



# Opalesque Round Table

## SOUTH AFRICA

# Introduction

Dear Reader,

The whole financial industry has reached an inflexion point, at which all market participants are challenged to identify the new themes and new paradigms that will determine asset management and how to create returns going forward. The Opalesque South Africa Roundtable discusses the range and consequences of this inflexion point, from a fund manager as well from an investor point of view.

Many global allocators may not be aware that the South African financial market infrastructure matches or exceeds its "first world" counterparts in many respects. The equity and fixed income markets demonstrated exemplary robustness throughout the turbulences of 2008: no short-selling ban, no trading halt and no failed trades. Offshore investors can benefit from efficient and proven ways to get pure South African alpha without taking currency risk.

The Opalesque South Africa Roundtable was sponsored by IDS Group and took place November 10th 2008 in their Cape Town Office. There, the participants also discussed the particularities of investing in Africa (ex-South Africa). You will hear portfolio managers explaining new ways to construct hedges and inform on new and upcoming products. How do you deal with restricted liquidity, is Africa really uncorrelated?

The following experts participated in the Opalesque South Africa Roundtable:

1. James Gubb, Founding Partner of [Clear Horizon Capital](#)
2. St. John Bungey, Partner, [Praesidium Capital Management](#)
3. James Addo, Portfolio Manager, [Finch Asset Management](#)
4. Simone Lowe, Portfolio Manager, [Thames River Capital](#)
5. Andy Pfaff, Founding Partner of [Trendline Funds](#)
6. Ian Hamilton, Founder, [IDS Group](#)
7. Ryan Proudfoot, Co-Head [RMB Prime Broking](#)
8. Warren Chapman, Head of [Peregrine Prime Broking](#)
9. Kevin Ewer, Portfolio Manager, [Blue Ink Investments](#)

With 28 pages, this is one of our larger Roundtable scripts, but as with all the other ones, you will find valuable intelligence on each page. For example, did you know that...:

- South African single strategy hedge funds offer transparency "far superior to anything anywhere else", according to investors?
- South African hedge funds suffered their first - and only until that point - net redemptions in October 2008, but only 2.5% of total assets?
- South Africa is the first country in the world that actually distinguishes between normal fund managers and hedge fund managers, with higher criteria required for hedge fund managers?
- Who is buying seats on African exchanges to get the benefit of local presence?
- Opportunities in currencies - did you know Nigeria has higher reserves than South Africa?
- Which new strategies are emerging in South Africa and pan-Africa?
- That the majority of the 53 African countries are driven by infrastructure spending and domestic demand, so not by commodities?
- Long-short managers, although constraint by offering monthly liquidity, still see "wonderful" opportunities in the liquid space
- Will there be an "united exchange of Africa"?

Enjoy "listening in" to the Opalesque South Africa Roundtable!

Matthias Knab

Director Opalesque Ltd.

[Knab@opalesque.com](mailto:Knab@opalesque.com)

## CASE STUDY: THE SUN STILL SHINES ON AFRICA

### Solar power and renewables make a case for Africa investing

NASA has identified part of Niger as the sunniest place on earth - solar power is therefore taken seriously. Senegal's president has ordered a study into the feasibility of the country becoming totally reliant on this form of energy.

Well-informed investors from outside the continent are also interested in African renewables and are prepared to commit substantial sums:

- **Egypt:** India's Editia Perla, a specialist in petrochemicals and renewable energy, will invest up to \$500m to produce photovoltaic silicon cells
- **Egypt:** to build a 200MW Red Sea wind farm, using a \$388m loan from a German commercial bank and the European Investment Bank
- **Libya:** starts construction of a \$5bn energy hub as JV between Libya and Bahrain's Gulf Finance House, which will contribute \$3.8bn
- **Tunisia:** to build two wind farms to generate 400000MW. The project is financed by a \$250m loan from the Spanish government
- **Nigeria:** China's Shenzhen Energy Group is planning to build a 3000MW power plant in a JV with Nigeria's First Bank at an estimated cost of US\$2.4 billion.
- **Ghana:** Brazil is to finance the \$555m construction of Ghana's Jule River and Puralugu hydro power plants. When completed in 2013, the plants will supply 3 500MW. Ghana's government is also investing \$400m to develop thermal power generation and China's Exim Bank is to finance the \$600m development of the Bui hydro project
- **Zambia:** China's Sino Hydro is to spend \$400m to expand the Kariba North Bank power station - a development to help mines on the Copperbelt achieve full potential. Exim Bank will provide 85% of the funds.

According to STANLIB, the US\$45bn Johannesburg based asset management operation of the Standard Bank of South Africa, "there are strong pro-Africa signals at a time when risk aversion is the norm in numerous investment markets."

Cover Photo: Table Mountain, South Africa

# Participant Profiles



Standing (left to right)

Ian Hamilton, Warren Chapman, Matthias Knab, James Gubb, Simone Lowe, St. John Bungey

Seated (left to right)

James Addo, Kevin Ewer, Ryan Proudfoot, Andy Pfaff

# Introduction

**Andy Pfaff**  
Trendline Funds

My name is Andy Pfaff. I am one of the founding partners of Trendline. We are a trend-following CTA with about 75 million Rands under management. We are up about 25% for the year.

**James Gubb**  
Clear Horizon Capital

My name is James Gubb, I am a founding partner of Clear Horizon Capital. We have been running hedge funds in South Africa for the last 10 years. Clear Horizon Capital is a multi-strategy, long-short fund, predominantly equity oriented. We also run a dollar-based multi-strategy fund that has an African focus. Our combined assets under management are around US \$50 million. Our performance this year has been testing, we are down about 20%. The year before, and the year before that we comfortably beat our benchmark of 20% and we tend to be oriented towards direction when we think value is apparent. So while we've done badly over the last 12 months, we think we are in the right having positive directional exposure to the market at this point in time.

**Ian Hamilton**  
IDS Group

My name is Ian Hamilton. I am the Head and the Founder of a company called IDS, which is the leading hedge fund administration company in South Africa. We administer roughly 35 billion Rands in hedge funds and funds of funds, and have about 15 billion in custody. Until recently, I have also been the Chairman of AIMA South Africa for a period of four years.

**St. John Bungey**  
Praesidium Capital Management

My name is St. John Bungey. I'm one of the partners in Praesidium Capital Management. We have two funds, a long/short equity fund and a structured finance or asset-backed debt fund, which is my main focus. Firm-wide assets at the moment are about 1 billion Rand. Our performance is mixed; the long/short fund is down roughly 20% for the year, the asset-backed debt fund is up about 15%.

**Ryan Proudfoot**  
RMB Prime Broking

My name is Ryan Proudfoot. I am co-head of RMB Prime Broking, which is a division of FirstRand Bank Limited, one of South Africa's four major banking Groups. I'm responsible for the Equity and Equity derivatives division of RMB Prime Broking. My co-head, Lauren Pearce, is responsible for the fixed income section of our offering, where we hold a substantial market share. Together, we provide a true multi-product prime broking service which leverages off the product offering and balance sheet strength of the FirstRand Group.

