



The new paradigm for hedge funds

Hedge funds are under great pressure to adapt to a much altered landscape following the financial crisis, and hedge funds in South Africa face more challenges than most. Chris Edwards, head of Prime Services at Absa Capital, discusses what hedge funds should be demanding from prime broker relationships in order to help them overcome some of these hurdles

What challenges do hedge funds need to address first in this new post-crisis environment?

Chris Edwards, Absa Capital: Following the 2008 financial crisis there has been a fundamental change in the relationship between hedge fund and prime broker. The Lehman default highlighted the need for hedge funds to carry out an increased amount of scrutiny in order to get a better understanding of the counterparties they face. They need to know who that counterparty is, what its credit looks like and what their exposure to it is. The days of one-directional scrutiny by prime brokers needing to look at the creditworthiness of the hedge fund are over, and things have been completely turned on their heads. The onus is now on the hedge fund to understand who is providing their financing and what the impact of a negative move against that counterparty would be.

As a result of this, hedge funds now have to focus on a number of issues that are changing the landscape for them. Firstly, they can no longer put all of their eggs in one basket. They need to operate in a multi-prime broker environment in order to diversify counterparty exposure. This adds a significant amount of complexity to running their businesses.

Secondly, institutional-style technology is needed to consolidate and aggregate portfolios, and this takes additional resources in terms of staff and enhanced platforms. As a result, the focus on non-investment infrastructure has really taken a step forward. The days of the small boutique hedge fund with two people and a Bloomberg terminal are gone – if a manager is serious about building a hedge fund business, they have to go down the road of institutionalising in terms of infrastructure. You can't be infrastructure-light anymore as your ability to face off against multiple counterparties will be compromised and this will have a negative implication for your potential investor base. Best-practice infrastructure is also being demanded by investors who have a heightened focus on their own due diligence. It is also increasingly needed in order to comply with regulatory requirements.



Chris Edwards

Thirdly, attracting investors has become more challenging for the majority of hedge funds as there has been a swing to more conservative choices. In 2010 and early 2011 the vast majority of global investor flows went to the top 200 hedge funds out of the total universe of some 25,000 funds. This perceived flight to quality was broadly driven by the need to seek comfort in institutional-sized managers.

Finally, another area on which hedge funds need to be focused is re-hypothecation (a bank's ability to use the fund's long inventory to finance its liabilities). As a result of the financial crisis, there has been a move to limit the amount of re-hypothecation that takes place. This has not only put pressure on prime brokers to come up with alternative sources of financing, but has also put

pressure on the hedge funds because the cost of their financing ultimately increases. So, it's a trade-off between what the hedge funds are prepared to let the prime brokers do with their assets and the resultant cost of the financing. Segregation and ring-fencing of long-only assets provides additional protection. This has consequently tightly coupled the prime broking function with its custodial service provision. Ring-fencing, however, comes at a cost, so hedge funds face the challenge of understanding what asset protection they require versus what the cost of that will be.

How are prime brokers adapting to meet these new requirements?

Chris Edwards: Prime brokers are having to do a lot of work around impending regulatory changes. One area in particular is the push coming from the Dodd-Frank Wall Street Reform and Consumer Protection Act to enforce the clearing of over-the-counter (OTC) derivatives trades. Currently, planning around this is very difficult as it is a fluid environment. There is a bit more certainty in the US on what form the regulation will take, but in Europe it's still very unclear and in South Africa we are very much in the dark.

Another challenge for prime brokers is that as hedge funds

increasingly look for risk segregated solutions, prime brokers have had to apply themselves more to the structure and provision of their custody solutions. As the requirement by investors to ring-fence/protect their assets increases, prime brokers need to become more inventive around the provision of bankruptcy remote and/or protected vehicles in which assets will be housed.

Finally, prime brokers are operating more and more in a consultative capacity to assist managers both in the restructuring of their businesses to ensure compliance with the changing regulatory environment, as well as assisting them in positioning to be investible given the heightened due diligence being conducted by investors.

What are the specific challenges facing hedge funds in South Africa?

