

**The Challenge of reigning-in Hedge Funds through
Regulation and
the Need to improve Disclosure Requirements**

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Declaration

By submitting this thesis electronically, I declare that the entirety of the work contained therein is my own, original work, that I am the owner of the copyright thereof (unless to the extent explicitly otherwise stated) and that I have not previously in its entirety or in part submitted it for obtaining any qualification.

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ABSTRACT

This study aims to look at the definition of the group of alternative investments commonly known as 'hedge funds', in order to better understand why regulatory bodies the world over are vehemently working on introducing new legislation and guidelines as a means of maintaining market security and integrity in order to ensure adequate investor protection. This study posits that the two most viable options available to regulatory bodies to ensure effective implementation of these changes are (i) to either further restrict access to hedge funds and thereby curb their 'retailization' and/or (ii) to introduce rigorous levels of disclosure on the part of hedge funds and their intermediaries.

It is the objective of this study to establish that for either of these options to be attained, tangible improvement in both the quantity and quality of information disclosure from hedge funds and their intermediaries about their positions, strategies and exposures in a manner that would enable them to continue to provide the market efficiency-enhancing services that they currently offer. After introducing all the key issues that have motivated this resolve, the study looks at the current regulatory environment and the challenges facing regulators such as the varying degrees of banking freedom offered by different states and jurisdictions. Proposed changes to current legislation are also considered across several jurisdictions. The results from the local market field study set the platform for recommendations to be investigated in future studies in order to provide guidelines for the supervision of the hedge fund industry.

ABSTRACT – AFRIKAANS OPSOMMING

Hierdie studie het ten doel om die definisie van die groep alternatiewe beleggings wat algemeen as ‘skansfondse’ bekend staan, te ondersoek ten einde beter te begryp waarom regulerende liggame wêreldwyd hulle vurig beywer vir die instelling van nuwe wetgewing en riglyne om marksekuriteit en -integriteit te handhaaf ten einde beleggers voldoende te beskerm.

Na die bespreking van die sleutelkwessie, stel die studie ondersoek in na die huidige regulerende omgewing en die uitdagings wat reguleerders in die gesig staar, soos die wisselende grade van bankvryheid wat verskillende state en jurisdiksies bied. Voorgenome veranderinge aan huidige wetgewing vir verskeie jurisdiksies word ook oorweeg.

Die studie toon deur opname in die mark dat die twee mees lewensvatbare opsies tot beskikking van regulerende liggame om te verseker dat hierdie veranderinge doeltreffend geïmplementeer word, is (i) om toegang tot skansfondse verder te beperk en sodoende die ‘verkleinhandeling’ (*retailization*) daarvan te kniehalter en/of (ii) om streng vlakke van openbaarmaking vir skansfondse en hulle tussengangers, in te stel. Die studie toon dat enigeen van hierdie opsies tasbare verbetering meebring in sowel die kwantiteit as die kwaliteit van die openbaarmaking van inligting deur skansfondse en hulle tussengangers aangaande hulle posisies, strategieë en blootstelling, en op ’n wyse dat hulle in staat gestel word dat hulle huidige dienste vir verbeterde markdoeltreffendheid, voortgesit word.

TABLE OF CONTENTS

CHAPTER 1	INTRODUCTION.....	1
1.1	Statement of Problem	3
1.2	Aims of the research.....	3
1.3	Importance of the study	3
1.4	Research methodology.....	4
1.6	Scope and limitations of the study	5
1.7	Brief overview of the study.....	6
1.8	Abbreviations and acronyms.....	8
CHAPTER 2	DEFINITION AND DESCRIPTION OF HEDGE FUNDS.....	9
2.1	The origin of hedge funds	9
2.2	The Investment process	11
2.2.1	Qualification requirements for US hedge funds.....	12
2.2.2	Investor restrictions for US hedge funds.....	12
2.2.3	Hedge fund structures	13
2.2.4	Investment strategies and styles	13
2.2.5	Advantages and benefits of hedge funds.....	14
2.3	Summary	16
CHAPTER 3	REPORTING STANDARDS AND REQUIREMENTS.....	17
3.1	Introduction.....	17
3.2	Criticism of hedge funds.....	18
3.3	Transparency	19
3.3.1	Standards and requirements	20
3.3.2	Investor due diligence	21
3.3.3	Investment mandate adherence.....	22
3.4	Benchmarking and performance measurement.....	22
3.4.1	Valuation of Assets.....	22
3.4.2	Return Calculation	23

Master of Commerce - Business Management

3.4.3	Dispersion of returns	24
3.5	Risk Management	25
3.5.1	Efficient Frontier	26
3.5.2	Mean-Variance	28
3.5.3	The Sharpe Ratio	29
3.5.4	Value at Risk (VaR).....	30
3.5.5	Correlation and the effect of 'herding'	30
3.6	Management fees.....	32
3.7	Index Surveys.....	34
3.7.1	Survivorship Bias	34
3.7.2	Selection Bias	35
3.7.3	Instant History Bias	35
3.8	Fund of Funds	36
3.9	Summary	39
CHAPTER 4 REGULATION AND SUPERVISION OF HEDGE FUNDS.....		41
4.1	Current regulation.....	41
4.1.1	USA	41
4.1.2	UK.....	42
4.1.3	Other countries	43
4.1.3.1	Hong Kong	43
4.1.3.2	Ireland	44
4.1.4	South Africa	45
4.2	Proposed regulatory changes	47
4.2.1	USA	48
4.2.2	UK.....	50
4.2.3	Other countries	52
4.2.3.1	Hong Kong	52
4.2.3.2	Ireland	52
4.2.4	South Africa	53
4.3	Summary	53

CHAPTER 5	EMPIRICAL RESEARCH.....	54
5.1	The plan and procedures of the study.....	54
5.2	Empirical Research.....	57
5.3	Summary.....	83
CHAPTER 6	CONCLUSIONS AND RECOMMENDATIONS.....	84
6.1	Summary of findings and conclusions.....	84
6.2	Recommendations.....	89
6.3	Suggestions for further research.....	91
ANNEXURES	92
	Annexure 1: The CSFB/Tremont Hedge Fund Index values for June 2004.....	92
	Annexure 2: The Hurst Index.....	93
	Annexure 3: Nedcor Hedge Fund Review.....	94
	Annexure 4: BJM Equity Fund.....	95
	Annexure 5 : Survey questionnaire.....	96
	BIBLIOGRAPHY.....	120

FIGURES:

Figure 1: Performance of the CSFB/Tremont Index relative to other leading indicators....	15
Figure 2: Risk Management is a puzzle.....	25
Figure 3: The Efficient Frontier.....	27
Figure 4: The current South African regulatory structure.....	46

TABLES:

Table 1: The World Bank's long term investment policy asset mix.....	28
Table 2: Correlation of hedge fund performance with the size of the fees charged.....	32
Table 3: Hedge Funds vs. Fund of Funds investment requirements.....	38
Table 4: Comparison of current vs. proposed thresholds in the USA.....	50
Table 5: Q 2.1. Cross-tabulation of assets under management in South Africa.....	58
Table 6: Q 7.1. Cross-tabulation of whether quality should be improved per firm type.....	61

Master of Commerce - Business Management

Table 7: Q 7.2.1. Communication more relevant to the investment decision of private investors.....	62
Table 8: Q 7.2.2. Communication more understandable to private investors.....	63
Table 9: Q. 7.2.3. Comparability of hedge funds from the point of view of private investors.....	65

GRAPHS:

Graph 1: Q 2.1 Assets under management in South Africa	57
Graph 2: Q2.2 Assets under management: Abroad	59
Graph 3: Q 3.1 Length of hedge fund investing/advising in South Africa	59
Graph 4: Q 3.2 Length of hedge fund investing/advising: Abroad	60
Graph 5: Q 7.2.1 Communication more relevant to the investment decision of private investors.....	62
Graph 6: Q 7.2.2 Communication more understandable to private investors.....	63
Graph 7: Q 7.2.3 Comparability of hedge funds from the point of view of private investors	64
Graph 8: Q 9 Factors preferred by the respondents for inclusion in a standard prospectus	67
Graph 9: Q 10 Setting of minimum hedge fund thresholds to make them more exclusive.	68
Graph 10: Q 11 Setting of minimum FOF thresholds to make them more exclusive	68
Graph 11: Q 13 Restrictions on educating private investors.....	70
Graph 12: Q 15 Accommodation of differences in styles and strategies within a single benchmark	72
Graph 13: Q 19 Introduction of standardised risk measures.....	73
Graph 14: Q22. Fee structures should be improved in terms of aligning manager and investor objectives.....	75
Graph 15: Q 24 Mandatory participation in independent survey	76
Graph 16: Q 25 Retailization of hedge funds in the South African market.....	77
Graph 17: Q 26. Are management skill levels different between hedge fund and fund of fund managers.....	78
Graph 18: Q 29.1 Stricter regulation to safeguard the industry	80
Graph 19: Q 29.3 SRU operating costs to be met by hedge fund operators	82

Chapter 1 Introduction

“It is a riddle wrapped in a mystery inside an enigma” - Sir Winston Churchill

This provocative quote by Mr Churchill, when deliberating on the seemingly unpredictable nature of the then Russian government, may appear prophetic to those who have taken a mild look at the group of alternative investment vehicles known as ‘hedge funds’.

Caldwell (1995) proposes that hedge funds are generally recognised as having been introduced to the world by journalist-turned-investment guru, Alfred Winslow Jones. A.W. Jones’ investment creation combined the concepts of short-selling and leverage into a single-purpose financial instrument. Short-selling involves borrowing a security and selling it to another party in anticipation that the market price of the security will fall before the debt is due enabling the initial buyer to repurchase it - at a lower price- in the market. Thus, the initial buyer (i.e. investor) can ‘return’ the security to the initial lender and earn a profit from the resultant price differential. Leverage is the process of investing with borrowed money as a means of amplifying potential gains.

Jones identified two sources of risk and sought to mitigate these by going *long* on the stocks he considered “undervalued” and *short* on the stocks he considered “overvalued”. By establishing a portfolio consisting of stocks that would be rewarded in part when the market went up with those that would also be rewarded when the market went down; the fund was thus considered to be hedged as losses from one position would be used to offset against profits of the other position. And so was born the term ‘hedge fund’. It may thus come somewhat as a shock to learn that most hedge funds today do not necessarily hedge at all – deliberately, so! Hedge funds are one of the largest growing investment vehicles amongst private investors, and endowment funds. Even the World Bank is heavily invested in them. Data from Managed Account Reports Inc. (Mar/Hedge) estimated that in 1998 US\$110 billion was invested in hedge funds. Figures quoted from Hedge Fund Review (HFR) puts the current asset under management for the year ending December 2003 at US\$817 billion. E-financialnews.com estimates that total assets invested in hedge funds will exceed US\$1 trillion by the end of December 2004. This forecast, however, still pales in comparison to the US\$25-plus trillion that is currently estimated to be invested in mutual funds, pension funds and insurance companies.

Master of Commerce - Business Management

According to the Investment Company Institute, the funds are “*highly regulated financial entities that comply with federal laws and regulations. In particular, the Securities and Exchange Commission (SEC) regulates [them] under the Investment Company Act of 1940, ...which imposes restrictions not only on [the] funds but also on their investment advisers, principal underwriters, directors, officers and employees*”.

However, the aforementioned attributes only apply to the mutual funds, pension funds and insurance companies, to the exclusion of hedge funds. Consequently, hedge funds are not bound by most of the aforementioned regulatory authorities because they fall beyond the reach of most regulatory platforms.

Hedge funds are an alternative investment group of assets that, in terms of classification, fall into a grey area. As with lifestyles and artistic genres, alternative investments define the exclusion of all that is in the mainstream. The term hedge fund is commonly, but erroneously, used to define the entire class of alternative investment vehicles, when in fact they are a subset, albeit a pre-eminent one as a result of the ability to attract seemingly ever increasing investor funds (see Kunene, 2002:8). Hedge funds find private equity and venture capitalists as neighbours under this banner. Gregoriou and Rouah (2003), in referring to earlier work by Bing (2000) and Brown et al. (1997), aptly noted that the current problem with hedge funds is that there is a dearth of academic literature available defining their operations as “most of the literature and analysis of hedge funds has focused on assessing their performance”.

Despite the billions of dollars entrusted to them, great uncertainty regarding hedge funds still persists. Even amongst academics and leading hedge fund managers, there is still no clear definition for the term ‘hedge funds’, and that is just the tip of the iceberg. The recurring issue is that research on hedge funds has been inhibited as a result of the lack of disclosure by industry participants. Subsequently, the present size of the hedge fund universe can at best only be estimated as significant numbers of hedge funds elect not to participate in statistical surveys conducted by index providers such as TASS and Mar/Hedge

1.1 Statement of Problem

Previously hedge funds restricted participation by sustaining prohibitively high minimum entrance requirements and by strictly adhering to private placement policies which ensured that they remained accessible exclusively to wealthy and sophisticated investors. Historically hedge funds have seemingly operated beyond the reach of most regulatory authorities, and thus their increasing proliferation into investment portfolios has motivated regulatory authorities to review policies and guidelines in an attempt to improve the standard of disclosure requirements and transparency offered by hedge fund operators.

1.2 Aims of the research

This study aims to shed light on the historical and current issues relevant to the hedge fund industry, and to identify some of the difficulties facing regulatory authorities in their attempts to regulate the industry. This study recognises that for regulatory mechanisms to be successfully implemented and enforced, a compromise is required to be struck between the views and concerns of stakeholders on the buy-side advocating for their entitlement to full and relevant disclosure to ensure investor protection and market integrity; with those on the sell-side, protesting the autonomy and sanctity of their standing partnership agreements and the need to safeguard their investment positions against those who would seek to profit from this knowledge.

1.3 Importance of the study

This paper's contribution comes at a crucial time for South Africa, given the growing interest in, and exposure to, hedge funds. South African investment industry stakeholders and the neighbouring regional economies that have historically emulated South African banking philosophies, standards and policies would also benefit from the suggestions proposed at the conclusion of this study. Existing uncertainty regarding the regulation of hedge funds presents a knowledge gap which all capital market centres must address in a consultative manner in order that compromise can be reached between the regulatory authorities and the hedge fund industry. It would be relatively facile for hedge funds to mutate into an entity even further from the reach of regulatory bodies.

Alan Greenspan assented to this school of thought when he said:

Master of Commerce - Business Management

“[M]ost hedge funds are only a short step away from cyberspace. Any direct US regulations restricting their flexibility will doubtless induce the more aggressive funds to emigrate from under our jurisdiction....If the funds move abroad, our oversight will diminish”.

The lack of transparency, dispersion of investment returns, liquidity and incentive structures are all cited by Meyer (2004) as the main reasons why regulators have decided to legally reign-in hedge funds. Various regulatory and legislative bodies (e.g. SEC, FSA, SRP, BIS and IOSCO) are working on the revisions and additions to existing legislations in an attempt to cater for this shortfall. What is still under deliberation and study is the extent to which regulation can be introduced (see Lacey, 2003; DiBiasio; 2002 and Champarnaud; 2000) and how it can be efficiently and effectively enforced across the globe. The current legislation governing hedge funds is readily accessible (CME, 2004) although regulatory authorities acknowledge that it does not adequately provide for investor protection (FSA, 2004).

From the published research of the leading academic scholars in the field of alternative investments and works by investment experts which has predominantly looked at the risk management and performance measurement tools and policies, it is apparent that there is need for more research to be undertaken in the area of hedge fund disclosure requirements.

1.4 Research methodology

A survey of role players in the South African industry will be carried out. Initially attempts will be made to establish written correspondence with the Securities Regulation Panel (SRP), the Financial Services Board (FSB), the Alternative Investment Managers Association (AIMA) and local (i.e. South African, mainly in Cape Town area) hedge fund experts. After a detailed study of issues raised in academic literature sources, a questionnaire will be drafted to highlight the most pertinent issues regarding the local industry's regulation and disclosure requirements. Interviews will be conducted wherever possible, in person, otherwise telephonically. Correspondence will be executed via electronic mail transmissions.

A sample of managers to be interviewed will be drawn from the following companies: Sanlam Investment Managers, Allan Gray, Nedcor Retail Bank, Coronation, African

Master of Commerce - Business Management

Harvest and Momentum Asset Management; which due to the concentration of the asset management industry in Cape Town, may be representative of the local industry. All the hedge fund managers participating in the Nedcor Hedge Fund Review will be invited to participate, as well as other that are not currently participating in this survey but have a presence in the market.

Pilot study

Initial interviews to several local investment companies should provide the feasibility basis to determine the scope of the investigation, to improve the study formulation and to provide feedback on the suitability and relevance of the survey questionnaire content. The pilot will also serve to establish whether the principal mode of investigation, i.e. interviews, will be feasible within the envisaged time frame.

Treatment of data

A qualitative analysis of the questionnaire responses will be carried out using SPSS and the results will be presented in either a summarised tabular form or in charts, or both. The comments will be incorporated into the study's conclusion, and where applicable, recommendations.

1.6 Scope and limitations of the study

Of the numerous issues concerning hedge funds, most notably the use of leverage, the level of fees and the disclosure requirements, the latter that will be the main focus of this study. The scope of the study will be restricted to hypothetical analyses and the field research will be limited to personal interviews and a questionnaire which will be distributed to as many stakeholders as can be reached within the available timeframe. The breadth of the on-site research will also be, as far as is possible, limited to the Cape Town area. Some of the limitations to this study include:

- Time constraints will limit the ability to carry out a broad-based study (Jan 2004 – July 2004). Several weeks (two or three) will be set aside for on-site interviews at various firms and authorities on the subject matter.
- Finances will also be a constraint as this study is privately funded.