**James Addo**  
Finch Asset Management

My name is James Addo. I just joined Finch Asset Management. I am currently running the Finch Africa Fund, which is technically not a hedge fund, we call it an opportunities fund. The fund is mainly long, with about US\$50 million (R500 million) under management. We have about 35 equity positions in the portfolio; in addition to that we also do some direct loans. While we are also down about 20% for the year, we believe that this is not a result of the value, rather a consequence of the cash flying out of the countries we are invested in. Before this downswing, we were up about 30%. Right now we are having investor meetings to raise about US \$150 million.

**Kevin Ewer**  
Blue Ink Investments

My name is Kevin Ewer, I work for Blue Ink Investments, which is a fund of hedge fund business which started investing in hedge funds in September 2001. Our assets are around 3 billion Rand in funds with different risk profiles. We run our institutional business through Legae Capital, which is a JV with Legae Securities. Our conservative funds are nicely up this year, our multi strategy profile is roughly flat and the more aggressive funds are down a couple of percentage points this year.

**Simone Lowe**  
Thames River Capital

My name is Simone Lowe, I've recently joined Thames River Capital, which is a UK-based specialist asset management firm which started in 1998. I've joined them to focus on the Africa and Middle-Eastern region, as we will be launching an Africa and Middle-Eastern focused fund-of-funds early next year. Thames River runs US \$11.8 billion across 7 different teams in the long-only, single strategy hedge fund and fund-of-funds space. Our approach tends to be quite opportunistic. Within the fund of hedge funds domain we run \$2.8 billion. I was previously a Portfolio Manager at Blue Ink Investments in South Africa.

**Warren Chapman**  
Peregrine Prime Broking

My name is Warren Chapman. I am the Head of Peregrine Prime Broking, which is an independent prime broking business in South Africa focusing mainly on equity hedge funds and some fixed income hedge funds. I've been involved in the industry for the last 10 years.



**James Addo**

In our case, we will maintain a long-biased perspective towards African equities. Within our corporate set-up, we are buying seats on a lot of African exchanges, just to get that advantage. We are also in a selective buying mode, where we still see value - for instance in banks based in Nigeria, which are trading at 1.2 price to book value, which is unheard of, given that they are all in expansion mode and sitting on piles of cash. The same applies to insurance companies.

We are also starting to see more activity on the hedging side. There are more synthetic hedges available from the banks, their prices are also dropping a bit, which is good. We also use GDRs as a sort of hedge.

Right now, a lot of the banking stocks are trading between 20-40% discount. If you pick that up plus a GDR, essentially, you have created a nice hedge. However, at this time, we will be doing more financials, infrastructure, and direct lending.

There is a huge appetite right now for investing in Africa, in our case primarily from endowments and pension funds. In the coming weeks we have some investor meetings in New York, interestingly six of the seven scheduled meetings are with university endowments. A lot of investors got burned recently and need to produce performance again to shoulder their funding requirements.

In our view, Africa is massively undervalued. The region is totally oversold in many ways.

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I also wanted to point out that we see opportunities on the currency side. A lot of African currencies have built up substantial reserves. For instance, Nigeria has higher reserves than South Africa - \$62 billion versus \$34 billion, which for many may be a little surprising.

We also see a lot more pre-IPO activities, in which we are getting involved on a selective basis. There is also value coming from the private side, up to 25% of our fund can go towards privately-negotiated deals. These deals can be very attractive, for example we recently structured a loan to a telecommunications firm which is compounding at 10% a month, which by any means is significant. Plus, we have hedged this deal as well...



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**St. John Bungey**

The asset-backed debt space in South Africa is very interesting. Huge opportunities are opening up as our local banks have started, as with their international counterparts, to tighten credit.

What you need to keep in mind is that banks are generally run with a non-proprietary mindset, so by employees rather than owners or providers of capital. This tends to lead to a “close the door after the horse has bolted” mindset. In my view, the “horse has largely bolted”, but the banks are stopping lending. This means for us that now we can easily get great deals paying reasonably high rates, whereas six or eight months ago, we were competing with the local banks.

While I wouldn't say that price – i.e. the rates that we charge – has become irrelevant, we do see that clients, or people who need financing, are far less concerned about the rate they may be charged provided that they can get the deal away. The big question mark is of course: What about bad debt? Here my feeling is to look at the loans which were made six months ago, rather than the new business which we are reviewing with stricter credit eyes. To this end, we have increased the provisions in the book to about 2.5% of AUM. Nevertheless, we believe asset-backed debt is a great strategy, it is largely untapped in the local market and with the current retreat of the banks – there are more opportunities for us.

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We have also created an US dollar conduit for this product. This invests into the local South African Fund and Sub-Saharan Africa. In this USD fund we have just made our first loan into Botswana and we are looking at further African opportunities.

I would like to add one comment about Africa. Everybody talks about Africa not being correlated to developed markets; my advice is to take care not to confuse correlation or non-correlation with assets that don't trade. Liquidity and correlation are two sides of the same coin.

In our fund, we aim to use this relationship in the best way possible. We take a maximum two year view on liquidity and we always look for a firm exit. Our deals are not the sort of never ending private equity plays. We believe that you need the full arsenal of semi-private equity, debt and

listed equity in order to operate successfully in the pan-African space. We are very bullish on the opportunities, but also cautious about how we are deploying our capital.

#### **James Gubb**

In general, the outlook for a lot of South African hedge funds is gloomy due to potential withdrawals. This means that - if you are committed to provide monthly liquidity - your opportunity set is reduced. Therein lies the real problem in my view...

The opportunity set that currently presents itself requires minimum one to one-and-a-half years from a value perspective, in order to come to any form of fruition. Given a monthly liquidity constraint, I find it difficult to enter some of those opportunities which tend to be illiquid for the moment. Furthermore, any forced selling hurts a fund, despite the fundamental value still being there.

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**This now means that as a hedge fund manager, I have to orient and limit myself to liquid assets. Sure, there are some wonderful opportunities even in the liquid space, but the super returns that one can deliver by providing liquidity, or investing in illiquid stocks, is limited if you provide monthly liquidity.**

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This now means that as a hedge fund manager, I have to orient and limit myself to liquid assets. Sure, there are some wonderful opportunities even in the liquid space, but the super returns that one can deliver by providing liquidity, or investing in illiquid stocks, is limited if you provide monthly liquidity. That's the major challenge facing us at the moment, and hence we have decided to avoid small cap illiquid stocks.

