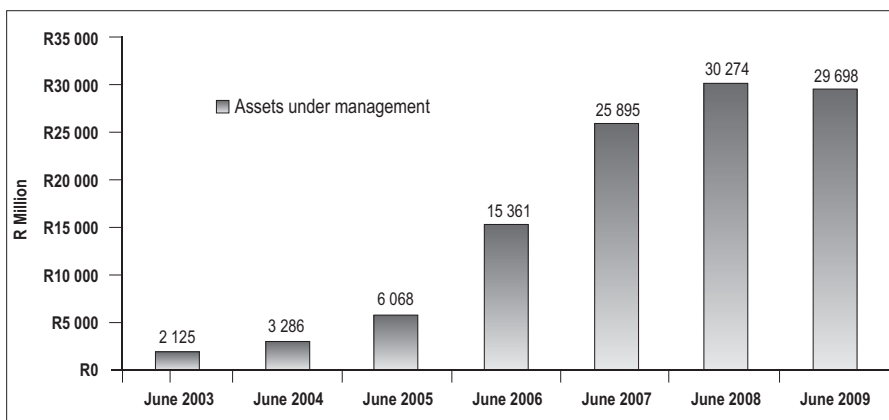


Hedging strategies in South Africa

By Carla de Waal, Portfolio Manager, Novare Investments

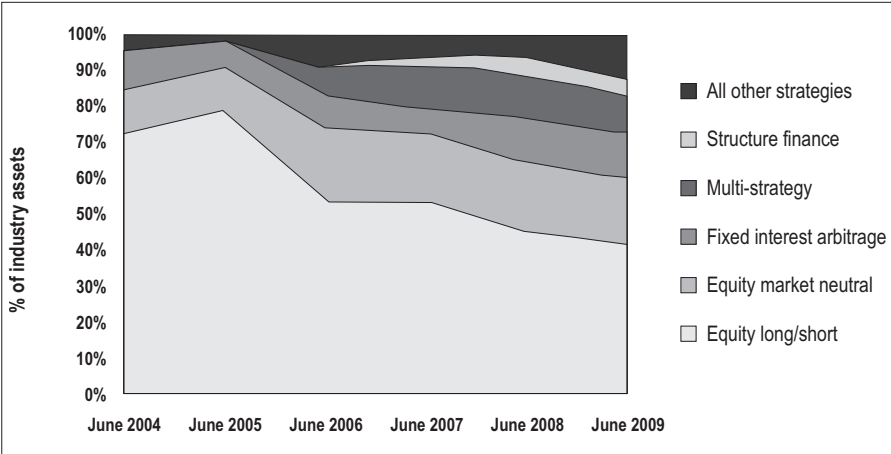
While the first hedge funds in South Africa were launched in the mid 1990's, the number of hedge funds only started to pick up in the early 2000's. The period from 2005 to 2007 witnessed exponential growth in industry assets under management – a period which coincided with the latter part of a strong bull market in local equities. The performance by local funds held up well amidst the global financial crisis in 2008, with most hedge funds preserving capital and suffering far smaller drawdowns than traditional equities. However, assets under management reached a plateau during this period and we currently estimate the total size of the industry at around R30bn.

Graph 1: Assets under management in SA hedge funds



Historically, the majority of local hedge funds invested in equity-based strategies, like equity long/short or equity market neutral. In recent years other strategies, most notably fixed income arbitrage, gained in popularity, bringing more diverse return drivers to the opportunity set for investors to choose from. Despite this, the number of hedge strategies on offer locally is still more limited (and more vanilla) than what you'll find offshore. In terms of financial instruments our local market does not yet offer investors as wide a variety as is available offshore, although there is continuous innovation, for example, commodity ETFs. Opportunities in certain hedge strategies that are based on these less conventional financial instruments, for example, convertible arbitrage, might thus be too limited to populate a whole fund given the limited number of convertible bonds in the local market. These ad hoc investment opportunities are most often pursued in a multi-strategy set-up and, as a separate hedge fund strategy, multi-strategy has also gained in popularity over recent years.

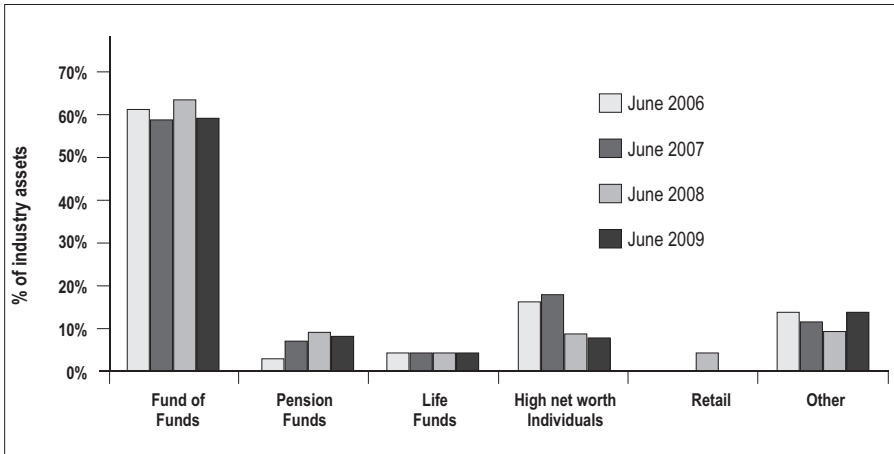
Graph 2: Evolution in SA hedge strategies



A benefit of having more strategies to choose from is that product suppliers such as funds of funds now have more scope to offer strategy-specific funds of funds. This can significantly support the strategic and tactical asset allocation process of the end investor, given the wider variety of strategies and risk-profiled solutions to optimise the portfolio blend. For example, exposure to equity long/short funds may be used to reduce the end investor portfolio’s overall market risk, with the size of the allocation dependent on the existing exposure to equities.