Master of Commerce - Business Management

- Participation of market players in the study is not guaranteed as their willingness, or lack thereof, will have to be established on a case-by-case basis.
- Hedge funds and asset management firms that currently offer hedge funds will be the prime targets of the survey, and thus for example the major banking groups through whose private wealth management divisions large hedge fund assets are held and invested will be under-represented.

1.7 Brief overview of the study

The study will attempt to highlight the major issues surrounding the regulation of hedge funds, from their history to the current proposals to improve disclosure and transparency. Further, it endeavours to shed new light on the options for improving regulation of the industry.

Chapter 1: Introduction

The problem statement and aims of the study are stated with emphasis on the relevance and importance of the study to the field.

Chapter 2: Definition and description of hedge funds

An overview of the hedge fund industry from its inception in the USA is given, as well as an analysis of the industry environment in terms of regulation and structures. A brief review of some of the most commonly used hedge fund strategies and styles is given and the advantages of hedge funds as both an additional and a stand-alone investment tool are reviewed.

Chapter 3: Reporting standards and requirements

The vilification of hedge funds as investment vehicles is introduced and some of the issues are discussed with emphasis on those issues that influence or are influenced by disclosure requirements or lack thereof. The selected issues for discussion include transparency; risk management; compensation fees; index surveys and fund of hedge funds.

Chapter 4: Regulation and supervision of hedge funds

The current and proposed regulatory structures and their limitations of the US, UK, Hong Kong, Ireland and South Africa are investigated and reviewed.

Chapter 5: Empirical research

The empirical research is executed by means of a questionnaire survey to role players in the local industry. The results are analysed and summarised.

Chapter 6: Conclusions and recommendations

Recommendations are made to the South African industry in particular and the industry in general.

1.8 Abbreviations and acronyms

Database operators

Mar/Hedge:	Managed Accounts Reports Inc.
ZCM:	Zurich Capital Markets
HFR:	Hedge Fund Review
TASS:	Tass Asset Management

Regulatory authorities

Basel Comm.:	Basel Committee on Banking Supervision
FSA:	Financial Services Authority (U.K.)
FSB:	Financial Services Board (South Africa)
FSC:	Financial Services Commission (Hong Kong)
IOSCO:	International Organization for governmental Securities Commissions
MAS:	Monetary Authority of Singapore (Singapore)
SEC:	Securities and Exchange Commission (U.S.A.)

Hedge fund associations:

AIMA:	Alternative Investments Management Association
HFA:	Hedge Fund Association
MFA:	Managed Funds Association (U.S.A.)

Other terms:

CIS:	Collective Investment Scheme Order (Unregulated)
CISDM:	Center for International Securities and Derivatives
CMT:	Conseil des Marches a Terme (France)
COB:	Conduct of Business Service book (EU)
COB:	Commision des Operations de Bourse (France)
CP 185:	Consultation Paper 185
DP16:	Discussion Paper 16 (U.K.)
FOF:	Fund of hedge Funds

Chapter 2 Definition and description of hedge funds

“Human history becomes more and more a race between education and catastrophe”

– H.G. Wells

Hedge funds, like black holes in space, are probably best defined by all the attributes that *cannot* be ascribed to them, and this paradoxically, is part of their attraction.

2.1 The origin of hedge funds

In attempting to add clarity to the definition of hedge funds Bookstaber (1991) notes that:

“In terms of leverage, hedge funds are the entire universe except those funds that are restricted to leverage no greater than 1. In terms of positions, they are the entire universe except those funds that are restricted to long only. In terms of securities, hedge funds are the entire universe except those funds that are restricted to a somewhat arbitrary and generally evolving set of traditional assets”.

To better understand these attempts at defining hedge funds, it is important to analyse the origin of hedge funds. Alfred W. Jones’ initial application of the term “hedge fund” was appropriate given the strict adherence to the equally long/short strategies employed by his investment structure. However, a plethora of investing strategies that have since evolved now cover such a broad spectrum as to negate the continued practical relevance of the use of the term.

So convinced was Jones of the viability of his hedging strategy that he pioneered two concepts that have remained hallmarks of the industry to this day. Firstly, he introduced a compensation fee of 20% of the fund’s realised profit for his managers. Secondly, most probably to allay the fears of investors, he personally invested significantly into the funds, thereby ensuring that his fortunes were irrevocably tied to those of his investors. It was not until “The Jones Nobody Keeps Up With” article (Loomis, 1966) appeared in Forbes magazine that hedge funds were introduced to the public on a broad scale. The article described how Jones’ funds had attained net of fee returns that were substantially higher than those of the best performing mutual funds. Subsequently several hedge funds sprouted

Master of Commerce - Business Management

as other investment managers sought to emulate Jones' success. According to Caldwell (1995) the SEC found that of 215 investment partnerships in a survey for the year ending 1968... 140 of these were hedge funds, with the majority having been formed that year.

The bear markets of 1969-70 and 1973-74 dampened the growth of the hedge fund industry, but they again made headlines in 1986 when an article in Institutional Investor highlighted the staggering compounded annual return of 43% (net of expenses and fees) earned by Julian Robertson's Tiger Fund during its first six months of operation. In the aftermath of this article, Wall Street experienced a spate of resignations as high profile traders and investment bankers cashed in their bonuses and severance packages, and established their own hedge funds. Originally touted as the investment tool that could earn absolute returns irrespective of the direction of the market, the underperformance of the industry in the late 1990's served to highlight the fallacy of this notion. Numerous highly publicised blow-ups, most notably the near-collapse of Long-Term Capital Management (LTCM) endorsed the reputation that hedge funds were "risky investments". Regulators feared that LTCM's excessive use of leverage and exposure to the fixed-income markets threatened to destabilise global markets when it failed to make payments for the pursuant margin calls.

The Federal Reserve, fearing systematic failure, facilitated a \$3.625 billion creditor-rescue from a consortium of major US and European banks and in so doing, staved a situation that Chairman Greenspan suggested "... could have potentially impaired the economies of many nations, including our own." This rescue invoked U.S. President Clinton to establish a committee to investigate hedge funds with a view to introducing legislation to curb their apparent threat to global systematic risk. The President's Working Group on Financial Markets, (The Working Group) in presenting their report defined hedge funds as follows:

"Although it is not statutory defined, the term [hedge fund] encompasses any pooled investment vehicle that is privately organized, administered by professional investment managers and not widely available to the public. The primary investors in hedge funds are wealthy individuals and institutional investors. In addition, hedge fund managers frequently have a stake in the funds they manage".

Some of the often-quoted reasons why the task of assigning a universally accepted definition for hedge funds is problematic include that hedge funds are rarely similar in

Master of Commerce - Business Management

nature, and that they often follow investment strategies that are also adopted by other investment funds and financial market participants.

One of the most comprehensive definitions of hedge funds was given in an International Organisation of Securities Commission (IOSCO, 2003) report. It states that hedge funds have at least some of the following characteristics:

- Borrowing and leverage restrictions, which are typically included in collective investment scheme regulation are not applied, and many (but not all) hedge funds use high levels of leverage (BIS, 2004)¹;
- Significant performance fees (often in the form of a percentage of profits) are paid to the manager in addition to an annual management fee;
- Investors are typically permitted to redeem their interest only periodically e.g. quarterly or semi-annually;
- Derivatives are used, often for speculative purposes, and there is an ability to short sell securities;
- More diverse risks or complex underlying products are involved.

The Dictionary of Finance and Investment Terms (Downes et al., 1998) makes a distinction between the definitions of a U.S. on-shore and an off-shore hedge fund, defining the former as “a private investment partnership” and the latter as “an investment corporation”.

2.2 The Investment process

In the U.S.A., hedge funds are restricted from accepting as partners, investors that do not qualify as “accredited investors”.

¹ The Bank for International Settlements refers to hedge funds as “Highly Leveraged Institutions”, (HLIs). [Online] Available at <http://www.bis.org/publ/bcbs79.htm#pgtop>.

2.2.1 Qualification requirements for US hedge funds

To qualify as an accredited investor, Hedgeco.net (2004) stipulates that one needs to meet one of the following criteria²:

- Individual, or combined with spouse, net-worth in excess of \$1 million.
- Individual income, excluding any income attributable to spouse, of more than \$200,000 in the previous two years, with reasonable expectation to do the same in current calendar year.
- Individual and spouses joint income of more than \$300,000 in the previous two years with reasonable expectation to do the same current calendar year.

2.2.2 Investor restrictions for US hedge funds

100 “accredited investors” or an unlimited number of “qualified purchasers” may invest in a single hedge fund. An investor may be a “qualified purchaser” if;

- the investor owns \$5 million or more in investments, including investments held jointly with a spouse;
- in the case of a family-held business, it owns \$5 million or more in investments;
- in the case of business that has discretionary authority over investments of \$25 million or more; or
- in the case of a trust sponsored by qualified purchasers.

As the use of hedge funds has expanded across the world and into varied financial market systems, their adoption in terms of legislation has been extensively based on that prevailing in the U.S.A. Yet, in the U.S.A., hedge funds have exploited and benefited from the exemptions that have been granted in various investment-related statutes, most notably the Investment Companies Act of 1940 and the Securities Act of 1933. This study will revisit these and other statutes. Nonetheless, it would seem as though regulators had set significant financial hurdles to ensure that hedge funds were only accessible to wealthy investors.

² Institutions and pension funds are subject to more complex criteria

2.2.3 Hedge fund structures

Despite following varying investment strategies with differing investment focuses, hedge fund structures are influenced by similar factors. Barker and Hui (2003) listed the following as the key determinants of a hedge fund's structure: tax, regulations, investors, marketing, employees and investment issues.

- Tax – the choice of domicile may be influenced by favourable tax rates and other concessions.
- Regulation – the fund may choose to be established in a jurisdiction with a level of regulation that best supports their investment and operating strategies.
- Investors – the domicile of prospective investors and their probable tax concerns and financial objectives will determine the fund's focus.
- Marketing – the fund's ability to market and attract new clients will depend on the applicable jurisdictions.
- Employees – the requirement of active fund management and the traditionally high levels of discretionary assets under management require the recruitment of highly trained and qualified staff.
- Investment – the geographical region or financial sector focus of the fund will impact where the fund will be based, as there will be a need to cater for time-zone influences etc.

Hedge fund activities are generally front-office operations and tend to outsource the middle and back-office functions to intermediaries such as large investment and commercial banks.

2.2.4 Investment strategies and styles

A.W. Jones' original 'long/short' strategy has now been replaced by a myriad assortment that encompasses most investment theories. Eichengreen and Mathieson (1999) identified three main classes of hedge funds as being macro funds, global funds and relative value funds, although they acknowledged that even further diversity lay within each of these classes. Eichengreen et al. (1998), noted 7 categories; whilst Gregoriou and Rouah (2003) noted 8 categories; and Billingsley and Chance (1996) (as cited in Fung and Hsieh. (1999))

Master of Commerce - Business Management

noted 11 categories. A summary of some of the more common categories reported in the CSFB Tremont Hedge Fund Index is given in Annexure 1.

Murguia (2004); Gregoriou and Rouah (2003); and Agarwal and Naik (1999); all contend that there is general agreement in academic circles confirming that hedge funds can be categorized into two distinct groups; “directional” and “non-directional”.

As a result of significant overlap between the categories, there has been a move away from this focus of classification. A more recent development has been the move towards categorising hedge funds based on the investment style followed by the fund. Brown and Goetzmann (2001) suggest that hedge funds are “better defined in terms of their freedom from the constraints imposed by the Investment Company Act of 1940 than they are by the particular style of investment”, although their paper concludes that appropriate style analysis and style management are critical to success for investors. The TASS and CSFB/Tremont databases used by Credit Suisse First Boston/Tremont Index LLC to track more than 3000 funds state on their website that funds are separated into ten primary subcategories based on their investment styles.

The investment style adopted by the fund is usually determined by the general partner of the hedge fund and is generally well-detailed in the hedge fund prospectus. In spite of this, hedge funds prospectuses have a reputation, maybe unfairly, of being unintelligible as a result of the extensive use of verbiage and industry jargon that some critics say, leave even seasoned investors clueless as to the funds’ focus even after having read one.

2.2.5 Advantages and benefits of hedge funds

Despite Warren Buffett’s assertion during the 2004 annual general meeting for Berkshire Hathaway investors in May 2004, that hedge funds were a Wall Street “fad” and warning that people who were not already invested and seeking to invest now in hedge funds were “going to be disappointed” (CNN, 2004), commentators do acknowledge distinct advantages and benefits of being invested in hedge funds. Some of the benefits include:

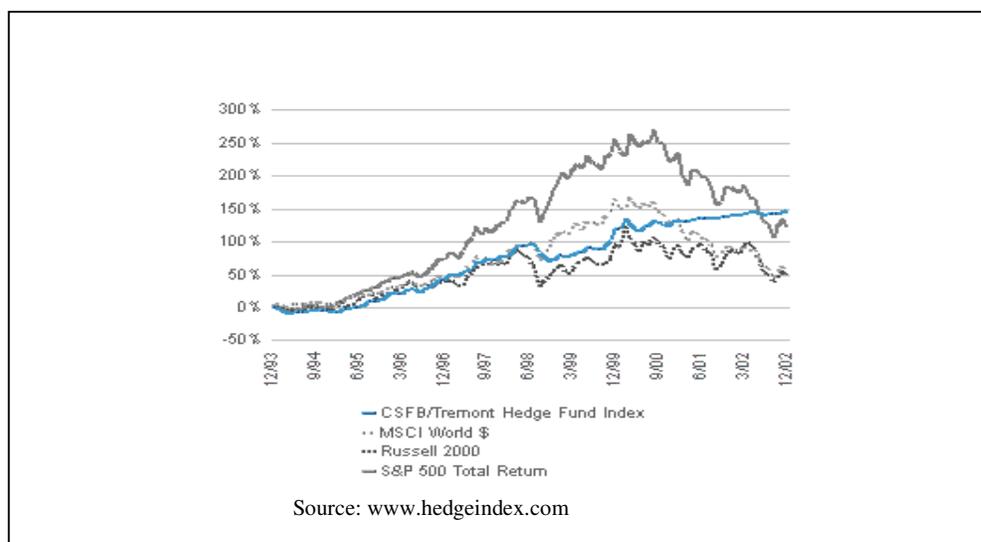
- Easier and cheaper diversification of investments assets across asset classes, sector and national boundaries.

Master of Commerce - Business Management

- Outsourcing the arduous and technical task of researching investment opportunities to skilled professional.
- Allows for the reallocation of risk and resources for investors
- Access to limited and closed hedge funds with attractive track records
- Low correlation to other more traditional asset classes such as equities and bonds and real estate.
- Use of leverage to amplify real returns
- Investments strategy flexibility

Waron Mann of Cape Town-based Abante Capital - a hedge fund manager which specialises in statistical arbitrage - states that due to the complex nature of some of the models necessary to execute the investment strategy their operation is staffed by experienced dealers and technical experts with Masters and PhD degree qualifications in Mathematics, Statistics and Physics (Mann, W., Personal Communication. 16 June 2004).

Figure 1: Performance of the CSFB/Tremont Index relative to other leading indicators.



Whereas LTCM reportedly had a leverage ratio of 300:1; that is, US\$300 borrowed for every US\$1 of investor capital, the average U.S. onshore and offshore hedge fund has a ratio of 1,6: 1 (Lacey, 2003). Van hedge funds, according to hedgefund.com, consider ratios above 2:1 as “high” and those below as “low” leverage. Hedge funds also enjoy unparalleled freedom from regulatory authorities in as far as selecting their investment

strategies thereby enabling them to short and use leverage as well as investing in illiquid assets.

2.3 Summary

From a single investment strategy, the hedge fund industry has grown to include classes and sub-classes of strategies making the duty of ascribing an inclusive definition difficult, although (hopefully) not impossible. The adoption of a style-based classification system has facilitated this task although austere challenges remain. Of the many issues raised against hedge funds, most notably the use of leverage, the level of fees and the disclosure requirements, it is solely the latter that will be the main focus of this study.

Chapter 3 Reporting standards and requirements

“Someone’s sitting in the shade today because someone planted a tree a long time ago”

- Warren Buffett

This chapter will attempt to highlight the main issues concerning disclosure standards in the hedge fund industry.

3.1 Introduction

Hedge funds have traditionally been secretive operations and varying views have been tabled to both defend and denounce this characteristic. With a significant number of hedge fund operators having honed their trading skills on proprietary desks where corporate governance statutes and “Chinese Wall” policies which ensure separation of duties and information between various arms of the same bank are sacrosanct, it does not come as a total surprise that the element of secrecy became part of the hedge fund doctrine. The digital revolution has enabled financial market systems to respond in “near real-time” to economic and socio-political developments. Increased market efficiency and continuous trading across the three major time zones has reduced the window period within which to effect a short-term trading strategy, (e.g. to arbitrage) to minutes before the opportunity is exploited by other market participants.