#### **Matthias Knab**

**In the past two months, I have held such Roundtables in Stockholm, Moscow, Sao Paulo and now South Africa. The one thing that is being discussed globally is this liquidity issue, and there are different takes on it. We have heard about Swiss banks going to a hedge fund manager and asking him to increase, so to extend, his liquidity terms, in order to be safe in his investments, and not to succumb to other investors who may have a too short-sighted view on what is the right liquidity to execute such strategies. So this discussion is going on globally, and finding new ways to agree to liquidity terms may be one of the investment paradigms we had been touching on in this Roundtable here.**

#### **Warren Chapman**

There is a paradox in the South African hedge fund market particularly, but perhaps even globally now. There are great opportunities available on the one hand, but on the other tightening liquidity, redemptions, and stress to the industry as a whole is restraining managers from taking advantage of these opportunities.



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**We do a lot of work with market neutral funds and stat arb funds, and interestingly they seem to be doing fine. October in particular was a very good month for them.**

**We do not want underestimate the liquidity threat to our industry, which we see continuing to play itself out over the next 12 months: the access and structure of short-term credit and access to gearing. We're already seeing what structural effect this has on our service providers. For example, the lending banks are looking for additional collateral, and not taking certain kinds.**

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One focus of our business is to ensure that our clients have access to liquidity and product and are in a position to take advantage of the current market conditions.

We do a lot of work with market neutral funds and stat arb funds, and interestingly they seem to be doing fine. October in particular was a very good month for them with all of the spreads and dislocations caused by distressed or forced sellers. There were clients who stepped in and took advantage of these opportunities.

We do not want underestimate the liquidity threat to our industry, which we see continuing to play itself out over the next 12 months: the access and structure of short-term credit and access to gearing. We're already seeing what structural effect this has on our service providers. For example, the lending banks are looking for additional collateral, and not taking certain kinds.

Fund managers might have to battle to get similar sizes for their shorts, and they may battle to pledge or repo certain shares. They may also not get the same kind of gearing through the derivatives markets. For example, a lot of the banks are increasing their margins on options and on single-stock futures as a vehicle to either get long or short exposure.

#### **Simone Lowe**

The panic and fear we are seeing globally at the moment is not something that many of us have seen before. We are seeing large withdrawals and deleveraging globally as this kind of wide-eyed panic is playing out agnostic to the strategies or geographies investors had invested into. We feel that these withdrawals are coming at the worst time possible, it seems like it is at the point of capitulation. We are seeing phenomenal opportunities out there right now, but it's obviously quite difficult to deploy that capital when you are not sure what the withdrawals are going to be in the next 3-6 months. The analogy "be brave when others are fearful" keeps on coming to mind.

In particular, for the next 12-18 months, we feel that some of these opportunities are going to be in credit. Companies are going to need to

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focus on fixing their balance sheets and this focus is going to be on the top end of the capital structure. Also at the moment a large majority of credit is pricing-in absolute Armageddon and as these gaps close and risk re-prices, great risk adjusted returns should be able to be made. There will be a number of big opportunities coming from that side. At Thames River, we are also looking at zero correlation strategies – those that are fundamentally uncorrelated to equity and debt markets – like shipping derivatives, carbon emissions, power trading and insurance related strategies.

Turning to Africa now, we always have been very opportunistic in how we invest; a testimony to that is the performance of our funds over the last couple of years. Historically, we have not positioned ourselves as a fund-of-funds shop that gives high single digit returns, but more on the higher return opportunities that give a good risk return payoff. Therefore, we don't just stick to mainstream investment themes but tend to be more opportunistic, and therefore we look at Africa and the Middle East as a large investment opportunity.

At this stage, we plan to launch this new Africa and Middle East focused fund in Q1 of 2009, and we think it is probably a fairly opportune time, once hopefully some of the panic has subsided, and people are looking for places which are fundamentally still strong, and which will offer good opportunities.

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Ian Hamilton

A brief comment on withdrawals here in the industry. I am talking about from our own company's book but given that we have a majority of the hedge funds on our books for administration, this does give some indication. This October has been the first time where we have actually experienced a withdrawal from our industry. Each month had been a positive inflow until then. We are talking about a withdrawal of around 500m Rand out of 35 billion Rand, and if you take out fund-of-funds, the total then is about R250 million.

So the October withdrawals represent a 2.5% from the total, and it has happened only that month so far. Some of these withdrawals may also be coming from the panic from international investors – I mean this seems still contained. Consider what you hear about withdrawals internationally. I am not saying that that is right across the board, I have heard of big withdrawals of funds that are self administered. There have been certain issues about some of those, maybe the prime brokers can actually comment on that.

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### Warren Chapman

My perception is that the withdrawals in South Africa have been higher than that. It seems to me that with some of our clients, a rather substantial part of their investment decisions is based on the fact that they expect substantial withdrawals of assets. They are keeping liquidity or trying to keep liquidity to fulfill those requirements.

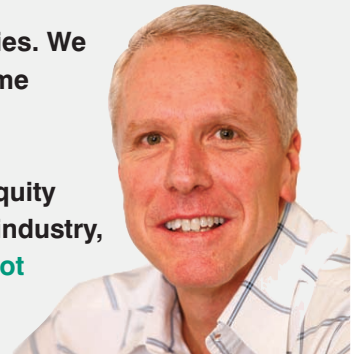
### Ryan Proudfoot

As a multi-product prime broker, what we tend to see from time to time is a flow of funds from equity based strategies into fixed income based strategies. We have seen this taking place over the past 6 months as investors favour fixed income strategies, which have shown solid returns. The growth in the fixed income space has been substantial and we haven't really seen a withdrawal from fixed income strategies yet, even though we suspect that there have been some general redemptions within the industry. Regarding the funds on our platform, I can comment that that returns from both equity and fixed income strategies have actually been quite favorable for October, compared to maybe two or three months ago. As an industry, we need to market these successes.

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### Ian Hamilton

We had seen reallocations into other funds, so those funds have not left the industry. Particularly funds with a three months notice period seemed to be affected by withdrawals. Also, money that has been promised has not been forthcoming. There is a slowdown from the investors' side.

I can confirm that some funds have gone from equities into fixed income. Multi-strategy and then some long/short equity funds are affected here.

### Kevin Ewer

Regarding the withdrawals, when we talk to our pension fund clients, a lot of them seem to be getting advice from their consultants to go long the equity market at the moment. Personally, I think it's a mistake, as I believe we are going to see volatile sideways markets for a lot longer than they expect. The funds and their advisors have seen the protection from hedge funds, and they now want to take quite a more aggressive stance.

Also the fund-of-funds are probably a major part of the reallocation from equity-based hedge funds to fixed income based strategies. I believe there are a couple of basic reasons behind that. A

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**Looking ahead at the prospects of our range of fund-of-funds, I am actually quite excited. A lot of managers are sitting with a lot of cash on their books, and unless some future outflows will restrict them, they have got the cash to exploit a lot of the opportunities arising. In the equity world, we will certainly be entering a stock picker's market.**

**Kevin Ewer**



lot of fixed income funds were recently formed, and fund-of-funds with longer histories were underweight in that space and overweight equity long/short.

