Novare is pleased to present the 14th edition of the annual Hedge Fund Survey. Under the new hedge fund regulation, 295 hedge fund portfolios have been approved by the Financial Services Board (FSB). The new regulation requirements have impacted the industry and changes are starting to filter through...
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Novare is pleased to present the 14th edition of the annual hedge fund survey. Under the new hedge fund regulation, 295 hedge fund portfolios have been approved by the Financial Services Board (FSB).

The new regulation requirements have impacted the industry and changes within the industry are filtering through. The most notable changes, as observed in the survey responses, include:

- Fund managers have either launched or appointed a Management Company (Manco) and include the name of the Manco in the name of the hedge fund.
- Minimum Disclosure Documents (MDDs) for retail investor hedge funds are available on company websites (which is apt as regulation allows for retail hedge funds to market to the public);
- More robust risk management is being implemented at Manco level and all mandate breaches are being reported to the FSB;
- The introduction of independent trustees for additional oversight (much like the CIS in securities environment).

The implementation of new regulation has led to it being a demanding time for industry participants. We observed some industry players consolidating their hedge fund product offering.

Despite these challenges there has been a growth in asset managers’ product suite outside of hedge funds. This has likely been done to diversify business risk and capture the growing share of the savings market.

The debate as to how the industry can raise assets continues as new challenges have made it harder to attract inflows into the hedge fund industry. This is one of the key trends we unpack in this year’s survey with the hope of shedding light on some of these hurdles.

Every industry undergoes teething and growth phases on the road to maturity. The local industry is undergoing a transitory phase into a mature industry profile.

This year, a total of 52 hedge fund asset managers collectively managing over 98 uniquely mandated hedge funds participated in the survey. The number of hedge funds participating in the survey has declined by eight since last year. As the industry is conforming to the new regulation, we have found that there are quite a few FSB approved funds that have not been launched yet as well as an increase in funds that no longer wish to be classified as hedge funds.

Participation in the survey is voluntary and the survey focuses solely on single-manager, South African domiciled hedge funds that invest predominantly in South African financial markets.

The intention of the Novare Hedge Fund Survey is to provide key insights into the industry, mainly highlighting changes over the past 12 months for the period ending 30 June 2017. All data is expressed as a percentage of the total industry or strategy assets under management unless stated otherwise.

We hope you find this report useful and we welcome any feedback you may have. For more information visit www.novare.com or contact Retaildistribution@novare.com.
Emphasis on fund sustainability

Last year, approximately 22 funds had an AUM of less than R50 million, accounting for R559 million in assets. During this year’s period under review, the number of funds below this mark has decreased.

A hedge fund with an AUM of less than R50 million charging a 1% annual management fee will collect R500 000 in fees. That is, of course, not taking into consideration other fees that might be at play, such as performance fees (to name but one example).

This highlights the reasoning for smaller start-up managers to first build a solid track record to increase the fund’s chances of survival. Overhead and fixed costs for the asset manager to run a fund would typically take the form of salaries, Manco fees, research fees (if outsourced), regulatory capital, marketing and so forth, all of which must be paid by the manager fees. With increased regulation and sometimes mellow performance, smaller hedge fund businesses are at a greater survival risk than before as this places pressure on asset growth.

During the period under review, some small asset managers have decided not to cross over to the regulated hedge fund environment. Delaying the transition is mainly done with the aim to build the fund’s track record before applying to the FSB and taking the offering to market. The regulation does not require segregated mandates with only one investor to be moved into the regulated hedge fund environment.

According to a global survey by Citi4, referencing the offshore hedge fund landscape and the effect of regulation on hedge funds, the survey estimates that a firm needs between US$224 million (R2.9 billion) and US$250 million (R3.2 billion) depending on the investment strategy, to break-even on management fee collections alone.

Education remains key

An adequate understanding of, and better education regarding hedge funds, its capabilities and how it works will encourage risk-averse investors to embrace the benefits of hedge funds. Despite the misconception that hedge funds are risky investments, South African-based funds are in fact relatively conservative. Interestingly, many South African investors still perceive hedge funds as the riskier investment when compared to unit trusts when, in fact, the two vehicles are very similar7.

There are many different hedge fund styles to suit the different investor risk profiles. Each fund manager has a different mandate, covering the entire spectrum from conservative to aggressive.

The modern-day South African hedge fund industry is ever more transparent and accessible to retail investors with increased oversight and regulation from the Financial Services Board (FSB)8. The industry has grown in leaps and bounds over the years, with operational sophistication and efficiency being at the forefront.

