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Editor's Note

Vast growth opportunities ahead for South African hedge fund managers

The South African hedge fund industry can compete very well internationally. When overseas investors take a deeper look at the returns, there is almost every time this element of surprise when they see the extent and the persistence of alpha generation in the South African market vis-à-vis global hedge fund managers.

The South African equity market as a percentage of GDP is running at about 250%. This is unique across the globe — in emerging as well as developed markets there are very few markets that look like that. Because this very deep, very liquid equity market is dominated by long-only fund managers, that on its own creates opportunity for hedge fund managers at the periphery extracting alpha from the opportunity set. Local South African institutions and high net worth investors have constantly increased their investments in local hedge funds over the past two years.

All current South African hedge funds will fall under the Collective Investment Schemes Control Act (CISCA) and become qualified investor funds (QIFs) once the draft regulations become effective, and the funds are declared as falling under CISCA by the Minister of Finance. It is envisaged that this should happen by 1 April 2015. Fund managers can then also change a QIF into a retail fund or launch new Retail Investor Hedge Funds (RIHF) and freely solicit from the public. A South African RIHF is similar to a UCITS product where the managers have a narrower mandate, although possibly a bit broader than what the current UCITS framework allows. Already now, investment advisers and wealth managers have expressed an interest to invest into this new breed of hedge funds, and are willing to be educated about the strategies and opportunities hedge funds offer.

The development and growth of the South African Unit Trust industry, operating within a well regulated environment has been significant. The CISCA regulations offered collective investment schemes significant opportunities to distribute, solicit, and develop new funds for the public. Industry insiders therefore see substantial similar growth opportunities for South African hedge fund managers once they operate under CISCA and have similar opportunities to solicit and distribute their funds.

The Opalesque 2015 South Africa Roundtable was sponsored by IDS Fund Services and took place end of 2014 at IDS' Cape Town office with:

1. Andy Pfaff, Commodities Fund Manager, MitonOptimal Group
2. Bradley Anthony, Head of Distribution & Product Strategy, Fairtree Capital
3. Genene Carse, Business Implementation Manager, IDS Fund Services
4. Pieter Viljoen, Chief Investment Officer, Edge Capital
5. Simone Blanckenberg, Head of Strategy and Product Development at Tantalum Capital
6. Tony Christien, Deputy CEO, IDS Fund Services

The group also discussed:

- Why there is still some upside in equity markets with long-only beta opportunities
- Bumper harvests provide opportunities in soft commodities, as does the collapse of oil prices in certain sectors in Africa
- QE has so far been sufficient to support equities, but insufficient to create inflation and turn the metals bullish nor the bond markets bearish. How far will QE continue?
- What's the best way to tax derivatives? And in general, does turnover in a portfolio represent the justification for different tax treatment, or is it the behavior and the intent of the unit holder, the investor?
- Why the high net worth market will be a key driver going forward, especially to fund smaller and new managers
- What are the best vehicles and strategies to participate in the Africa story?

Enjoy!

Matthias Knab
Knab@Opalesque.com

Participant Profiles

(LEFT TO RIGHT)

Simone Blanckenberg, Bradley Anthony, Pieter Viljoen, Tony Christien, Andy Pfaff, Genene Carse, Matthias Knab.

View from Table Mountain Hotel, Cape Town © Matthias Knab

Introduction

Andy Pfaff
MitonOptimal Group

I am Andy Pfaff. I manage MitonOptimal Commodities, which is a boutique in the MitonOptimal Group, and I manage a suite of commodity funds from beta index trackers, to active long-only, to hedge funds, both locally and internationally.

Genene Carse
IDS Fund Services

Genene Carse, Implementation Manager at IDS Fund Services, a specialist in party administrator, administering over 200 funds.

Pieter Viljoen
Edge Capital

Pieter Viljoen. I am the Chief Investment Officer at Edge Capital. Edge Capital is a South African focused fund of hedge fund business. Our mandates are split between traditional absolute return mandates, strategy specific mandates and equity long-only mandates, managed via portable alpha strategies incorporating hedge funds and low cost beta.

Tony Christien
IDS Fund Services

I am Tony Christien, Deputy CEO of IDS Fund Services, a specialist Fund Administrator here in Cape Town.

Simone Blanckenberg
Tantalum Capital

I am Simone Blanckenberg, COO at Tantalum Capital. We are a boutique asset manager running strategies across both hedge and long-only funds. We manage both equity and fixed income mandates for both institutional and more recently, retail clients.

Bradley Anthony
Fairtree Capital

I am Bradley Anthony, Director at Fairtree Capital. We are a diversified fund management business, with about three-quarters of our business being long-only products, with the remainder being hedge. We run money in equity markets, fixed income markets, credit markets, and soft commodity markets.

Matthias Knab What is your outlook for 2015?

Bradley Anthony: We have seen many exciting opportunities across all asset products that we currently manage.

We think that in the beta space, in long-only world, there is some upside in equity markets despite the fact that many people deem them to be expensive. Conditions which precede crashes are not currently evident: yield curves are still steep, real economies are picking up, specifically in the U.S, and there still seems to be a fair amount of commitment by authorities to fight the deflationary threat and to stimulate economies, where they perceive a need.

So from that side we believe long-only beta opportunities still persist. We like the opportunity set in relative value as well in equities. We think that correlations continue to break down. When equity-risk premiums contract, correlations typically are low and so it presents an opportunity for relative value investing.

In the commodity space, Andy would probably be able to add more detail, we think that certainly in the agricultural commodity space where we operate, a lot of these grains and crops are facing bumper harvests, so supply is going to be higher than it has been in a number of years. That has driven prices in some instances below production cost levels, which in itself I suppose presents an opportunity on the long side in some of these commodities.

I think some of the disruptions in the oil market has had some ramifications on fixed income and currency markets globally, but specifically across Africa as a frontier investment destination. We have seen the Nigerian Niara collapse almost 10% in the space of six weeks.

A lot of those disruptions actually create opportunities. Despite the fact that 2014 was not that easy to navigate, when I look forward into 2015 I believe it should be quite interesting because of the opportunities that are being created.

Simone Blanckenberg: We are really excited about 2015 from a business perspective. For the first seven year of Tantalum's life, we were very much below the radar and operated purely as hedge fund managers. In the last two years we have placed a lot of focus on building out our long-only business, which has gained some good traction, with decent performance. We launched our first retail products in the last couple of months, quite successfully, and are excited about the opportunities that exist in this space.