So this move is probably less return driven, and rather more about investors balancing their funds in regards to where they were maybe a year or two years ago, when the local fund of hedge funds had to run fairly unbalanced portfolios in some ways.

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### Andy Pfaff

James had articulated the global concerns about providing liquidity and gaining access to liquidity. While in many markets there is gloom and doom, for us, as a CTA, this is a great environment. Obviously we function in liquid areas, we don't have credit problems and we don't trade in illiquid areas and we have had large and protracted moves. This all suits us, but, I still do not see any comfort in the current price levels, I do not see any price equilibrium. Therefore, we also try to diversify the account across bonds, commodities, currencies, and equities. There is a lot of volatility, a lot of movement in many different markets and places, so this is great for our strategy.

Because of this, global allocators have been allocating to macro and CTA strategies; they have been increasing the allocations for over a year. However, the local investor base so far hasn't made that switch - we all know that a lot of people are sitting on a lot of cash - but they haven't made the transition away from long-biased equity-based strategies.

From an overall perspective, discussing the industry development for a moment, I would say we have got to be very careful, because our equity strategies were loaded up on beta for the last three, four years. The markets have done extremely well here in South Africa over that period, but that game isn't on anymore, and now if we just sit on cash and wait for the next bull market, we would be acting like the mutual fund industry. With the one difference that our fee structure doesn't compete with theirs, so we have to mature, we have to evolve from that.

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### Warren Chapman

I would like to add one comment here. We had already indicated earlier that the local hedge fund performance in October was actually quite good notwithstanding the fact that the market was down about 23% at its lows and after a month-end rally finished down about 13%.

I do think that where hedge funds generally battle on average is in recognizing inflexion points and addressing the challenge of identifying the new themes and new paradigms that come along with that. There is no doubt that earlier and during the course of this year the financial world has reached an inflexion point. The way the world operated for the last years is not the way that it's going to operate going forward. Bearish themes, deleverage and volatility are playing out. There are funds that have identified these short term themes are taking advantage but it seems that with the majority there is a lack of conviction. Once the new paradigm and longer term themes become apparent, more people will move to capture these opportunities which may precipitate a decrease in the volatility.



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**Warren Chapman**



**Ian Hamilton**

...And once that happens, we may also see more positive press here in South Africa and they may stop copying articles just straight from overseas. We have one issue here in newspapers, and lazy journalists in this country who are just quite happy to lift articles from overseas on hedge funds. So you end up seeing here too all these headlines about hedge funds being down, hedge fund disasters, etcetera and none of these journalists even bothers to pick up a phone and speak to a local manager to find out what the local industry is doing.

I have to correct myself; in fact this is coming not so much actually from the journalists, but rather the editors themselves. They are confronted with cost squeezes, but it can't be an option not to have proper journalism in this country.

To be able to interact more with the media, and engage myself in a sort of education of the media and the broader market place, was actually one of the reasons I resigned as the chairman of the AIMA South Africa chapter. I believe I can play a more active role in the South-Africa promoting the industry, even if it is only making clear to media, regulators and others how well the local hedge funds are actually navigating through this period, compared to what I would have been able to do under the restrictions of an internationally governed body like AIMA.



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**So we will actually be forming a new association in early 2009 to take a more proactive approach and dialog. I am personally very proud of how the hedge fund industry here has come through.**

**Ian Hamilton**

So we will actually be forming a new association in early 2009 to take a more proactive approach and dialog. I am personally very proud of how the hedge fund industry here has come through. Sure, we might hear some funds and equity performance being down, but if I take a broader look and study the pensions and fund-of-funds, I have to say that they had a very valuable protection offered to them by the local hedge fund industry.

**Simone Lowe**

South African hedge fund managers, in general, have performed phenomenally well through this



period, for a number of different reasons. Ken Kinsey-Quick, who is our head of multi-manager, pointed to that when he was visiting here three weeks ago, saying “it so nice to see real hedge fund managers, where they are focusing on the short side, generating alpha that way, looking for opportunities and being quite adaptive.” Because our market is relatively small, the managers have to be fairly flexible and opportunistic in the way they approach things. The majority of the funds are also still a lot smaller than what we are seeing offshore so they can still be relatively nimble. Also, they generally have a wealth of experience in managing money in different market environments. This has been apparent with how well they have adjusted their net and gross exposure going into this difficult time and in general read things very well.

Also, the strategies deployed here are still relatively simple and easy to understand. Fund managers aren’t suddenly waking up to find that they are holding a whole lot of instruments whose risks they didn’t properly understand when they took them into their portfolios. Generally the local hedge funds and fund-of-funds, looking over a 1-year, 3-year or 5-year term, have delivered really great risk-adjusted returns.

### St. John Bungey

I started my career in the markets in 1993, and many on this Opalesque Roundtable were there even long before me, but just looking during my career, we have had arguably as many, if not more, crises than many other counties. Whether it was the first democratic elections in 1994, the first currency crisis in 1997, Emerging Markets Crisis of 1998, the run on the currency in 2001 or the Credit Crisis, now, South African hedge fund managers in whatever shape or form, whether they came from the buy side, or sell side, have grown up with volatility. They have earned their stripes. We have not just had a big bull market from 1989 onwards.

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Sure for the past 3 years long was the way forward, but a lot of managers have experience in different markets. If we all knew how to call the exact top and bottom then I suppose we wouldn’t be trading other people’s money. What hedge fund managers are good at is trying to pick the new theme, but you can’t just pick it immediately. At such inflexion points you are going to be whipped, that is the nature of the markets. You have got to back your managers and say these guys know how to trade their asset classes and allow them time to pick the new winning theme.

### Ian Hamilton

Well, as in any other industry or market place, there have also been a few casualties in the marketplace over the year. Some were forced to wind down, not all have earned the stripes.

### Kevin Ewer

I believe the fund-of-funds industry in particular also has a certain responsibility not to be too reactive to short-term returns and go and effectively put some top class managers out of business, basically for a couple of months of bad returns. Unfortunately, we have witnessed this year how a couple of experienced hedge fund managers have suffered a draw-down and investors have been very quick to disinvest entirely.

In some cases that was valid, but in other cases you actually want those managers around as part of the industry going forward. So I think the challenge is to structure your portfolio as a fund-of-funds which is able to carry some under-performing funds through some draw downs, if this industry is going to grow successfully. You need to build a fund that is able to weather the storms without requiring mass firings. My concern is that we may, in this period, lose some very



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**Kevin Ewer**

experienced managers who may well just go and trade their own money, because they are worried about short-term outflows of their funds and not being able to implement their strategy effectively because of liquidity considerations.

**Andy Pfaff**

Kevin, I think it is worthwhile noting that this is a Darwinian industry. You cannot carry people too long or you will be carried out. So there is an inflexion point, there are multiple inflexion points that you all have to be aware of.

