



# Opalesque Round Table Series '14

# SOUTH AFRICA

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# Editor's Note

When I traveled to Cape Town to conduct this Roundtable, I also spent all day at a cap intro event where the South African prime broker Peregrine Securities presented South African hedge funds to local and some international investors. On such a day you can meet eight or ten managers, and they all have five year plus track records annualising net 15-20% or more. People come and take a look at those managers, and for the right reasons.

While it is impossible to say whether we are at a market high or a market low, but we can look at the scenery and determine if we are in the neighbourhood of a high or of a bottom. Hedge funds follow diverse strategies, and many have very good hedging and shorting skills, so they might become more relevant in the next couple of years as the place to be, relative to the recent history where long-only was a better place to be. And indeed, South African hedge fund managers are now getting approached by managers who were historically allocating primarily to long only managers.

## A change of perception - the forgotten lesson from 2008

The hedge fund space a unique skill-based world where some very skilled fund managers actually do better than the markets. That means investors don't lose something by investing in hedge funds, but actually mitigate risk and improve return over the long term. *However, the general perception seems to be that investors have to give up a huge amount of return when they invest into hedge funds.* But, at the same time, investors should also be concerned about lowering their risk. Hedge funds offer protective mechanisms, but only for those who are not too greedy. With the skill-based world of hedge funds, investors can do much more than the market over the long term, and also benefit from the risk mitigation that is inherent in many strategies.

Institutions, not only in South Africa, tend to be behind the curve and reactive. In a rampant bull market, they are looking at hedge fund exposure and say, "well, it's not yielding what my long exposure is giving me, there must be something wrong with that..." This issue really comes down to institutions needing to understand that many hedge funds strategies, particularly within the equity space, aim to provide protection in down markets. That means they will often not be able to offer 100% to the upside. There are hedge funds that can outperform even a rampant market, but then downside protection may not be their focus.

In 2008, many hedge funds did what they were supposed to do and helped protect on the downside. *But, the dip (and the rebound) was so quick that the long-only managers overtook in terms of returns again within a 12-month period. So, many investors never really got to see or experience the full benefit of that downside protection, because the recovery was so sharp and quick.* This could be one factor why hedge funds are still underrepresented in many institutional and high net worth portfolios. If we would have had a bit more volatility or the downturn had been a bit longer, this could have solved the case of hedge funds a lot quicker.

The 2014 Opalesque South Africa Roundtable was sponsored by IDS and Eurex and took place end of 2013 in Cape Town with:

1. Andy Pfaff, **Commodities Fund Manager, MitonOptimal Group**
2. Andre Steyn, **Founder and Portfolio Manager, Steyn Capital Management**
3. Claire Rentzke, **Head of Manager Research, 27four Investment Managers**
4. Devon Olander, **Analyst, Skybound Capital**
5. Ian Hamilton, **Founder, IDS Group**
6. James Gilfillan, **Chief Investment Strategist, Alpha Wealth**

The group also discussed:

- **Investing in Africa:** There is significant interest for Africa. Driven by their clients - mainly European single and multifamily offices - some of the very large asset consultants have all been over the continent looking at some of the local managers. With 1,200 listed stocks, Africa offers investors a lot of idiosyncratic opportunities and market inefficiencies. There are approximately 100 Africa-focused funds, many of them managed from outside Africa.

- Investment process when investing in Africa ex-South Africa

- Perceived and actual investment risk: why company specific risk is more important than political risk
- How can investors evaluate corporate governance in Africa?
- What are Africa's new top investment destinations?
- Can Africa funds run an absolute return mandate?
- Update on the growing African debt market; liquidity and idiosyncratic trading rules at African stock exchanges

#### - Opportunities in Commodities

- **New regulations:** South African pensions can now invest 10% in hedge funds and up to up to 30% in international equities
- How **new platforms** provide access to African and South African fund managers



# Participant Profiles



(LEFT TO RIGHT)

Ian Hamilton, Devon Olander, Claire Rentzke, Andy Pfaff, Andre Steyn, James Gilfillan, Matthias Knab.

# Introduction

**Andy Pfaff**  
MitonOptimal Group

My name is Andy Pfaff. I manage Cassandra Commodities, which is a boutique within the MitonOptimal Group. I manage a full suite of commodity products from beta, active long-only, and hedge funds.

**Andre Steyn**  
Steyn Capital Management

I am Andre Steyn, founder and Portfolio Manager of Steyn Capital Management, an alternative investment firm focused on Africa. We manage two funds; long/short South Africa Fund as well as a Pan-Africa Fund. Since inception the South African fund is amongst the top five performing South African long/short funds, while the Africa fund is the second best performing African fund. This performance was achieved with zero portfolio overlap between the two funds.

**James Gilfillan**  
Alpha Wealth

My name is James Gilfillan. I am the Chief Investment Strategist at Alpha Wealth. We are investment advisory firm and also run fund of funds in South Africa, as well as globally.

**Ian Hamilton**  
IDS Group

Ian Hamilton. I am Head of the IDS Group, which is the largest hedge fund administrator in Africa. We are based in Cape Town; we are also in Malta and in Mauritius. We are the administrators for a lot of the South African funds and a growing number of African funds.

**Devon Olander**  
Skybound Capital

My name is Devon Olander. I work as an analyst for Skybound Capital. We have both onshore and offshore products, with a bias towards Africa and Asia.

**Claire Rentzke**  
27four Investment Managers

I am Claire Rentzke. I am Head of Manager Research at 27four Investment Managers. We are a multi-manager based in South Africa. We manage long-only, as well as hedge fund of funds. We also offer exposure to Africa ex-South Africa fund of funds.

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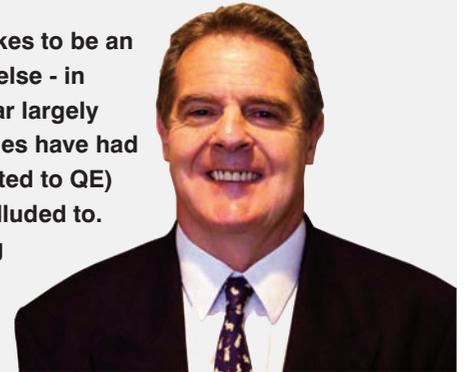


**James Gilfillan:** One of the simple observations about the local market is that the P/Es of the South African equity market appear to be close to the highest of all emerging markets in the world, and yet the earnings momentum, the growth of these companies and GDP is very low relative to these very high prices.