The high-risk reputation accorded to hedge funds has, it would seem, for long romantically appealed to those investors who otherwise found the articulate world of financial investing both cumbersome and a slow route to financial prosperity. Subsequent to the several highly publicised hedge fund disasters such as John Meriwether’s LTCM, David Askin’s Granite Capital and Victor Niederhoffer’s Global Systems, it would seem that preventative action could have been taken by regulatory authorities had they had access to comprehensive information detailing the extent of the respective funds’ exposure in various instruments and markets.

3.2 Criticism of hedge funds

To further endear themselves to critics, hedge funds have also been cited for their alleged role in fuelling, if not orchestrating, the run on the British Pound in 1992 (Soros,1995:22) and the fall of the Asian Tigers following a runs on the Baht (Thailand) and the Ringgit (Malaysia). The collapse of the latter led the then Prime Minister Mahatir Mohamad to complain that “all these countries have spent 40 years trying to build up their economies and a moron like [George] Soros comes along with a lot of money to speculate and ruin things”.

Research by Eichengreen and Mathieson (1999), in attempting to answer the question, whether hedge funds trading in currency markets had acquired the distinctive role as lead steers in the herding by investors in these markets or whether they are in fact more (or less) likely to join in a generalised move by other market participants against a weakening currency concluded that hedge funds tended to take positions as contrarians, “leaning against the wind, often serving as stabilising spectators”. Aside from shorting, hedge funds are also renowned for taking long positions in securities (or currencies) that had depreciated, thereby introducing liquidity to an illiquid market. Fung and Hsieh (2000) found no evidence of hedge funds using positive feedback trading strategies as well as little evidence suggesting that hedge funds systematically caused markets to deviate from economic fundamentals.

Data from financial institutions can also confirm that hedge funds are primarily purchasers of new securities (i.e. warrants, initial public offerings and mortgage backed securities’), both in the primary market and the secondary market, thereby providing greater risk management and capital raising opportunities for corporations which enables them to have lower costs of capital. It is further argued, that by taking advantage of relative pricing inefficiencies in different markets, hedge funds also serve to improve market efficiency through rationalisation of security and currency prices. This view is partially contested by Rankin (1999:159) who asserts that:

“The real issue facing small countries is not the liquidity of their markets, but [rather] the potential to be overwhelmed by the flow of funds originating from the large economies”.

Master of Commerce - Business Management

The turn of the millennium has seen hedge funds making significant in-roads into investment portfolios. Lacklustre equity growth figures and volatile markets have enticed previously conservative investors (Gregoriou and Rouah., 2003) to seek out alternative investments as they try to improve portfolio diversity and ostensibly achieve higher investment returns. This renewed drive has resulted in increased asset allocations to hedge funds (Mills, 2003)³ as well as the retailing of fund of funds (FOFs) to lower income investors.

3.3 Transparency

Filimonov and Sogoloff (2001) aptly refer to transparency as a “double-edge sword”.

- Firstly because hedge funds sometimes take such large positions in illiquid markets or securities going through corporate transactions, that publication of their positions could increase the risk of exiting these positions. In instances, the stake held by hedge funds in illiquid markets has effectively made them the market maker for the sector.

Consequently hedge funds prescribe restrictive lock-up and withdrawal periods in order for them to better manage their extraction from such investments. These periods can range from six months to five years. The absence of active trading in these markets may at times hinder the independent valuation of the assets resulting in the hedge fund taking the onus to internally assign a valuation to the investments. Unsurprisingly, allegations of padding the values have been levelled in some instances (Neil, 2002).

- Secondly, the velocity with which some (if not most), hedge funds traditionally move into and out of positions makes quarterly or even monthly statements irrelevant other than for the historical tracking purpose. Brown et al., (1998), citing earlier work by Brown et al. (1997); and Fung and Hsieh (1997); researched on the extent to which hedge fund strategies differed from those of open-ended equity mutual fund managers. Whereas Fung and Hsieh (1997) used Sharpe’s style and

³ MILLS, Q.D. 2003. “*In 2001, the California Public Employees Retirement System (CALPERS), America’s largest pension fund, put \$1 billion into hedge funds. It was a major stamp of approval*”.

Master of Commerce - Business Management

showed that hedge funds actively shifted their factor exposures over a given period of time, concluded that the shifting dynamism rendered traditional performance measurement difficult, if not impossible. The approach used by Brown et al., differed in that they grouped managers based on an algorithm that gave prominence to realised performance as opposed to professed mandates.

- Thirdly, for hedge funds holding swaps or esoteric mortgage instruments, merely providing a full listing without indicating how the positions held correspondingly offset each other would not be useful when trying to determine the fund's overall strategy or risk exposure.
- Fourthly, disclosure before a desired equity level is acquired in a targeted stock would inevitably attract the attention of other participants leading to an increase in the offering price. Myers and Shackelford (2001) define 'copycat funds' as being funds that simply mirror the investment positions held by other hedge funds without bothering to undertake any independent research of their own and thereby making significant financial savings on personnel and research costs. Based on a limited sample of high expense funds, the study concluded that after expenses "copycat funds earn statistically indistinguishable, and possibly higher returns than the underlying actively managed funds" giving credence to the insistence by some hedge funds on the need for continued secrecy.

3.3.1 Standards and requirements

By not having more than 35 non-accredited investors and not engaging in solicitation (i.e. marketing through means other than word-of-mouth), US hedge funds qualify for exemptions from most registration and disclosure requirements under the provision of Rule 506 in Regulation D of the US Securities Act of 1933. To compound the problem of supervision, by not having more than 15 clients and by adhering to the non-solicitation guidelines, a hedge fund manager may be exempted from registration as an investment manager, as per the US Investment Advisers Act of 1930. It thus comes as small wonder that, in order to preserve their exemption statuses, most hedge funds are closed to new members, with replacement of a liquidating investor done by private placement at the discretion of the hedge fund manager or general partner.

Baily et al. (2000) suggest that rather than trying to limit hedge fund activities, regulators should focus on improving the quality of information provided to investors by improving disclosure, financial transparency and investor protection.

3.3.2 Investor due diligence

Eccleston (2003) duly notes that the NASD requires a heightened responsibility investors to thoroughly investigate, as well as substantial due diligence to perform on the part of fund managers in executing their fiduciary duties prior to recommending a hedge fund investment to clients. For private investors, this onus falls squarely on their shoulders. Current US legislation recognises that hedge funds are restricted to ‘sophisticated and/or wealthy investors’ – which for regulatory purposes refers to one and the same group of individuals. Subsequently they are not deemed to require additional protection beyond that of being free from systematic risk.

The hedge fund prospectus is regarded as the main communication tool between the fund and prospective investors. Lux (2002) dismisses the practicality of assessing a fund based on the information contained in most of these documents. Disparagingly he alleges that:

“Secretive and far from pristine, the industry has long been notorious for providing scant information (if any at all).”

Lavinio (1999:42) concurs stating that the information tends to be submerged in an intricate and “obscure dialect of legalese” as well as sometimes being so blandly generic as to be more prescribed than informative.

The dual responsibility for due diligence by both parties to a transaction is highlighted in an unpublished thesis paper by Kunene (2002:15) who cites *Morgan Stanley UK Group v Puglisi Cosentino* (High Court, London), a 1998 case in which the high net-worth investor with experience investing in straight forward swap contracts who failed to repurchase a foreign exchange structured note after it had lost 70% of its value when the contract fell due. The court ruled that the transaction in question was beyond his comprehension and he could not therefore be considered an expert investor, thereby saddling the bank with the onus of ascertaining a client’s effective level of comprehension.

3.3.3 Investment mandate adherence

Acknowledging hedge funds' need for flexibility in order to exploit market pricing inefficiencies, investors acquiescing to the prospectus' terms can at best hope that the hedge fund will respect the investment mandate by adhering to the investment philosophy therein contained. Barring the aforementioned vagueness and legal verbiage that allegedly characterises a significant number of prospectuses, investors should comfortably expect to have legal recourse should the hedge fund manager deviate from the mandated parameters.

Fung and Hsieh (1997) suggest that some hedge fund managers, when faced with large capital withdrawals on the back of poor performance - sometimes to the extent where the fixed management fee from the remaining assets fails to even cover the fund's operating expenses - may opt to place a single large bet in the hope of attaining the high-water mark target. Even so, they contend that the "betting the farm approach" is somewhat mitigated by exogenous offsetting costs to the fund manager, such as reputational costs.

3.4 Benchmarking and performance measurement

The selective assignment of benchmarks by hedge funds has long riled critics who proclaim that benchmarking errors nullify the objectives of performance assessment. Fung and Hsieh (2002) however propose that fund of hedge funds (FOFs) should be used as a benchmark for hedge funds as this would minimise the measurement biases experienced, and thus produce a "cleaner estimate" than more traditional approaches. However, the simple adoption of indices and peer group analyses seems borne to carry significant latent inaccuracies. Firstly, because even hedge funds following similar investment styles produce differing results because of different investment strategies and focuses; and secondly because the accuracy, and subsequent relevancy, of said indices has been questioned. This study will return to this issue at a later stage.

3.4.1 Valuation of Assets

The most traditional evaluation method of the investment performance for active fund management has been the simple comparison with earnings achieved by following a passive (i.e. buy-and-hold) investment strategy in a similar opportunity set. Liang (2001) advocates that, after adjusting for varying market exposures, hedge funds have tended to exhibit a significant amount of alpha, that is, excess returns. The uniqueness of the hedge

Master of Commerce - Business Management

funds makes application of the measure difficult. The net asset value (NAV) is thus considered to be the standard reference for performance measurement of hedge funds. The three most commonly used methods to determine the NAV are:

- **Marked-to-spot** – this refers to the replacement cost of the asset. However, when dealing with derivatives where both time value and volatility impact on the value of the underlying asset, it is found that the quoted market price is seldom equal to the replacement cost.
- **Marked-to-model** – this refers to where the theoretical price of the asset is determined by a mathematical model capturing the spot price, as well as the time value and volatility factors. This method may produce a value significantly different from the market-related price.
- **Marked-to-market** – this refers to a process where the prevailing market price is tracked, and is thus thought to be the most accurate of the three methods. Nonetheless, it encounters difficulties when assessing illiquid and other non-actively traded securities. In such instances the investment manager or the broker-dealer determine the value subjectively (Rigby and Wiggins, 2003)

3.4.2 Return Calculation

It is well documented in financial literature (see Harrison, 2003) that as much as 80% of a fund's investment return can be attributed to the asset allocation decision as opposed to stock selection. David White, the Chief Investment Officer of the Rockefeller Foundation claims the reverse to be true for hedge fund managers (Cheever and Keary, 2000). Murguia (2004) cautions that reliance on simple return data and traditional evaluation measures may lead to "inaccurate conclusions and inappropriate risk exposure". Aside from the impact of statistical biases on the accuracy of hedge fund returns, the 'issue of article' is also a major concern. The issue of article is best demonstrated by the "Axe problem" (Lavinio, 1999). Essentially; suppose an investor acquires an axe in 2004 and after three years replaces the handle. If, 2 years later the blade is also replaced, how accurate would it be to claim that we were still assessing the same axe acquired in 2004? The impact of this conundrum is exacerbated by the mobility of invest mangers and the changes in investment strategies and focus followed by the hedge funds as they indelibly alter the characteristics of the hedge fund and thereby making effective return calculation difficult.

3.4.3 Dispersion of returns

“The dispersion of investment returns makes the use of the term “hedge funds” confusing” -Glenn Meyer

According to research published by the University of Massachusetts-affiliated CISDM hedge fund returns are mean reverting (CISDM, 2003). That is, funds with high returns (as well as alphas and/or Sharpe ratios) in a period often have lower returns (and alphas and/or Sharpe ratios) in the next period.

Given the general acceptance that past performance is not necessarily indicative of future results the question of persistence undeniably persists. As previously mentioned, hedge funds have at times been marketed as sources of absolute returns, irregardless of the direction of the market. Research by Agarwal and Naik, (2000) established that there is greater persistency shown by losing [U.S. onshore] hedge funds continuing to be losers, than by winning hedge funds continuing to outperform. An investigation by Brown et al. (1999) into the U.S. offshore hedge funds found no evidence of positive performance persistency. Agarwal and Naik (2000) found that performance persistence amongst hedge funds decreases with the length of the measurement interval and this seemed to be unaffected by whether the followed a directional or an arbitrage based strategy.

In citing previous studies by Fung and Hsieh (2002a, 2001), Murguia (2004) contends that the hedge fund return characteristics are largely influenced by three factors, namely:

- Location factors – payoffs from asset class positions
- Trading factors – payoffs from option-like payoffs
- Leverage factors – payoffs due to the degree of leverage

Murguia supports the view held in earlier studies by Schneeweis and Spurgin (1998), which suggest that the use of passive multi-factor models coupled with exchange-traded options on stocks, bonds, currencies and commodities can simulate the returns achieved by managed futures hedge funds, not only at lesser cost, but also through providing greater transparency to investors.

3.5 Risk Management

“Risk varies inversely with knowledge“ – Irving Fisher

The management of risk is of great importance to all investment managers, more so for hedge funds given their propensity to use leverage which serves to magnify the potential return by accepting higher risk. The white paper on sound practices issued by the Managed Funds Association (MFA) (2003) lists four types of risk; namely Market Risk, Credit Risk, Liquidity Risk and Operational Risk. Operational risk, which refers to data entry errors, fraud, system failures and errors in valuation or risk measurement models, is not as well documented as the other forms of risk (Koh et al., 2002) and will be the focus of this section of the study. Each piece of the puzzle needs to be addressed (www.cmra.com).

Figure 2: Risk Management is a puzzle.



As mentioned above, there are many facets of risk management involved with hedge funds, and solely for the purpose of brevity, this study will merely introduce the key issues namely; the impact of the addition of hedge funds to a existing portfolio's efficient frontier, the mean-variance and normal distribution of return debate, the suitability of the Sharpe Ratio, Value at Risk and other 'traditional' performance evaluation tools, as well as the issue of herding and its effect on asset correlations.

Master of Commerce - Business Management

The complexity and the often dynamic trading strategies adopted by hedge funds, make traditional performance evaluation inapplicable (Kazemi et al., 2003) by complicating the determination of the risk. Contrasting earlier work by Liang (1999); Schneeweis and Spurgin (1998); and Fung and Hsieh (1997) on the use of multi-factor models to the single-factor model studies by Brown et al., (1999); Ackermann et al.; Kazemi et al. (2003) concluded that the major drawback was that the unconditional approaches assumed that hedge fund risk measures were constant over time.

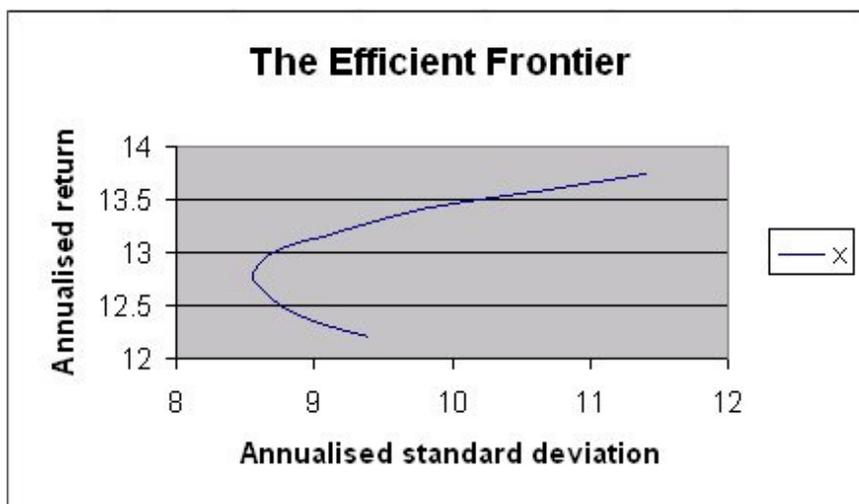
3.5.1 Efficient Frontier

Consequently, the potential ability of hedge fund portfolios to lift the Efficient Frontier is also argued. Agarwal and Naik (1999); using a broad asset class factor model determined that combining hedge funds with passive indexing provided significantly better risk-return tradeoffs than passive investment in the different asset classes alone. Their study showed that out-performance of the benchmark ranged between 6% and 15%, although the associated risk per month ranged from 0.9% to 4.2%.

A study by Amin and Kat (2003) used a continuous-time version of Dybvig's payoff distribution pricing evaluation model which does not require any assumptions with regard to the return distribution of the funds to be evaluated, and applied it to the monthly returns of 77 hedge funds and 13 hedge fund indices from May 1990 to April 2000. Their study concluded that although stand-alone hedge funds could not provide a superior risk-return profile, a 10% to 20% allocation, in conjunction with an equity portfolio, achieved the best results. Hedgeco.net on the other hand, recommends that an allocation of between 20% and 50% of an investment portfolio should be in hedge funds.

Harding et al., (2003) cite Schneeweis et al., (2002) and extend the concept further by advocating for the inclusion of an allocation to managed futures in mixed portfolios containing other hedge fund investment in order to not only reduce the portfolio's standard deviation and increase the attainable returns, but also to achieve a superior risk profile.

Figure 3: The Efficient Frontier.



Source: <http://www.bjmdirect.com>

Baeb (2003) states that all the Ivy League universities are reported to have an average of 19.9% allocation of their endowments in hedge funds. According to Bloomberg, Yale University's US\$ 10.7 billion endowment fund's hedge fund allocation has earned the fund a 17 % per annum gain over the last 10 years. The US\$17 billion Harvard University endowment declined by 0,5 % for the year-ending 30 June 2004, despite averaging 15.2 % in the 10 year period to 20 June 2003. The target return for these institutions is commonly accepted as being around 5 %; equal to their approximate annual spending, with the additional accommodation for inflation.