Funds of hedge funds form the largest allocator of assets to local hedge funds and this is also the preferred route for end investors to gain access to the local hedge fund industry.

Graph 3: Investor profile



Besides the additional diversification gained for a similar investment amount, potential lower initial minimum investment amounts and access to hedge funds with limited capacity, funds of funds also offer additional value-adding services, including another level of monitoring and oversight. Hedge funds have always been accused of being opaque, but locally funds of funds have been instrumental in changing this for the better. As a result the South African hedge fund industry has over the past few years been characterised by a high level of self-regulation in an environment lacking formal legislation at product level.

The monitoring process starts even before a fund of funds invests in an underlying fund, with a thorough due diligence process aimed at scrutinising all aspects of the hedge fund manager's business conduct, investment process and operational support, including the choice of service providers. It should not stop here. Continuous risk monitoring is crucial in managing and mitigating market as well as non-market related risks in the alternatives space. Indeed, when one looks more closely at the global headline-making "hedge fund blow-ups", most often these problems resulted from operational, that is non-market related issues, such as fraud by fund principals. Monitoring these risks and implementing practices to prevent their occurrence are valuable services rendered by funds of funds.

Local is lekker - highlighting some unique features

The South African hedge fund industry is uniquely positioned in certain aspects. Local hedge fund managers may apply for a specialised category license as financial services providers under FAIS legislation, which adds an additional layer of regulatory supervision. This differs from other financial services provider categories by requiring a higher level of experience, qualifications, and financial soundness, to name a few of the specifications.

It is common practice locally to use independent service providers. The administration of 89% of industry assets is outsourced. Prime brokers service more than 77% of industry assets and hedge funds are audited on an annual basis.

Another unique feature of the local industry is the level of reporting and transparency offered to investors. Besides regular performance reporting, local investors can receive detailed portfolio holdings reporting on a regular basis. As at 30 June 2009 funds representing half of industry assets reported actual holdings to investors on a daily basis, with funds representing a further quarter of assets reporting holdings on a monthly basis. This helps investors to monitor mandate compliance and risk exposures. The "investor" that actually receives these reports is more often than not an intermediary like the fund of funds manager or an independent risk monitor who has the necessary infrastructure and expertise to deal with the information and interpret it.

The local industry is thus well poised for potential changes in financial markets regulation that might call for increased transparency. Following the 2008 credit crisis regulators globally called for increased regulation and disclosure, with the ultimate goal to monitor systemic risk posed by financial institutions with a view to preventing a similar meltdown.

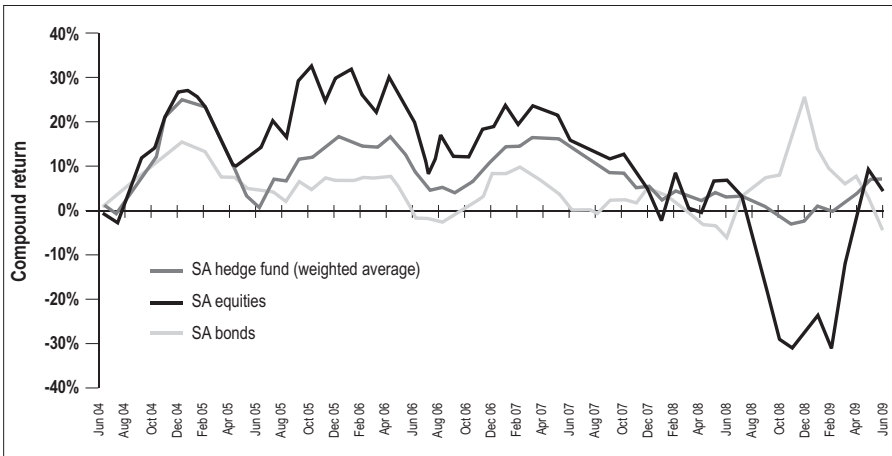
Besides benefits to the investor, including higher risk-adjusted performance, hedge funds play an important role in financial markets. Through short selling, liquidity in markets is often improved as hedge fund activity increases the number of buyers and

sellers in the market. This is valuable especially in markets of tightly-held shares or less researched areas of the market often overlooked by other participants. Short selling also helps increase market efficiency and price discovery.

Given that its size as a percentage of total JSE capitalisation is less than 1% South Africa's industry is still small but the opportunity to grow is evident. Potential investors can take significant comfort from the way that the industry has evolved in terms of operational set-up, disclosure and reporting to investors. There's also been increased alignment of manager and investor interests, and a high level of oversight by the Regulator in terms of current hedge fund manager legislation.

Local hedge funds remained strong during the financial crisis and are still offering an attractive risk-return profile to investors. They remain longer term investments requiring expertise when choosing the right fit for an investor's portfolio and a thorough understanding of the risks involved (as with any investment decision). Hedge funds have the ability to provide a cushion against market downturns, resulting in an overall smoother ride for the investor over the long term, and a better chance of meeting investment objectives.

Graph 4: 5-year rolling 6-month returns of SA assets



Novare Investments (Pty) Ltd



Third Floor, The Cliffs Office BLOCK 1, Niagara Way,
Tyger Falls, Carl Cronje Drive, Bellville, 7530

Tel: +27 (0) 21 914 7730

Fax: +27 (0) 21 914 7733

Email: carla@novare.co.za

Web: www.novare.co.za