That leads me to my belief that the hedge fund community of South Africa, which happens to have very good hedging and shorting skills, might become more relevant in the next couple of years as the place to be, relative to the recent history where long-only was a better place to be.

My view is that investors should at least diversify their asset base towards alternative strategies relative to the long-biased strategies that have been very good for the last five years.

**Andy Pfaff:** My interest is exclusively in commodities. In a certain way, everyone likes to be an expert in at least one thing. I don't think there are any experts here – or anywhere else - in quantitative easing, but if you allow me to speculate a bit, I would submit that so far largely equities have benefited from quantitative easing, commodities haven't. Commodities have had the bulk of the selloff – particularly agriculture (not related to QE) and metals (related to QE) have had big selloffs - and that might be part of the sector rotation which James alluded to. Equities might be reasonably fully priced and commodities might be an interesting place to be going forward.



**Andre Steyn** Do you guys invest in any commodity equities or is it just direct commodities?

**Andy Pfaff** We only invest in direct commodities and have no equity exposure at all.

**Andre Steyn:** So 2014, I fully agree with James, South African P/Es are nudging around 20. Thankfully, there is quite a bit of dispersion in that, so I think for a long/short manager that will still create some opportunity.



At Steyn Capital, we have for the last year or so been shrinking our net exposure and expanding our gross exposure. Historically, we have been able to generate quite significant alpha, both in the long side and the short side. In fact, since inception we have generated 22% annualized alpha in the long book and 17% alpha in the short book. So, the idea is at the moment to verge closer to a market neutral exposure.

We also manage an Africa fund, and I am quite a bit more constructive there. Our African portfolio trades at about six times earnings, which is very cheap given the quality of the businesses in the portfolio. I think going forward we will most likely see quite a bit of a re-rating towards a higher valuation, given continuing business and investor interest.

**Ian Hamilton**

Andre, one of the things that always worries me when I am working more on the international side is the availability of quality investments in Africa. How do you see the developments there over the next couple of years?

**Andre Steyn:** In Africa, we have about 1,200 listed stocks currently, so the universe we are looking at is roughly three times the size of South Africa. But, the market capitalization is a lot smaller. It still lends itself to a number of opportunities. In terms of market inefficiencies, it's a nice place to be. One of our current trades is in a rights offering, where we are buying the rights including the premium, at 1.50 and selling the shares at over 2. There are several idiosyncratic opportunities like this where we are able to participate, given our modest fund size.



**Matthias Knab**

You said that with your African funds you invest in high quality African companies. How do you define a high quality African company? What are some of the parameters you use when you search for, or simply want to describe, these type of companies?

**Andre Steyn:** We start out with a quantitative screening process. However, the key difference is that we don't purchase third party data, but compile the data from source financial statements using three of our own analysts. All of them are highly qualified, and in fact, quite senior. They source financial statements, make accounting adjustments to glean the true economic earnings, and then focus on companies with a high return on invested capital. Our work concentrates on trying to see if this return on capital is sustainable.



We look for barriers to entry or other reasons why these returns will stay high. To give you some examples, we are invested in a few tobacco companies - some of them are monopoly businesses. Other examples would be companies involved with container ports, pharmaceutical businesses, and a couple of other consumer goods companies - all of these are semi-monopoly businesses in that they sell a product only they are allowed to manufacture.

**Matthias Knab**

By geography, where are you active?

**Andre Steyn**

The majority to the portfolio right now is in Nigeria, Egypt, and Zimbabwe. We tend to gyrate towards where the markets are cheap in absolute terms, and given the recent developments it's easy to see why we have big exposures to Egypt and Zimbabwe.

**Claire Rentzke:** I agree with the view that South African equity overall is definitely looking top heavy, and Africa overall has far more potential. Obviously, the continent is coming off a low base and still has the ability to grow GDP. Most companies in those countries have a growing consumer base and are still able to deliver quality earnings, which we are not seeing so much in the SA markets. So we are far more optimistic about what Africa is likely to do in 2014 relative to SA.

The one thing we are particularly concerned about in South Africa specifically, is even with the



equity markets looking fairly expensive, where do you diversify away from? We have the potential for tapering – of course, no one is going to have a clue exactly when that happens – and the bond market looks susceptible as well. So investors will very likely be using different alternative strategies, and maybe commodities will be one of those strategies.



**Ian Hamilton:** I always view hedge funds as insurance when markets have topped. Maybe this coming year is going to be the time where local institutions really need to be protected. They all have a significant equity exposure, and if we go back to the correction in 2008, the equity market fell dramatically but hedge funds, while not having a strong performance either, didn't cause such a big, negative drawdown at all. We must stress that the hedge fund market here in South Africa is mostly institutional money, pension funds, life insurance companies, etc. So being diversified through hedge funds is a good form of insurance for institutional investors.

**Claire Rentzke:** The problem is that many of the institutions tend to be behind the curve and reactive. So, in a rampant bull market, they are looking at hedge fund exposure and saying, well, it's not giving me what my long exposure is giving me, there must be something wrong with that. This really comes down to institutions needing to understand that many hedge funds strategies particularly within the equity space, aim to provide protection in down markets. So, they will often not be able to offer 100% to the upside. There are hedge funds that can outperform even a rampant market but then downside protection may not be their focus. You have to understand the strategy.



#### Ian Hamilton

I think one of the issues that we still have with institutions, is the lack of a regulated structure here in South Africa. Every year I keep saying it will take another four years before we get regulated structures for hedge funds and alternative investments in South Africa. I am still of the same opinion this year, even though there has been a lot of advancement over the past year in forming a framework. We now have tax clarity. It will be very much a mutual fund taxation situation, in the sense that you will be taxed in the hands of the investor on capital gains after three years. So that is all very favorable, but the momentum for all of this has slowed again.

Furthermore, hedge funds will fall under the Collective Investment Schemes Control Act, which they are talking about rewriting next year, and the original one took a over four years to write. So if you are going to conclude from that, I used to say three years and now I am saying four years.

But nevertheless, the market is very well self-regulated. Foreign investors have been very impressed by the way we operate in South Africa. A lot more funds managed by best-in-breed South African hedge fund managers are now available to international investors through international jurisdictions - Cayman, Malta, Mauritius, etc. Foreigners can buy exposure to Africa and South Africa though those regulated environments. They are not shying off from that perspective.