Dow Jones News Wire reported that the world's largest pension fund, the California Public Employees Retirement Plan (CALPERS) approved the increase allocation from 1% to between 2% and 4% of its US\$130 billion on 16 June 2003 (www.blumontcapital.com). The US\$21 billion Pennsylvania State Employees' Retirement System, (PennSERS), invested US\$2.5 billion, (approximately 12% of its assets), into hedge funds. (Serwer, 2003)

The World Bank staff retirement plan has been invested in hedge funds for over 20 years, although their allocations have been of smaller magnitude than is espoused by the Ivy League institutions.

Table 1: The World Bank's long term investment policy asset mix.

Asset Class (As at December 2002)	%
Equities:	40
U.S. Equities	22
Non-U.S. Equities	<u>18</u>
Developed Markets	16
Emerging Markets	2
Alternatives:	20
Hedge Funds	Up to 8
Private Equity	Up to 10
Real Estate	Up to 6
Fixed Income:	40
TOTAL	100

Source: <http://inweb18.worldbank.org/tre/ClientServices.nsf/reference/03.html>

3.5.2 Mean-Variance

Akan (2002) points out that the general adoption of Markowitz's mean-variance as an evaluation tool contradicts the reasoning for its use, as it assumes normal distribution of individual asset returns in a portfolio over time. The debate regarding the suitability of measures using the first two moments, (i.e. mean and standard deviation) to determine risk has been extensively addressed in recent times. Given that hedge fund returns are generally accepted as not being normally distributed coupled with the general use of the Sharpe Ratio as a standard risk measurement tool often included in hedge fund prospectuses to highlight the associated level of risk has brought this matter to the fore (Akan, 2002)⁴.

The CISDM (2003)⁵ contend that "a strategy's distribution may not be normal, even if the historical data says it is, and it may be normal even if the data says it is not". Fung and Hsieh (1999) concluded that using a mean-variance criterion to rank hedge funds and mutual funds will produce rankings that are *nearly* correct. They concede however, that in

⁴ AKAN (2002) notes that this can be proven by calculating "the skewness, kurtosis and Jacque-Berra numbers for each hedge fund strategy".

⁵ Center for International Securities and Derivative Markets

Master of Commerce - Business Management

the case of hedge funds where returns are not normally distributed, the mean and standard deviation do not provide an accurate probability. Lavinio (1999) proposes that the Hurst index (Annexure 2) be used to mitigate the problems presented by the non-normal distribution of hedge fund returns.

3.5.3 The Sharpe Ratio

The Sharpe Ratio is attributed to William F. Sharpe who described a measure of “return to variability” for use in comparing investment performance. The ratio is given as follows:

$$\frac{R_j - R_f}{\sigma_j}$$

where R_j is the return earned by portfolio j

R_f is the risk free rate (RFR)

σ_j (risk incurred) is the standard deviation of the portfolio's daily return.

The main advantage of the Sharpe Ratio is its simplicity of use and this feature has enhanced its common use as a tool for measuring risk. Murguia reiterates the conclusion of earlier studies by Amin and Kat (2003) which note that the continued use of Sharpe ratios and other traditional evaluation techniques will result in misinterpretation of the risk-reward profile of funds. Spurgin (2001) and Goetzmann et al., (2002) have exposed how the Sharpe Ratio could be manipulated to reflect a higher investment strategy ratio than for the corresponding benchmark. Kazemi et al., (2003) proposed a generalised Sharpe Ratio formula which involves transforming an asset's returns to match the benchmark's distribution, and to then calculate the benchmark based on the adjusted distribution. This new approach is given by the formula:

$$P = \frac{E_Q [F (1 - R)]}{1 - r_f}$$

The advantages suggested by this new formula aside, in the CISDM Monthly Review for (September, 2003) Schneeweis reiterates that the Sharpe Ratio's main shortcoming lies in its inability to assist an investor to establish the impact of an asset's risk on one's individual portfolio.

3.5.4 Value at Risk (VaR)

VaR measures the maximum change in the value of a portfolio that would be expected at a specified confidence level over a specified holding period. It therefore provides a summary risk measure that takes into account the respective correlations between positions. The MFA notes three methodologies for calculating VaR that have become standard over the past several years.

These are:

- Variance/ Covariance – this is the most commonly used measure and the least process intensive. Drawing from historic variance and covariance data, this method estimates volatility and assumes a normal distribution.
- Historical Volatility – this method requires daily actual portfolio re-pricing and is thus considered to be the most accurate. However, given the higher demands placed by the process, it is not a popularly adopted method.
- Monte Carlo Simulation – this method re-prices the portfolio based on large random simulation outcomes and is typically used for when calculating very complex portfolios with multiple non-linearities.

The MFA advocate that because VaR focuses on standard market movements as opposed to extreme events, it is thus an incomplete measure of risk when used alone. The MFA also recommends that ‘backtesting’⁶ and ‘stress-testing’⁷ be applied in conjunction with VaR computations to improve accuracy and reliability.

3.5.5 Correlation and the effect of ‘herding’

The intricate trade-off between risk and return has raised several contentious issues. The integration of hedge funds into investment portfolios has essentially hinged on two factors; namely relatively low correlation with standard asset classes as well as minimized risk for any given level of expected return or maximized returns for a given level of risk (Akan, 2002). Akan affirms the widely held view (see Agarwal et al., (2000); Gregoriou et al.

⁶ Backtesting compares the actual changes in the portfolio values to those generated by the VaR calculation

⁷ Stress-testing is a scenario analysis forecasting tool that uses a VaR model to manipulate the parameters that are believed to impact on the actual values to anticipate the effect of a change in the input factors.

Master of Commerce - Business Management

(2003); Lubochinsky et al., (2003) and Koh et al., (2002)) that the lower correlation to traditional asset classes enables hedge funds to potentially decrease portfolio variance significantly when included in a traditional asset portfolio. Amin and Kat (2003), as has already been noted, contest whether the efficient frontier is effectively lowered although they recommend a 10% to 20% hedge fund allocation to an equity portfolio for best portfolio results.

Herding is the contagion process by which market players participate in buying (or selling) a security en masse and thereby sending the targeted stock's share price rocketing up (or crashing down). Persaud's acclaimed article, "Sending the Herd Off the Cliff Edge (2000)" looks at how correlation between two seemingly independent asset classes (examples given are the Korean property and UK technology stocks) can be affected by the decision of a single large investor in both stocks to either buy (or sell) to rationalize a portfolio's allocation. Thus, as both stock prices rise (or fall) the correlation between the two seemingly uncorrelated assets increases and this can result in other market participants erring on the side of caution by following suit. Replication of the same trade or its inverse by the same or other portfolio managers may insinuate a relationship between the stocks, despite the absence of fundamental logic to support the correlation. Since hedge fund managers are generally 'only' rewarded for out-performance, it is not unreasonable to expect that given the option, they would generally prefer to be wrong along with their peers, than risk being wrong alone as the herding phenomena infers.

It must also be borne in mind that even where low correlation is achieved, significant exposure may still remain. Furthermore, investment managers should note that the varying hedge fund strategies enable hedge funds to act not only as risk diversifiers, but also as risk reducers and in certain instances, as risk enhancers. And lastly, most hedge funds are stand-alone operations which do not have the revenue support from diversified business units that is available to investment and commercial banks that house similar vehicles and therefore paying ascetic attention to the risk management process is crucial for their survival.

3.6 Management fees

“Its not whether you’re right or wrong that’s important, but how much money you make when you’re right and how much you lose when you’re wrong” - George Soros

The flexibility and challenges presented by hedge funds not only attracted the most astute investment managers from the investment banking field, but also those seeking to make retiring in comfort at the age of 40 a realizable goal.

A.W. Jones’s concept of a 1% annual assets-management fee and an incentive fee amounting to 20% of realized profits has remained the standard compensation structure for the industry (Jankhe, (2004) and Agarwal et al., (1999)). It should be noted however that the 1% fee is usually charged in 0.25% quarterly increments, in advance. This structure was introduced as an initiative to better align the prospects of the fund with those of the investment managers. The question that begs to be answered is therefore, whether hedge fund performance is consistent with the size of fees that they charge? According to the CISDM (2003), performance fees do not provide a means to differentiate manager return. (See Table 2)

Table 2: Correlation of hedge fund performance with the size of the fees charged.

Style	Incentive Fee	Monthly Return	Standard Deviation	Information Ratio
Value	10.00	1.63%	4.41%	0.37
Value	20.00	1.70%	3.88%	0.47
Growth	10.00	1.74%	8.30%	0.21
Growth	20.00	1.63%	4.41%	0.37
Small	20.00	1.78%	3.28%	0.54

U.S. Hedge Equity data (1997-2000) Source: CISDM/ UMASS- Amherst. 2003.

The fact that hedge funds take a share of the benchmark out-performance whilst not claiming a similar stake when performance is poor distinguishes them even further from mutual funds which adopt a fulcrum principle. The fulcrum principle has a symmetric effect as it ties the incentive fee earned by the investment manager to both the upside and the downside of the fund’s performance (Fung and Hsieh, 1999).

Master of Commerce - Business Management

However, HedgeCo reports that most hedge funds observe a high-water mark, which ensures that once a hedge fund has lost a portion of the amount invested, the investors are not charged during later periods until the losses have been recuperated by the fund. Another variation of this is the “preferred return” method which prevents a fund from collecting a performance fee until a certain return is achieved. The prescribed return can either be a fixed or a floating rate (e.g. Consumer Price Index (CPI) + 2%). Lynch and Musto (1997) conclude that performance fees, both asymmetric and fulcrum are able to extract superior effort from investment managers than fees that are fixed to the net asset value of the assets under management.

As always, there are examples that stray from the mainstream. Vickers (2003) observes that Steve Cohen’s firm SAC Capital Advisors charge an “eye-popping” 50% performance fee. The US\$4 billion hedge fund reportedly accounts for as much as 3% of the New York Stock Exchange’s average daily trading, as well as up to 1% of the NASDAQ’s - a total of at least 20 million shares a day. On the back of an average of 40% per annum return over the firm’s 12 year history, it is unsurprising that Cohen is reported to have earned US\$428 million and US\$128 million in 2001 and 2002, respectively. For that level of return, a 50% performance fee may even start to look cheap in comparison.

Astoundingly, Cohen’s enviable earnings for 2002 kept him out of the top three earners for that year (Rigby, 2003). Those podium positions went to Bruce Kovner, founder of the US\$10 billion Caxton Associates with a bounty of US\$ 600 million. He was followed by Paul Tudor Jones, founder of Tudor Investments with US\$ 250 million and Citadel’s Ken Griffin with US\$ 225 million. It seems as though the hedge funds with the crystal balls in the credenzas continued to make profits for themselves and their select group of clients whilst the rest of the world staggered to recover from the dotcom blow-out. Brown (2003) dismissed suggestions that the compensation arrangements adopted by hedge funds would appear to encourage risk-taking behaviour as fund managers aimed for extraordinary returns. His study of hedge fund activities found hedge funds to have been fairly “gun-shy” during the Asian financial crises events of 1997 contrary to the views of some who have labelled them “gunslingers” (Brown, 2001).

3.7 Index Surveys

“If past history was all there was to the game, the richest people would be librarians”

– Warren Buffett

Although it is generally agreed that analysis of the past can never give a perfect prognosis of the future, it does however offer analysts the advantages of both experience and probability. Hedge fund indices were established in an attempt to attract investors who had thus far resisted wading in deeper than their ankles into hedge funds as a result of the paucity of reliable fund information.

The main database vendors to date are TASS Asset Management (TASS), Hedge Fund Research Inc. (HFR), Mar/Hedge and Zurich Capital Markets (ZCM) (Gregoriou and Rouah, 2003). Unfortunately, all four sources are plagued by operational risk inadequacies, namely: survivorship bias, selection bias and instant history bias. All three biases (Schneeweis et al., 2001) purportedly contribute to the exaggeration of the returns reported by the indices. Furthermore, the database vendors apply unique indices and sub-indices making comparison between them difficult.

3.7.1 Survivorship Bias

Survivorship bias refers to the distortion introduced into a sample as a result of only including funds that are operating at the end of the sampling period. Failed funds are totally ignored; as are funds that collapsed subsequent to 1994 – the date which most of the indices use as their ‘base year’. Attrition usually occurs when a fund dissolves because of investor withdrawals resulting from continued poor performance by the fund (Brown et al., 1998). This is termed a ‘dead fund.’ A defunct fund differs from a dead fund in that, in the case of the former, the database vendor takes the decision to de-list the fund; usually when it has failed to maintain the required reporting standards.

Using data from the TASS database Fung and Hsieh (1997) found that the dissolution rates and costs in commodity trading advisors (CTAs), which include hedge funds, to be much higher than those for mutual funds. Their study determined the average attrition rate of CTA funds to be 19% (1989-1995) in comparison to an earlier (1992) study by Brown et

Master of Commerce - Business Management

al.⁸ which found an average attrition rate of 4,8% (1977-1985). Murguia (2004) cites earlier studies (Brown et al., (1995); Carhart (1997), and Malkiel (1999)) which found survivorship bias in mutual funds to overestimate returns between 0,5% and 1,4% per annum. Managed futures (Fung et al., 1997) and offshore funds (Brown et al., 1999) studies reported biases of 3,54% and 3,0% respectively.

3.7.2 Selection Bias

Selection bias arises when the inclusion criteria set by the various database vendors differ as well as from the voluntary reporting of returns. A fund with a great performance history would be more inclined to submit data in order to attract new additional funds as opposed to a fund that has been under-performing. For example, the TASS database accepts funds with a minimum of US\$ 10 million under management, a somewhat generous minimum one-year track record, and current audited financial statements. Nonetheless, there are some stellar performers that resist being included in the surveys either because they have attained their ideal mass and are not keen on attracting new investors or simply because they just cannot be bothered to do so.

3.7.3 Instant History Bias

Instant history bias occurs subsequent to an incubation period when a fund has proved its viability and the owners seek to market it in order to attract additional funds based on its past performance record. It is for this reason that the TASS database, for example, records both the fund's entry date into the database as well as the fund's own inception data. It can reasonably be expected that unsuccessful funds disappear and are thus never recorded on any database. In citing Fung and Hsieh (2000), Murguia reports that instant history bias overestimates returns by up to 1,4% per annum. On the other hand, funds that are successful may eventually be accepted for inclusion by the database vendors who then 'backfill' the returns to the fund's inception.

Van der Sluis and Posthuma (2003) found the average length of instant histories to be 3 years demonstrating a backfill bias of about 4% per annum. Their study of the TASS database for the period 1996 - 2002 eliminated backfill bias and found that the average

⁸ Fung and Hsieh [1997] estimate the dissolution rate for hedge funds and CTAs to be between 4,3% and 8,6% per year, while Brown, Goetzmann and Ibbotson [1996] find 20% for offshore hedge funds.

Master of Commerce - Business Management

annual return dropped from 10,7% to 6,4%. If one considers that it can be reasonably assumed that underperforming hedge funds do not provide survey reports a few months before they cease operations, it therefore stands to reason that the 6.4% could still be regarded as overly optimistic. Fung and Hsieh (2002) suggest that the instant history bias can be remedied by simply dropping the fund's returns prior to its inclusion in the survey.

Although the differences between the database vendors were mentioned earlier, the extent of these differences is best highlighted in the study by Liang (2000). In attempting to examine survivorship based on investment styles, the study used the two large databases of HFR and TASS. HFR (as of July 1997) had 1,162 (1,052 survived funds, 110 dissolved funds) whereas TASS had 1,627 funds (1,201 survived funds, 426 dissolved funds). Only 465 funds were common to both databases and even they showed differences in fund returns, inception dates, net asset value, incentive fee, management fee and investment styles. Subsequently, Liang notes that:

“It should not be surprising that different studies based on different databases draw conflicting conclusions.”

All three biases in one way or the other overestimate the positive returns by neglecting or passively excluding the negative returns in their summaries. The above biases notwithstanding, Institutional Investor ran a ‘warts and all’ inaugural annual ranking of the “Top 100 Hedge Funds” in July 2002 emphasising the demand by investors for improved disclosure and performance surveys. Nedcor Collective Investments also launched the inaugural performance ranking survey for the South African Market in December 2003 in which 16 out of an invited 32 funds agreed to participate (Annexure C).

3.8 Fund of Funds

“It is better to have a permanent income than to be fascinating” - Oscar Wilde

Subsequent to the LTCM disaster Schneeweis (1998) summed up his editorial with three forecasts for the hedge fund industry which were that:

Master of Commerce - Business Management

- More hedge funds would probably close as rumours at the time suggested more spectacular failures would emerge,
- Funds would reduce their use of leverage as banks tightened up their credit standards, and
- Pursuant to the scramble for the exits, the remaining investors would seek to diversify their holdings across many funds.

Fund of hedge funds (FOFs) are essentially hedge funds which have diversified their holdings by investing in a pool of other hedge funds. By adopting this approach the vendors of such vehicles need only to ensure (as best as they can) that the appointed hedge funds attain their benchmark targets. Although fund of funds were already available when Schneeweis published his article (i.e. 1998), their allure has increased in recent times as they have been packaged as less volatile – and therefore less risky than stand alone hedge funds as well as more accessible to the less wealthy investors. Gregoriou and Rouah (2003) note that the benefits of diversifying traditional stock and bond portfolios with FOFs have been discussed by numerous authors.