Hedge fund specific regulation may have only come into effect recently, however, hedge fund asset managers have been regulated under the Financial Advisory and Intermediary Services Act (FAIS)9 ever since October 2007 under a separate license category, CATIIA. (Discretionary asset managers such as unit trust asset managers require a CATII licence.) In 2015, hedge funds were included under the regulation of the local Collective Investment Schemes Control Act also known as CISCA10. Under the new regulation, hedge funds have become more accessible to a broader investor base.

Navigating and levelling the local playing field

The South African Hedge fund industry is only a small role-player in the overall South Africa savings industry, representing less than 1% of the total assets managed. The hedge fund industry is substantially smaller than the local and more traditional unit trust industry5.

To place this into perspective – one unit trust fund is almost double the asset size of the entire hedge fund industry6.
Highlights

• More than 90% of industry assets have successfully transitioned into the regulated environment.

• The industry experienced its first decline in AUM in five years with assets dropping to R62.2 billion. This was caused by a combination of factors, such as poor fund performance, outflows and the transitory phase.

• Investors withdrew capital mainly from bigger funds due to poor performance. As a result, there was a decrease in funds with over R2 billion in assets.

• Historically, industry growth has been driven by good returns, however, performance has been subdued over the past 12 months.

• Fixed income was the best performing strategy and received the most net inflows.

• It was a tough environment for equity long/short funds and the strategy suffered the most outflows compared to other strategies.

• Fund of hedge funds AUM dropped significantly by over 7%, and an increase in direct pension fund allocations was observed.
Hedge funds 101

What is a hedge fund?

Hedge Funds aim to achieve positive returns at a reduced level of risk. Characteristics making hedge funds unique includes the use of derivatives, short selling, leveraging etc. to be able to extract positive performance in both upward or downward trending financial markets. While hedge funds invest in the same asset classes as traditional unit trust funds, it can take advantage of a wide range of investment tools and thereby generate other sources of return. Hedge funds tend to have low correlations to traditional portfolios of stocks and bonds, therefore, allocating an exposure to hedge funds can be a good diversifier.

Under the new regulation, CISCA classifies hedge funds into two categories: retail investor funds (RIHF) which have more stringent regulation requirements, and qualified investor hedge funds (QIHF) which are less stringent.

<table>
<thead>
<tr>
<th>RETAIL INVESTOR HEDGE FUNDS</th>
<th>QUALIFIED INVESTOR HEDGE FUNDS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investors</td>
<td>Available to general public (varying minimums)</td>
</tr>
<tr>
<td>Gross exposure limit</td>
<td>&lt; 200%</td>
</tr>
<tr>
<td>VAR limit</td>
<td>&lt; 20%</td>
</tr>
<tr>
<td>Disclosure to clients</td>
<td>Monthly</td>
</tr>
<tr>
<td>Max equity holdings</td>
<td>&lt; 10%</td>
</tr>
<tr>
<td>Investor liquidity</td>
<td>Calendar month</td>
</tr>
<tr>
<td>Risk management</td>
<td>Daily</td>
</tr>
<tr>
<td>Marketing</td>
<td>Able to solicit investments from all investors.</td>
</tr>
</tbody>
</table>

Taking a look at industry regulation

After the 2008 Global Financial Crisis, the Group of Twenty (G20) dedicated itself to enhanced regulation and oversight of private pools of capital, which included hedge funds. South Africa, as a member of the G20, then embarked on a consultative process with the South African hedge fund industry to create suitable regulation to monitor systemic risk and also enhance investor protection.

Most hedge funds in South Africa operate as collective investments, therefore it was decided that hedge fund regulation should be in line with existing collective investment regulation. To address the regulation of the hedge fund product, the FSB together with National Treasury and industry players embarked on a consultative process to understand the South African hedge fund landscape and compile suitable regulation, which saw hedge funds being regulated under CISCA. CISCA also regulates the well-known unit trust industry.

According to the Association for Savings and Investments South Africa (ASISA) the unit trust industry managed assets of R2.087 trillion and offered investors 1556 different portfolios at the end of June 2017.

Although hedge fund specific regulation is only coming into effect now, hedge fund asset managers have been regulated under the Financial Advisory and Intermediary Services Act (FAIS) since October 2007 under a separate license category, CATIIA. Discretionary asset managers (unit trust asset managers) require a CATII licence.

One of the main objectives of the regulation of hedge funds by National Treasury is the monitoring and measuring of systemic risk while enhancing product requirements to protect investor interests.
Other regulatory benefits include:

- Uniform structures similar to the current unit trust environment which manages more than R2.087 trillion of assets;
- The funds are compelled to appoint an independent trustee. The trustee is usually a bank that is not affiliated with the unit trust company or asset manager;
- Additional risk management and compliance monitoring of hedge funds performed independently from the asset manager;
- Ongoing supervision by the FSB, aligning hedge funds to the local unit trust industry;
- Promotion of industry integrity;
- Enhanced transparency for investors including fees, more frequent disclosure and portfolio turnover.