**James Gilfillan:** I just wanted to reference a recent article produced by the Harvard and Yale Endowments. They have produced annual reports on their endowments - Yale's \$30bn endowment has been including alternative investment strategies for over 20 years now.

These endowments are facing a major challenge. On the one hand, they have pretty high short-term needs, and at the same time, another part of their money follows on an open-ended long-term endowment horizon which needs to be taken care of. So their investment strategy has to consider an open-ended long-term growth, as well as short-term needs, which are pretty

intense. The question is, how do they deploy their capital?

The report was very informative. I would like to poise a question: if you look at the Yale endowment strategy, what do you think is the percentage of their assets is dedicated to long equity exposure in both developed markets and emerging markets? What do you think the percentage might be?

Ian Hamilton 5 or 10%.

**James Gilfillan:** 12% of Yale's total assets is in long equity. Now, if we look at a typical pension fund in this or most countries in the world, equities will certainly count for 50-60%, and alternatives typically up to 10%, as we have it in South Africa. Different countries have different approaches to this, but the reality is that 21% of the capital of the Yale Endowment is around hedge funds, and private equity represents 30%.

Everyone knows that we have a lot of good skills in the long/short area. Alternative investments are a skill-based approach to investing. However, because the long-only space has done so well from a return perspective, it hasn't always been useful to have anything other than long-biased strategies, because the real return over ten years has been 14%. But, the nominal returns have been 20% per annum in this country. This is very unusual: over 100 years the real returns in equities are close to 5-6 %.

That means we had such a good nominal return in this country for pension funds that you wouldn't need to approach any alternative strategies per se. Actually, it would have detracted from the outcomes of your pension fund.

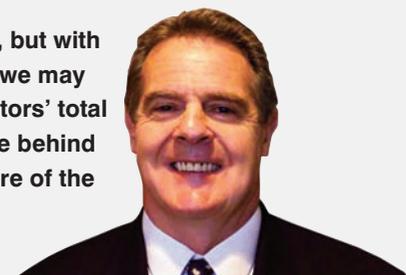
But I would challenge that things will progress as they have for another five years. More people should study the Yale model. They also had to work through periods with very difficult nominal and real returns. Maybe the allocation models should be reassessed based on the fact that there are skill sets out there that can produce real returns that are not conventional, and that going forward you may not necessarily have to be 60% in equity only. The details of the Yale endowment model are not necessarily well-known and probably under represented in the local context.



**Andre Steyn:** I'd like to share an observation. There has been quite a bit of a discussion about the relatively expensive nature of the South African stock market, and indeed we are now getting approached by managers who were historically allocating primarily to long only managers. These investors are now increasingly looking at hedge funds to mitigate against a potential market correction, so I think that a reallocation is indeed starting locally.



**Andy Pfaff:** Both James and Claire referred to the institutions being behind the curve, but with reference to 2008, do you think that hedge funds did well enough? Personally I think we may have done enough to defend our existence, but didn't provide much help to our investors' total portfolios. Do you think that, bearing 2008 in mind, larger investors will continue to be behind the curve because of skepticism about hedge funds track record, or is it just the nature of the animal they will always be behind the curve?



## Who we are and what we do?

The IDS Group is an independent fund administration group which was founded in 2002. We specialize in providing back office services to alternative asset managers including hedge funds, funds of hedge funds, private equity and property funds. We are the largest fund administrator in Africa with assets under administration of approximately \$6bn and international offices in London, Malta and Mauritius. Our clients trade all investment strategies and we pride ourselves on providing a tailored solution to meet their differing requirements.

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**Claire Rentzke:** This is probably an overgeneralization, but institutions tend to move slowly. I've had experience of a three-year decision cycle for a pension fund. So the nature of the beast is that decisions often take a very long time to be made, while markets move quickly. So, your long-term goals remain an important aspect. Having said that, there are some of the bigger funds with very sophisticated Boards of Trustees who are able to take quick decisions and are able to switch and adapt.



I think in 2008, many hedge funds did what they were supposed to do and they helped protect on the downside. But, the dip (and the rebound) was so quick that the long-only managers overtook in terms of returns again within a 12-month period. So, many investors never really got to see or experience the full benefit of that downside protection, because the recovery was so sharp and quick, that it didn't really sell pension funds on why they should have a big hedge fund exposure.

If we would have had a bit more volatility or the downturn had been a bit longer, I think this would have solved the case of hedge funds a lot quicker. But apart from that, I also think that the negative press is a big impact for pension funds. They read the mass media and all you ever read about hedge funds in the mass media is about the blowups and fraud and problems.

**Matthias Knab** Are you referring to global events or in South Africa?

**Claire Rentzke** Globally, because in South Africa there have been very, very few issues.

**Ian Hamilton:** I can comment on the local press as well. The local press is extremely lazy, as all they do is reprint any international scandal, which actually has no relationship or reference to the local industry. Madoff was obviously very big news, but every South African hedge fund has already got a third-party administrator since 2009. We have had no Ponzi schemes that were actually involved in the hedge fund world. We have had one Ponzi scheme recently, it was not a hedge fund, but a pure Ponzi scheme marketed to high net worth individuals who should have known better.



**Ian Hamilton** I have a question for Claire: is your Africa fund hedged or is it more a long only Africa fund?

**Claire Rentzke** It's a long only African fund of funds, it's not a hedge fund because you don't have the instruments available to be able to run a typical hedge fund type strategy in Africa. You don't have the necessary derivative markets, for example. So at this stage our fund is long-only Africa.

**Andre Steyn:** While I agree that there is no ability to short in most African markets, excluding South Africa, we still try to run an absolute mandate.



For example, there is large and well-known fund manager in Boston who runs a long only fund using a "margin of safety" philosophy. He doesn't short, but nobody would say he doesn't run a hedge fund, given that he only suffered a fraction of the market's drawdown in 2008. There are clearly ways other than just shorting stocks to mitigate market risk.

We hold some cash, and on average we have traded with about 12% cash in the portfolio. We have on average approximately 10% of the portfolio in merger or other

arbitrage situations. We can also invest in fixed income on an opportunistic basis, and we also invest in some fairly low beta stocks.