With thousands of onshore (U.S.A.) and offshore hedge funds now available, there is greater flexibility to hire and fire hedge funds from the fund of funds portfolio. FOFs typically invest in 20 to 40 underlying individual hedge funds managed by ‘advisors’ across many investment styles. For instance, South African stockbroker Barnard Jacobs Mellet’s (PCS) Equity Fund (advised by SEI Investment Management Corporation) as at 31 March 2004 had 25 sub-advisors. (See Annexure 4)

The relatively low entry fees demanded by FOFs have attracted large numbers of institutional as well as private investors. At the conclusion of the Hedge Fund Roundtable meeting, the SEC’s Chairman reiterated his concerns about the “retailization of hedge funds” through FOFs (MFA, 2003). Clow (2002) cites statistics from a market study by consultants Casey, Quirk & Acito and the Hennessee Group which found that assets under management for FOFs had grown “45,9% between 1987 and 2002, and 39,9% over the past three years.” Weinberg (2003) summarised the SEC’s concerns as being the failure of FOF vendors to explain the impact of multiple layers of expenses or properly gauging investor suitability; exposing investors to unacceptable risk; wrongly valuing assets and

Master of Commerce - Business Management

hiding inherent conflicts of interest. As an example Weinberg notes that the Oppenheimer Tremont Opportunity Fund charges the following fees:

- 3.5% of assets annually (management fee),
- plus 10% of any realised profits earned above an 8% annual rate,
- plus a 2.5% load for investments up to US\$ 500,000.

With each of the underlying hedge funds also deducting fees and retaining between 10% and 25% of realised profits even when the FOF loses money, it is hardly surprising that the fund earned 6.3% as opposed to the S&P 500's 13% for the same period.

Table 3: Hedge Funds vs. Fund of Funds investment requirements.

Country	Hedge Funds	Fund of Funds
Hong Kong	US\$ 50,000	US\$ 10,000
Singapore	S\$ 100,000 US\$ 56,920	S\$ 20,000 US\$ 11,384
Ireland	E 125,000 US\$ 141,000	E 14,100 US\$ 14,100
USA	*US\$ 500,000	US\$ 25,000
South Africa +	R100, 000++ US\$14,727.44	

* If registered.

+ Added to original table for the sake of comparison. Exchange rate as at 16.05.04 = 1 USD: 6.79005 ZAR

++ Source: Kemp, S. 2004. New Hedge Fund Hopeful.

Source: <http://www.celent.com>

As can be established from the above table, the minimum entry requirements of FOFs are significantly cheaper than for their hedge fund counterparts.

Although Mills (2003) suggests that the growth in FOFs is merely the result of cannibalization by hedge funds in a last ditch attempt to maintain their income flows, studies have questioned the efficacy of their net-of-fees performance. Brown et al., (2003) conclude that individual hedge funds' dominance over FOFs on both an after-fee return and on the Sharpe Ratio basis is because of the fee arrangement. Traditionally, FOF

Master of Commerce - Business Management

managers charge an administration fee for their ability to stock-pick the best performing hedge funds for their portfolios.

Brown et al. (2002) propose a new fee arrangement that may provide improved incentives at a lower cost for FOF investors. It advocates for the FOF manager to absorb the underlying hedge funds' incentive fees, and thereby assume greater performance risk, in return for the option to charge a higher FOF management and/or incentive fee. This way, FOF investors would then not be required to pay incentive fees in the event of capital losses by the FOF. An additional benefit would be for that the increased exposure of the FOF manager as a result of high volatility would then motivate better value-adding initiatives as they stand to be substantially rewarded for positive performances.

Nonetheless, Fung and Hsieh (2002) list several advantages derived from investing in fund of funds. Because fund of funds also 'target' institutional investors and therefore have to meet stringent fiduciary terms, they tend to provide audited performance reports which would imply greater accuracy (Ennis and Sebastian, 2003). Secondly, survivorship bias is mitigated as historic performance remains on the FOF's record, even after the fund has ceased operating or to be included in the portfolio (Schneeweis et al., 2003). Thirdly, the performance of individual hedge funds that chose not to report directly to the database vendors (i.e. indices) will still be represented in the overlying FOF thereby containing the effects of selection bias. And finally, by not backfilling historic performance prior to the fund's inclusion in the FOF portfolio, the issue of instant history becomes irrelevant.

Interestingly, the alleviation of the biases offered by FOFs and the apparent relative under-performance to composite hedge fund index and stock and bond indexes (Murguia, 2003) lends support to the overestimation of individual hedge fund returns by the biases in question.

3.9 Summary

Reporting standards and requirements are the root of the disclosure debate surrounding hedge funds, and subsequently are the main sources of criticism of hedge funds. The problem is that if the hedge fund becomes too transparent, it gives away its edge. However, the lack of transparency in the operations of the funds and adequacy of the ongoing

Master of Commerce - Business Management

communication to investors places greater onus on investors to carry out extensive due diligence before investing in a fund. The absence of standard performance benchmarks and adequate risk measurement tools casts doubt on the appropriateness of the remuneration structures that hedge fund managers enjoy. Participation in index surveys is optional, and the different inclusion criteria adopted by the database vendors makes comparison between hedge funds difficult.

Survivorship, selection and instant history biases continue to be problematic issues. By offering lower entry requirements and greater access to more diversified and including some 'closed' funds, fund of hedge funds are making hedge funds more accessible to the general public. The retailization of hedge funds has raised alarm amongst regulatory authorities who have now set about reviewing the legislation and regulatory guidelines governing the operations of hedge funds.

Chapter 4 Regulation and supervision of hedge funds

“Prophecy as much as you like, but always hedge” - Oliver Wendell Holmes

Whilst the preceding chapters have highlighted the main issues endorsing the rationale behind the movement to introduce better regulation and supervision through improved disclosure, the study will now highlight the current regulatory environments in which hedge funds prevail. More often than not, most international regulatory bodies have taken their cue from the US legislation and subsequently distinct similarities are to be found.

4.1 Current regulation

4.1.1 USA

In the US, several governmental agencies are tasked with regulating institutions that deal with the general public. The Securities Exchange Commission (SEC) oversees all publicly traded securities and the corporations that issue them as well as the broker-dealers who act as market makers for the issues. The Commodity Futures Trading Commission (CFTC) regulates the futures industry. The Federal Reserve, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision have supervisory dominion over the commercial banking and thrift industry.

But because hedge funds are effectively dealt through private placements to sophisticated investors, these regulatory bodies have limited oversight over them. This fact notwithstanding, in 1999 the SEC allowed hedge funds to exceed the previous limit of 100 investors (including the General Partner) from 99 to 499 limited partners. Without requiring additional disclosure requirements, the only concession to this windfall for the hedge fund industry was the requirement that each qualifying partner should have at least US\$ 5 million invested in the fund (Agarwal and Naik, 1999).

The MFA's White Paper on registration of hedge fund advisers under the Investment Adviser's Act of 1940 (2003), whilst confirming that various safe harbour clauses enable hedge funds to effectively avoid regulation, argued that the suggestion of exclusion from governmental oversight was a misconception. To this end, the document cites the adherence by hedge funds to regulations regarding the reporting of (direct or indirect)

Master of Commerce - Business Management

equity ownership exceeding 5% of a registered security to the SEC within 10 days of the acquisition, and to standing anti-money laundering guidelines as examples. Champarnaud (2000) also notes that hedge funds also have to comply with control limits and margin calls as the LTCM experience confirmed, as well as being subjected to inspection under the 1974 ERISA Act when they have pension funds as clients, and therefore deduces that it would be a mistake to conclude that hedge funds are unregulated. Champarnaud advocates that “hedge funds are neither unregulated entities, not even players operating at the edge of the law. They are fund managers making full use of exemptions explicitly provided by the law.”

On the question of ensuring that the marketing of hedge funds was only being made to sophisticated investors and for whom hedge funds were appropriate, the SEC were faced with the seemingly insurmountable challenge presented by the Internet. The SEC established a web-site (www.growthventure.com/grdi) for the spoof firm Guaranteed Returns Diversified Inc., with creatively named hedge funds such as the “Leveraged Safety Fund” and backed by outlandish claims of generating “cumulative returns of up to 148% for investors”. The acronym GRDI (read “greedy”) did little to deter more than 80,000 visitors to the site who to the last, looked for “the little fund that could!” Quelch and Klein (1996) postulate that once a company establishes a site on the Internet, “it automatically becomes global, at least in terms of its potential to reach global customers with information.”

The Hedge Fund Roundtable held by the SEC with key hedge fund industry representatives in May 2003 sought to outline reforms for the sector in order to guard against the documented shortcomings.

4.1.2 UK

The UK is the largest hedge fund centre outside the US. This development has been due as much to the prominence of the British banking establishment as it has been to the relative leniency shown by the Financial Services Authority which has classified hedge funds as lower risk as a result of their limited public access. Subsequently London manages about 70% of all European single-manager hedge funds; this despite that fact that neither single manager hedge fund or FOF is domiciled in the UK (Phillips and Dawson, 2003).

Master of Commerce - Business Management

Most of these hedge funds are domiciled in the Caribbean, Bermuda, Guernsey and The Isle of Man where regulatory standards are not only more accommodating, but the tax regime is also more favourable. The FSA confirms that a UK domiciled fund would be subject to corporate taxation on income and capital gains.

UK hedge funds, like their American counterparts, are beneficiaries of legislative exemptions within existing statutes. The Financial Services and Market Act 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001 (SI 2001/ 1060) as amended and the exemptions to the Conduct of Business Rules, Chapter 3, Annex 5, is a case in point (Statman, 2003). The FSA's Discussion Paper 16 (DP16) issued in August 2002 addressed two issues; the selling and marketing of hedge funds and the regulation of hedge fund managers. DP16 reiterates that the FSA only has regulatory authority over authorized persons (i.e. the hedge fund manager) without implying that this transcends to the hedge fund itself. The persons authorized to market unregulated securities are governed by two statutes; the Conduct of Business Sourcebook (COB) and the Unregulated Collective Investment Scheme Order (CIS).⁹

A 2001 Goldman Sachs and Frank Russell Company survey 'Alternative Investing by Tax-Exempt Organisations, 2001' forecasted that the £750 billion UK pension funds allocation to hedge funds would increase by 1.5% to 3.3%; an effective cash injection of £11.25 billion (Aimar, 2002).

4.1.3 Other countries

In Europe, London leads the way, with France, Ireland, Italy, Luxembourg, Sweden and Switzerland all making in-roads at introducing hedge funds to the main stream (Phillips and Dawson, 2003). Even traditionally conservative powerhouse Germany passed a bill permitting the retailing of shares to both institutions and private investors on 1 January, 2004. The bill gives equal tax treatment to both domestic and foreign funds.

4.1.3.1 Hong Kong

Competition for hedge fund investment assets with neighbouring Singapore has been the main driving force for Hong Kong's aggressive approach to the introduction and regulation of hedge funds. A 1990 decision by Singapore's economic planning board which identified

⁹ Available at <http://www.fsa.gov.uk>

Master of Commerce - Business Management

the hedge fund industry as a key future investment sector resulted in the earmarking of US\$21 billion as seed capital for the exercise (Harrison, 2003).

According to Harrison, the government of Singapore has supported the local industry by offering subsidies in the form of:

- tax holidays for firms during their first 2 years of operation,
- development grants assisting firms to establish their offices
- 50% staff salary subsidies
- 70% subsidy for the overseas training of staff

Hong Kong's Securities and Futures Commission (HKSF) had as at 30 December 2003 approved eight hedge funds, with approval for an additional two funds pending, to be sold to its high-net worth investors since November 2002 (Eng, 2003). Some of the terms hedge fund managers need to meet in order to qualify for approval include having at least US\$ 100 million under management, and "five years" general experience in "hedge fund strategies". Minimum investment amounts for single hedge funds and FOFs are US\$ 50,000 and US\$ 10,000 respectively. However, a 100% capital guarantee or capital protected structure secures an exemption from these minimums.

As is the norm in Singapore, a prominent label on the front cover of the prospectus stating the special risks involved is mandatory. A further requirement insisted on by both jurisdictions is quarterly window period to allow investors to withdraw their investments, although more frequent opportunities may be granted by the respective hedge funds. The HKSF also requires a hedge fund to have within its management structure two managers with at least five years hedge fund management experience, two years of which must have been spent on the specific investment strategy adopted by the fund. Despite the imposition of these hurdles, recent moves to grant profit tax exemptions to offshore funds were seen as further governmental endorsement for the hedge fund industry.

4.1.3.2 Ireland

Ireland has gone one step further than Hong Kong in that aside from requiring the proof of US\$ 100 million of third party assets under discretionary management; offshore hedge funds may seek an offshore listing on condition that barring a few countries, their

Master of Commerce - Business Management

investment minimum is US\$ 100,000. The countries for which this minimum does not apply surprisingly seems to include all the jurisdictions where the majority of hedge funds are domiciled; the Isle of Man, Guernsey, Jersey and Bermuda. (FSA, 2002).

4.1.4 South Africa

The fledgling South African hedge fund industry is currently represented by 60 local hedge funds with an approximate total R7 billion under management. Hedge funds are currently unregulated in South Africa (Cameron, 2004) and they have been established in the form of trusts, companies and partnerships. Strict exchange control regulations imposed by the central bank, continued devaluation of the rand (especially in 2001) and the hedge fund-esque facilities offered in various forms by local asset managers in the form of wrap funds and unit trusts were regarded as the optimal vehicles for attaining offshore investment portfolio exposure.

According to financial information services provider, I-net Bridge local investment (60%) is dominated by high net worth individuals. Pension funds, fledgling-enterprise incubators and life assurance products represent 15%, 15% and 10%, respectively (This Day, 2004). Among key constraints facing the local industry are the limited opportunities to apply varied arbitrage strategies due to the relatively small size of the JSE Securities Exchange (Vanek, 2004).

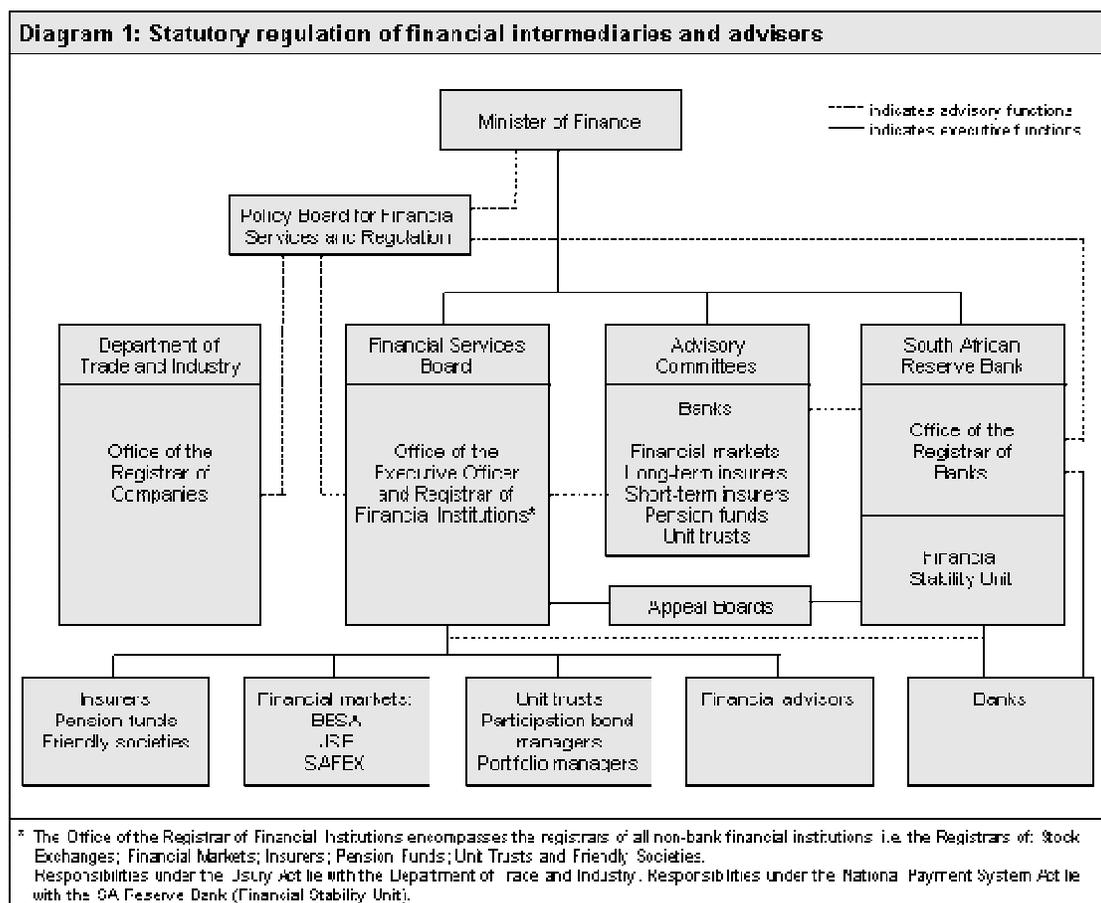
The local regulatory body, the Financial Services Board (FSB) caused a stir in February 2004 when it declared that the practice by some investment managers of issuing hedge funds packaged in endowment policies was illegal as it endangered the savings of other policy holders (Wessels, 2004). Further, the directive required all Life companies to conform to the requirements of the Long-Term Insurance Act which precludes the use of leveraged structures. Fourteen months earlier, the FSB had also acted against hedge funds that were being packaged in unit trusts. Following a flurry of discussions with the Association of Collective Investments (ACI) and the South African Charter of the Alternative Investment Management Association (AIMA), the FSB softened its stance the following day by re-affirming that hedge fund managers could continue operating as long as they did not purport to be directly or indirectly approved or regulated by the FSB in their communication to investors. The FSB also confirmed plans to introduce distinctive guidelines dealing with the issues of supervision, regulation and exposure. M-Cubed

Master of Commerce - Business Management

Holding's Carla Fiford reiterates that the 40 largest stocks on the JSE Securities Exchange account for more than 90% of the exchange's daily liquidity (Fiford, 2004). An SEI sponsored survey conducted by the University of Pretoria¹⁰ found that, of the pension funds not already invested in hedge funds:

- 62% would consider doing so, although
- 68% had 'poor to average' knowledge on the industry, and
- most respondents regarded hedge funds as a diversification tool to lower the portfolio risk profile rather than as a source of additional out-performance (Wood, 2004).