**Kevin Ewer**

The key thing is that I have seen hedge funds suffering redemptions as soon as certain investors got knowledge of the return. I am not suggesting that we should hold on to managers who ultimately just produce bad returns, but such a reactive practice is pure return investing. The return needs to be understood and portfolio construction better. If this return investing is what's going to happen in the fund-of-funds space, then I think it's quite unhealthy. As an investor, you should look at the bigger picture, beyond a particular fund's return in one or two months.

**James Gubb**

In the end, it's a bet on people and process versus short-term performance.

**Warren Chapman**

We need to carefully differentiate between a style and a bad manager. For example in 2006 and 2007, a lot of good market-neutral funds were cast by the wayside, because they were "just" showing early teens, the environment wasn't ideal for the strategy that year. Now in 2008, there are some with very good performance out of these funds; I assume that unfortunately, they are largely underrepresented in the fund of funds space because of the 2006 and 2007 reallocations...

**Kevin Ewer**

As a fund-of-funds allocator, let me comment briefly what you are bringing up here with the market neutral funds. It may surprise you that the majority of the assets we raised were for the most aggressive mandates. So out of a 3 billion Rand total, only 360 million Rand went into our conservative fund-of-funds, which has largely a market neutral focus, and zero of that money came from the pension funds. Certainly, you can only allocate where your mandate allows it.

For me personally and for Simone, who used to work with me before, it was a disappointment! We could never understand why institutions were not looking for more conservative products, and now possibly some of them may have been burnt by that.

**Simone Lowe**

Let me clarify here that this wasn't necessarily coming from the pension funds, but often the consultants who wanted us to move our fund-of-funds up the risk curve back in 2006 and 2007. We were kind of constantly fighting that battle. I believe the underlying issue is that the pension funds may not understand how to allocate to hedge funds and fund-of-funds, how and where they fit into the asset allocation process. I believe we are going to see a review or a change of that going forward, where hopefully alternatives are used more actively as part of the pension fund allocation.

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**Kevin Ewer**

**St. John Bungey**

I think we are talking about human nature here. Even though we all try and not default to chasing returns, ultimately there is always that creep. There is a tendency in favor of those new managers that have been performing, in whatever cycle. Whether it is the end investor in their mandates, the pension fund trustees who cannot help themselves or the fund-of-funds in their allocation; even finally how an equity manager deploys that money, we all try very hard to keep that element of diversity, but you do tend to follow the latest and greatest things, even if it's incrementally.

We also have to have in mind that in South Africa the opportunity set was very limited. If I look back 3, 4 years ago, the concentration was about 95% long/short managers, of which let's say 15% were market neutral. So in reality, the opportunity set was based on a bull market footing, which worked well until very recently. Now this asset allocation may not serve you as well. Unless you jumped at all the new strategies that were opening, and made a substantial allocation, which would have been very difficult, you would remain long biased. So there is a sort of, default of history here.

**Matthias Knab**

**What are the some of the strategies that emerged in South Africa?**

**St. John Bungey**

Long/short in South Africa is to some degree a catch-all for equity strategies. I mean you cannot be a pure merger arbitrage manager in South Africa. We have sophistication of markets in terms of our settlement systems, our banks etc, but we don't have depth of market. So you cannot afford to be so specialized that you only do merger arbitrage or you only do any specialized equity strategy. You can be various degrees of aggressive in terms of the directionality, but you need to be a bit of

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**I was one of the first people to start an asset-backed strategy, so this strategy has started in South Africa. We have also seen the emergence of good, I think very good fixed-interest managers. The credit space is starting to grow.**

**St. John Bungey**



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I was one of the first people to start an asset-backed strategy. I was traveling and I saw that in Asia they have a similar problem. In their event driven category, there is no space for pure distressed funds or pure event-driven funds or pure asset-backed debt funds. But those people who came out of banking or credit, with a certain skill of investing, sort of started or morphed an event-driven strategy, which was a partly distressed and partly asset-backed.

So this strategy has started in South Africa. We have also seen the emergence of good, I think very good fixed-interest managers. The credit space is starting to grow. I finish off repeating myself, one can't be too specific in what one does because the opportunity set is not going to remain there same forever one must be able to be flexible in a broader mandate.



**In one previous market correction I have witnessed how people suddenly all went into the market neutral funds. Six months later when the bull market started again and the market neutral funds were under-performing the general equity funds, the same brokers and investment advisors were slating the market neutral funds. We need to get away from such behavior, and this is not only a South African issue. It not about looking for the top returns, you have to actually weigh your risk against what those returns are.**

**Ian Hamilton**

**Ian Hamilton**

We talk about the maturity of the hedge fund market, but what really missing here is the maturity of the investor market. The local investors have enjoyed bull markets for so long, and unfortunately there is very limited experience amongst consultants and advisers as to taking a more conservative approach particularly when it comes to institutional funds. So the current situation can also serve to clean out a lot of those advisors who have just pushed people into long equity.

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**Matthias Knab**

**Warren, you had one more comment on liquidity and the paradigm change we discussed, you had a second point.**

**Warren Chapman**

In the international and local markets during benign phases, one has not been "paid" to take risk. What I mean by that is that there is an opportunity set that too many people are chasing, which in turn diminishes. One way to deal with this situation, in order to sustain returns, is to gear up the reduced alpha. Financial institutions, the likes of Lehman, Bear etc. have allowed clients and hedge funds take on substantial leverage to do this. This has come to an end, and the current great deleveraging is depressing asset-prices and the equity markets and once again widening spreads.

In South Africa, we have seen gearing, but not to the same extent. About one year ago, the average gearing of our funds was probably around 2.3 times; whereas at the moment it's probably around 1.2. As a consequence, our clients have been relatively well positioned, because they have not been forced to de-gear as much as some of our international counterparts. This in turn is now one of the real opportunities in the current environment, particularly for foreign investors, as the de-gearing has happened in South Africa already. It may be an attractive option for an international allocator to come into this market, because I think there is still some de-gearing and de-risking going to

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**Warren Chapman**



happen internationally.

Investors need to note comments from JPMorgan and others who stated that the internal trading desks are going to be closed down. I suspect we have not yet felt the full impact of the large scale of redemptions in the international hedge fund space.

**Ryan Proudfoot**

There is no doubt in my mind that the focus over the next couple of months will be to continuously review counterparty and credit risk. I don't believe that the South African market has properly evaluated these risks, nor do some products effectively price in this risk. Moving forward, it will result in some knock-on ramifications by way of increased margins or a review of acceptable collateral. This is going to have an impact on our hedge fund industry as the South African Banks re-price for counterparty and credit risk.

**Ian Hamilton**

If you look at the history of the South African hedge fund industry, even though it's a relatively short one, we have gone from a sort of Wild West cowboy high-return trading model to a far more conservative model, because many of the investors are institutional investors. Our markets have achieved a remarkable maturity, and the regulators have already imposed certain disciplines on the hedge fund managers here.