The result of that is that we have on average traded with about 60% exposure to the market, and that kind of strategy mix has worked well for us in periods where the market was weak. We have significantly outperformed during weak periods. We don't use gearing. What I have discovered on leverage is that it just makes your job a lot harder.

**James Gilfillan:** There are also arguments we could bring up to counter the view that you need hedge funds. Let's look at the experiment of printing money – it's not really clear how that will pan out. The hedge fund world typically loves to use the antidote of reversion to mean, and offers projections of all kinds of negative consequences that could happen to the world. And while the printing of money may lead to inflation, and also an inordinate growth in equity values - the hedge fund world could actually suffer the consequence that being long might, in fact, be a better strategy to protect your capital long-term because of the long-term effects of the money printing. That's one scenario.

If inflation actually kicks in, investors may end up using even more equities as a way of defending themselves against the inflationary environment... So, quantitative easing keeps pushing funds high and investors may end up borrowing more for a greater participation, and that could protect them. That's another scenario.

Having said that, I find the hedge fund space a unique skill-based world where some very skilled fund managers actually do better than the markets. That means you don't lose something by investing in the hedge fund, but you actually mitigate risk and improve return over the long term. My thinking is that this may be a more appropriate view about hedge funds. However, the general perception seems to be that investors have to give up a huge amount of return when they invest into hedge funds. At the same time, investors should also be concerned about lowering their risk.

So you get something (stable returns) and you lose something (risk) - that's a world investors should want to operate in. Hedge funds offer you protective mechanisms, but only for those who are not too greedy. With the skill-based world of hedge funds investors can do much more than the market over the long term, and also benefit from the risk mitigation that is inherent in many strategies. While hedge funds have certainly grown over the years, there is still a lot of room for more participation, and foremost for a change of perception. So again, my point here is that even in a bullish scenario for equities, there is still a place for hedge fund strategies.



**Ian Hamilton:** Looking back for the last couple of years you see that many hedge fund managers have transferred their skills into other styles of investing. A number of managers have turned into investment houses, utilizing their skills from the hedge fund side like fundamental analysis, and stock picking, and have launched long only products in addition to their hedge fund products.

In South Africa you can clearly see this development of what I would call the next generation of finance houses or big investment firms. Some of them are growing very rapidly. From a business strategy, those firms are well covered. In the case of a downturn, they have still their hedge funds, and when equities have strong runs, they also participate on that side.



**Matthias Knab**

In Africa, South Africa is really the only country to have developed a hedge fund industry. Tell us more about the diversity of strategies that are being run here?

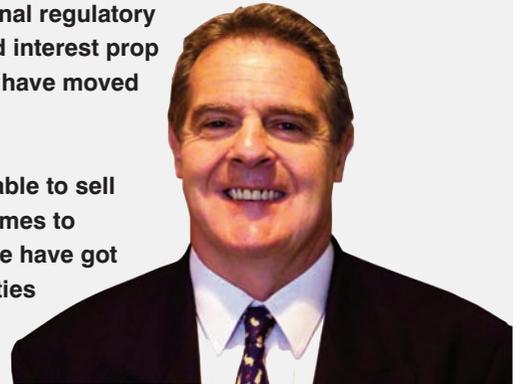
**Claire Rentzke**

I think that long/short equity is still predominant in our market, but the level of sophistication within fixed income is increasing too. As more instruments become available, more strategies can be applied within the fixed income market, so that space has grown. The other chunk would then be the market neutral funds, but a large portion of that is also sort of bordering on long/short strategies.

**Andy Pfaff:** I think for some reason I have always been regarded as being on the esoteric fringe. Managing commodities in South Africa is regarded as esoteric by South African investors. South Africa is a very equity-centric environment. As Claire said, the bulk of the strategies are equity long/short and equity market neutral, and I think most of the managers have come from the long-only side.

In contrast, the bulk of the fixed interest managers, which Claire also referred to have come from the bank prop desks, which have been decimated as a result of the international regulatory environment. There are some very skilled managers in the South African fixed interest prop trading environment, maybe more skilled than the long-only managers which have moved to hedge funds.

There is not really that much outside of that. I think fund of funds have been able to sell some of those concepts to the end user - to the investor. However, when it comes to commodities, generally South Africans will say, "we have got commodities, we have got Anglo American and Billiton". But in reality, they are confusing resource equities with commodities, so for me this is an ongoing educational effort.



**Matthias Knab**

What do you typically tell those investors about the benefits of your offerings?

**Andy Pfaff**

We offer a full product spectrum, from beta products to active long-only funds and also hedge funds. The investment strategy, which is a reasonably conventional CTA strategy, will be familiar to the international investor. Our funds only trades listed commodity instruments, we do not trade into Africa as there are no commodity derivative exchanges outside South Africa yet. Nonetheless, South Africa is a major regional producer of commodities, including agriculture, coal and metals. Many of these commodities are produced & consumed locally, reducing their price correlation with international commodities and improving their diversification benefits.

**Matthias Knab**

So it is a CTA with long/short strategies.

**Andy Pfaff**

Yes. The hedge funds have gearing and long & short positions. The positions are all independent directional positions, not pair trades or mean reversion strategies.



**Ian Hamilton:** Our regulations for pension funds as to what they can invest in, has been revised over the last few years. Previously, they were extremely restricted on private equity was capped at 2.5% for large institutions. That combination is now up to 10%, so they can be up to 10% in hedge funds. Claire, I think our pensions can also invest 5% into Africa, right?

**Claire Rentzke**

Correct, you can have an additional 5% over and above your 25% international allocations. So in total South African pensions can have up to 30% in international equities.

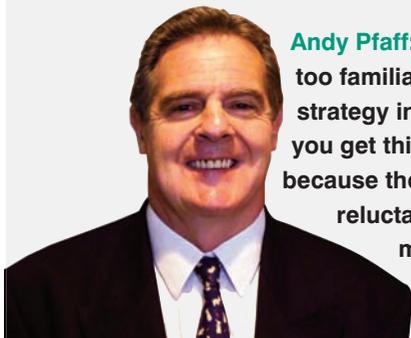
**Ian Hamilton**

Right, and we also have commodities recognized as an investment class. So there is a lot of catch up, and I don't know if it's really so much the pension funds who have to do the work, or the investment advisors to the pension funds. That is the party we have need to convince, and in some cases also through the actuaries as well.