Figure 4: The current South African regulatory structure.



Source: <http://www.finforum.co.za/regulate/regstruc.htm>

It should be noted that a decision has been made by the Government to move toward a

¹⁰ The survey took place during April and May 2003 and surveyed 41 of the top-100 pension funds that manage R130bn - 23% of the total assets of SA retirement funds.

single, mega-regulatory structure (as exists now in the UK).

The impasse has since been resolved with the recent issue of the Joint Discussion Paper (2004) by the FSB, ACI and AIMA which covers three main issues, namely:

- The approach to the regulation of hedge fund managers;
- The viability of creating a regulated product structure specifically for hedge funds; and
- The governance of selling and marketing of hedge funds in South Africa.

The document explicitly states that the appropriateness of hedge funds for pension funds and life insurers is excluded from consideration, as is the accommodation of private equity funds within the existing regulatory framework. Nedcor Retail Investments launched the first local hedge fund review as at 31 December 2003 (Appendix 3) comprising of 18 South African hedge funds which at a total of R1,4 billion represented about a fifth of the local industry's assets under management.

4.2 Proposed regulatory changes

The jurisdictions mentioned above are currently at various stages of introducing changes to the legislation governing the hedge fund industry. Eichengreen and Mathieson (1999) identified three reasons why governments should regulate and supervise hedge funds; to protect investors, to protect market integrity and to manage systematic risk. Hanlon (2002) recently proposed a framework for introducing a disclosure regime which concluded that in order for it to be effective:

- participants needed to have access to relevant data;
- must be incentivised to record and disclose data; and that
- their ability to evade disclosure obligations by switching jurisdictions must be curtailed.

The suggestion that hedge funds must not only be held to higher standards of disclosure but so too must their sources of capital, namely banks, has been raised by policy makers (BIS Review, 2003). The International Organisation of Securities Commissions (IOSCO)

Master of Commerce - Business Management

and the Basel Committee of Banking Supervisors (Basel Committee) have both advocated for improved disclosure by individual hedge funds although their suggested approaches differ. The IOSCO propose voluntary disclosure by all large hedge funds (i.e. US\$100 Million) whilst the Basel Committee prefer to support the creation of a Central Register of Leveraged Positions which would then be made accessible to all third parties, regardless of geographical location.

Others advocate (see Persaud, 2000), not for a new regime, but simply to improve the efficiency of the existing one. The MFA's Sound Practices for Hedge Fund Managers report (2003) suggests that through self-regulation by the hedge fund industry, two streams of communication should be generated in order to ensure adequate disclosure in future. One stream is proposed to be tailor-made for the needs of the investors and the other stream for the needs of the regulators. Champarnaud (2001) makes reference to the distinction between the two streams by assigning the terms "reporting" and "disclosure"; in which reporting is defined as the regular provision of quantitative or qualitative information to regulators and disclosure is providing data to the public in order to inform potential investors of counter-parties as to the nature of the business and its associated risks.

Compulsory registration, improved disclosure, minimum income thresholds and curbs on hedge fund trading activities that unfairly disadvantage other investors are four methods suggested by Weiss and Borrus, (2003) for reigning-in hedge funds.

4.2.1 USA

The terrorist events of September 11th and the comments by US Reserve Bank Chairman Alan Greenspan regarding "excessive exuberance and malfeasance" following the Enron and other financial scandals paved the way for the USA PATRIOT Act¹¹. The Act aims to introduce greater surveillance to the financial machinations of individuals and institutions by promoting the prevention, detection and prosecution of international money laundering activities connected with terrorism. The MFA has responded to the findings of the SEC review of the hedge fund industry with 3 documents that provide suggestions for remedying the concerns raised.

¹¹ Acronym: **U**niting and **S**trengthening **A**merica by **P**roviding **A**ppropriate **T**ools **R**equired to **I**ntercept and **O**bstruct **T**errorism (USA PATRIOT) Act

a) The Registration of Hedge Fund Advisers under the Investment Advisers Act of 1940 Report.

The MFA put forward that increasing the eligibility requirements for investors would be simplest and most efficient method of providing greater investor protection.

The report cites the Senate Report to the National Securities markets Improvement Act (NSMIA) enacted by Congress in 1996 which stated that:

“The qualified purchaser pool reflects the Committee’s recognition that financially sophisticated investors are in a position to appreciate the risks associated with investment pools that do not have the Investment Company Act’s protection. Generally, these investors can evaluate on their own behalf matters such as the level of a fund’s management fees, governance provisions, transactions with affiliates, investment risk, leverage risk and redemption risks.”

The MFA report raises 4 reasons why hedge fund managers object to mandatory registration and regulation, namely:

- Hedge fund investors are generally sophisticated
- The existing regime already provides regulation through dealings with other securities market participants such as investment and commercial banks
- Registration would only divert already scarce resources from the Commission
- The regulatory burden would stifle an innovative and creative industry.

b) The Financial Eligibility Standards Report

This report proposes amendments to the current definition of an “accredited investor”. The following revisions to the eligibility thresholds are also put forward:

Table 4: Comparison of current vs. proposed thresholds in the USA.

Current Requirements	Proposed Requirements
US\$1 Million net worth	Increase to US\$2 Million net worth
US\$ 200,000 annual income	Increase to US\$ 400,000 annual income
US\$ 300,000 joint annual income (i.e. with spouse)	Increase to US\$ 500,000 joint annual income

c) The Sound Practices for Hedge Fund Managers Report

This document seeks to establish guidelines for “best practices” in the hedge fund industry. The recommendations put forward range from the introduction of better of internal controls for establishing risk parameters and practices to promote sound valuation practices, to regulatory controls and compliance issues in terms of documentation practices.

The SEC’s decision will either see the introduction of a new regime or stricter amendments to the existing framework. There is still little indication as to which option will be adopted. Introducing the legislation will be the easy part, although it rests to be seen whether supervision and enforcement of the industry will finally be achieved.

4.2.2 UK

The UK, like the rest of the EU member states, is generally guided by the Directive on Undertakings for Collective Investments in Transferable Securities (UCITS). The latest Directive, UCITS III includes derivatives for the first time, although restrictions on short-selling, gearing and liquidity results in the exclusion of hedge funds. Envisaged harmonisation set out in the Financial Services Action Plan is co-ordinated by the Committee of European Securities Regulators (Phillips et al., 2003).

The DP16 consultation concluded on two key rulings made by the FSA:

- The existing regulatory treatment of hedge fund managers in the same manner as other investment managers was appropriate.

Master of Commerce - Business Management

- There was currently insufficient demand for the retailization of hedge fund products to merit the creation of new rules in order to accommodate them as collective investment schemes.

Through CP185, also known as the CIS Sourcebook, the FSA is looking into the introduction of Non-Retail Funds which would allow the use of leverage, the charging of performance-related fees and the short-selling of securities in certain instances.

Data protection, a constitutionally enforced requirement for funds domiciled outside the EU, must meet EU standards in terms of protecting an individual's investment information. This presents a potential hindrance to EU investor's access to global funds. Currently, even US funds do not meet the required criteria on investor data handling and transmission.

Fitch, the international rating agency recently introduced a rating scheme for alternative asset managers. The scheme rates from best to worst on a scale of 'AAM1' to 'AAM5' respectively. London-based Atlas Capital was awarded a conservative 'AAM3+' for its Sigma Asset management FOF business in November, 2003 (AtlasCG, 2003). Financial News reported in the 23rd February 2004 newsletter that the management of RAB Capital, another London-based hedge fund was considering an initial public offering of the business on the UK's Alternative Investment Market. A listing would make RAB Capital the first dedicated hedge fund to do so (Rutter, 2003).

April 2004 saw the launch of the FTSE Hedge; a global index comprising of 40 diverse hedge funds across a range that covers the major hedge fund investing strategies. Harcourt Investing, a Zurich-based independent consultancy has been retained to perform the due diligence on the funds that will constitute the index.

The fund aims to offer investors the opportunity to trade on three levels (Greenblo, 2004), notably:

- The global share class into the full index or 40 funds;
- The 3 style-based share classes (Directional, Non-directional and Event-driven) each comprising of 10 to 20 funds; and
- 8 trading strategy-based shares, each comprising of between 3 and 12 funds.

Master of Commerce - Business Management

The fee structure is merely a 1% management fee; a zero% performance fee is to be charged. However, a rebateable initial fee of 3% is required and no exit penalties are charged.

4.2.3 Other countries**4.2.3.1 Hong Kong**

The HKSFC is currently contemplating radical legislative changes that would surpass the levels currently envisaged in either the US or the UK. (DiBiasio, 2002). Some of the proposed changes include:

- Disclosure detailing more than just the top 10 fund holdings - as is the current industry norm.
- Detailed information regarding Sharpe ratios and draw-downs
- Use of International Accounting Standards (IAS) as opposed to the Generally Accepted Accounting Principles (GAAP). The US and Ireland currently insist in the use of GAAP.

Greater disclosure is entrenched through the stringent requirements set for hedge fund prospectuses which must state: the nature of the fund; the markets covered; instruments used; risk reward characteristics of the strategy; circumstances under which the fund is most suitable; circumstances under where the fund is least or plainly unsuitable; the risk control mechanism, including the setting of investment and borrowing parameters; the terms of the offering and the responsibilities of each of the relevant parties (Lacey, 2003).

Despite offering greater regulation, the author believes that these changes might discourage hedge funds from seeking a Hong Kong registration. The HKSFC hopes to mitigate such a backlash by highlighting the huge potential that exists in the event that the new standards result in approval for retailization by the authorities overseeing the mainland China market.

4.2.3.2 Ireland

The existing approach which gradually reduces the legislative requirements based on the professed sophistication and wealth of an investor currently sets Ireland a step ahead of its contemporaries in terms of regulation. Other stipulations such as limiting the investments

Master of Commerce - Business Management

in any single issuer to a maximum of 10% of the fund's net asset value, also entrenches diversification and risk management in Dublin-based funds. The prohibition on short-selling may however detract hedge funds from seeking a Dublin registration.

4.2.4 South Africa

Feedback on the Joint Discussion paper and the recommendations of this study should pave the way for the future of South African hedge funds.

4.3 Summary

It would seem that regulation of hedge funds by means of introduction and supervision of more stringent disclosure requirements would provide the protection that regulators want for investors.

However, Frison-Roche (2001) and the IOSCO's Report of the Technical Committee of the International Organisation of Securities Commission (2003) both question the legality of how the powers of regulatory authorities should be established in terms of law. The mandates of most financial regulatory authorities have included ensuring market transparency, investor equality and enforcing prudential and ethical rules on all market participants. Highlighting the current role played by the French Commission des Opérations de Bourse (COB, The French Stock Market Operations Authority) and the Conseil des Marchés à Terme (CMT, The French Derivatives Market Organisation) and their ability to punish operators, Frison-Roche hypothesises that this enforcement of behavioural standards seeks to replace the powers of Parliament and Government, by substituting the might of expertise for the power of democracy.

Hence, the study considers these authorities to be independent of political power as they lack regressive legitimacy, and retrospectively, are not empowered by the very people they claim to represent and protect. Falling short of stating that regulatory authorities may thus be a law unto themselves, the study concedes that although they (i.e. the COB and CMT) lack political responsibility, they remain accountable through annual financial and parliamentary reports. The SEC, for instance, is answerable to various working sub-committees and commissions. Furthermore, the nomination and appointment of members to these bodies by elected officials (e.g. heads of government) does confer political legitimacy in some respect.

Chapter 5 Empirical Research

This section deals with the empirical research of the study.

5.1 The plan and procedures of the study

Each of the identified key factors contributing to the disclosure debate was introduced and reviewed in Chapter 3 and the impact of these factors on existing and proposed regulations was made in Chapter 4. The main issues regarding the same factors were then summarised in a questionnaire survey which was distributed to hand-picked hedge fund-affiliated firms from the financial and legal spectrums.

Initially a draft questionnaire was forwarded to one of the firms to determine and confirm the comprehensibility and relevance of the questions raised. Received comments and suggestions were acknowledged and revisions were made to the draft questionnaire. A trial interview was held to test the improved draft, following which further amendments were made to the questionnaire. Once satisfied with the questionnaire, approximately 40 firms affiliated directly and indirectly with the hedge fund industry were approached. Due to the diverse range of the questions (33 in total) in the survey, some questions required the respondents to select a single answer whilst others allowed for more than one answer to be selected. To allow for the qualification of the responses, respondents were invited to provide additional comments to the questions for which space was set aside for in the questionnaire. An attempt was made to attract respondents from the USA, Canada, UK, Ireland, Hong Kong, Singapore, and throughout South Africa. Initially, an e-mail outlining the nature and purpose, as well as the envisaged time frame for the survey responses was sent to each potential respondent.

Some invitees indicated immediately that they were unable or unwilling to participate. Others either consented or did not respond. Questionnaires were sent to the 25 firms that had not ruled out participation in the survey along with a reminder for them to provide their questionnaire responses within 2 weeks. Subsequently, written reminders were sent thrice; after the one-and-a-half, two, and three week marks. A total of 6¹² personal interviews were held with four distinct firms and the questionnaires were completed during

¹² 2 of which were with the draft questionnaire during the development stages.

Master of Commerce - Business Management

the course of these discussions. Each response to the questionnaire was confirmed by the respondent for the record. A Dictaphone was used at two of the six interviews to document the discussions. Queries raised in the e-mailed questionnaire responses were followed up with the firms to establish clarity. This procedure was applied several times to clarify some of the comments received to the questionnaire questions.

A total of 14 responses had been received after the third week. One of the 14 questionnaires on hand had been entirely based on the draft questionnaire format. Although a copy of the revised questionnaire was forwarded to the concerned firm with a request for them to include the outstanding responses, no further responses were received despite several reminders. This questionnaire was then deemed flawed and excluded from the survey entirely. Among other factors, the restrictive time constraint was probably the eminent contributor for the relatively small final pool of respondents. Subsequently, the responses of the remaining 13 respondents were statistically analysed and have been presented below. Although 11 of the 13 survey respondents were from the South African market, the survey is only deemed to be representative of the market in as far as it transcends the different role players in the market by including representatives from hedge funds, fund of hedge funds, asset management and a professional association.

A UK law firm and a Canadian investment consultancy also participated in the survey. At the time of the survey (Fall, 2004) less than 14¹³ fund managers participated in the Nedcor Hedge Fund Review, arguably the largest South African hedge fund database. A significant number of funds operating in the South African market are either closed to new money; are denominated in US dollars; are still trying to establish a track record; are not interested in participating in surveys or were simply not discovered for inclusion in the survey. In terms of size, 9 of the respondents reported assets under management of less than R50 million each. 2 of the respondents reported offshore assets under management exceeding R1.2 billion each.

In light of the afore-mentioned, the survey was fairly representative of the 'known' funds and the assets under management represented significant amount relative to the acknowledged estimated size of the South African hedge fund industry. Nonetheless, it is

¹³ Nedcor Retail Investments now has a database with the names of 65 hedge fund managers (as at December 2004) although only 24 are currently monitored in the Nedcor Hedge Fund Review.

Master of Commerce - Business Management

acknowledged that a larger pool would have been more representative and therefore more desirable.

Responses from the following 13 firms were received and included in the results.

1. Allan Gray
2. Association of Collective Investments
3. Cadiz
4. Coronation
5. Future Growth
6. Interneuron
7. Momentum Asset Managers
8. PSG Capital
9. Matheson Ormsby Prentice (UK)
10. Signal Futures
11. Statman Consulting (Canada)
12. Strategy Securities
13. Trendline

5.2 Empirical Research

The questionnaire was split into two parts. Part 1, questions 1 through to 6, dealt with the respondents' profile and background. Part 2, questions 7 through to 33, was divided into sections targeted at addressing issues arising from the study namely: (a) transparency; (b) benchmarking; (c) risk measurement; (d) remuneration; (e) index surveys; (f) fund of funds and (g) general issues.