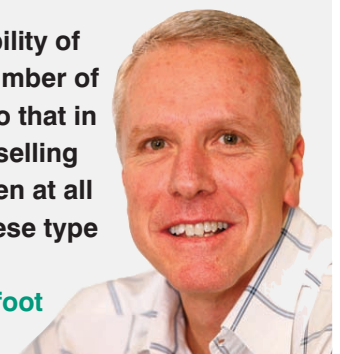
Our hedge funds here have always used a medium leverage basis; generally we have not had a leverage crunch in this country, our banks are relatively healthy, so you don't have to worry about what bank you are using for cash or short term liquidity. It's a good model to how an industry should be run.

**Ryan Proudfoot**

One of the important elements that needs to be emphasized is the maturity and stability of the equity and fixed income markets in times of extreme volatility. For example, a number of countries banned short selling during the recent crisis, whereas we didn't have to do that in South Africa. We understood what the problems were, for example, no naked short selling is allowed and the markets could carry on trading. In addition, our markets were open at all times and trading was never halted. Hedge fund strategies were not impacted as these type of risks were a non event in South Africa.

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**Ryan Proudfoot**





**Matthias Knab**

Let us take a deeper look now at the South African market infrastructure. We already mentioned that the banks are sound, de-leveraging was rather controlled and naked short selling had been banned already years ago, so the regulators here did not need to impose any additional measures on the markets, much to the contrary to what happened in other markets. Is there anything to add regarding the development of the South African market infrastructure?

**Warren Chapman**

I think one of the things that differentiate the South African market from the international market is exactly the nature and sophistication of its infrastructure. We have three well run exchanges, participation at structure level by all the major SA banks and several large multinationals. The exchanges are mostly electronic and have proved efficient vehicles for getting long and short exposure to South African capital markets.

The equity and equity derivative market which are our primary markets are in my view are world class. They have sophisticated and tested rules, regulations and procedures, a wide range of participants and central clearing houses and securities depositories. All members and participants are basically interconnected via technology making for efficiency and robustness.

**James Gubb**

There has never been a failed trade.

**Ryan Proudfoot**

Well there have been some close calls but the STRATE settlement authorities worked hard to resolve the issues. I think that we may have had only one, which was effectively resolved by rolling out the settlement date. Just to clarify on the South African Exchanges – the JSE is primarily an equity exchange (JSE), we also have a fixed income exchange (Bond Exchange of South Africa).

**James Gubb**

So one failed trade since STRATE was initiated six years ago, I mean that is extraordinary.

**Warren Chapman**

That is right, so the nature of the market is very robust. Whether you are a clearing member, custodian or broking firm, there are well defined rules and regulations and all participants are connected to a closed SWIFT network.

The second thing is that South Africa's legal framework, combined with the participant network above, allows for the easy and transparent segregation of assets. For example, a firm like Peregrine can hold large amount of assets within this standardized and tested market structure, where assets are clearly segregated and where clients can take comfort that their assets are not co-mingled with that of their service provider.

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Thirdly regulators, particularly on the equity market have almost real time access to each participant's financial position and those of its clients and can monitor and enforce the market structure.

This is evident in the way that securities lending process works in the market. Naked short selling is not permitted, not merely as policy, but more in terms of the nature of the market structure. One cannot sell a security, that one does not own, unless it has been identified in the network as available for sale and flagged as such. In the same way, collateral that is pledged is also clearly identified.

This does not mean that there are not weaknesses in the system, and I think as this global crisis plays out, there are going to be certain issues that are raised. However, one can take confidence from the fact that, during the last difficult nine months or so, South Africa shown the robustness of its markets, mechanisms and regulations. From a business and investor point of view, I believe we have shown it is a quite attractive place to operate a hedge fund business or to invest in hedge funds, or operate in this market.

#### **Ryan Proudfoot**

I think one of the problems with the international securities lending and prime broking markets is that re-hypothecation of client assets is allowed to take place. In other words, client collateral may be on lent to other borrowers in order to generate additional income. The unwind of these positions is legally extremely difficult when Prime Brokers default. We don't allow re-hypothecation in South Africa unless specifically agreed to by the parties.

#### **St. John Bungey**

Just one other small point which may be interesting to know for anybody who has tried to transfer money internationally, which includes into and from Cayman Islands, the overnight or 48 hour delays can be extremely frustrating. By contrast our domestic National Payment System clears any inter-bank deal over 5 million Rand within half-an-hour. I believe this has helped contribute to our banking system stability. As a treasurer of a bank or regulator, you know exactly where you stand, in real time, as opposed to overnight or 48 hours later.

#### **James Gubb**

International investors should know that a lot of groundwork has been covered by the local institutions investing in local hedge funds. A set of fairly onerous and strenuous conditions on investment into the hedge funds have been defined regarding risk disclosures and positions of the underlying funds.

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**This includes tying in independent risk companies, who perform important tasks like sharing information on the level of risk involved with hedge funds or fund-of-funds. To a large extent, the funds allow a daily look through into their positions after a certain period of time. The market is very institutionalized, the risk levels are very well-known to the investors and therefore greater confidence can be placed when they invest their money.**

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**Warren Chapman**

This is certainly the case with us, and I think it's the case with Deutsche and with Investec, RMB and the other players in the space in South Africa. Our risk team can see portfolios real-time, at any point during the course of a day look at exposures, look at movements and assess the risk of any fund. Our analysis uses most of the traditional risk measures, but with a specific focus on ensuring a fund's ability to meet its obligations in any market conditions.

**Ian Hamilton**

As administrator we are actually doing daily valuations as well, obviously not for daily trading, but for a daily assessment of a fund's positions. In fact, we are doing this for 25 funds at the moment, which is a bit of an arduous process.

One warning here is related to the trend of hedge funds to start using multiple prime brokers, a trend that has is quite visible overseas where funds started doing this to split their risk. Of course this all makes sense, but then you may still want to get the overall picture of the risk from a third party like the administrator, who provides the composite.

**Andy Pfaff**

We haven't mentioned yet the South African single stock futures market. It had been said that it is one of the largest and deepest single stock future markets in the world. Can one of the prime brokers here comment on the latest development of the single stock futures market?

**Warren Chapman**

The Single stock futures market has been very successful over the last few years, as a tool for institutional and retail investors and hedge funds. It has provided the ability to gear and to go short without entering into securities lending contracts and all contracts are guaranteed by the exchange.

In recent months there have, however, been two issues with the South African single stock futures market, which is not dissimilar to issues internationally. The one is that margining processes have been inappropriate - institutional margins have been passed on directly to unsophisticated investors and the bull market of the last few years, followed by the recent downturns, have left quite a few investors burned

Fortunately, the banks which have been providing that gearing have more than sufficient balance sheets to support those businesses. We have heard stories about some banks taking losses where their clients have not been able to meet their obligations. But the bottom line is that for the capital of those banks, even if we multiply the losses by 10 or 20 times, it would have no real impact on the market structure.