**James Gilfillan:** But just looking at as many strategies as you can, may also miss the point. Here is another aspect when it comes to the selection of strategies and portfolio building. Some investors just say “please give me a basket of really well diversified, different strategies.” They may not want to analyze the value add of each individual strategy, but look at the portfolio level. In my view, if a manager is not adding alpha in any particular area, your diversification benefit won't matter that much. What is much more relevant is if you can you add alpha to whatever strategy you follow. Sometimes people lay out a whole spectrum of strategies that represent building blocks, each in a different color, trying to prove that there is a value add because of the diversification, but actually there is no real value add because the skill sets aren't adding any value when there is no alpha.

For example, I have invested in a very sophisticated currency strategy run by highly skilled practitioners in London, and they have added zero alpha as far as I can tell. You may feel good about having a diversified building block, but they are not adding any value in terms of a net effect on the overall alpha of your portfolio.

You may sometimes hear statements about South Africa being very equity-centric or that we don't have enough diversification, but I believe the much more relevant aspect of our industry here is that thanks to their skills, our managers can add a lot of value, and that's more useful to both the international and local investor. We have fantastic skills in the equity space and in fixed income, but so far, probably because of liquidity restrictions, we haven't extended those skills into many other spaces. This may happen with more liquidity, but in my view the investors' focus should be around the alpha being added, no matter which country or market he is looking at.



**Andy Pfaff:** James, I think a lot of that includes the business case feedback loop that we are all too familiar with. A new manager with a new strategy spends relatively more time explaining his strategy in order to raise assets, and less time managing his fund, and so the returns suffer, and you get this whole cycle, which we all know very well. It's not purely they are not getting assets because they are not producing the alpha, it's because many investors are either skeptical or reluctant to break from the herd and invest in a new strategy. So investors end up with more manager diversification than strategy diversification. It's part of a complex feedback loop.

**Andre Steyn**

Andy, given South Africa's importance in mining resources, does that translate into an edge for you guys managing a commodities fund from South Africa?

**Andy Pfaff**

True, for the South African equity investor, South African mines constitute a large weighting, but for a diversified commodities fund they are not as heavily weighted. My investment universe includes the agriculture, energy and metal sectors. Mining therefore forms a part of our investment universe, and we do have access to some very experienced and competent analysts and managers.

Nonetheless if you go on a marketing trip to London, managing a commodity fund from South Africa does provide a degree of differentiation and facilitates getting an audience with investors – there's definitely more interest there than the South African domestic investors seem to display. So it's strangely more beneficial for distribution than analysis or returns.

**Matthias Knab**

We already talked a bit about the availability of South African offshore funds for international investors. In your experience, who are these investors in those funds, and what trends do you see from the international investor side in respect to these products?

**Ian Hamilton:** What restricts foreign investments though into South African hedge funds is the relatively small size of our funds. Very few local hedge funds are over one billion rand or \$100m. Most of them are sitting between 250 and maybe 500m rands, that's \$25m to \$50m. The overseas investor wants to invest \$5 to \$10m, but doesn't want to be the major investor in the fund or own a disproportionate share of the fund.

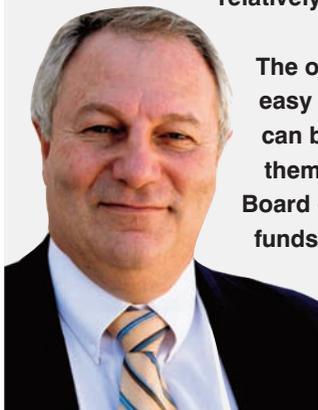
However, the situation is starting to improve, there are more and more opportunities developed with some of the South African fund managers who are now managing mirror funds overseas, and some of them are reaching the \$100m level. At that level it has a snowball effect, when they reach that size they are starting to attract more investors, because for investors there is comfort in large groups.



**Matthias Knab**

Who are the investors in those offshore products?

**Ian Hamilton:** So far mostly family offices have been investing in South African offshore funds, but there are some of the institutions coming in as well. The big issue SA managers face is finding access to the American market. There are so many obstacles to be able to accept American money into offshore funds. You need a US onshore structure such as a Delaware partnership which in turn invests in the off-shore structure. It's extremely expensive and the fund manager has got to spend quite a bit of money. At the moment the hedge fund investment houses in South Africa are relatively small and also restricted by exchange control.



The other thing is the costs to operate in South Africa have been very cheap, and it has been very easy to set up local funds in the current environment, which is unregulated. Our fund structures can be set up very quickly and easily, and you don't have to wait ages for regulators to approve them. Heaven forbid as to when we do have a regulated structure, our current Financial Services Board can't even manage the insurance and unit trust industry. I don't know how we are going to get funds approved. If South African fund managers want to run offshore structures, they need to understand that there will be certain added cost and difficulties in setting up funds. When you are setting up a small fund, it's usually a struggle to find a custodian or a prime broker. Those are all issues. In fact, even the smaller European fund managers having these kinds of problems.

**Andre Steyn:** Still, it's very clear that there is significant interest for Africa. Some of the very large asset consultants have all been over here in South Africa and across Africa looking at some of the local managers, and that's driven by their clients who are mainly European single and multifamily offices. Our African assets tripled, primarily driven by the European family offices.



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**Matthias Knab**

There is one thing to be said about South African hedge funds. Yesterday I spent all day at the Peregrine Hedge Fund Day, where the prime broker Peregrine has been presenting South African hedge funds to local and some international investors. On such a day you can meet eight or ten managers, and they all have five year plus track records annualizing net 15-20% or more. So I agree, people come and take a look, and for the right reasons.

**Ian Hamilton**

Africa in general does have attractive investment products for the international investor community. We are achieving excellent returns far exceeding the international hedge fund average return. But we still need to have the products in structures accessible for foreign investors.

**Matthias Knab**

Let's look at the risk side of the equation. Andre, you are investing in places like Egypt and Nigeria, some people shy away from those countries considering the political instability. You have been studying and investing in these markets for years, what are the risks that you monitor when you invest in Africa?

**Andre Steyn:** We invest in 20 different African markets. Right off the bat what I can say is that we are not political experts in 20 different markets, that would be hubris. What we do monitor very closely is company specific risks. We spend the majority of our time trying to determine sustainability of returns, evaluating corporate governance, looking at managements' track records. Over long periods of time, we found that by and large the politics don't matter that much. To the contrary, political events often lead to knee jerk reactions, and if we are able to allocate capital as a response to some of the market's knee jerk reactions, it's actually beneficial to our returns.