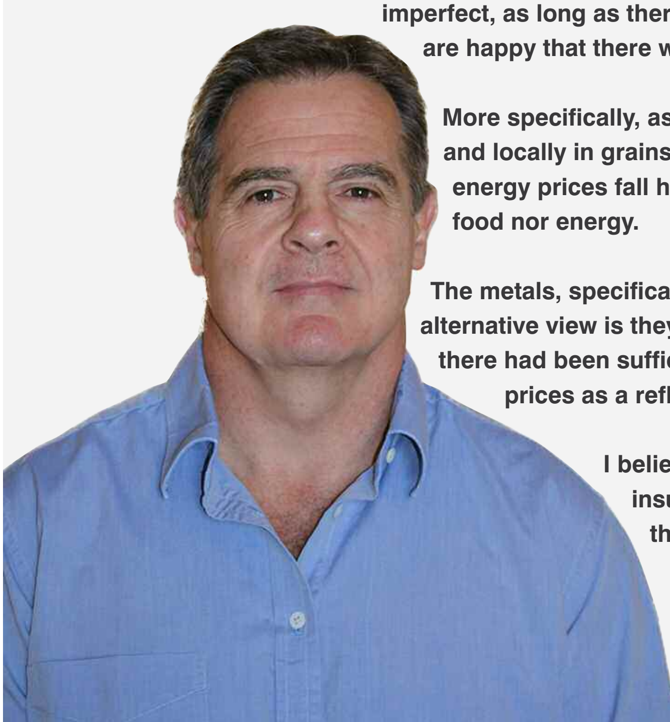
I know we are going to talk about regulation later, but let me state upfront that we are quietly optimistic about the opportunities that will hopefully materialize in the retail hedge fund space. When we have been out there talking to financial advisers and other people who potentially allocate into this space, we have seen a willingness to learn more about this space, and some appetite to allocate. At the same time, huge efforts have to be undertaken by the industry in terms of education. In addition, the lead time for allocations to actually happen will probably be at least two to three years. Still, these developments are very promising and will, we hope, provide exciting growth opportunities for the hedge fund market.

Pieter Viljoen: I agree mostly with what Bradley said before. Interest rates, both locally and offshore, are very low compared to their long-term historical values. Volatility levels are still relatively low although we do expect levels to increase in 2015. The low oil price and strong dollar are strong headwinds for several emerging economies and this will be an interesting space to watch in 2015.

Just in terms of the environment for hedge fund and asset managers, we can clearly see that the market levels and the level of the underlying earnings of the stocks have diverted to the extent that we have now a quite large divergence. That gap has opened up substantially. By that indication, either the market must come down or the earnings must appreciate quite a lot to get those two in line again. This also implies that stock selection will be very important going forward, which should be good for hedge funds in general where the good ones generally have the ability to identify potential shortfalls in earnings or on the upside positive earnings surprises. Relative valuations will most likely be more important than momentum, and the risk of foreign outflows still lurks given the high level of foreign ownership of our local shares ands bonds.

We believe markets are going to be volatile, making money will be difficult, but as I mentioned the focus on bottom-up stock selection will play a bigger role going forward. Hopefully, in 2015 managers are going to benefit more on the short side than in the last couple of years where this was quite difficult in an upturning market, so we hope to see a change in the environment.

Andy Pfaff: We have a ditty in our commodities team that agricultural commodity prices are driven by the weather, energy prices are driven by politics, and metals are driven by economics. So, as long as our weather forecasting is imperfect, as long as there are politicians, and as long as there are economic cycles, we are happy that there will be something to trade.



More specifically, as Bradley referred to, we have seen huge harvests both globally and locally in grains and other soft commodities. We have obviously also seen energy prices fall hard in H2 2014, so we're not seeing inflationary pressures from food nor energy.

The metals, specifically the precious metals & PGMs, have also sold off. An alternative view is they are reflecting that there has been insufficient QE globally. If there had been sufficient QE, you would have seen that reflected in rising metal prices as a reflation-type hedge trade. We haven't seen that.

I believe that there is sufficient QE to support equities, but insufficient QE to create inflation and turn the metals bullish nor the bond markets bearish.

So I think we will continue to see interesting behavior from the monetary authorities, and whether they have got deep enough pockets to do "whatever it takes."

Simone Blanckenberg: One aspect that I think will be exciting is that going forward those managers who really have skill when it comes to stock picking will come to the fore.

The last few years, the markets have been very momentum-driven. Regardless of what you were modeling and irrespective of what you thought the valuation of the company was, external factors like for instance massive offshore flows continued to push share prices way beyond what we believed was fair to be paying. I believe we will be having a correction there where valuations will matter again instead of just seeing pure momentum-driven plays. That will potentially offer exciting opportunity for bottom-up stock pickers.

But, managers operating in the South African market also need to be cognizant of the macro environment. South Africa is such an open environment, and our currency so liquid, that any manager who tries to manage money here without being cognizant of what's happening on the macro level would be missing a potential trick or missing a potential driver of our markets.

Tony Christien: As Simone touched on, we are obviously going to discuss the regulations in a bit more detail. It appears that the new regulations in South Africa will be bringing both upside and a bit of downside.

On the positive side we will gain certainty on how we deal with certain alternative investments, and on the downside are the typical operational aspects like the establishment of lots of different levels of reporting and controls. And that's not just in the local market. We administer out of Malta as well where we find that AIFMD in Europe is creating a huge ruckus. Some of the managers here in South Africa have interest offshore.

When it comes to managing such diverse bases of assets, there are some things managers will be able to deal with, and some they will not be able to. But when it comes to the financial controls that are being put in place, you have either got to live with it or get out of the industry. Therefore, as long as you are in a position to look at these things positively and deal with them positively, then next year will be positive.

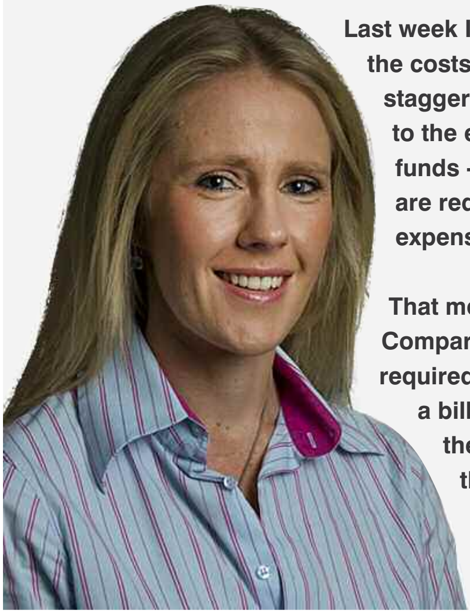
Andy Pfaff Tony, do you think that it's increasing the barriers to entry in terms of system requirements and also requirements on the business and the asset side?

Tony Christien Definitely!

Andy Pfaff Because this issue of rising barriers to entry has been with us for some years.

Pieter Viljoen: Andy, you are quite correct, it will raise the barrier from all sides; from the manager side, from the administration side, and from any of the other service providers operating in our industry. To start a new hedge fund on your own becomes very difficult both from a funding as well as an operational/legal perspective. At this point of the cycle of our industry, consolidation will most likely increase.

Simone Blanckenberg: If you just look at the capital requirements as they are defined now in South Africa, a R3 million capital requirement for a startup is significant, I believe. I am not saying it's a bad thing, but this certainly represents an immediate barrier to entry.



