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Special Report



## Allocating to **alternative** assets

A handbook for South African investors



# Pension funds need to do some comparative shopping

By Fatima Vawda, managing director and chief investment officer, 27four Investment Managers



Fatima Vawda

The challenge faced by many retirement funds, post the financial crisis of 2008, is how to effectively utilise their risk budget to ensure, with a significant level of confidence, that the pension fund will be adequately funded to meet its liabilities over the long-term. An appropriate asset allocation must be decided upon, taking into account the risk budget of the various investment strategies and other inputs, such as member information and regulatory constraints.

In South Africa, recent amendments to Regulation 28 of the Pension Fund Act have been generous in a number of previously vague areas, and signal South Africa's alignment with global financial practices. In particular, the 10% allowance in hedge fund provision equates to a noteworthy financial reshuffle that will trigger a market shake-up. Hedge funds can now compete for an allocation relative to other asset classes and investment strategies in a pension fund's risk budget. Exposure to hedge funds means previously unavailable access to downside protection. South African pension funds looking to rebalance would do well to do a bit of comparative shopping and allocating active risk to enhance the returns available from beta management.

The period immediately following the drop in markets, due to the credit crisis, was not an inspiring period for South African hedge funds. The credit crisis saw the JSE SWIX fall 36.99% from its peak of 7,813.20 in October 2007 to 4,923.14 in February 2009 in line with moves in global markets. This was followed by an aggressive correction that has seen markets recover to pre-crisis levels. The recovery was partially on the back of cheap value offered as a result of the hard drop, and partially on the back of government stimulatory efforts to restore confidence through the application of fiscal and monetary measures to prevent a total collapse.

In the growth period since the collapse, South African hedge funds have protected capital, and those with a long beta bias have picked up some of the upside. Those going market-neutral, delivered returns in line with money market type investments. Overall, it was not a great period for many hedge fund managers whose strategies proved inadaptable to the changes in volatility and, in many instances, the structural drivers behind positions proved ineffective as was the case with mean-reverting strategies. The increase in correlations and the lack of variability in relative stock returns resulted in a lack of profitable opportunities to

bank (see figure 1).

The future of beta, however, is not bright. The jury is still out on whether the excessive quantitative easing globally has worked. The general health of developed markets is not looking good. The US dollar is on shaky ground, as is the euro; contagion seems to loom. However, hunkering down in one's bunker means that prospects for growth are grim. In a climate in which post-crisis jitters remain, increased volatility and uncertainty make good ingredients for hedge funds to perform. Bearish markets favour hedging (see figure 2) and hedge funds are particularly useful, since they protect investors against fluctuations, reduce risk and allow for diversification. Year-to-date to 30 June 2011 SWIX is marginally up 0.62% while the average fund of hedge fund has almost unilaterally produced gains and are up 3.92% on average. The timing couldn't be better for hedge funds. Pension funds looking to rebalance their investment portfolios and tweak their risk budgets, based on their confidence of future asset-class returns, may want to allocate a portion to hedge funds. A well-balanced pension portfolio, that includes hedge funds, can provide better long-term returns with lower volatility.

The regulatory reforms have helped restore investor confidence in hedge fund investing. While investor awareness may need a little jogging, overall perceptions are changing – and the true value-add of hedge funds to an overall portfolio is recognisable.

South African hedge funds have proved their value by preserving capital during a downturn and delivering reduced volatility. As uncertainty looms, the diverse strategies available to hedge funds enable them to reduce downside risk through active risk management. The new legislation allows pension funds greater access to these strategies. It's time to look at what the hedge fund industry has to offer and to do some comparative shopping.

*27four provides fund of fund solutions to retirement funds, offering a choice of optimally structured portfolios to suit varying needs based on our experience in identifying investment talent and portfolio construction.*

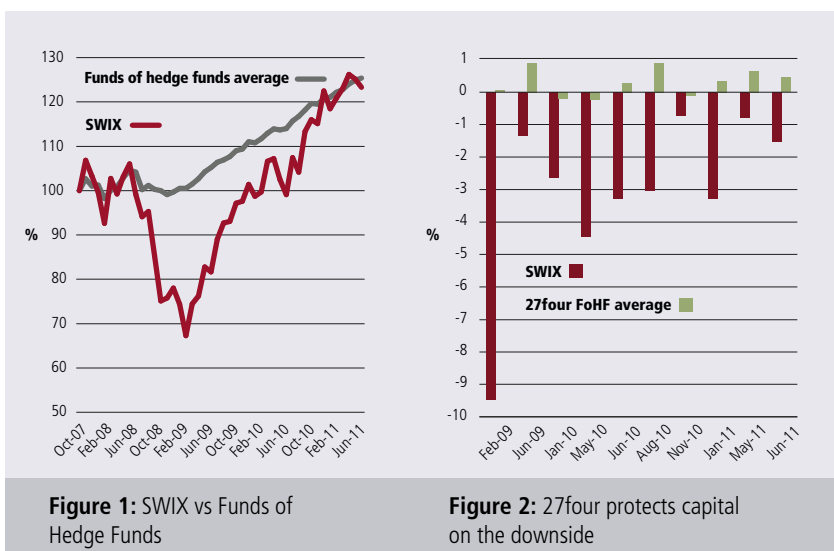


Figure 1: SWIX vs Funds of Hedge Funds

Figure 2: 27four protects capital on the downside

# How can investors access **African growth** while protecting against risk?

By Oliver Hoffmann, 27four Investment Managers



Oliver Hoffmann

**A**frica is increasingly being dubbed the “final growth frontier” for its investment opportunities and favourable pricing in relation to its growth potential. Billions in capital is required to build roads, rail, power, water and telecommunications/IT infrastructure, as well as to transform farmlands and build industries across the continent, to sustainably improve livelihoods through business.