In addition, CISCA also prohibits funds from making certain investments that may result in increased portfolio risk.

One of the requirements under the new regulation is for a hedge fund to appoint a management company (Manco) for all administrative, operational and risk monitoring duties and for the appointed Manco to be approved by the FSB. This is similar to the set-up of the well-known and established unit trust environment.

According to the FSB, as of June 2017, 15 Manco’s and 295 portfolios have been approved by the FSB. Of the 295 approved portfolio’s, 145 were Retail Investor Hedge Funds (RIHFs) and 150 Qualified Investor Hedge Funds (QIHFs). Though the portfolios have been approved by the FSB, it does not necessarily mean that they have been launched or opened for new investments.

Going forward all hedge fund products will require the services of a Manco which is approved by the FSB for hedge funds.

The FSB and National Treasury embarked on a process to enhance and expand the scope of regulation and oversight over hedge funds. A proposed framework for regulating hedge funds in South Africa was released and after engagement with industry, draft regulation for public comment was released in April 2014.

The evolution of South African hedge funds

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1949</td>
<td>Alfred Winslow Jones coins the term ‘hedge fund’.</td>
</tr>
<tr>
<td>1998</td>
<td>First South African single manager hedge fund established.</td>
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<tr>
<td>2003</td>
<td>First fund of hedge funds created.</td>
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<tr>
<td>2007</td>
<td>FSB starts regulating hedge fund managers, requiring that they hold a CAT II A licence.</td>
</tr>
<tr>
<td>2011</td>
<td>Introduction of Regulation 28 for pension funds which introduced a 10% investment allocation limit to hedge funds. Previously the regulation did not explicitly refer to hedge funds.</td>
</tr>
<tr>
<td>2012</td>
<td>National Treasury and FSB finalises regulation of hedge funds. Hedge funds are regulated under the existing Collective Investment Schemes Control Act, No. 45 of 2002 (CISCA).</td>
</tr>
</tbody>
</table>

Let us explain

**Long position**

The buying of a security such as a stock, commodity or currency, with the expectation that the asset will rise in value.

For example, an owner of shares in Stock Water is said to be “long Water” or “has a long position in Stock Water”

FOR EXAMPLE – LONG POSITION

Buy 10 Water shares @ R100 per share (with the expectation that the asset will rise in value).

Total Investment = R100 x 10 = R1000
Share price rises = R135 per share
Portfolio Value = R135 x 10 = R1350
Profit (when selling) = R1350 - R1000 = R350 / R35 per share

**Short position**

The sale of a borrowed security, commodity or currency with the expectation that the asset will fall in value.

For example, if a manager borrows and sells Stock Mabone, it is said to be “short Mabone” or “has a short position in Stock Mabone”

FOR EXAMPLE – SHORT POSITION

Borrows 10 Mabone shares and sells on the open market @ R100 per share (with the expectation that the asset will fall in value).

Share price declines = R75 per share
Portfolio Value = R75 x 10 = R750
Profit (when buying back) = R1000 - R750 = R250 / R25 per share
Different types of strategies

**Equity long/short:**
Funds aim to generate positive returns by being simultaneously long and short in the equity market. Market risk is reduced while company-specific risk is retained. The majority of local equity long/short funds tend to be long biased.

An investing strategy of taking long positions in stocks that are expected to appreciate and short positions in stocks that are expected to decline. A long/short equity strategy seeks to minimise market exposure, while profiting from stock gains in the long positions and price declines in the short positions.

**Equity market neutral:**
Funds take similar sized long and short positions in related equity sectors with the effect that directional market risk is offset.

A strategy undertaken by a manager that seeks to profit from both increasing and decreasing prices. Market-neutral strategies are often attained by taking matching long and short positions in different stocks to benefit from mispricing and delivering positive returns from both the long and short stock selections and reducing risk from movements in the broad market.

**Fixed income:**
An investment strategy that attempts to profit from arbitrage opportunities in interest rate securities. When using a fixed-income arbitrage strategy, the investor assumes opposing positions in the market to take advantage of small price discrepancies while limiting interest rate risk.

This general strategy type includes basis (e.g., cash vs. futures), yield-curve and credit spread trading, as well as volatility arbitrage.

**Statistical arbitrage:**
Quantitative models are used to identify market opportunities and establish short-term positions involving a large number of securities.

**Volatility arbitrage:**
Funds aim to exploit mispricing between similar instruments where the mispricing is the result of different volatility assumptions by price makers.