Last week I was at a RMB Morgan Stanley operational conference where they ran through the costs and capital you require to start a hedge fund in London, and the numbers are staggering. The total number to run a hedge fund business for one year, so from startup to the end of year one was $1.6 million. Just $400,000 of that could be attributable to the funds - trading costs, legal documents, that kind of thing. The remaining $1.2 million are required just to launch a startup in London and cover rents, salaries and such expenses.

That means the average London-based fund breaks even at about $70 million assets. Comparing that to costs in South Africa, we are in a good place as the capital base required here isn't anywhere near that. It's probably closer to R100 million, certainly not a billion rand. Generally, a fund manager here in South Africa will be able to source the required services cheaper here than offshore, but of course, as we pointed out, the costs have risen here because of the additional requirements, creating major impediments to new startups and growth in the industry.

Matthias Knab In spite of all this pressure, a number of funds have succeeded and grown, also in South Africa.

Pieter Viljoen: Still, it has become much more onerous for a new manager or potential manager to set up a business, not only from an operational perspective, but also from an industry perspective.

Over the last couple of years, most of the growth in the industry here in South Africa has been asset growth, there hasn't really been a lot of new flows coming into the industry. So when there are not a lot of flows coming into the industry and on the other side you have this huge operational setup cost as a tradeoff against that, that makes it very difficult for new talent to come into the industry.

Genene Carse: Just to confirm what Pieter is saying, a lot of the new funds that we have seen are either very small funds who want to get recognized as a hedge fund or as a fund prior to regulation, or players repositioning and restructuring their legal structure.

Let me come back for a moment to the initial question about our outlook as an administrator. For the past ten years we have successfully positioned ourselves as a specialist firm for hedge funds, but we have in fact broad capabilities across a wide product offering that spreads from collective investment schemes, securities, long-only, to private equity. We have implemented new systems, because each of these product categories have unique reporting requirements and therefore unique systems are required.

What we will probably do over the next year or two is to reposition and bring the message out that we are not just focused on hedge funds, because in the end it is not about a particular label like "hedge fund", but actually what capability do you offer your clients.

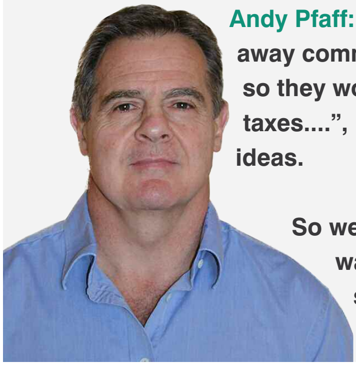
IDS continues to expand both the scope as well as the depth of the services that we provide and keep focusing on reporting, AML, data exchange, and ongoing liaison with the regulator regarding new requirements and standards.

Tony Christien: Pieter, Edge Capital specifically was one of the first fund of funds that actually seeded new fund managers, years back already. Because of your size, you have the capacity of actually bringing new managers on board and starting something new with someone new. However, when that guy is on his own and he has got no one to turn to, that is where the problem is.

So with regard to the regulations that are currently finalized, it was also extremely important that high net worth individuals retain their capability of investing into newer funds, because traditionally that is not what your typical institutional pension fund would do, they don't receive new businesses concepts easily. It's generally the high net worth guys who take their chance with somebody new. The issue is that unless we maintain that capacity to get new people coming to market, then the industry itself can only stagnate in the long-term.

Pieter Viljoen: You are right, and there is also a slight peculiarity here at play. While globally it was the high net worth investors and the family offices that created the hedge fund industry, locally in South Africa, it's vice versa, those guys have generally stayed away and the institutions invested first. I believe that the HNW market will be a key driver going forward to fund smaller and new managers as they look for niche opportunities. We must also accept that our market is relatively small, so the opportunity for a lot of new managers and strategies is limited purely from a market dynamic perspective.

Genene Carse: I think the deeper issue when it comes to new products, ideas or innovation in the alternatives space is that the regulator wants to regulate what is known to them, but what we are talking about here is the unknown. I think that is an ongoing, underlying issue based on how regulators work, and the challenge in an increasingly regulated world will be how do we keep the dynamics of the industry and the innovation going within that regulated space? That concerns not only tax, but a whole host of other issues as well.



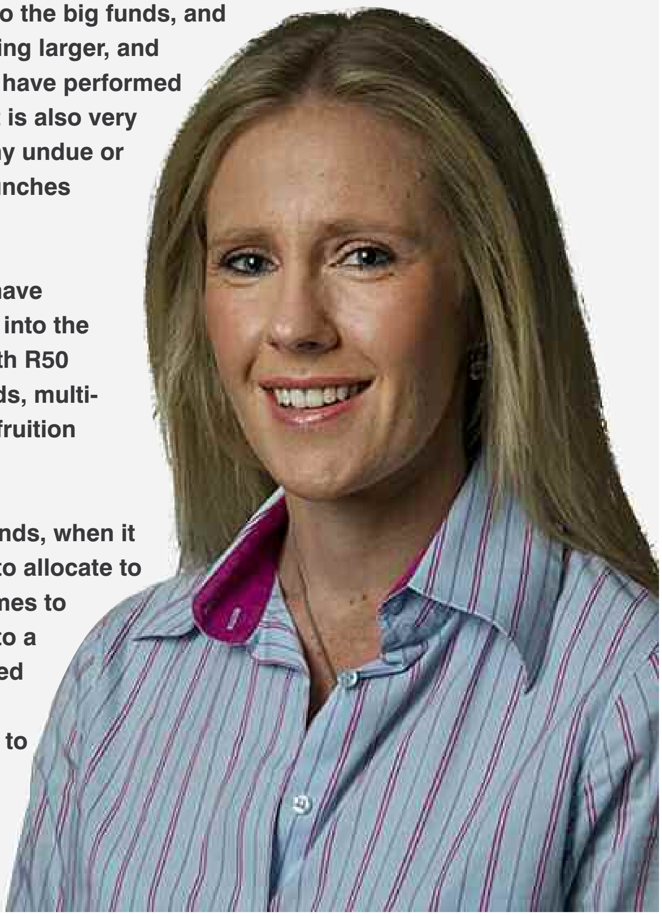
Andy Pfaff: If you look at the discussions around tax, on the qualified fund or the retail fund, the throw away comment seems to be, "Well, most of the investors in the qualified fund are institutional bases, so they won't be paying taxes any way, it's just the high net worth investor who will be paying taxes....", but those are exactly the guys that we need to seed the start-up fund with the creative new ideas.

So we want to be careful that those investors don't get painted out of the picture accidentally. If it was a deliberate policy we could argue whether it is right or wrong, but we don't want something like that to happen by accident.

Simone Blanckenberg: The majority of the fund flows are going to the big funds, and that is happening globally too. The large fund managers are getting larger, and that's where everybody is allocating, whether it be because they have performed well, because they are seen as a safe pair of hands, and where it is also very easy for the consultants to tick the box, so they are not taking any undue or unexplained risks. On the other hand that results in less fund launches globally, and the small guys are staying smaller.