For example, we more than doubled our exposure to Zimbabwe when the stock market declined 22% in the month after the election. The election result essentially meant a continuation of the status quo, and our increased allocation at a substantially lower price has helped our return since then.

**Matthias Knab**

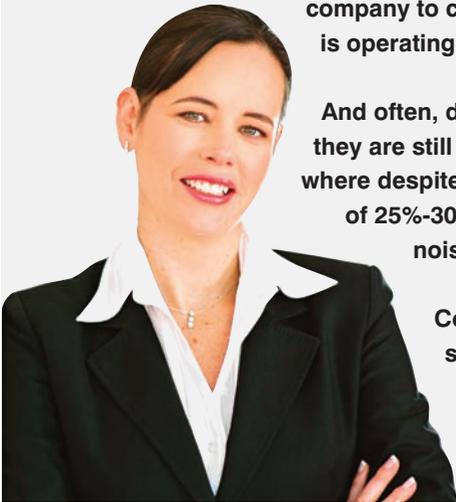
How do you recognize corporate governance?

**Andre Steyn:** For us, it all starts with financial statements. I started in this industry as a dedicated short seller focusing on companies who were lying about the quality of the earnings. If you can't trust what the CFO's telling you in his audited accounts, then you certainly can't trust what he tells you about the company's prospects in an hour long meeting. We also spend a lot of time looking at the management's history or their "paper trail," making sure that they haven't hurt minority shareholders or aren't otherwise affiliated with unsavory characters. What your Mom told you about hanging out with the wrong crowd also holds true for corporate managers.

And even though Africa isn't completely the Wild West, we have identified at least half a dozen companies which we think are outright frauds. So obviously what that means in a long only fund is that we only get to avoid them and not short them, but clearly that still adds to returns.



**Claire Rentzke:** I think there is a very clear distinction between perceived risk and actual investment risk. I believe a lot of the noise that we get in terms of political risk relates to a perception of risk that investors have. Those things are usually portrayed in the media, whereas the real investment risk is usually about the ability of the company to continue doing business and to continue to grow its earnings in the country that it is operating.



And often, despite what's going on in the streets, people still need goods and services, and they are still paying for them, and the companies are still profiting. Case in point is Egypt where despite the political turmoil some companies were still growing their earnings in excess of 25%-30% throughout the crisis. Investing is about being able to look through a lot of the noise and to actually analyze the investment case and the quality of the companies.

Corporate governance in Africa is increasing, and the level of their accounting standards is improving as well. For many firms in a lot of the countries now throughout the continents, so maybe up to 80% of the total number of companies, you are getting quarterly financial statements, or at least on a six monthly basis.

**Andy Pfaff**

I am going to ask a question to Devon because your company is actually more focused on the high net worth individual. What is the perception of the hedge funds, and how easy is it to sell hedge funds to the high net worth individual, given that at least in South Africa those investors have traditionally invested on the long only side?

**Devon Olander**

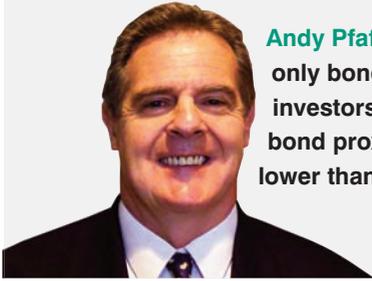
For our clients we aim to achieve on average 12% to 15% compounded per annum. We achieve this through a fund of funds structure, so each year we have to blend the underlying portfolios to give them those returns, and they are quite happy with when we are able to achieve them. So for our local investors, we are setting those objectives, and as long as we are achieving them, the clients are quite happy how we go about doing it. Obviously they do get a bit spooked when the markets crash, but as long as we can show that we can protect capital, we are proving that we do have skills in different markets.

On the offshore side, we are finding that our high net worth clients are chasing the yield. One of our funds that operates within Africa is more focused on the market financing area. Specifically, government payroll deduction. They are happy in cash terms; but the way how we have structured our portfolio we are able to yield 8.5%. They are quite happy with that sort of return. A big portion of the portfolio that they have with us can be in that fund. They also diversify it to equities and bonds, depending on what products they choose. As long as we manage the underlying risk and deliver returns to our clients, they are quite happy.

**James Gilfillan:** I think that generally, as long as the world is constructive to long equities, it's a very difficult backdrop to introduce a building block of absolute returns, probably even more so in the global context. At a time when hedge funds return maybe 7% but your long only box is yielding 20%, hedge funds will probably struggle a bit when it comes to people's asset allocation. Absolute return and hedge fund products become more relevant when the environment becomes more tricky and the long only space starts struggling. Then hedge funds will be seen as adding value in one way or one for one another.

Investing for us is really a skill search. Both long and short investing have their merits. We focus on educating our clients, both on the private and the institutional side, about the different strategy building blocks and how they would behave in different environments.





**Andy Pfaff:** James, rather than positioning hedge fund of funds as equity proxies, given that long only bonds have had a great run for 20 years now but things may reverse quickly there and investors may be allocating away from bonds, isn't this now a good time to present yourself as bond proxies rather than equity proxies? In other words, presenting yourself as a yield generator lower than equity capital returns but with much less volatility?

**James Gilfillan:** For us, funds of hedge funds are a direct hedge. I mean, cash is giving a negative real yield, and bonds are doing the same. So the reality is that investors' choices are in fact becoming more limited. This is a time where hedge funds become more relevant because our toolbox allows you to utilize the anomalies that happen globally in the markets. You are right, normally investors would allocate a large portion to bonds, because we had a global bond bull market for 30 years as interest rates have gone to zero. Now, investors are facing a lot of risk when interest rates will go up again, and the larger the portfolios, the bigger the challenge. A market like Germany, where a lot of investors are mostly in bonds and a little bit of equity, would be great to approach. Probably now is a good time to show them options and ideas like long equity and alternative strategies like credit arbitrage, private equity, whatever, as a proxy for their bonds, and to lower their risk.



I believe the hedge fund space has a lot of opportunity at the moment, if they can sell it well, because the opportunity is pretty good as a complement to equities.