Chris Edwards: The hedge fund landscape in South Africa is very interesting at the moment. Despite escaping the financial crisis relatively unscathed in comparison to their international counterparts, the 100 or so South African hedge fund managers haven't attracted the interest you might expect. Considering the emerging market sector was down around 15–20% through the financial crisis, you would expect some fairly significant appetite for South Africa where most funds were generally flat for the same period. However, they have continued to remain off the international radar due to a lack of understanding of the opportunities in South Africa and poor international engagement by local managers. In terms of marketing, most South African hedge funds haven't tackled the international investor base as aggressively as they perhaps could have. Emerging market allocation tends to go first to Asia, then Latin America. Allocation to South Africa is more likely to come from a sophisticated emerging markets investor who is looking to diversify his existing emerging markets exposure. South African hedge funds need to engage with international investors and share the story that South Africa is a high-yielding market within the emerging market space.

In addition, the national regulatory environment has imposed constraints by putting limitations on what pension funds can allocate to alternative investments. A mandatory 'other bucket' allocation cap of 2.5% has kept total assets under management (AUM) in hedge funds in South Africa static at around 25–30 billion ZAR for a few years now.

However, this could be about to change due to the February 2011 redraft of Regulation 28 of the Pensions Fund Act, which – from July 1, 2011 – has allowed a 10% allocation to hedge funds. This provides real significant upside to the hedge funds industry in South Africa. While I think it is unrealistic to expect the full 10% allocation to come to hedge funds, we believe it could lead to a doubling of AUM in the hedge fund industry in the next two to three years.

But it is important that hedge funds don't just sit and wait in a queue for the allocation to come to them – their challenge is going to be in engaging the typically conservative pension funds. To do that, they need to overcome their image of being more risky than other investments and get the message across that a hedge fund investment can provide the investor with broader protection for their existing long-only portfolio. Hedge funds need to be proactive in demystifying their industry and they need to embark on an education programme with investors.

What is Absa Capital doing to help hedge funds in South Africa address these challenges?

Chris Edwards: Absa Capital is committed to assisting hedge funds develop their businesses more broadly via the following main routes:

- 1. Balance sheet.** Historically, prime brokers in South Africa have been very execution-driven without providing much in terms of extension of funding. Leveraging our AAA balance sheet to provide stable funding is now one of our biggest focuses. A strong and stable balance sheet should now be a major thrust of a prime broker platform and hedge funds should be more cognisant of this when selecting them.
- 2. Cross-asset support.** Increasingly, hedge fund managers are looking for alternative multi-asset class products to put in front of investors, and prime brokers now need to be truly able to provide a multi-asset platform to support this. Absa Capital offers clients a seamless cross-product prime broking offering allowing a single solution for fixed-income- and equity-focused hedge funds.
- 3. Consulting services.** Prime brokers should be offering hedge funds consultative advice on how to position themselves in the market. Hedge funds need to be seen as investible by both domestic and international investors. We're doing a lot of work with managers on how they should be pitching their product to the market in order to demonstrate that it is robust, stable and able to stand up to international-grade due diligence. They need to be seen as independent with the infrastructure in place to support what it is the business is trying to achieve. In addition, Absa Capital is doing more work around investor consulting, advising hedge funds on how best to engage with pension funds (for example). This is beyond an introductory service, it's a consulting service. Hedge funds need to work out how to scale their business to remain investible at different levels and how to demonstrate that to investors. Finally, Absa Capital can offer a lot of advice around regulatory changes and how to adapt to changes that could affect the OTC landscape. This is where our affiliation with Barclays Capital comes into its own. As Barclays Capital is a market leader in interest rates and OTC cleared products, we are able to leverage a lot of their technology base to extend that to ZAR products. We think many of the requirements of Dodd-Frank will eventually trickle down into South Africa and we'll be well placed to deal with it due to our links to Barclays Capital.

Overall, we are moving from being solely an execution platform to an all-encompassing balance sheet and strategic consulting partner. Through Barclays Capital we not only leverage an international-grade technology platform but are also provided with an international conduit to both products and investors. Absa Capital is execution-agnostic and the primary thrust of the business is now on portfolio financing and balance-sheet support. We believe this is the right approach given the current focus on counterparty credit and we are leading and differentiated in that regard.



Chris Edwards
Head: Prime Services
T. +27 11 895 5189
E. chris.edwards@absacapital.com

Andrew Cairns
Prime Services Distribution
T. +27 11 895 5413
E. andrew.cairns@absacapital.com
www.absacapital.com