We have the same here in South Africa as well. The big players have generally gotten bigger and we haven't had a lot of new entrants into the market. The small guys who launched three or four years ago with R50 million hoping that they would get the support of the fund of funds, multi-managers, institutions or consultants, this hasn't really come to fruition across the board.

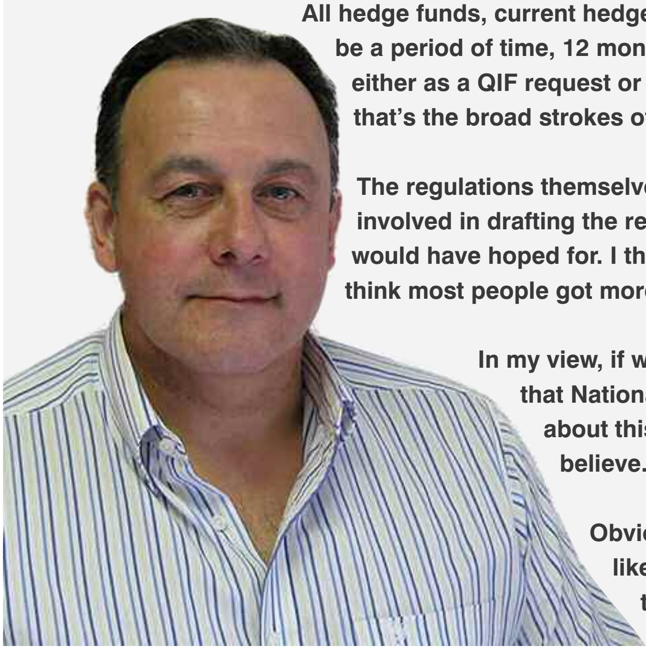
Even though the theory is great about wanting to support new funds, when it actually comes to allocating the capital, that allocation decision to allocate to a small fund manager is incredibly difficult. And then when it comes to existing allocations, investors aren't always willing to reallocate to a smaller manager. Even if the large shop may have underperformed the smaller manager, but not necessarily disappointed the allocators, why would an investor reallocate away from that fund to take the risk with a guy who is smaller and relatively unknown?



Matthias Knab Some of you already referred to the new regulations that are finally coming in South Africa. It seems like this will be the theme for 2015 here. Can you elaborate more on those regulations?

Tony Christien: What we are looking at here is the culmination of 10, 11 years worth of work by a lot of people, including most of us around the table here, I think. And as things stand right now, I think we are on the cusp. We will know probably next week where the final draft regulations will be at.

As things stand now, we have been led to believe that these regulations will be effective as of March 1. The Minister of Finance in his February budget speech will declare that all current hedge funds fall under the Collective Investment Schemes Control Act (CISCA).



All hedge funds, current hedge funds will become qualified investor funds, and then there will be a period of time, 12 months initially, whereby you register with the authority, the FSB, and either as a QIF request or change yourself into a retail fund, if that is your wish. I think that's the broad strokes of where we are.

The regulations themselves – and we can get into details, Genene was very heavily involved in drafting the regulations – are probably around about 90-95% of what people would have hoped for. I think some people didn't get perhaps everything they wanted, but I think most people got more than they expected.

In my view, if we want to be honest with ourselves, I think we need to express that National Treasury has actually come to the party and been pretty broad about this. We, in South Africa, can be pretty happy with where we are, I believe.

Obviously there's going to be more regulatory reporting and things like that, but I mean we all have the capacity to do. So I don't think that in itself is a major issue.

Matthias Knab Tell us more about how the new regime is different to the previous one? I believe in your previous regulatory set up, the managers were supervised, so every hedge fund manager operating in South Africa has to be authorized. Now the supervision was extended to the product level, right?

Tony Christien Correct!

Matthias Knab Also how is a QIF, a Qualifying Investor Funds, now defined?

Genene Carse: Let's start with the retail investment funds. I think what defines that is the rules around eligible assets and investment exposures. Bradley was very heavily involved in the working group at the CISCA, defining the universe. The current Board Notice 80 was used as a reference point, and the eligible classes of securities and exposure limits expanded for the retail investor hedge funds.

So you need to look at both, onto both categories, retail and qualified; what are the assets, what's allowed on the assets, and what is the typical investor's rules around that.

There are rules around liquidity in the retail space. More frequent liquidity is required.

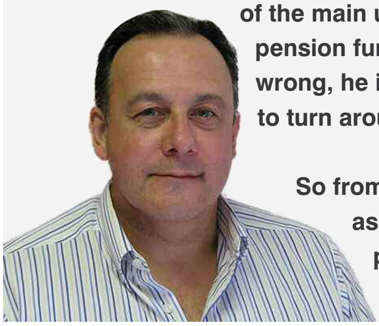
In the qualified space, the mandate is unrestricted, within reason I would say.

Liquidity is three monthly, which most of the current industry will more than exceed, and they have really accommodated the industry around the definition of a qualified fund. The initial proposal was very contrived definition on who is a qualified investor, but they have made that fairly easy to meet requirements. The one requirement that they have is a minimum I think of a million rand per fund or portfolio that you invest in, for new investors.

So I mean, the devil is really in the detail. It is possible that although there will be a set of regulations, there won't necessarily be any supporting board notices or guidance notes at the outset. The result is that many aspects as described in the draft regulations will need further clarification.

So there's a lot of detail that has to be worked out, firstly at an industry level; and then secondly, where appropriate with the regulator.

Tony Christien: Following up on what we discussed about lack of fresh institutional cash into the industry, I believe one of the main underlying issues, and I think Genene just alluded to something similar, is that when a pension fund advisor has to make the choice of going into a hedge fund and say something goes wrong, he is on the line. Whereas if he invested into CIS and that investment went wrong, it's easy to turn around and say the market is down.



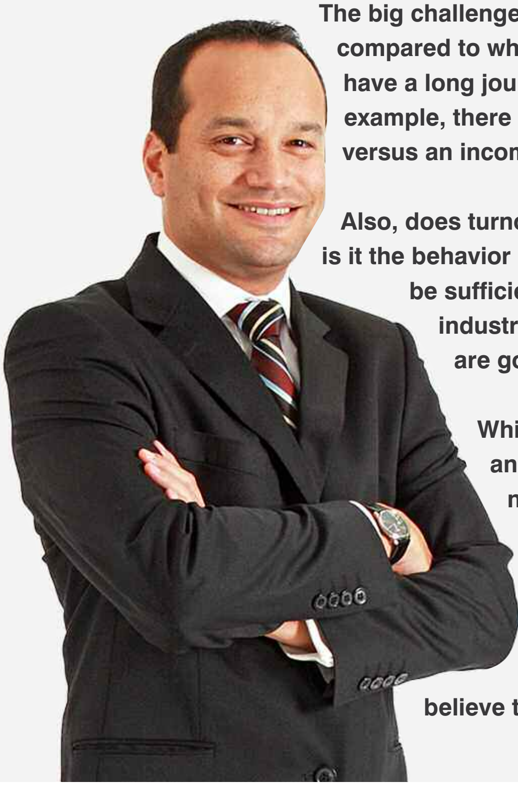
So from that perspective, the fact that hedge funds, both retail and qualified, now fall under CIS as a product could potentially make it easier for people to make decisions without having personal repercussions.