**Ian Hamilton**

I am seeing a lot of forecasters talking about a 10%-15% correction of equity markets in the next three to four months. Is that a view shared here?



**Andre Steyn:** We don't try to time markets, but we do price them to a certain extent. I think it's impossible to say whether you are at a market high or a market low, but you can kind of look at the scenery and say, well, maybe we are in the neighborhood of a high or of a bottom.

Certainly we are closer to a high in South Africa, so I think some hesitation is called for. It's true that you can hear a lot of people talking about all these risks, but currently the real career risk for equity managers is under-performing. That is the reason why although you hear a lot of conservative dialogue, you don't see a lot of very conservative portfolios. I would like to hear if the fund of funds managers here agree with my assertion.

**Claire Rentzke:** At the moment, there is not lot of diversification across different managers. But you are right, the risk is to underperform relative to the other managers. In addition, the stocks that have performed and run really hard in the market have become so large in the index that also the index is doing well relative to the active managers. As a result, we have moved to the active-passive debate again which happens every time the index has big runs. That can be really frustrating, because if we're having any kind of correction in the market, passive is the last place that you want to be. You want to be able to make use of all the tools in your toolbox to try and protect capital, and most people will then wish their managers were doing that for you.



**Devon Olander**

We have observed that there is quite a bit of herding happening towards the same sort of stock. As Claire pointed, that is also part of trying to keep up relative to what the markets doing, no one really wants to underperform at the moment. When markets have had such prolonged runs, this is something we need to aware of.

**Ian Hamilton:** The big dilemma is the question what are the viable alternatives, where can investors put their money to work? There are challenges in the fixed interest market, a potential property bubble may be forming, and commodities typically ride on the back of recovery of economies. So I believe we are all trying to chase the devil in the deep blue sea, and that is probably why nobody is actually coming out with any strong answer.

The other thing I see happening on a global basis is that investors, particularly institutions who invest more and more into hedge funds, are all looking at the fee structures. Since 2008 there is a huge squeeze on funds, or the whole discussion about “what's the value-add from a fund of funds?” As a consequence there has been a bit of reinvention or evolution on that particular side.



But probably the biggest challenge hedge funds face going forward is dealing with all the regulations, whether it's in South Africa, or Europe AIFMD that also affects non-European managers if they want to market to Europe. All those regulations are in the end adding to the cost structures, and the costs are of course being pushed onto the fees by the managers.

My take is that the next couple of years will be tough, hedge funds are not the glory boy industry any more. As a manager, you will have to worry about what your bottom line looks like as a company, and you are always going to worry how to get your performance. And up to now the hedge fund managers haven't had to worry about that -- and I am talking about South Africa and in Europe as well.

**Claire Rentzke:** The South African treasury is proposing a big reform to the pension industry, and one of the big areas under the spotlight is fees, not only just in the hedge fund space, but in the long-only space as well. But to a certain degree, fees are really a soft spot to attack, because when you look at the overall costs within retirement funds, investment management fees are probably the smallest fraction of what your total cost base. Fees just have become an easy target, because it's something that the treasury can focus on quite easily because they are visible and high profile. In addition, at the moment many people tend to see the financial world industry as the cause of all the world's problems, everyone hits the bankers, so fees are easy to target. But if at the end of the day if your manager is delivering you performance in excess of what the market is doing, delivering that performance should get rewarded.



**Devon Olander**

All the fingers are all pointed at us because of the management fees, performance fees etc. But no one is really looking at the platform fees that these funds are listed on as well as the IFA and the upfront commissions that are being taken. No one really wants to investigate that space but people rather point fingers at hedge fund managers who are achieving the returns they set out to achieve for their investors. But I just found that somebody should actually looking at what the platforms are doing these days and what type of fees are embedded in those.

**Ian Hamilton**

We must not confuse marketing or distribution platforms with hosting platforms which are option for start-up and smaller funds. We are talking about marketing and capital-raising, all which cost money. But I agree, some of these marketing platforms charge excessive fees. The hosting platforms that I am talking about are a low cost entry into the international market for SA Hedge Fund Managers.

Let me also go back to Claire's comment about the treasury's suggested pension reforms on fees.

I wondered if you had more comments about this?

**James Gilfillan**

One idea is that you just do what the CFA rules say that allows managers to maximize the maximum charge you can have. A lot of managers make 4%-5% returns and they could just sell up to 2.5% as a cap. Most operate more between 0.5% and 1%, and then very exceptional funds will get 2.5% and may get 4%, 5%, if they have very good returns. That's the tee-off, a very good hedge fund is really 2% to 5% in fees, no?

The other argument is that you have never hear people complain about paying extreme amounts of money paid to a professional athlete for wearing a branded band or logo. The extreme amount of money paid for example to the top 20 golfers or tennis players, relative to the actual value-add, is beyond comprehension. You can't justify those amounts of money spent on any basis, similar to establishing the cost of paintings, when in the end, you are looking at just some paint on a canvas. What I am trying to say is that this whole cost structure discussion is very tricky.

On the one side you have regulators trying to cap what could be a potential misuse and exploitation, and then on the other hand you have skill-sets, which are delivering exceptional outcomes. It's a battle that's always going to go back and forth between managers, investors and regulators about what is reasonable and what's not. I would say that it's always going to be debate one way or the other, and in both ways it can end up.

**Andre Steyn**

Our funds are structured a little bit differently. We don't charge any management fees, we only have a performance fee with a high watermark. And obviously, if we perform well, we get remunerated well, and if we don't, then the client does get some benefit on the fee side.



**Andy Pfaff:** When we talk about fees, it is important to see them in their larger context. We get so stuck in comparing hedge fund fees with pension fund fees, instead of looking at the whole feeding chain of fees that add up when a manager professionally manages assets for a third party. We as managers are pushed into a corner where we now are defending our fees, but they need to be seen in context of the full feeding chain, which includes things like brokerage, execution, custody, administration, the platforms, distribution, and then the fund management.

**Ian Hamilton**

I agree with Andy that the whole food chain needs to be considered. For example, an advisor may put you into a product, get a huge upfront commission and then disappear, whereas the fund manager is the person who has to deal with the markets and potential losses in his portfolio. Meanwhile, the person who put the person into the wrong product never face these consequences.

We just alluded to a Ponzi scheme in this country - not one business introducer who earned commissions of up to 15% has been followed up and prosecuted by the authorities.

