South African industry relies heavily on relationships. It is illegal to promote or advertise hedge funds in South Africa. For foreign investors to access this market, it makes sense to partner with one of the local institutions. In this regard, Peregrine has established itself with a track record in innovation, an understanding of the industry and very deep industry connections. The group's exposure to the hedge fund industry is extensive with investments across a broad range of strategies totalling approximately \$1.4 billion worldwide. In addition to being an investor in, and part-owner of, two of South Africa's oldest, most successful and highly respected hedge fund teams, Peregrine Capital and Big Rock Capital, the firm also has a range of other funds in various stages of development.

A recent survey
shows returns in
excess of cash of
9.4% over one year,
and 41.6% over
three years

The Peregrine Ballast Fund offers investors access to the full range of Peregrine hedge funds, blended into a single portfolio, with capital allocation by a team who are very close to the underlying managers.

Contact Details:

Gavin Glick
Fund Manager
Peregrine Ballast Fund
Tel: 27-11-722-7450
Mobile: 27-83-442-7477
gaving@peregrine.co.za