Pieter Viljoen: Also, the new regulations will also be very helpful from a governing perspective in general. In the past, some people may have chosen to stay out of hedge funds because of potential governance issues. While the new regulations probably aren't the perfect solution, I think it's a big step forward.

Bradley Anthony: I do agree with you on that. I believe we are going to look at regulations through two different lenses. The one lens is giving us the picture where we have to admit that in certain instances we are price takers, and there's not much we can do about it.

Since 2008, regulation has become a part of our businesses and there's a cost to regulation in the retail investor hedge funds, the reporting requirements are nothing short of onerous, and I think it's going to require an additional investment, either on the administrator's behalf or on the manager's behalf in order to meet those reporting requirements. I think ultimately the person who finally bears the cost of all of these will be the investor.

The other lens is the lens of opportunity. If you look at the development of the unit trust Industry, at the time collective investment schemes moved into a regulatory net, that opened up an opportunity to distribute, to solicit, and to actually develop an industry which has grown tremendously over the past 15 years. We have got to look through this lens at that opportunity as well.



The big challenge always lies in the detail. So while we have made tremendous strides compared to where we were three to four years ago in the hedge fund industry, we still have a long journey to go and a fair number of issues still need to be addressed. For example, there are issues around what gets considered to be returns of a capital nature versus an income nature.

Also, does turnover in a portfolio represent the justification for different tax treatment, or is it the behavior and the intent of the unit holder, the investor? Will qualified investor funds be sufficiently supported from a regulatory framework to assist innovation in the industry and to allow future growth into new directions – we don't know what they are going to be today, but we certainly must allow for innovation and growth?

While such issues make life difficult for startup funds, I believe there is even another layer of managers beyond startups that will struggle as well in the new regulatory environment if they don't have the required of operational infrastructure.

I saw some research from Barclays which says that in 2013 every U.S. startup has more or less a 2:1 employment ratio of ops people versus investment professionals. Our business definitely doesn't have that ratio. I believe this is an interesting challenge going forward.

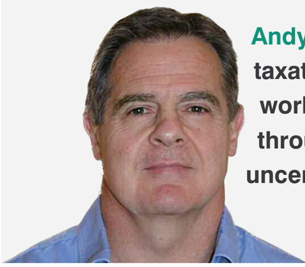
Simone Blanckenberg: I can confirm what Tony said earlier, Treasury and the FSB have been fantastic in their approach to really wanting to hear what we would like the hedge fund regulation to look like and to try to accommodate that as much as possible.

I think the one thing which hasn't been fully dealt with or addressed, which hopefully will be done so prior to the regulation coming out, is the lack of clarity on the tax side. This is the main area people ask about all the time, and unfortunately we still have to push back to investors and tell them that we are not sure about certain aspects, and that they as the investor need to decide for themselves. If this condition would continue, I believe it would be very disappointing and really a cog in the wheel that we really need to try and fix before regulation finally comes out.

Personally, I think at least on the retail side, there needs to be some kind of tax clarity. On the QIF side, I think given that the majority of investors probably have their own tax regime anyway and are protected from that perspective, we don't necessarily need parity. Rather, we need clarity as opposed to parity – clarity on taxation but not necessarily parity with regards to QIFs and RIFs.

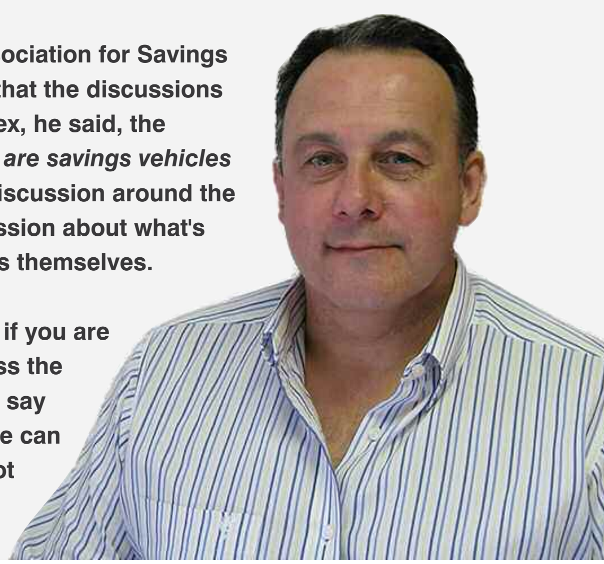
Andy Pfaff I think that's wrong.

Simone Blanckenberg Why?



Andy Pfaff: I would strongly disagree with such a position. I believe regulation generally and taxation specifically should follow a principled approach, not a series of ad hoc fixes and workarounds. The taxation approach should be a principled one which is applied consistently right through the whole regulatory environment. Without consistency of logic all planning is fraught with uncertainty.

Tony Christien: Just to add on to that, and this came out of the meeting of the industry body at CISCA the other day, and I don't think you were there. There was discussion once again about this clarity and parity scenario. Just to give you an example, in terms of the designations of funds under the RIF and the QIF space, a fund like Andy's cannot be a RIF. He can only be a QIF. So therefore by definition, if we went the other way with the tax thing, then he is shot out of the water, he is dead.



What came out quite strongly from Steve Smith, who is from the Association for Savings and Investment South Africa (ASISA) in charge there, was that now that the discussions had been had and they have come to a conclusion on the tax complex, he said, the important thing to remember is that the *CIS and products inside CIS are savings vehicles and they should then be dealt with on a similar basis*. He says, the discussion around the derivatives, the revenue or capital discussion should not be a discussion about what's happening in the funds; it should be a discussion about the products themselves.

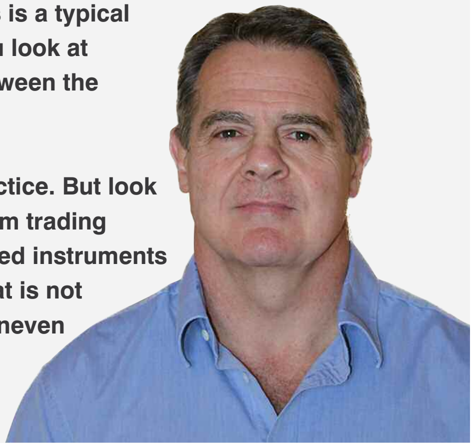
That then of course goes back to how they are being used, because if you are going to look at those particular products, they are being used across the whole variety of current and future CIS funds. So to turn around and say that one lot should be kicked out of the bed just because that way we can get the other two done, is from a principled perspective, probably not correct.

Bradley Anthony: I agree with Tony. I tried to allude to this earlier, maybe it was a bit vague. I would also be interested to hear Pieter's view as an allocator of capital, so putting the investor hat on. Now, the taxman is looking at the underlying behavior of the manager and the way in which the manager is using a range of securities in order to derive a payoff profile, and I think that's incorrect.