**James Gilfillan**

In this country, the hedge fund industry runs 80bn rand versus a 1.6tn rand savings industry. So, if you want to make a major impact on fees, you have to look at the banks and compare the fees also in relationship to the outcome.

Hedge funds are really a small little strip within the financial industry, and before we continue castigating that particular industry, we should rather look where the real money is, and what the majority of people are being charged, and for which results.

**Matthias Knab**

Let's look at new products, new services, or new ideas. Who has recently launched a new product or is working on one?

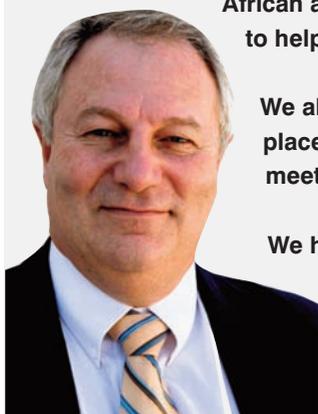
**Andre Steyn:** Our South African fund had been hard closed since 2010. However in May 2013 we reopened a large cap mirror of the existing fund. It is a mirror of all stocks trading more than 3m rand a day in the existing fund. We launched it with internal capital and will have over 200m rand by January.



**Andy Pfaff** My whole business and therefore all my products – beta, active long-only and hedge fund products - are new, facilitated largely by the recent change of pension fund regulations which approved a 10% allocation into long only commodities strategies.

As we mentioned before, the general hedge fund allocation was also increased, so generally regulatory changes have opened up more strategies and alternative asset classes both for long only and the hedge fund managers.

**Ian Hamilton:** I have been concentrating very much on providing opportunities for foreign investors to have access to African and Sub-Saharan funds. Most of this has been done through Malta, but also through Cayman, to help incubate a lot of the South African fund managers in the international environment.



We also have to pay a lot of attention to issues like AIFMD. IDS and Scotstone have got solutions in place, for example, we have set up both funds and the asset management companies in Europe to meet the AIFMD requirements.

We have an exciting next couple of years. While some people seem to have lost their orientation or are afraid of European regulations and AIFMD we have seen this coming and we have actually a lot prepared in advance to ensure that South African fund managers, if they want to obtain money from off-shore investors, can meet the various regulatory changes.

**Claire Rentzke** The new sector we went into was the Africa listed equity space excluding SA. The next product we are looking to launch will be within the African debts space throughout the continent excluding South Africa.

**Matthias Knab** Can you tell us more details about the Africa ex-SA debt market?

**Claire Rentzke:** One predominating force in all of the African countries issuing government bonds are the pension funds in those countries. Pension funds in countries like Nigeria, Ghana, Kenya, hold significant chunks of the government debt. More-and-more of the African countries now are listing debts outside of Africa in Europe. Recently, African governments have issued more and more Eurobonds. The corporate bond market is very small. Generally, you don't see a lot of corporate bonds in issuance, but even there you see that a market or a trend is starting to grow and to pick up.

When you invest into African bonds, you have the choice of going into the local currency or you can look at what the Eurobonds are doing. Our task as the fund of funds manager is to select managers in the various regions who are in best position to take advantage of opportunities in those areas.



**Ian Hamilton**

There have been a couple of announcements regarding the establishment of futures exchanges in Africa, including a commodities exchange in Nigeria. I think it's a given that in a couple of years' time the African markets will have more sophisticated markets we can invest in.

**Andy Pfaff:** Actually, the South African Futures Exchange (Safex) is one of the best functioning derivatives exchanges in the world. It has one of the highest turnovers in single stock equity futures, has some reasonably efficient index futures and an efficient margining process. It has a lot of flexibility and has brought a lot of what used to be OTC products on to exchange, they call them "can-do" products. So, it's a very efficient exchange.



There is actually an operation in Johannesburg set up by former exchange and banking executives who are exporting their skills into Africa, both from a technology and regulatory standpoint. There is a push and pull effect going on, and certainly over time you will see how the financial infrastructure will be filtering north as a result of that. These people are building the infrastructure, and with investors coming in from the other this will probably accelerate.

**Andre Steyn:** In Nigeria, I have seen a relaxation of some of the market pricing rules over the last year. Previously stocks were only allowed to fluctuate up to 5% a day, while the bands have now been widened to 10% which is helping price discovery and liquidity, and then generally across Africa we have seen information levels improve.



So again, in Nigeria we now see much more timely financial reporting. We have also seen some new listings coming to the market - a few new listings in Egypt, and companies in Nigeria came to the market for rights offerings.

**Andy Pfaff**

Andre, tell us more what happens if a stock reaches such a 10% limit. Does the stock then go to auction, or do they stop trade for the day? What happens?

**Andre Steyn**

As a stock strikes its 10% limit, it basically just can't move beyond that. So what you have to wait until the next trading day when the 10% limit resets. That threshold used to be 5%, so this is a big step in the right direction. There is however a further issue in Nigeria. The stock needs to trade 50,000 shares in order to change the price. So, if you have new information that dramatically alters the valuation of a stock, you need to see 50,000 shares trade at a 10% higher or lower level before the 10% limit price changes again. This has occasionally led to some gridlock.

**Andy Pfaff**

If it's still gridlocked, will those limits open or after three or five days? Because that is how circuit-breakers work in the commodity environment. There, after a certain number of days, the parameters will widen.

**Andre Steyn**

The parameters for Nigerian stocks don't get widened. Normally the situation resolves over a few days. We have not seen that many instances where stocks move 30% or 40% within a couple of days. But this is certainly an aspect the exchange has worked on and has improved, and is continuing to look at.



**Andre Steyn:** The liquidity in markets like Nigeria is up significantly. You see the same in Kenya and Zimbabwe. In Egypt the liquidity is still quite weak. We have seen a few global emerging market funds coming into some of the Nigerian stocks, especially some of the Nigerian consumer stocks, and pushing them up to do valuation levels where we won't be involved with them. We have also seen some of the local pension fund managers move out of some of their bond positions into stocks.

**Andre Steyn:** Absolutely. There are approximately 100 Africa-focused funds, many of them managed from outside Africa. Together with certain GEM funds and South Africa's own trillion rand Public Investment Corporation, I expect that foreigners represent the majority of trading on the continent's bourses.

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