**Multi-strategy:**
An investment philosophy allocating investment capital to a variety of investment strategies and potentially across several asset classes.

**Commodities:**
Funds that predominantly invest in soft or hard commodities. These funds can follow a number of different strategies to obtain alpha from this asset class, including trend following or non-directional market neutral strategies.
What we review

1. **Assets under management:**
   Looks at industry assets growth since the inception of the survey in 2002. The main drivers of asset growth have varied over time but each year the survey has attempted to give a comprehensive picture of these drivers.

2. **Strategy assets:**
   This is a representation of strategy as a portion of total assets under management. Assets are reviewed by net flows and by growth in strategy. The aim is to measure which strategy houses the bulk of the assets.

3. **Investors:**
   This section investigates the type of investors for hedge funds as well as possible trends in new investors and/or allocators.

4. **Operations:**
   This section covers the operational aspects of the hedge fund. For the purpose of the survey, it has been grouped according to Manco responsibilities and non-Manco responsibilities. This is to give insight regarding the operational efficiency of hedge funds, transparency into the smooth running of hedge funds, its capabilities and resources.

5. **Structure:**
   The legal structure of a hedge fund is important as it highlights who will bear the brunt of liabilities should extreme losses be incurred.

6. **Fees:**
   This section covers fees how the fees are calculated as well as the trends regarding costs.

7. **Performance:**
   Performance of the entire industry across strategy and across different fund size. This shows where the bulk of the industry returns came from.

8. **Strategy behaviour:**
   This is viewed as per strategy. The gross and net exposure is analysed to examine the risk that managers have taken on during the period under review.
Assets under management decreased by 9.1% during the period under review. According to the survey findings, the main contributing factors to the decline include:

1. in-house consolidations of product offerings by managers,
2. outflows, and
3. meagre performance in the period under review.

With the introduction of the new regulation, there was uncertainty within the hedge fund industry. Subsequently, a few anticipative trends emerged, such as:

- Investors changing mandates and switching to either traditional long/only mandates, to unique segregated mandates or to move the capital offshore.
- Consolidating smaller hedge funds and not classifying these funds as hedge funds anymore. This is done with the aim of running the fund as a private portfolio until such time that it achieves a solid track record and asset base.

It was a challenging year performance-wise across the industry. The drop in assets also came from bigger hedge funds, especially equity long/short funds. The strategy experienced a challenging year and subsequently showed the biggest withdrawals.

The industry also witnessed an increased amount of hard closed funds, up from 15.9% in the previous period to 19.5%. This was prevalent in major hedge fund asset managers not wanting to dilute returns and rather focus on satisfying existing investors return expectations. With hard closed funds, the fund is not open to new investments, meaning that the fund is not accepting investments from new or existing investors.

We remain optimistic that inflows will pick up the pace once the regulation dust has settled and the new requirements become more acceptable to investors.
Assets growth

The below graph highlights performance as the main driver of industry asset growth since 2009. The left axis represents the AUM and net flows, and the right axis represents the year-on-year growth rate of assets.

New funds and closed funds did not significantly impact the industry in terms of contributing to year-on-year growth. Given the current economic climate and subsequent pedestrian fund performance experienced over the last year, it comes as no surprise that the industry experienced a drop in assets.

In the coming year(s), it would serve the industry well to explore external investor sources in addition to improving performance in order to attract new inflows and achieve sustainable growth.

![Assets under management graph](image)

### Asset managers’ total assets

While the perception may be that hedge funds are managed by niche, boutique investment houses, the reality is that hedge funds form part of most of South Africa’s largest financial service providers’ offering. The section that follows illustrates that hedge funds’ assets are not the only assets managed by hedge fund managers and that most form part of a well-diversified asset management business, managing a multitude of investment offerings.

**As indicated by the below graph –**

- The majority of hedge fund assets are managed by firms who have more than R2 billion worth of assets.
- Hedge funds managed by asset managers who have less than R500 million increased from 2.5% to 3.3%, supported by the addition of new funds.
- Hedge funds managed by asset managers who have more than R100 billion in assets grew from 8.9% to 10.2%.
Product offering

The graph below illustrates the role hedge funds play within the participating 52 assets managers’ overall product offering.

Survey participants were asked to classify their product offering among the following categories:

- local
- local hedge funds
- offshore
- offshore hedge funds

The aim of including the specific options above was to gauge the hedge fund offering within each investment house. The survey only measures ZAR denominated funds, however, over the years we have seen hedge fund managers having

US dollar denominated funds in their existing strategy which offers a different source of revenue.