Question 1: Respondents were asked to select the description that best defined the nature of their enterprise from a list which included: Hedge fund (Type 1.11); Fund of Funds (Type 1.12); Intermediary which invests in Hedge Funds (Type 1.13); Intermediary which invests in Fund of Funds (Type 1.14); Asset management firm (Type 1.15); Law firm (Type 1.16); Investment advisor (Type 1.17); and Other (Type 1.18). These classifications were then cross-tabulated with subsequent responses and the results presented in the tables in an attempt to identify possible patterns in the responses provided. Of the 13 respondents, 5 identified themselves as hedge funds; 5 as asset management firms; 1 as a law firm and 1 as an investment advisor. 1 respondent which identified itself as "Other" turned out to be a financial consultancy.

Question 2.1: Respondents were asked to declare their assets under management in South Africa.

Graph 1: Q 2.1 Assets under management in South Africa

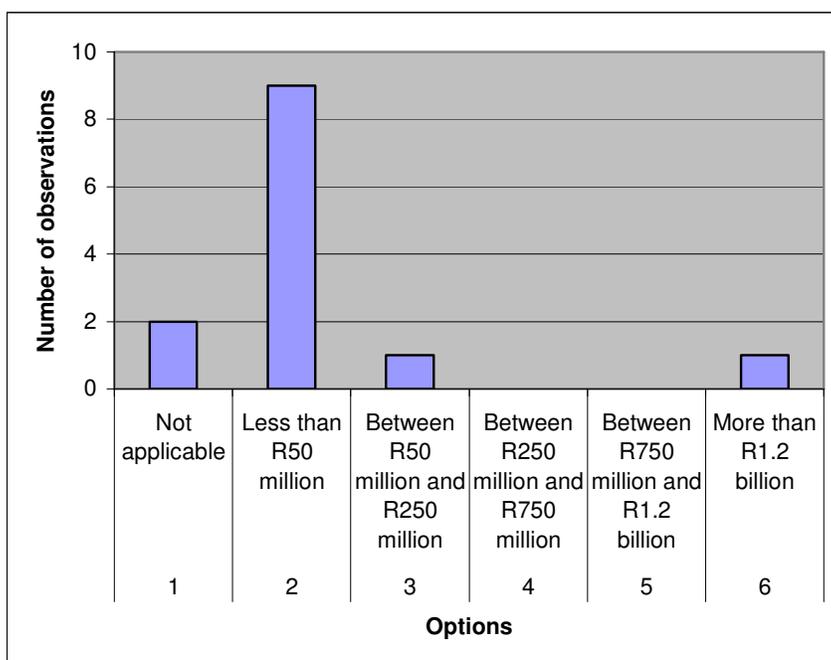


Table 5: Q 2.1. Cross-tabulation of assets under management in South Africa

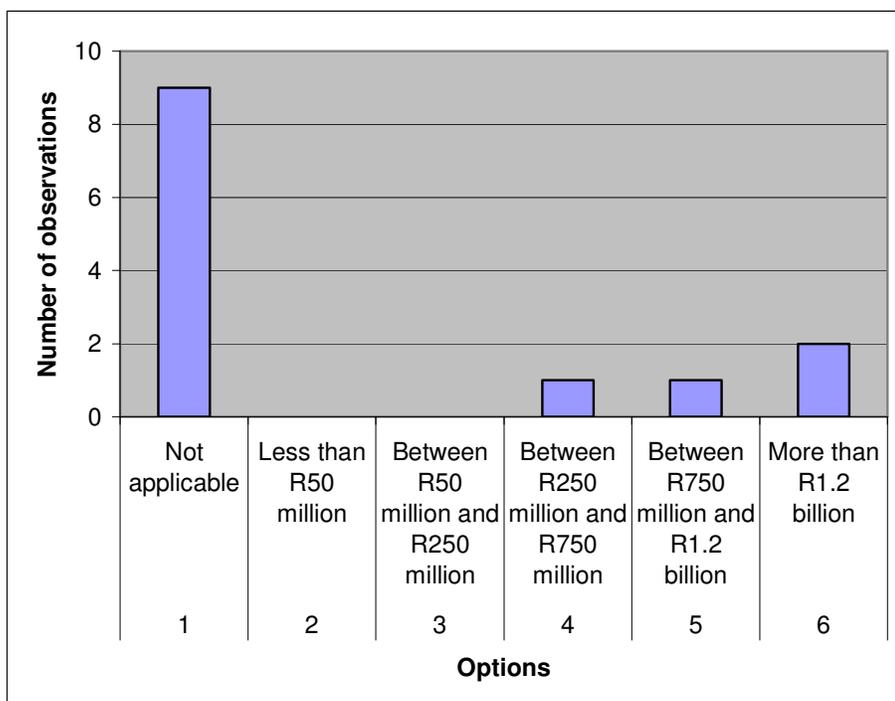
	SA AUM 2.1	Type 1.11	Type 1.15	Type 1.16	Type 1.17	Type 1.18	Row Totals
		Hedge Fund	Asset Manager	Law Firm	Investment Advisor	Other	
Count	1	0	0	0	1	1	2
Column percent		0.00%	0.00%	0.00%	100.00%	100.00%	
Row Percent		0.00%	0.00%	0.00%	50.00%	50.00%	
Count	2	4	4	1	0	0	9
Column percent		80.00%	80.00%	100.00%	0.00%	0.00%	
Row Percent		44.44%	44.44%	11.11%	0.00%	0.00%	
Count	3	1	0	0	0	0	1
Column percent		20.00%	0.00%	0.00%	0.00%	0.00%	
Row Percent		100.00%	0.00%	0.00%	0.00%	0.00%	
Count	6	0	1	0	0	0	1
Column percent		0.00%	20.00%	0.00%	0.00%	0.00%	
Row Percent		0.00%	100.00%	0.00%	0.00%	0.00%	
Count	All Groups	5	5	1	1	1	13

The above frequency cross-tabulation table shows that¹⁴, for example, of the 5 respondents who identified themselves as “hedge funds” (i.e. Type 1.11) in question 1 of the survey questionnaire, 4 currently manage assets of less than R50 million, and 1 manages assets between R50 million and R250 million in South Africa. Similarly, of the 5 who identified themselves as “asset management firms” (i.e. Type 1.16), 4 currently manage assets of less than R50 million, and 1 manages assets of more than R1.2 billion.

Question 2.2: Respondents we asked declare their assets under management abroad. 9 of 13 respondents did not find this question applicable. One respondent managed between R250 million and R750 million; another managed between R750 million and R1.2 billion and 2 had over R1.2 billion under management offshore.

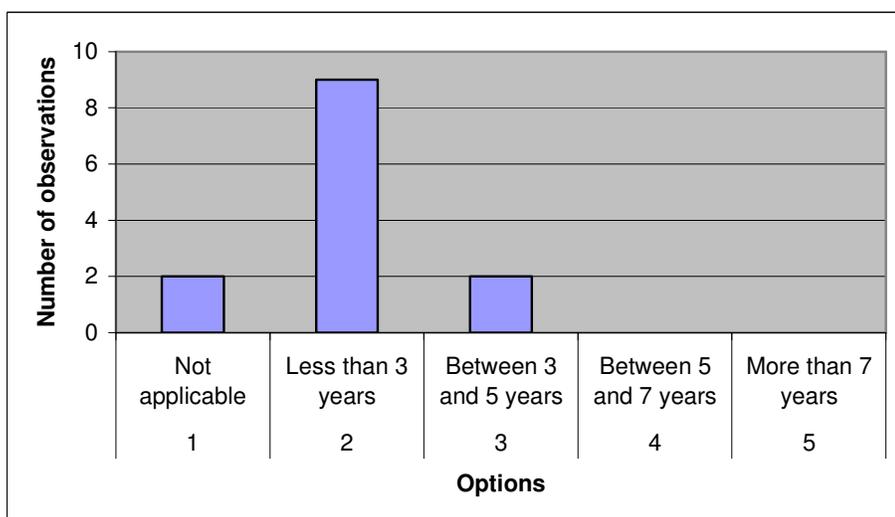
¹⁴ Hedge Fund (Type 1.11) ; Asset Management Firm (1.15); Law Firm (1.16); (Type 1.17) Investment Advisor (Type 1.17); Other (1.18). No responses were received for these types: Fund of Funds (Type 1.12); Intermediary that invests in hedge funds (Type 1.13); and Intermediary that invests in FOF (Type 1.14)

Graph 2: Q2.2 Assets under management: Abroad



Question 3.1: Respondents were asked to confirm the length of time that their enterprises had been carrying out investing or advising activities in South Africa. The 2 foreign respondents indicated that the question was not applicable to them; 9 of the 13 respondents indicated that they had been active in the SA market for less than 3 years; and a remaining 2 indicated that they had been active in the SA market for between 3 and 5 years.

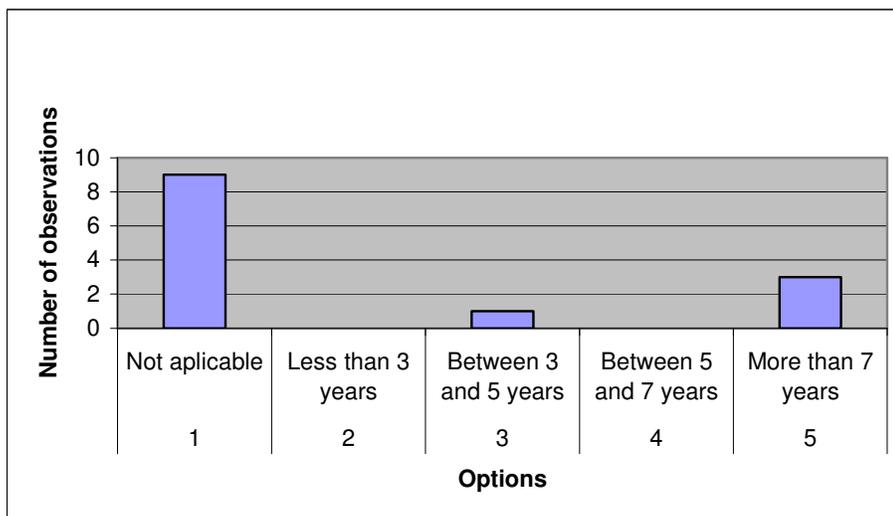
Graph 3: Q 3.1 Length of hedge fund investing/advising in South Africa



Master of Commerce - Business Management

Question 3.2: Respondents were asked to indicate the extent of their investment experience in foreign markets. 9 of the 13 respondents indicated that the question was not applicable to them; 1 respondent had between 3 and 5 years' experience and a further 3 respondents had more than 7 years of investing experience in foreign markets.

Graph 4: Q 3.2 Length of hedge fund investing/advising: Abroad



Question 4.1: Respondents were asked the size of their professional hedge fund teams in South Africa. Of the 13 respondents, 3 respondents had no dedicated hedge fund team; 9 respondents had between 1 and 5 professional hedge fund team members; and 1 respondent had between 5 and 10 members.

Question 4.2: Respondents were asked the size of their professional hedge fund teams abroad. Of the 13 respondents, 8 had no dedicated hedge fund team abroad; 1 respondent had between 1 and 5 team members abroad; 1 respondent had between 5 and 10 team members; 2 respondents had between 10 and 25 team members abroad; and 1 respondent had more than 25 team members abroad.

Question 5: Respondents were asked to indicate whether they had a dedicated staff member responsible for regulation compliance. Of the 13 respondents, 10 indicated that they had a dedicated regulation compliance officer whilst the remaining 3 did not have a dedicated staff member for this purpose. Of the 3 firms that do not have a dedicated member of staff responsible for compliance, 2 are hedge funds, and the third is a financial consultancy.

Master of Commerce - Business Management

Question 6: Respondents were asked to declare the size of their dedicated hedge fund compliance teams. 10 or 13 respondents had between 1 and 5 members in their compliance team; a further 3 did not have a dedicated team.

Question 7.1: Respondents were asked whether, in their opinion, the quality of communication provided by hedge funds needed to be greatly improved. Of the 13 respondents, 11 respondents said “Yes”, and 2 said “No”. The 2 who indicated “No” were both hedge funds.

Table 6: Q 7.1. Cross-tabulation of whether quality should be improved per firm type.

	QtyImp7.1	Type 1.11	Type 1.15	Type 1.16	Type 1.17	Type 1.18	Row Totals
		Hedge Fund	Asset Manager	Law Firm	Investment Advisor	Other	
Count	1	2	0	0	0	0	2
Column percent		40.00%	0.00%	0.00%	0.00%	0.00%	
Row Percent		100.00%	0.00%	0.00%	0.00%	0.00%	
Count	2	3	5	1	1	1	11
Column percent		60.00%	100.00%	100.00%	100.00%	100.00%	
Row Percent		27.27%	45.45%	9.09%	9.09%	9.09%	
Count	All Groups	5	5	1	1	1	13

Question 7.2 was staggered into 3 parts consisting of statements proclaiming that the communication to private investors should be improved to make it more relevant to the investment decision (Q 7.2.1); more understandable to private investors (Q 7.2.2) and more comparable between hedge funds for private investors (Q 7.2.3).

Question 7.2.1: Respondents were asked to respond to the statement that hedge fund communication to private investors should be improved to make it more relevant to the investment decision. Of the 13 respondents, 12 respondents either agreed (7) or strongly agreed (5) with the statement that communication to private investors should be improved to make it more relevant to their investment decision. One respondent indicated that they were unsure.

Master of Commerce - Business Management

Graph 5: Q 7.2.1 Communication more relevant to the investment decision of private investors

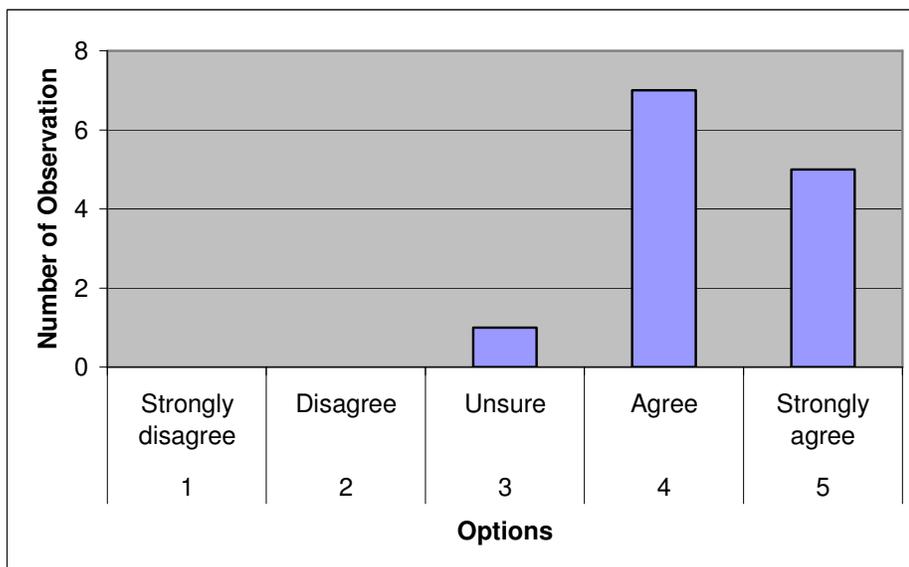


Table 7: Q 7.2.1. Communication more relevant to the investment decision of private investors.

	C. Rel. 7.2.1	Type 1.11 Hedge Fund	Type 1.15 Asset Manager	Type 1.16 Law Firm	Type 1.17 Investment Advisor	Type 1.18 Other	Row Totals
Count	3	1	0	0	0	0	1
Column percent		20.00%	0.00%	0.00%	0.00%	0.00%	
Row Percent		100.00%	0.00%	0.00%	0.00%	0.00%	
Count	4	2	2	1	1	1	7
Column percent		40.00%	40.00%	100.00%	100.00%	100.00%	
Row Percent		28.57%	28.57%	14.29%	14.29%	14.29%	
Count	5	2	3	0	0	0	5
Column percent		40.00%	60.00%	0.00%	0.00%	0.00%	
Row Percent		40.00%	60.00%	0.00%	0.00%	0.00%	
Count	All Groups	5	5	1	1	1	13

Several respondents commented that the continuing ‘stigma’ surrounding hedge funds in the minds of the public due to in part to misinformation about the risks involved in hedge funds investing, and in part by well documented accounts of major blowouts by LTCM and other funds places the onus of managing this perception on the hedge fund industry itself. To this end, most respondents welcome the move towards improving the quality of communication, especially to private investors (i.e. as opposed to institutional investors) as

Master of Commerce - Business Management

they tend to have less resources available to them to carry out proper due diligence and to monitor the hedge funds on an on-going basis.

Question 7.2.2: Respondents were asked to respond to the statement that hedge fund communication should be made more understandable to private investors. Of 13 the respondents, 12 respondents either agreed (9) or strongly agreed (3) with the statement. 1 respondent disagreed with the statement.