I think even in the Collective Investment Schemes Control Act (CISCA) meetings, reference was made to long-term investors. Now, we believe that we are long-term investors and we are supporting long-term investments and savings. The fact that a hedge fund manager produces a specific pay-off profile to investors which complements the rest of the payoff profiles they currently have exposure to, in terms of their long-term savings plan. All of us in this industry share the aim to provide long-term benefits to our overall portfolios. We are not day trading, but are all in portfolio construction. That is a big difference.

So in my opinion we should argue the case that investors' behavior and intent should be the primary source of determining the taxability of the investment vehicle as opposed to the way in which the manager derives a particular payoff profile for the investor.

Andy Pfaff: My apologies for jumping the queue - I will be very brief. I believe this is a typical example of collateral damage, the unintended consequences phenomenon. If you look at commodities, for example, you run into the current built-in conflict that exists between the instrument definitions and the tax treatment of derivatives.



The taxman treats all derivatives profits as income – that's a well-established practice. But look at the definitions of tradable instruments. A commodity manager is prohibited from trading something that is deliverable, or the underlying commodity itself - only cash settled instruments are permissible. That means that a commodity manager can't trade something that is not regarded as speculative and taxable by the taxman. That creates the proverbial uneven playing field.

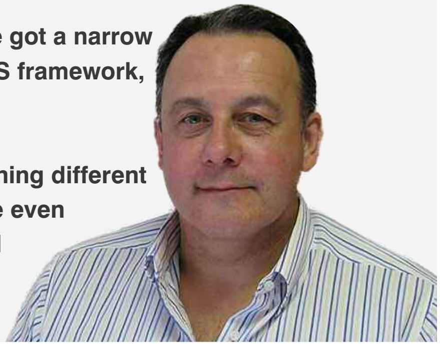
Genene Carse: Coming back to Bradley's point that for taxation the focus should be on the investor intent, and not really what's happening in the portfolio. What happens now is that you are forcing managers to make a choice between setting up a retail fund and a qualified fund based on tax considerations. There are many funds whose mandate at this point in time might be completely suitable to become a retail fund, but due to the governance structure, or the liquidity requirements, or other investor related requirements, they want to remain a qualified fund. They might be able to exactly duplicate their strategy as a retail fund, but they don't want to do that.

So I do think you need to consider both investor behavior as well as investment and trading activities, and apply a consistent set of principles across the CIS space.

Tony Christien: I think just to go along with that as well, Simone, I was chatting to one of the larger single fund managers the other day, who also runs long-only money. I said to him, "I have looked at your mandate and your funds, they could also fit into a retail fund product quite easily".

Let me add that a South African retail fund is like an UCITS product where you have got a narrow mandate, although it seems to me we are a bit broader set up than the current UCITS framework, if I am not mistaken.

And he said, "yes, I can fit into the retail space today. But what if I want to do something different tomorrow, and what if the regulator comes back next year and narrows that mandate even further, how do I get out then? But still, I may well run a retail product as well." And I think a lot of the guys we have spoken to will probably go that route.



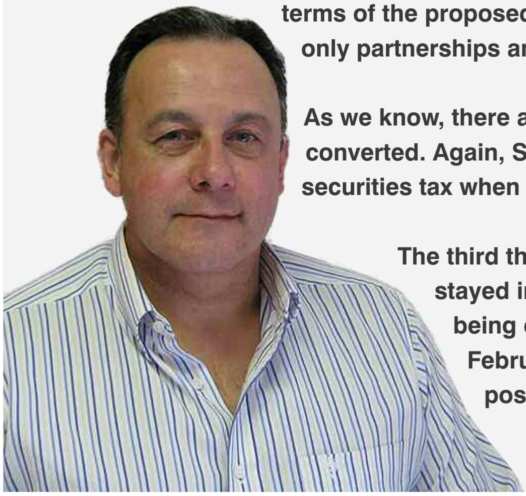
Simone Blanckenberg They won't transfer their QIF to become a RIF; they will keep the QIF?

Tony Christien There will be some who will do that and actually keep the QIF.

Simone Blanckenberg Right, if a manager has a QIF he can start with a RIF right away, but others may opt to keep their QIF and maintain their track record there, and then launch a new RIF.

Tony Christien: Yes, absolutely! So far we have discussed here the various available products and a little bit about the tax issues. We haven't spoken about transitioning; in other words, on March 1st 2015, what happens then?

Once again, the South African Revenue Service (SARS) have come to the party and have indicated that there will be no tax consequences relating to vehicle changes which may be required by the new regulations. In terms of the proposed regulations, only partnership structures will be allowed for retail funds and only partnerships and a certain type of trust will be permitted for qualified funds.



As we know, there are a lot of debenture structures out there that will then have to be converted. Again, SARS' indication is that there will be no tax for the investors and also no securities tax when it comes to shifting assets at prime broker level, and so on.

The third thing is that, as Bradley alluded to, with regard to people who have saved and stayed in the fund, the current term is three years, and you are then classified as being capital. They have also granted that all people in hedge funds as of 28 of February 2015 will carry their time in fund into the new funds, which is a hugely positive thing to do.

Matthias Knab Just stepping back from the details for a moment and looking at the overall industry again: how will the South African hedge fund industry grow and develop following the regulatory reforms?

Tony Christien: The tax structure that hedge funds will carry in both retail and qualified will be the same dispensation that is currently enjoyed by the long-only securities. I think this is where people wanted a little bit more certainty because that dispensation is currently unwritten. It has been in place for how long? 40 years, I think, and it has never been challenged once. It has never been challenged once by SARS.

I think there will be some follow-on effects. As we said, there will be people who stay as qualified funds, people who will change to retail funds, others that will open retail funds, and those who open qualified funds.

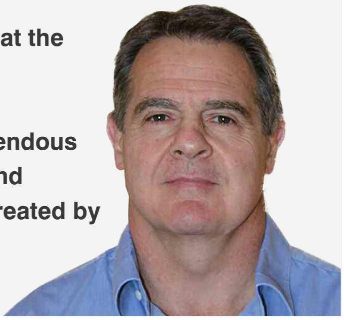
Our view is that in the longer term you will probably find fewer securities funds and more retail hedge funds being opened. If the manager has got wider powers to act and to produce returns, why would he go to the more restrictive mandate in the securities space?

Therefore, from a hedge fund perspective – because we are still running hedge funds, whether you are retail or qualified – going forward, the opportunities are massive.

Bradley Anthony: Well, in theory we have massive growth opportunities, but if you just think about the conversation we had probably 20 minutes ago about the number of new entrants to the markets and the capacity limits in the markets, I wonder whether the growth opportunity is as large as we wished it to be. While certain markets will offer a lot of capacity, we don't have a whole host of available capacity in our business, because there are constraints to some markets. If you purely try to derive alpha from markets, your capacity will probably be constrained.

We might however find some sort of hedge fund "light" products coming to markets which have greater capacity, but not the hedge funds that we have grown used to.