The initial results indicated that only 3.1% of assets were allocated to hedge funds, 85.8% allocated to local products, 10.1% to offshore and the remainder to offshore hedge funds. It was evident that the results were slightly skewed by larger asset managers.

Upon removing the bigger asset managers and concentrating only on asset managers with R10 billion under management, a different picture comes to the fore. Within this group, hedge funds represent 43.5% of assets with 37.1% allocated to local products that are not hedge funds, offshore hedge funds and other offshore offerings account for 12.3% and 6.94% respectively. We have seen a rise in US Dollar denominated hedge fund offerings.

Hedge fund assets by size

Net flows remained muted over the period. Over all, the industry suffered a net outflow of R1.2 billion for the period under review.

- For the first time in three years, funds with over R1 billion in AUM experienced net outflows of R1.7 billion.
- The biggest losses came from funds with assets over R2 billion, registering outflows of R1.4 billion.
- Net inflows were observed for funds with assets between R500 million - R1 billion.
Net flows by fund size

Additional contributing factors to the net outflows from the industry include:

- Six funds were dissolved which accounted for over R343 million in outflows.
- Managers amalgamated funds and changed previous mandates, however, some of the assets were reallocated to existing hedge funds.
- Small funds, averaging R57 million in size, closed. Some of the reasons sighted for the closures were the costs brought about by the new regulation and that it would be too costly to run a fund with only a small amount of assets under management.

Industry concentration

The graph below illustrates the 10 largest hedge funds as a proportion of the total industry AUM.

With the drop in assets, the top 10 largest funds (as a proportion of the total industry AUM) have increased from 30.0% to 47.6%.

The consolidation of assets by some managers at the top level was observed as the main reason behind the climb. The mergers increased fund assets under management drastically when compared to previous periods.
Fund launches and closures

- Six funds closed during the period and returned capital to investors. Of these six funds, four were equity long/short funds.
- Some funds closed due to poor performance and investors becoming uncomfortable with drawdowns.
- Fund consolidations occurred during the period (more so than before), mostly from bigger hedge funds.
- Seven new funds were launched during the period, split equally between equity long/short, multi-strategy and one commodities fund.
- Only one fund launched with more than R150 million AUM.
- Five new asset managers entered the playing field and new funds were launched by bigger asset managers who previously did not have a hedge fund offering.

It is always encouraging to see new strategies coming into the industry, especially as the industry tends to favour equity long/short as the preferred strategy.

We have observed that managers tend to have a better chance of survival if they have a solid business plan in place and collaborate with the right business partners (more so from an ownership point of view).

With the increased regulatory costs, it will be prudent for managers to build up a track record for a hedge fund with single investor money and only elect to be classified as a hedge fund once there is enough confidence of capital inflows.

Capacity

- 19.5% funds were hard closed, meaning the fund did not accept any capital from investors. This increased by 4% from 15.9% the previous period.
- Funds that were soft closed, meaning it was only open to existing investors, dropped from 7.6% to 1.9%.
- Capacity in the industry increased from 76.3% to 78.5% over the period, signifying that the industry has close to R48.9 billion in capacity.
During the period under review, the composition of strategies remained relatively unchanged.

- Equity long/short still holds the bulk of assets but the loss of assets in equity long/short dropped the strategy from 61.6% to 60.4%.
- Fixed income increased from 13.0% to 14.1% aided by good flows and strong returns.
- A variety of funds are being launched by new asset managers, including multi-strategy and commodities.
Net flows by strategy

- Net outflows were mostly experienced in the equity long/short funds. These outflows were more pronounced for the larger hedge funds.

\[
\begin{array}{c|c|c|c|c|c|c}
\text{Strategy} & \text{Net Cashflow} & \text{Dissolved Funds} \\
\hline
\text{Equity long/short} & -1,858.21 & -258.27 \\
\text{Equity market neutral} & 916.5 & -136.43 \\
\text{Fixed income hedge} & -48.31 & -67.72 \\
\text{Multi-strategy} & -258.27 & -67.72 \\
\text{Commodities} & 916.5 & -136.43 \\
\text{Others} & -48.31 & -67.41 \\
\end{array}
\]
Asset allocators

Funds of funds assets have dropped considerably, from 56% to 48.8%. The drop in FOHFs is concerning as they tend to be the main allocators to new talent in the industry and, therefore, this could potentially dampen the support for new hedge funds. This drop has been followed by an increase in direct pension fund allocations which is up from 8.5% to 21.0%.

The previously discussed global survey by Citi noted a decrease of 2% in allocations by Fund of Funds (since 2008), nevertheless, the industry grew by 88% during the same time frame.