Going forward, I have no doubt that the margining is going to be reviewed, that the banks involved in these spaces are going to reassess their business models and implement changes. But again, these events were limited and ultimate counterparties were well capitalized.

**The transparency that particularly South African single strategy hedge funds are offering is far superior to anything you get anywhere else. And I think that gives a great deal of creditability especially on a daily basis.**

**Something which may need to be addressed if South African hedge fund managers want to raise substantial offshore capital is the proper segregation of duties, that there is actually a designated COO who takes care of such tasks. Yes, the South African managers have outsourced that to a large extent, but I believe this still needs to be a focus on in-house and designated people who do this.**

**Simone Lowe**



- Ryan Proudfoot** I'd agree with Warren in that local banks will review counterparty and credit risk and apply measures that should result in de-leveraging and a reduction in the risk to inappropriate investors.
- Simone Lowe** The transparency that particularly South African single strategy hedge funds are offering is far superior to anything you get anywhere else. And I think that gives a great deal of creditability especially on a daily basis.
- Something which may need to be addressed if South African hedge fund managers want to raise substantial offshore capital is the proper segregation of duties, that there is actually a designated COO who takes care of such tasks. Yes, the South African managers have outsourced that to a large extent, but I believe this still needs to be a focus on in-house and designated people who do this.
- Ian Hamilton** This is going to have to happen, because now there is a dedicated regulation for hedge fund managers in our country, which comes with extremely onerous restrictions not only for the hedge fund, but also on the investment industry to ensure proper segregation of duties and designated priorities etcetera. I think we are quite far down the line in implementing the new rules. Out of all the hedge fund managers that applied for the new license, we only had one rejection right up front. But going forward, there definitely will be some policing on the new rules.
- Simone Lowe** My comments weren't meant as a criticism, rather a comment. If you look at how the local industry started and evolved, where a fund manager could have started his fund with R1 million or R5 million, and so couldn't necessarily afford to support a big team. As they started to hire, the focus was normally on building the investment team as opposed to the operational side because we had such a good regulatory and operational framework around us which was there right from that beginning that we didn't necessarily need to primarily focus on in-house operations.
- James Gubb** I hear you, but we also have to make an important point here to explain this new 2A license, which is a huge advantage for any investor. It's a world first.
- Ian Hamilton** Correct, we are the first country in the world that actually has distinguished between normal fund managers and hedge fund managers, that there is a higher criteria required for hedge fund managers. There are disclosure issues for hedge fund managers; we really have upped the game as to who can come into this space, the qualifications of the people in the industry and so on.

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**In South Africa - and here our position may differ a bit from other jurisdictions - the local industry has actually said for many, years that we actually want to operate in a regulated environment. It makes things a lot easier if you know the ground rules.**

**Some of my international counterparts at AIMA were saying "no, you don't want to have any regulatory framework. You have got to have this laissez-faire type of operation." And I said that this can only lead an industry into trouble, because you have no benchmarks etc. in the industry.**

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So in South Africa, we have developed this framework and benchmarks for hedge fund managers. So we have our hedge fund managers, who are well regulated, we touched on the market regulations, and we have no problem on the shorting issue. We are the only country where our authorities came out and said, "we have no problems with shorting, because we banned naked shorting years ago", so we have a market in equilibrium on that particular front.

We still have other forms of regulations that we want to have which relate to disclosure, and the other issue is that we still have no formal regulated structures for an actual hedge fund. Like a form of collective investment scheme which offers tax and investor clarity.

Having dealt with the authorities, I am very confident that in 2009 we will have something done, because the pension fund industry understands the need to have hedge funds. Their Financial Services Board has recognized hedge funds and even provided a definition for hedge funds; not that I agree with it, but they have recognized that there is a thing called hedge fund by having hedge fund managers. The point where we are now is rather funny, we have hedge fund managers but no hedge fund structure.

**Matthias Knab**

**Let's move out of South Africa, into the pan-African domain. Is South Africa a model for the rest of Africa for the market infrastructure?**

**James Gubb**

I would love to see a united exchange of Africa. This will make a lot of sense. Clearly, South Africa is at the forefront of that development, and were that to happen, you would find liquidity in Africa being certainly enhanced.

**St. John Bungey**

I just came back a couple of few weeks ago from Uganda and East Africa. We had this discussion about an united exchange of Africa with the exchanges in Uganda and Kenya, and just like anywhere in the world, this is not African specific, nobody is really in the mood to combine their exchanges with someone else's, because it means that they then lose the power. From a commercial point of view, it makes fantastic sense, but you have got to get through the political and bureaucratic nightmare that it would take to do that.

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**St. John Bungey**



**Ryan Proudfoot**

The big concern I have with Africa is there is no capability to short the market on any African exchange, apart from South Africa. So from a hedge fund point of view you are really applying a long-only strategy. Can normal fees charged by hedge funds then be justified?

**James Addo**

We have had a great discussion about South Africa, but we did not speak about pricing, and there are a lot of issues related to pricing. Just look at the U.S. - obviously it's the most unregulated hedge fund industry - where you have managers engage in their own pricing and reporting to administrators. That's unheard of anywhere. But also for us looking at pan-African investing,



pricing is an issue, also because it determines your performance and how well you do relative to other markets. I will come back to that later.

Investing in Africa (ex-South Africa) carries some major challenges in those markets, and shorting is one of them. I mean, that's good and bad. It looks like the default position seems to be that it is a long-only strategy. However, there are other opportunities on the private side.

Pricing is as I mentioned a key issue, whether you have to mark-to-market on a monthly basis, or you do it on an annual basis, whatever. How do you determine pricing and how do you report that?

#### St. John Bungey

One comment which I made earlier, and I am going to reiterate is not to confuse illiquidity for non-correlation. The exchange in Uganda opens twice a week for two-and-an-half hours, and most of those trades are naught, naught, naught all day, so of course they are going to show that they are not correlated to the rest of world. I agree with James Addo, when you are going to buy a listed stock, but you can't sell it because there are no real buyers, and the exchange is only open two days a week, you may as well be in the private equity game. Don't try and pretend to be what you are not.

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St. John Bungey



#### Kevin Ewer

I believe anyone looking to invest in Africa should see it more as a private equity investment than a hedge fund investment. The capital needs to be locked up like private equity, if the investments are going to be successful.

The fee structures consequently should be more similar probably to private equity fee structures than hedge fund fee structures.

Investments shouldn't be limited to listed equity only. It should be far more around infrastructure development throughout Africa, because that's where the good returns are really going to come and the benefits for Africa as well.

#### St. John Bungey

The returns are there, and my perception is that people are incredibly price insensitive. Most of these projects can carry huge costs in terms of returns to investors. They are far less fussed about the cost of funding than they are about the ability to deliver and to structure it. So the returns are there in Africa, there is absolutely no doubt, it's about getting ownership of sufficiently patient capital.

#### Simone Lowe

I think we all agree around the table that you can't play Africa ex-South Africa through a hedge fund strategy, it just doesn't work.