Andy Pfaff: Bradley, I just need to remind you of that second eye or lens that you referred to at the beginning of the discussion regarding the prism of opportunity.



If the flows aren't oncoming from the institutional side, I think the retail side presents a tremendous opportunity for industry growth. It will be a slow-burn because roll-out will be incremental, and distribution capability is required. This will probably imply new fund of fund-type products created by the major houses with major brands and distribution capabilities.

Pieter Viljoen: Capacity sometimes is also a function of flows coming into the industry. I am pretty sure if we start to see flows, we potentially will see more capacity becoming available in different areas of the market. But as it stands now, the available capacity in the market is limited. Of course there are different opinions on that, but I don't think it is as big as many people think it is.

Also, remember that at the end of the day, we compete with other investment opportunities and solutions out there. All these regulations really should promote savings.

In South Africa, and many other places as well, the savings rates are too low, so the bigger context here is that all those investment products are created to open up another avenue for the main industry to invest for the longer term, and to help make people less rely on state funding and state support when they retire.

That also means we have to make sure we have a value proposition relative to the other opportunities out there. And this is also linked to capacity. The less opportunities there are for hedge fund managers, the worse the value proposition is going be. That's the tradeoff, and I think this is a fine balance at the end of the day: capacity versus the value proposition that you can give your client.

Bradley Anthony: This is a very valid point. I believe the South African hedge fund industry can compete very well also from a global perspective. Those of you in the room that have met with offshore investors and capital allocators know the extent to which South African managers are able to produce alpha on a consistent basis, vis-à-vis global hedge fund managers. When overseas investors take a deeper look at our industry and returns, there is almost every time this element of surprise when they see the extent and the persistence of alpha generation in the South African market.

Also, if you just look at the local equity market in isolation, the South African equity market as a percentage of GDP is running at about 250%. This is unique across the globe. In emerging as well as developed markets there are very few markets that look like ours. So, because we have this very deep, very liquid equity market dominated by long-only fund managers, that on its own creates opportunity for hedge fund managers at the periphery extracting alpha from the opportunity set. Coming back to my original concern, if you now broaden and grow the alpha part of the industry tremendously, I don't know how much alpha will be available going forward.

Simone Blanckenberg: There's no doubt that the opportunity exists; but what on top of that will it take to get the capital allocated here? A lot of offshore funds and investors are looking for ways to make an African or South African allocation. Everybody loves to hear the story, everybody wants to hear the pitch and they are excited, but when it actually comes to writing the cheque, it then becomes so much more difficult.

I think that is where the industry here almost needs to come together, identify what is missing and focus on educating the potential allocators. What is the value proposition that we want to put forward? How do we articulate that simply? I do believe the money will come, but I don't believe that there is this massive wall waiting that will start to flow as soon as regulations come through. So I think this is an 18 month to two or three years educational process for the hedge funds themselves and for potential investors.

Matthias Knab From where will the money be coming?

Tony Christien Just to give you an indication, we as an administrator obviously see across different things, and if we look at the last 12-18 months, we have seen each month institutional inflows of one or two billion rand and from high net-worth between 200 million and 500 million.

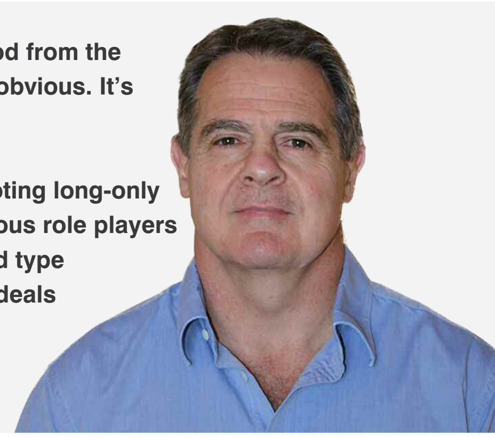
Pieter Viljoen Tony, I have spoken to a couple of people in the market and I was surprised to learn how much lazy capital from high net worth individuals there are out there.

Genene Carse If we look at the retail space, how do you see the distribution mechanisms changing and developing in that space?

Bradley Anthony: How retail distribution of alternative products will develop is of course an unbelievably difficult question to answer, and made almost more difficult to answer in the last week-and-a-half because of RDR, the Retail Distribution Review, which we are looking to implement in our market. RDR has been implemented in the UK and effectively changed the landscape altogether with regards to distribution in the IFA industry in the U.K.

We as a fund manager think all the time about how can we best access this high net worth market, or the very lazy capital that Pieter referred to? We need to find a mechanism to access it. We have got to recognize that fund of funds are probably best positioned, especially the ones who are already embedded in a big retail house, like the Sanlams of the world – those are probably best positioned to capture some of those flows, but we can't rely only on that. We have to try to develop our own capability and reach. But again, RDR will have its effects, so we are not sure what those would look like.

Simone Blanckenberg: There's obviously the potential to co-brand relationships. The ManCo houses, some of whom have some kind of distribution skills and have those IFA relationships already, can assist you to open those doors. But it's going to be very interesting to see how it plays out and where the capital actually lands up coming from, and how those hopefully new avenues look like, but there's no obvious answer.



Andy Pfaff: Regarding this distribution issue, sometimes we don't see the wood from the trees: if we just step back and take the long view, the answer is easy and it is obvious. It's just whether the industry can get over itself and actually do it.

There's not really a lot of differentiation between the competing brands promoting long-only product. This presents an easy opportunity for collaboration between the various role players to create e.g. stand-alone hedge fund products or hybrid long only/hedge fund type products. Now this is the issue, can the industry get over itself and put these deals together? Like with legislation, it's the nuts and bolts of putting the deals together...

Something else worth commenting on, a simultaneous opportunity and threat, is to pick up on Pieter's comment about the value proposition. We have noted before that hedge funds are perceived as being a high fee part of the industry in an era of cost compression. I think we need to get our ducks in a row as an industry. We need to be able to articulate what our fee structure is, what our TER is, what the impact is with or without performance fees and why is this TER volatile?

As a savings industry, the private sector pension fund industry AUM is approximately ZAR3 trillion, and hedge funds manage approximately ZAR40 billion -- a very small portion of the total. Hedge funds therefore don't represent much of the industry's cost structure. But I think we need to be able to articulate those costs sensibly and put them in context, otherwise we are going to be on the back foot defending those fees.

Bradley Anthony: I think that to a large extent, performance fees are a red herring. This is a very obscure perspective I suppose, but if you look at the long-only world, their base fees are effectively performance fees, because equity markets generally go up, and they are not necessarily taking active risk for the assets to go up. That means their fees increase as their benchmark rallies.

Genene Carse: I think one of the bottlenecks is that you need other enabling legislation other than CISCA, such as FAIS (Financial Advisory and Intermediary Services Act). There is actually no specific category or list of competencies regarding people who can provide advice on hedge fund type products. So that has to be developed for the distribution channel to be formalized in strictly a retail space. There are a lot of small little bits and pieces that need to get together, and this will only happen over time.