Manager track record

- 72.2% of assets are managed by hedge fund managers with more than eight years’ hedge fund experience, representing 43.9% of funds.
- Only 24.4% of the industry assets are managed by managers with less than five years’ experience.

INVESTORS
During the period under review, 68.8% of industry assets were allocated to Qualified Investor Hedge Funds, and 29.9% were allocated to Retail Investor Hedge Funds.

In line with new regulation, only certain structures are allowed within the CIS environment. A portfolio can only use the following structures for its hedge fund assets -

- A collective investment scheme trust arrangement as contemplated in the Act; or
- An en commandite partnership

An en commandite partnership is a partnership where the en commandite partner's (the partner whose name is undisclosed) liability towards co-partners of the partnership is limited to the specified capital amount which the en commandite partner has contributed or undertaken to contribute to the partnership. The en commandite partner is not at risk of suffering a loss or liability in excess of its investment in or the contractual commitment to the partnership.

1.3% of participants had not yet launched funds after the new regulation.

Under the new regulation, hedge funds can either be an en commandite partnership or a CIS Trust. While most hedge funds have been in an en commandite partnership before, new structures will have to be approved by the FSB to fit in the regulated environment.

- More than 90% of industry participants have fully transitioned into the regulated space. Some of the bigger asset managers with in-house capabilities have opted for limited liability partnerships. This is allowed under the new regulation, however, the schemes are still required to be registered as either a retail or qualified hedge fund.
- More than 89.3% of the assets are housed as CIS Trusts and 10.7% as limited liability partners. During the previous period under review, 61.0% of assets were limited liability partnerships and 25.7% were in a CIS Trust.
**Daily pricing**

One of the obstacles that single manager hedge funds have been faced with when dealing with retail clients has been the dealing and pricing frequency of funds.

- 31.4% of funds offered daily pricing.
- Despite some hedge funds offering daily pricing, only a few offer daily dealing. There has been an increase in daily dealing funds, from 2.3% to 3.1%, mostly by smaller and new hedge funds that offer looser liquidity terms.

**Prime broker**

Funds that use only one prime broker have increased from 64.8% to 75.4%. This could be a function of Mancos preferring certain prime brokers on their platforms. Under the new regulation, Mancos have to sign new agreements with prime brokers as these were previously signed with the CATIIA manager.

Funds that do not use a prime broker decreased from 27.6% to 19.2%. This is typically due to bigger asset management companies that are able to fulfil the function in-house.
Prime broker breakdown

As illustrated by the graph below, the industry is dominated by two players that represent more than 70% of the assets.

Management companies

One of the requirements under the new regulation is for a hedge fund to appoint a management company (Manco) for all administrative, operational and risk monitoring duties and for the appointed Manco to be approved by the FSB. This is similar to the set-up of the well-known and established unit trust environment.

Under this new regulatory requirement, a hedge fund manager could either establish and operate its own Manco or call on a third-party Manco service provider. This development has been of great importance as the operational risk associated with hedge funds has been reduced.

As of June 2017, 15 Manco’s and 295 portfolios have been approved by the FSB. Of the 295 approved portfolio’s, 145 were retail investor hedge funds (RIHFs) and 150 Qualified Investor Hedge Funds (QIHFs).

For the same period a year earlier (as at 30 June 2016), eight Manco’s had been approved for eight retail investment schemes and 10 qualified schemes.

It should be noted that even if a fund has been approved it does not necessarily mean that it has been launched as a regulated hedge fund, the same strategy can have more than one registered fund with different Mancos.

Three Mancos represent 70.4% of the industry assets.
Management fees

As a first and under the new regulation, hedge funds will have to disclose its Total Expense Ratio (TER) to the public. Hedge funds have 12 months to disclose these fees following the launch of the fund in the regulated space. The local hedge fund industry does not follow the typical 2.0% Annual Management Fee (AMF) and 20.0% performance fee ratio which tends to be the norm internationally. Instead a 1.0% AMF and 20.0% performance fee ratio is the popular charge.

Both locally and internationally, the issue of fees has been an ongoing debate that gained traction during the period under review. Both long only and hedge funds have been placed under scrutiny by investors and regulators. Investors are increasingly concerned about the hefty fees charged upon investments that are generating muted returns.

Active managers tend to charge higher fees compared to passive managers. In a climate where returns are muted, investors opt to scale down on fees and invest in passive strategies. The growth in passive strategies has subsequently put pressure on active managers as the management fee for passive investments can be as low as a mere 10 basis points. The survey showed that most of the industry participants charge an annual management fee of 1%.

The Treating Customers Fairly (TCF) legislation requires managers to disclose all costs incurred by investors on the fund’s minimum disclosure document or fund fact sheet. Hedge funds will also be subject to the same standard.