The compelling reason, the great investment story for Africa is infrastructure spending and domestic driven demand. There are 53 different countries or 52 different countries, if you exclude South Africa, which have very different drivers in terms of their economies. So part of your risk management will be the diversification by investing across the different countries; not because the countries are uncorrelated to the rest of the world, but because they have different growth drivers

**The compelling reason, the great investment story for Africa is infrastructure spending and domestic driven demand. There are 53 different countries or 52 different countries, if you exclude South Africa, which have very different drivers in terms of their economies. So part of your risk management will be the diversification by investing across the different countries; not because the countries are uncorrelated to the rest of the world, but because they have different growth drivers which help determine their performance and success. So although you don't have the instruments which allow you to hedge your portfolio, there are still effective ways that you can control the risk in your portfolio.**

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Africa is also not just a commodity play either, a common misperception. Eight out of the 52 countries have the majority of their GDP driven by commodities, but for the majority of the other countries their GDP is driven by internal domestic demand in services and other areas – this is much more relevant.

**Matthias Knab**

**You are about to start a pan-African fund-of-funds. Can you tell us a little bit more about your approach and the set-up? How does the universe of your underlying managers look like?**

**Simone Lowe**

The fund will be initially biased towards South Africa because of the depth and expertise of the managers here as well as the ability to hedge and protect capital. It will also be investing across managers managing money across the rest of Africa as well as having a smaller, more opportunistic weight to managers in the MENA region. It will be multi-strategy in its approach. Some of the South African managers are now looking opportunistically across the borders into the rest of Africa which is opening up the market as well.

I have probably visited about 30 African (ex-S.A.) managers, or let's say 20 in the last two months alone. Many of those are based predominantly in London and invest from there into Africa. There

**I have probably visited about 30 African (ex-S.A.) managers, or let's say 20 in the last two months alone. Many of those are based predominantly in London and invest from there into Africa. There are some good and there are some not so good, as with any industry. Managers need to be opportunistic and flexible. It is an absolute requirement to spend time on the ground in Africa understanding the nuances of investing here. Some of these London funds have offices in Nigeria, Angola etc. It's not possible to simply sit in London and buy the latest growth story and hyped share.**

**So people have feet on the ground in Africa and spend a lot of time traveling as well. The managers tend to base themselves in London, as they find it easier to get to Africa from there, opposed to basing themselves within Africa itself, which can be limited in terms of how easy it is to fly to the rest of Africa.**

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So people have feet on the ground in Africa and spend a lot of time traveling as well. The managers tend to base themselves in London, as they find it easier to get to Africa from there, opposed to basing themselves within Africa itself, which can be limited in terms of how easy it is to fly to the rest of Africa. But there is no doubt that there is a very steep learning curve happening at the moment in terms of how to invest in Africa and the constraints of investing here, specifically from a liquidity point of view.

#### Warren Chapman

Some of our funds trade in Zimbabwe or in Kenya, and my observation is that you do need to partner with brokers or research firms like Securities Africa, entities that have feet on the ground. You need to understand the way each market works. Not all of the 53 African countries have exchanges, and the 43 African exchanges that do exist mostly have different rules, different structures and different personalities. You need to partner with people who have got understanding of those markets and who can facilitate doing business there.

#### James Gubb

If investing in pan-Africa is more a long-only play, what is then the justification for a 2 and 20 fee structure? Another area we haven't talked about is how do you manage your currency risk of your investments in these countries relative to the dollar?

#### James Addo

I guess the really simple answer is you don't, but you try and wing it. There are synthetic hedges available, it really varies based on the region that we are in. Zimbabwe, we all know the game there, Old Mutual. For East Africa, we have got into an agreement with Standard Bank where we create a synthetic hedge. During October they withdrew, and it accounted for a third of our loss on our portfolio. In places like Nigeria we buy the GDRs.

If the underlying stock is trading at a discount, that is an easy game. Beyond that, really it's a wing and a prayer. You try and pick the stocks that make sense, which will grow faster than the depreciation in the currency.

#### James Gubb

Let me point out, as a theme for the international investors or readers, that the Rand is a very deep market. It is the de facto emerging market currency worldwide. We have very liquid contracts that can be traded easily on the exchange during market hours and even after hours as well. So while it is volatile, you can at least easily hedge the currency.

#### Warren Chapman

There is an interest from offshore investors to get pure South African alpha or to benefit from the opportunities in the South African market without taking currency risk. We have several clients who only convert dollars to Rands to the extent that it is necessary to take advantage of a particular strategy. They then hedge out this rand exposure and keep the balance offshore on call.

This is surprisingly efficient, and it's one of the things that we recommend to investors who want to benefit from the alpha components of our market.

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**Warren Chapman**



On the African story, when you invest you make an investment in the country and the currency and your return includes the currency. So if you invest in Zimbabwe at the moment, you would take into account that hyper inflation environment and factor the depreciating currency. I think it would be much harder to extract pure alpha in Zimbabwe or African markets efficiently and hedge the exposure to their respective currencies.

### **St. John Bungey**

Nobody has really addressed the issue of exchange control in South Africa, and I am sure it will come up in due course. Although normally a swear word, it has been a double-edged sword as it seems that exchange controls have to some extent helped the country by sheltering it from this credit crisis.

In terms of the African investment thesis, one thing I was very surprised about, particularly in East Africa, is that none of those countries have exchange controls. Secondly, when we were looking to negotiate deals, most locals were happy to denominate deals in U.S. Dollars. They are so comfortable with essentially using U.S. Dollars as the de facto currency, for day-to-day business transactions, that they are quite happy to denominate debt or equity in U.S. Dollars. This in itself is quite an opportunity, because they are happy to pay rates of between 35% and 45% per annum in U.S. Dollars to secure funding, because no one else is offering this to them.

### **James Addo**

As we go along, new products are being developed and will be available soon. We are helping a couple banks in Nigeria develop ETFs, which will be interesting from a liquidity perspective. Those instruments will be available early next year. As I said at the beginning, the banks there are highly liquid; they still have piles of cash. We also try to refine the synthetic hedge product with the Standard Bank just to see how that would go.

Nigeria, as you know, recently removed caps, i.e. limits off of its daily market price movements and that really caused a dip in the market. While the market was in under lock-down, the market participants were trading listed stocks OTC. So it's an interesting market - when they finally lifted it, prices adjusted down. That was an interesting situation to actually study and try and figure out if that could be replicated in different ways.

In terms of market infrastructure, we are seeing more and more of the markets move towards a US-style regulatory environment with the local stock exchanges. That's good and bad. Obviously, I agree that the US market is probably the most regulated stock market around, and we want better regulated markets in Africa.

The Africa Board is probably a step in the wrong direction given its requirement that the African securities de-list first. Instead, the Africa Board should rather sell exchange seats to all the various African exchanges. That will probably make more sense. In that way, the Africans will have a stake in it.

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