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The Wild, Wild South:

Africa's Largest Economy Gives Rise to Frothy Hedge Fund Market

Hedge fund managers worldwide once looked to South Africa as the place to get into gold in advance of hard times. Today, that nation's economy is far more diverse, and its home-grown hedge fund industry is placing bets on domestic companies involved in everything from textiles to electronics to financial services.

"We invest largely in the financial field," says Carl Isernhinke, chief investment officer of Clade Investment Management, a Cape Town investment and advisory firm, noting that the mining industry for which South Africa is traditionally known is not an area of focus.

Isernhinke's firm is new, founded in September 2006, and small, only R30 million ($4.3 million) in assets. Still, Clade is widely for its signature product, the South African Investable Hedge Fund Index fund of funds, which identifies 34 funds that are domiciled in South Africa, externally administered and open to new investment. Isernihinke, whose background is in pricing derivatives, says this index saw a 12.66% return in 2007, its only full calendar year of operation.

Investment comes mostly from South African institutions. Retail has not yet become a major factor, and the government estimates that overseas institutions account for only 15% of capital raised. Funds of funds provide the majority of capital while insurers and pension funds are smaller players.

The index further identifies its components by strategy and – although there are market-neutral, fixed-interest and quantitative-trading plays in the mix – 57% of the assets under management in the funds Isernihinke follows are long-short. This conservatism is born of exchange controls that require hedge funds to focus on domestic securities, although hedge funds can play in futures and derivative markets as well as in the underlying paper. These exchange controls – which govern South African-domiciled funds only – have been around since the onset of World War Two, were reinforced during the country's default crisis in 1985 and again during the advent of majority rule in 1994, but have been gradually easing since 1996; currently, South African hedge funds can invest up to 30% of their capital in non-African securities, a figure that government officials project to increase each year. Also, arbitrage opportunities in Johannesburg are hampered by market thinness; the Johannesburg Stock Exchange traded 311 billion shares in 2006, compared with 7.6 trillion on the London bourse or 21.8 trillion on New York's Big Board.

According to Cape Town-based portfolio management firm Novare Investments (R4.7 billion [$671.4 million] assets under management), total hedge fund assets grew 68.6% to R25.9 billion ($3.7 billion) from June 2006 through June 2007 as the number of funds grew from 90 to 131. Novare notes the 10 largest funds manage 40% of total assets.

A niche for funds targeted at socially responsible investing arose from South Africa's recent history of throwing off the apartheid policies the prevented members of Zulu, Xhosa and other pre-colonial cultures from attaining political or economic power until 1994. South African companies wishing to do business with the government – any country's largest consumer – must be designated Black Economic Empowerment enterprises, or BEEs. By definition, BEEs must be at least 25.1% black-owned.

"When we buy equity in a company, we give that company BEE status," says Zuko Kubukeli, executive director of Johannesburg-based Pan-African Capital, a black-owned investment management company affiliated with Rand Merchant Bank.

Kubukeli estimates that 18% of the capital invested in his firm's R2.5 billion ($357.1 million) assets under management was raised abroad from development banks and "families of conscientious investors".

Regulating hedge funds falls to a government agency, the Financial Services Board. It has historically done little. That may be changing now in the wake of South Africa's home-grown hedge fund scandal, when Cape Town-based Evercrest Capital made a bad bet shorting the stock of insurer Sanlam in April 2007 and lost R132 million ($18.9 million), or almost two-thirds of its value. Rules were quickly drafted to require licensure and insure minimal levels of experience and education: a college graduate needs three years' experience while a high school graduate needs five. Even these modest standards, which went into effect February 1, may be difficult to enforce initially because, according to Novare, two-thirds of South African hedge funds have been in business three years or less.

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