As a survey first, managers were surveyed on their annual borrowing cost (associated with shorting instruments). The results showed the band to be quite broad, ranging from 0.14% to 10%. These costs can push up the TER to some degree.

In future the survey will have a large focus on TER as these will be reported by managers.

Performance fees

- Approximately 93.0% of funds charge a performance fee of 20%, with 69.9% of managers employing a cash+ hurdle.

- The calculation of performance fees using different accounting standards (series accounting versus equalisation) has also been prevalent in the industry, there are no set guidelines under the new regulation as to which to use as yet.
In 2016, 99.9% of funds did not have a cap on performance, however, this has changed in the current period under review. As at 30 June 2017, 17.1% of funds reported having a cap on performance fees.
Performance

The 12 month period ending 30 June 2017 was filled with political turmoil - both locally and abroad. Brexit quickly became a household term as the United Kingdom set in motion its withdrawal from the European Union and dominating headlines across the globe. South African managers who were highly exposed to the pound were hardest hit as pound denominated stocks tumbled over the period. Some managers were seen buying during the period, taking advantage of the lower prices as other managers sold off.

The surprise election of Donald Trump as U.S. President quickly stole the Brexit limelight and had an unprecedented impact on markets. ‘Trumpflation’ trades gained ground as market participants believed that the President’s policies would spur inflation in the U.S. Following Trump’s victory, the yield curve steepened, indicative of a rise in inflation expectations, thus Trumpflation taking effect. Since Trump has taken his seat at the table, markets have grown wearier as to whether the U.S. President will, in fact, be able to deliver on his campaign promises.

On the local front, President Zuma announced his 11th cabinet reshuffle in late March 2017. Then minister of finance, Pravin Gordon was relieved of duty and the former minister of home affairs, Malusi Gigaba, appointed as the new minister of finance. Shortly after the reshuffle, rating agency Standard & Poor’s downgraded South Africa to sub-investment grade, sighting that the move put policy continuation at risk.

The All Share index returned 1.6% over the period, the All Bond Index 7.9% and cash 7.6%. The Resource sector was the main driver of returns in 2016 and hedge fund managers who were short resources and long rand hedges were impacted negatively. Fixed income managers experienced a better period in 2016 as the strategy recovered from the ‘Nenegate’ events of December 2015.

Overall, it has been a particularly difficult period for equity long/short managers. In the first half of the measured period managers trading portfolios actively did well (as opposed to the long-term fundamental stock pickers). During the same period, some macro managers have excelled at navigating the prevailing market conditions.

- Funds managing between R500 million and R1 billion posted the best returns and new inflows to these funds were also observed.
- Funds with less than R100 million assets under management posted a negative return of -1.0%.
Strategy performance

- Equity long/short managers experienced a challenging 12 months of late and returns remained muted. The majority of funds performed within the range of -5% and 5%. The period under review marks the second year of underperformance for the strategy as it was once again the laggard when compared to the rest of the strategies (yet this time by a bigger margin).

- Equity Market Neutral had less deviating returns but managed to stay mostly positive and within the 5%-10% band. One fund posted a loss of more than 25%.

- Fixed income Hedge was the best performer strategy-wise, with an average of 8.9%. The strategy also recorded better net inflows in comparison to the other strategies.

- Multi-strategy was the second-best performer, helped by the fixed income component.
**Equity long/short**

**Gross exposure**

There was a general increase in gross exposure, notably between 200% to 300% from 4.1% to 9.0%. Gross between 100% to 150% dropped from 44.4% to 38.3%. An increase in trading over the term was observed, which explains the increase in gross exposure to some extent.

**Net equity exposure**

Net equity exposure between 0% and 10% increased from 0.1% to 6.4%. Decreasing the net equity exposure is also a way of managing risk within the portfolio.

**Trading activity**

Portfolio managers had to remain nimble and constantly adjust positions. Portfolio turnover of 2-4x increased from 5.9% to 35.2%. Managers were active and tried to navigate the political uncertainty and choppy markets.
**Equity market neutral**

**Gross equity exposure**

Average gross exposure of 150% to 200% increased from 5.0% to 28.8%. On average, most Market Neutral funds increased its gross exposure.

**Net equity exposure**

In contrast to the long/short managers, equity market neutral managers increased their net equity exposure. Net equity exposure of 10% to 50% increased from 51.0% to 76.0%.

**Trading activity**

A growth of 6.6% was observed for 0-2x portfolio turnover and a slight increase for trading over 10x of Net Annual Value (NAV). There was also an increase in funds trading 4-6x of NAV.