In terms of investment returns, Africa’s markets continue to perform well. Out of a total of 25 stock exchanges, representing 36 nations (there are two regional exchanges – Bourse Regionale des Valeurs Mobilières and Bourse Regionale des Valeurs Mobilières’ Afrique Centrale), the majority have outperformed world markets since the trough of the credit crisis. In 2010, the average return of African equity markets was 14.8% in US dollar terms versus 9.6% for the MSCI World Index, despite most African countries experiencing currency depreciations to the US dollar (South Africa and Botswana were exceptions). Overall strong equity market performance has been supported by a rebound in GDP growth. Excluding South Africa, growth in sub-Saharan Africa is estimated to have expanded by 5.8% in 2010, up from 3.8% in 2009. The outlook remains favourable, with the International Monetary Fund and other agencies predicting GDP growth to be maintained at between 5.5%-6% over the next two years.

While African markets offer excellent diversification benefits, owing to their low correlations to world markets (correlation co-efficient of less than 0.4), the majority of these equity markets are immature. Average capitalisation, often less than 25% of GDP, is well below the norm of most other emerging markets. Practically speaking, liquidity constraints force most equity investors to narrow their focus to only nine exchanges. Larger international investors often do not venture beyond the four most liquid and sophisticated markets – Egypt, Kenya, Nigeria and Morocco – and none of these have

a regulated derivatives exchange.

A number of international funds operating in the pan-African space (excluding South Africa) are designated as hedge funds and have similar fee structures. However, the ability of these funds to implement standard hedge fund strategies, involving short-selling, is extremely limited. Firstly, security regulations in the majority of African countries prohibit selling short. In addition, current settlement systems, which are all based on delivery versus payment (DVP), are unable to provide for scrip lending. For this to change, settlement systems need to be revamped and securities regulations rewritten – a prospect not likely in the immediate future.

While the inability to sell short is a significant constraining factor in protecting against downside risks in African markets, this does not mean fund managers’ hands are completely tied. There are other, albeit limited, methods:

**1.** Managers can short African-focused companies that are listed on the developed, international exchanges. The London Stock Exchange, Toronto Stock Exchange, Australian Stock Exchange, Frankfurt Stock Exchange and the Johannesburg Securities Exchange (JSE) have a number of “African” listings, mostly junior mining and exploration firms, but also a sprinkling of agricultural, finance and industrial companies.

**2.** Secondly, managers can short African companies that have secondary listings on developed exchanges. Examples include Oando (Nigeria), Trustco (Namibia) and Wilderness Safaris (Botswana), which are dual-listed on the JSE, and Zambeef (Zambia), which has recently been approved for a secondary listing on the Alternative Investment Market, a sub-market of the London Stock Exchange. However, the general low liquidity of trade in these shares may make shorting expensive and impractical, while share fungibility can often be a relatively lengthy process. It is unfortunate that none of the global depository receipt (GDR) pro-

grammes of the Egyptian and Nigerian companies allow for short selling.

**3.** A further option is to short the internationally listed multinationals that have subsidiaries (some listed) across various African countries, the most notable being Barclays Bank, Standard Chartered, Standard Bank, Unilever, Nestlé and Lafarge Cement. However, this strategy is problematic, as in almost all cases, African operations generally contribute a small proportion to total group profits.

**4.** In times of global market distress, when market correlations tend to increase, the final option would be to short an alternative index proxy. One would assume the closest proxy in this case to be a financial index (such as the FTSE/JSE Financial Index) owing to the high weighting of financial shares across the majority of African stock markets.

With respect to over-the-counter (OTC) derivative contracts, currency forwards are now a fairly vanilla product offered by many banks operating in Africa. A few investment banks have begun to offer OTC call options on individual African exchange listed shares and indices. However, none of these are currently willing to write put options and will only consider doing so on an agency basis. As such, derivative markets remain significantly underdeveloped across Africa.

African countries as a whole have embraced a number of fundamental structural reform programmes in recent years. For current economic growth rates to be fuelled with capital, skills and further improvements in the business environment, African capital markets will need to undergo their own reform programmes. This will depend on regulators beginning to prize liquidity and efficiency over exchange sovereignty issues.

*27four offers institutional investors access to the listed markets in Africa, through its Pangaea Africa Fund of Funds, a geographically diversified portfolio, where each underlying manager is hand-picked, following thorough due diligence.*



# What dark continent?

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Ask about our Pangaea Africa Fund of Funds.

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