Bradley Anthony: I agree, Genene. I think the other thing which is also important to note is that I have never found a retail investor who is passionate about hedge funds. I have actually never found a retail investor who is passionate about any asset class. At the end of the day, they want a particular return objective met, and see the product packaged in a way that they have comfort that a return on risk is going to be made.

So, also in that regard, as Andy expressed it, we hedge fund managers sometimes have to get over ourselves as well in respect to beating the drum of who we are as hedge fund managers and educate on the nature of our absolute or uncorrelated returns. At the end of the day, if you are a true hedge fund manager and you are able to produce alpha, how do you package and communicate that alpha to meet the return objective of the investors? Maybe we just need to come up with innovative ways to do it. I know Pieter, your business has been doing it for a while, and I think we need to start thinking along the same lines.

Pieter Viljoen: I agree with you. Especially from a fund of funds perspective, we have access to all the different vehicles in the market. You then need to create unique solutions that make sense in the broader scheme of things.

Of course we won't be the only investment of the individual, so we also need to view our product offering in a bigger picture of what the typical man in the street or high net worth individual is looking for.

At the end of the day, it might not be a pure vanilla fund of hedge fund solution but actually also something more specialized that is part of a larger portfolio. So we also need to think about that and not just about selling a unique single strategy or fund of fund solution, making sure that our portion will be adding value to the whole.

Tony Christien: We were talking earlier about derivatives and their taxation aspects. I was wondering, when it comes to trading in those sorts of instruments, specifically hedge fund managers trading, both in the equity and in the fixed income space, how much do they add to the liquidity in those markets? And, if hedge fund activities would be taken away, what effects would that have?

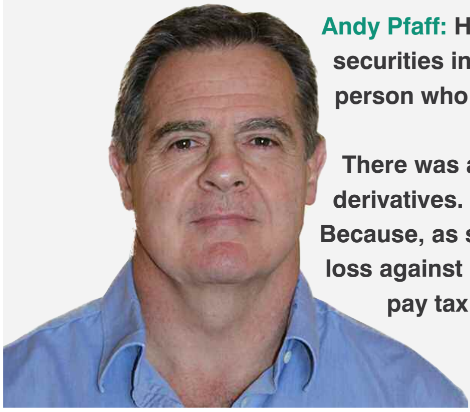
Bradley Anthony: I think this is a very interesting question. My background is fixed income, so let me comment from that side. You have to keep in mind that not just hedge funds have come under lots of regulation but banks are facing a whole raft of regulation as well. Foremost, they need to reduce their prop trading activities, which means the degree to which they can take risk onto their books has now greatly diminished.

But that doesn't change the fact that the property developer down the road who is looking at developing a new property may find himself exposed to significant interest rate risk, so he needs a counterparty to provide him an interest rate swap.

Those type of facts don't change because of Basel II or III or V, nor will it change because of RIFs or QIFs. Hedge fund managers have been able to step into the breach or the gap that has been left by those prop traders that have been closed down in providing liquidity to the market, specifically in interest rate markets, and I believe this probably pertains across other markets too.

As Andy can confirm, in commodity markets this has been the nature of the industry for decades. Commodity markets are among the few markets where you probably find less dominance of financial market participants and more real economy participants.

The fact that commodity traders, hedge fund managers and the like have been able to provide liquidity to those markets has actually positively contributed to issues of food security, whereas regulators tend to be scared that speculators are negatively influencing the issues around food security.



Andy Pfaff: Here's an out-of-the-box suggestion. We all know that derivatives differ from securities in the sense that if for example you look at exchange rate derivatives, for every person who makes a rand profit, there is someone losing a rand and vice versa.

There was an interesting proposal in the U.K. in the early 90s regarding the taxation of derivatives. The gist of the proposal was: why bother to tax anyone's derivatives profits? Because, as sure as eggs, that trader or investor who is losing one rand is going to set off that loss against his taxable income. But there is the possibility that an investor might possibly not pay tax on some of his profits.

Therefore at best, the taxman can only come out square - so why go through the whole effort of trying to tax derivatives when it is, at best, the proverbial zero sum game for the taxman.

The proposal was therefore just don't bother to pursue tax on derivatives.

Tony Christien Maybe that needs to be scratched off from the drawer...

Andy Pfaff I'm not confident that I should be the one to propose it. But, as per the clarity/parity discussion that Simone referred to earlier, it is very clear.

Matthias Knab Usually at this Roundtable we also talk a bit about Pan-african themes and developments. Anyone wants to comment about that?

Bradley Anthony: We are not as active as we would like to be, so let me just put that disclaimer upfront.

I do think there are tremendous challenges to development of financial markets across the African continent, and I am uncertain about the extent hedge fund managers play a role in that. I think the merchant banks probably need to play a greater role in developing these financial markets.

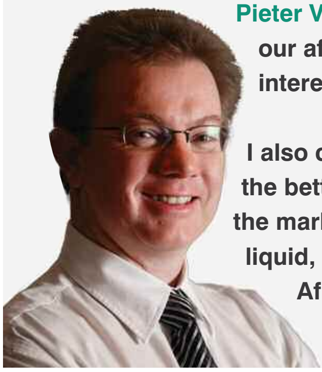
But not withstanding that, Nigeria surpassed South Africa as the largest economy on the continent, but its stock market is still roughly 9% the size of the South African market. That means South Africa is still the dominant financial market to access the African opportunity set.

Of course, from a long-only perspective, you certainly can dabble in these African markets. There are some interesting things that are happening across the continent where you see a disparity between commodity producers and commodity consumers. The Kenyan and the Egyptian markets have all pumped along nicely while the Angolan market and the Nigerian market have fallen in a heap. From a stock picking perspective, these things create opportunities in themselves.

But exercising those opportunities is not always the easiest thing to do, and I think that often is a misjudged phenomenon. We have global investors who come to our offices on a regular basis who are looking to access the African growth story. Over time, I have become more convinced that the way to access the African growth story is not through listed African exchanges, but rather through a combination of Africa listed stock and companies who have operations across the African continent, but are listed elsewhere.

It might not be the pure play that you are looking for, but I think it's the one way in which you have certainty about the ability to access those opportunities on a listed basis.

If you have the appetite to access Africa in a less liquid type structure, private equity vehicles are probably more appropriate. You can go direct into markets and speak to people who are on the ground deploying capital into particular sectors there, but certainly from a listed perspective, we are sticking to liquid markets.



Pieter Viljoen: I am not the expert on our African side of the business, but we do have exposure via our affiliated company in Mauritius. I agree that over the last couple of years there has been a lot of interest, especially from larger institutions and foreign investors, for the whole Africa theme.

I also concur with Bradley that looking from a value proposition currently, private equity is potentially the better access vehicles for those investors. Also, have in mind that a lot of liquidity has come into the market and valuations are not the same as two or three years ago. So these markets are not that liquid, and also the range of listed opportunities, given the amount of dollars that have flown into Africa, has come down, but the longer term story remains structurally very compelling.