**Fixed income trading**

Fixed income managers traded more the past 12 months due to the increased political noise locally and abroad. Movements in currency and spreads were also observed.
The much-anticipated regulations have come to the fore and market participants are slowly but surely finding their footing. It has been a tough period performance-wise as net outflows as well as a series of underperformance was observed. The new regulation has put a spotlight on the industry and it is unfortunate that the muted performance comes at this particular period in time.

Novare continues to be optimistic about the growth prospects of the industry and believes, even though the industry is still small, it has the potential to be a key role player in the South African savings industry. With that being said, the industry will need to raise assets from external players. This is where the new regulation is of particular importance as it has provided a much-needed structure for making hedge funds marketable to new investors, including retail investors.

Local hedge fund managers are steering unchartered waters and get to be at the forefront of this transitioning phase. It is often during challenging transitory periods that new investment horizons are discovered, innovation and creativity are better explored and manager finesse and skill comes to the fore.
A collective investment scheme (CIS) can be described as an investment product that allows many different investors to pool their money into a portfolio. Unit trusts were the first collective investment scheme to be offered to investors in South Africa. It is still the most popular and widely available form of CIS in the country.

A Multi-manager fund combines multiple professionally-managed investment funds into a single offering. Multi-manager funds provide a cost-effective way to achieve breadth in an investment portfolio without having to constantly re-evaluate the holdings.

Regulation 28 to the Pension Funds Act imposed limits on the investments of retirement funds. These were intended to protect funds against making imprudent investments. For example, you may only invest in a fund that has a max of 75% invested in equities, 25% in property, no more than 25% of the fund’s assets can be invested offshore.

FAIS CAT II license: an authorised financial services provider (FSP) that renders intermediary services of a discretionary nature as regards the choice of a particular financial product.

FAIS CAT IIA license: an authorised hedge fund FSP that renders intermediary services of a discretionary nature in relation to a particular hedge fund or fund of hedge funds in connection with a particular financial product.

A hurdle rate is the minimum return on investment necessary to cover all costs associated with a project.

A lock-up period refers to a widow of time or a period within which hedge funds or other closely held investment vehicles are not allowed to redeem or sell shares.

Asset administration is an important function for all investment firms. This function is generally responsible for administrative tasks such as performance reports, compliance duties, risk monitoring and analysis reports.

The Financial Advisor and Intermediary Services (FAIS) is a division within the FSB that is responsible for the administration of the FAIS Act, 37 of 2002.

FAIS register financial services providers after being satisfied that they meet the fit and proper requirements, supervise such providers on an on-going basis to ensure that they comply with the duties imposed by the Act at all times and take the necessary regulatory action against those who do not comply, which include unregistered entities or persons.

The prime broker provides a consolidation service, including services such as custody of the securities, loaning of securities for short sales, providing margin financing, and providing back office technology and reporting.

Fund Administrators: A service provider whose main job includes providing certain accounting and back office services to a hedge fund.

An en commandite partnership is created when parties agree to carry on the partnership in the name of one or some of the partners, while the partners whose names are not disclosed are known as en commandite partners (ECPs).

The hurdle rate refers to the rate of return that a fund manager must beat in order to collect performance fees.

Using “cash as a hurdle” means that the performance of the hedge fund is compared to that of the performance of cash investments and thereby comparing and determining if the hedge fund performance is above the hurdle. If the hedge fund performance is above the hurdle rate only then the 20% performance/incentive fee may be charged.

Gross exposure is the absolute level of a fund’s investments. It indicates the total exposure to financial markets, thereby providing insight into the amount of risk the investment is subject to due to possible market fluctuations. The higher the gross exposure, the bigger the potential loss or gain.

Net exposure is the percentage difference between a hedge fund’s long and short exposure.

NAV refers to Net Asset Value. This is the value per share of a fund on a specific date or time. The value per share amount is based on the total value of all the securities in its portfolio, any liabilities the fund has and the number of fund shares outstanding.

**TECHNICAL TERMS EXPLAINED**

A lock-up period refers to a widow of time or a period within which hedge funds or other closely held investment vehicles are not allowed to redeem or sell shares.

资产管理是投资公司的重要功能，负责行政任务如绩效报告、合规责任、风险监控和分析报告。

财务顾问及中介服务（FAIS）是FSB的一个部门，负责管理FAIS法，37号，2002年。

FAIS注册金融服务提供商，确保其符合“合适和适当”的要求，对未能履行其职责的提供商进行持续监督，采取必要措施，包括未注册的实体或个人。

最高行权率是基金必须超过的最低回报率，以覆盖所有相关成本。

封存期是指在特定期间内，对对冲基金或其他紧密投资的工具，未经允许不得赎回或出售。

资产管理是所有投资公司的重要功能，负责管理资产。

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