Graph 6: Q 7.2.2 Communication more understandable to private investors

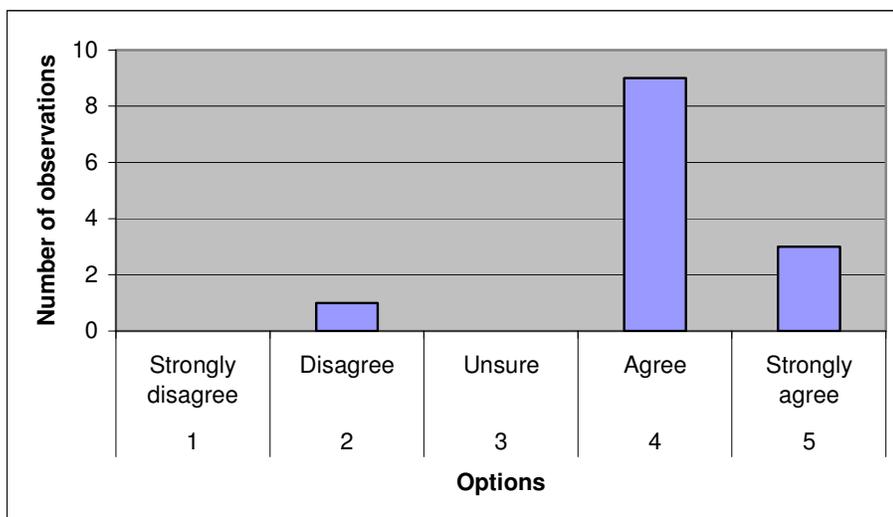


Table 8: Q 7.2.2. Communication more understandable to private investors

	C.Undc 7.2.2	Type 1.11 Hedge Fund	Type 1.15 Asset Manager	Type 1.16 Law Firm	Type 1.17 Investment Advisor	Type 1.18 Other	Row Totals
Count	2	0	1	0	0	0	1
Column percent		0.00%	20.00%	0.00%	0.00%	0.00%	
Row Percent		0.00%	100.00%	0.00%	0.00%	0.00%	
Count	4	4	3	0	1	1	9
Column percent		80.00%	60.00%	0.00%	100.00%	100.00%	
Row Percent		44.44%	33.33%	0.00%	11.11%	11.11%	
Count	5	1	1	1	0	0	3
Column percent		20.00%	2.00%	100.00%	0.00%	0.00%	
Row Percent		33.33%	33.33%	33.33%	0.00%	0.00%	
Count	All Groups	5	5	1	1	1	13

From the personal interviews held, the recurring issue was the need to tone down the use of technical jargon in the communication material enough to ensure that a diligent or

Master of Commerce - Business Management

sophisticated investor who may not necessarily be a specialist would still be able to get a clear understanding of the situation, e.g. the investment strategy followed by the fund. The focus should thus be on making the language in communication documents as simple as possible without underplaying the true nature of the fund’s philosophy and approach. One respondent reiterated the investors’ duty to inform themselves as follows:

“I think that communication by hedge fund managers to private investors should only take place once retail/private investors have had opportunity to fully understand the type of investment they are investing in. In other words, I think that private investors should first fully ensure that they understand the environment before investing and receiving communication from a hedge fund operator.”

Question 7.2.3: Respondents were asked to respond to the statement that hedge fund communication to private investors should be improved to make hedge funds more comparable. Of the 13 respondents, 8 either agreed (6) or strongly agreed (2) with the statement. 3 respondents disagreed and 1 respondent strongly disagreed. 1 of the respondents was unsure.

Graph 7: Q 7.2.3 Comparability of hedge funds from the point of view of private investors

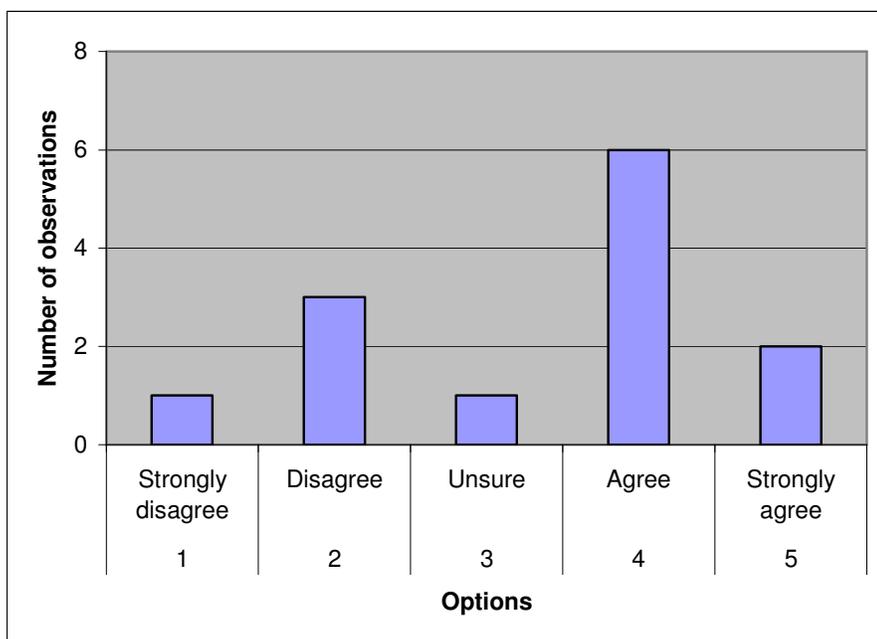


Table 9: Q. 7.2.3. Comparability of hedge funds from the point of view of private investors.

	C.Comp 7.2.3	Type 1.11	Type 1.15	Type 1.16	Type 1.17	Type 1.18	Row Totals
		Hedge Fund	Asset Manager	Law Firm	Investme nt Advisor	Other	
Count	1	0	0	0	1	0	1
Column percent		0.00%	0.00%	0.00%	100.00%	0.00%	
Row Percent		0.00%	0.00%	0.00%	100.00%	0.00%	
Count	2	2	1	0	0	0	3
Column percent		40.00%	20.00%	0.00%	0.00%	0.00%	
Row Percent		66.67%	33.33%	0.00%	0.00%	0.00%	
Count	3	1	0	0	0	0	1
Column percent		20.00%	80.00%	100.00%	0.00%	0.00%	
Row Percent		100.00%	0.00%	0.00%	0.00%	0.00%	
Count	4	1	4	1	0	0	6
Column percent		20.00%	80.00%	100.00%	0.00%	0.00%	
Row Percent		16.67%	66.67%	16.67%	0.00%	0.00%	
Count	5	1	0	0	0	1	2
Column percent		20.00%	0.00%	0.00%	0.00%	100.00%	
Row Percent		50.00%	0.00%	0.00%	0.00%	50.00%	
Count	All Groups	5	5	1	1	1	13

The statement ‘whether hedge fund communication to private investors should be improved to make it more comparable between hedge funds’ produced the most divergent responses from the 13 respondents. This was due to the fact that to answer the question, the respondents needed to make an assumption about whether it was even possible to compare different hedge funds; and assuming this were possible, the extent to which such comparison could be effected, and the extent to which such comparison was then relevant. One of the respondents who disagreed with the statement noted:

“You can only compare similar styles because funds differ markedly”.

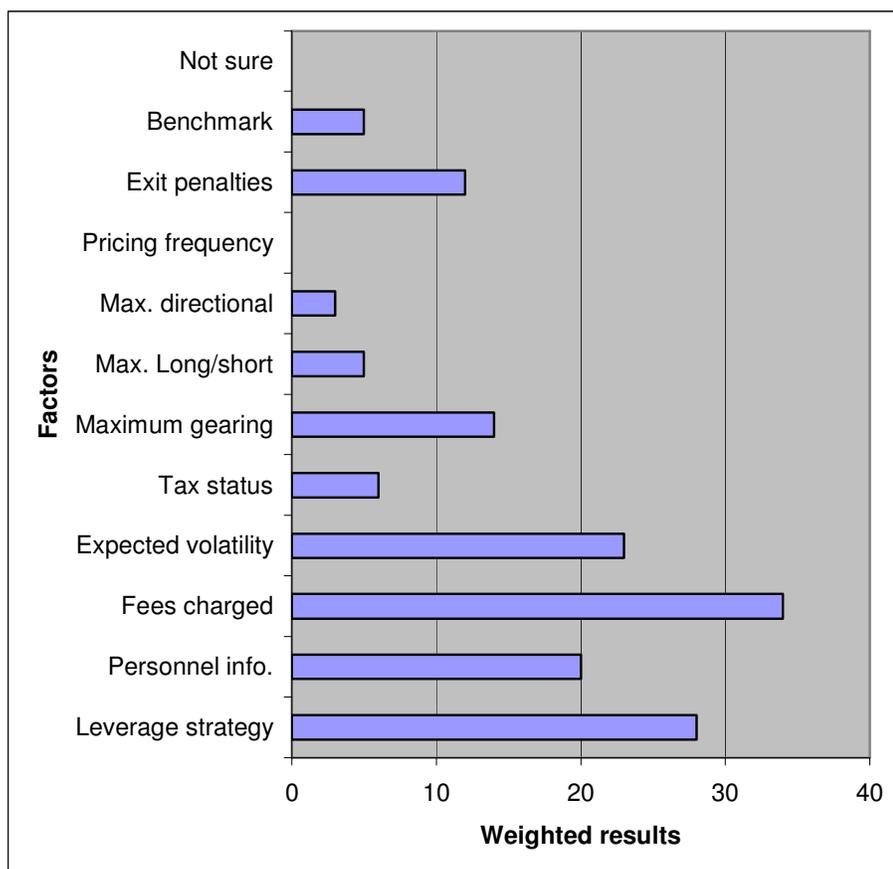
Question 8: Respondents were asked to respond to the statement that a standardised prospectus fact sheet stating minimum disclosure requirements should be introduced. As with other questions in this part of the survey, a statement was provided and the respondents were required to indicate on a scale rating the extent of their agreement or disagreement with the statement. A scale ranging from 1 (strongly disagree) to 5 (strongly agree) was provided. Respondents were also able to elect “unsure”, which was option 3 on the scale.¹⁵

All 13 respondents agreed (9) or strongly agreed (4) that a standardised prospectus fact sheet stating minimum disclosure requirements should be introduced.

Question 9: Respondents were asked to select their ‘top 5’ specifications in order of preference for the minimum disclosure requirements to be included in a standardised prospectus from a given list of 12 possible options. The results were then weighted, with 5 points for first choice selections, 4 points for the second choice, 3 points for the third choice, 2 points for the fourth choice and 1 point for fifth choice selections.

¹⁵ Henceforth referred to as the scale

Graph 8: Q 9 Factors preferred by the respondents for inclusion in a standard prospectus



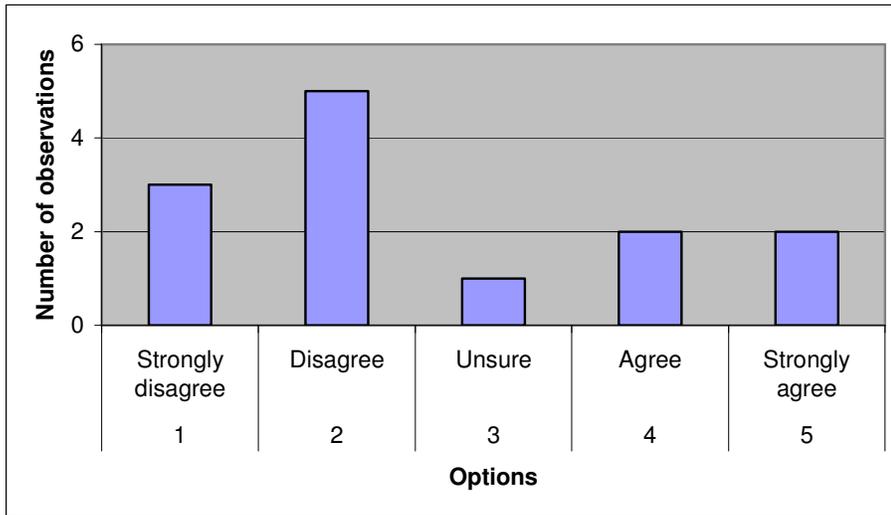
In questions 10 and 11 respondents were asked to respond to the statement whether ‘investment thresholds’ should be set to exclude all but the most sophisticated and affluent investors’ for hedge funds and fund of funds respectively. Respondents were also invited to suggest a rand amount which in their view would be adequate as an investment threshold.

Question 10: 8 of the respondents disagreed (5) or disagreed strongly (3), whilst 4 agreed (2) or agreed strongly (2) with the statement that hedge funds should set investment thresholds so as to exclude all but the most sophisticated and affluent investors. Conversely, 4 respondents agreed or 3 respondents agreed strongly with the statement.

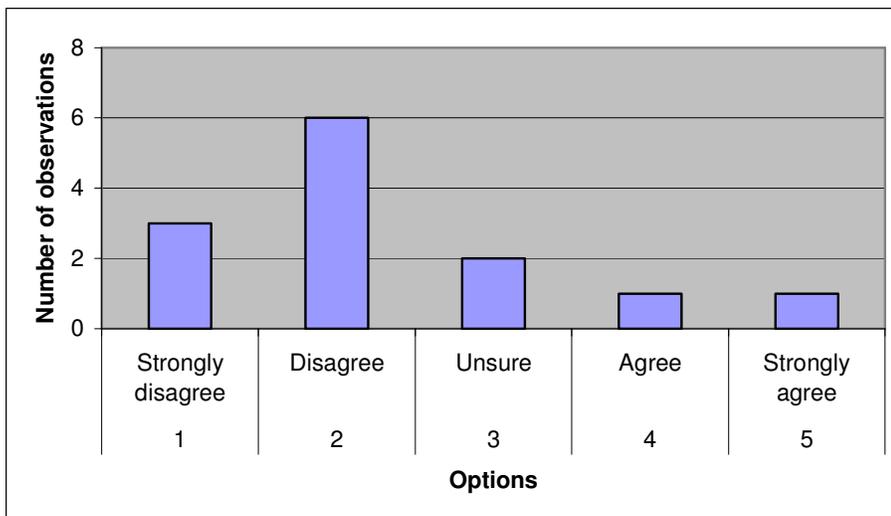
Question 10: Respondents were asked to respond to the statement that ‘fund of funds should set investment thresholds so as to exclude all but the most sophisticated and

affluent investors'. 9 of the respondents disagreed (6) or disagreed strongly (3), whilst 1 agreed; 1 agreed strongly and 2 were unsure.

Graph 9: Q 10 Setting of minimum hedge fund thresholds to make them more exclusive



Graph 10: Q 11 Setting of minimum FOF thresholds to make them more exclusive



Some of the comments received from respondents regarding the introduction of thresholds set to exclude all but the most sophisticated and affluent investors included the following:

“They are relevant for all investors.”

On hedge funds: “Everybody should have access – no exclusion. R50 000 minimum; this is a practical solution rather than a barrier to entry.”

On fund of funds: “They can pool so once again no minimum needed, but maybe R10 000 as a practical solution”

“Obviously it would be fantastic to enable as many investors as possible to enter the industry, but administering a large number of small clients might not be worth while or economical for the particular firm. Hedge Funds set their minimum investment criteria NOT to exclude all but the most affluent investors, but rather based on other factors such as the instrument(s) they invest in, their chosen level of gearing, cost-effective considerations, efficiency etc. It would also be inappropriate to set an industry standard minimum for all Hedge Funds – each firm should draw up their own investment criteria. So yes, thresholds do exist and should be set, but this is *not* an attempt to exclude the majority of investors, but rather enabling funds to operate more efficiently and perform better for their clients.”

“R100,000 for hedge funds”

“R100,000 upwards for fund of funds”

“R500,000 upwards, for hedge funds”

One of the respondents suggested a two-tier approach for both hedge funds and fund of funds, with Class 1 funds having “no set limits” and Class 2 funds having a “R250,000 investment threshold”. In this format both classes would be registered with a supervisory/regulatory body; and the distinction between the two would be determined by the amount of leverage accepted by the fund. A Class 1 accreditation would be for funds where the ‘sum of the borrowing and derivative positions do not result in leverage of greater than 1. A Class 2 accreditation would be restricted to leverage of greater than 1 but less than 4. Funds with leverage exceeding 4 would then not be registered, i.e. “total gross exposure amounting to 4 times investor equity”.

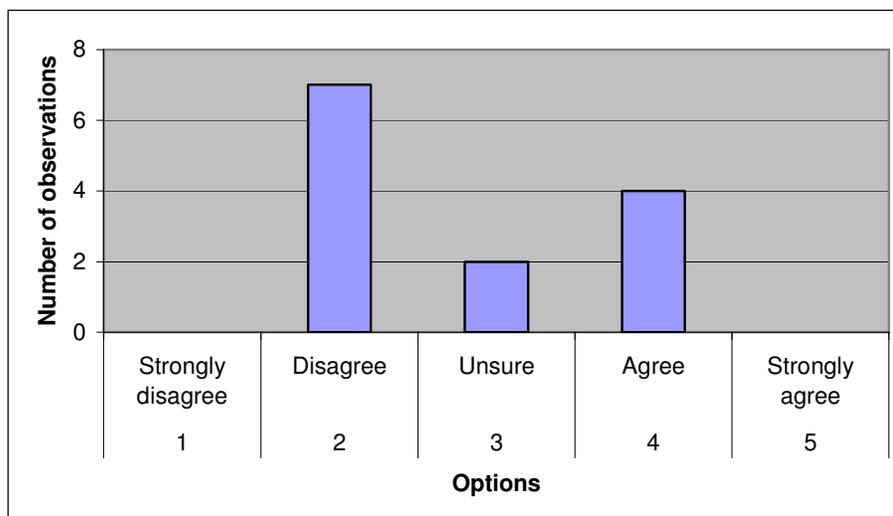
The respondent in question concedes that the choice of 4 as a limit was selected unscientifically although consideration was given to the observation that “relatively unqualified investors in futures contracts on SAFEX have access to much higher levels of leverage (greater than 10 times on many contracts).”

Question 12.1 required respondents to indicate how frequently pricing communication should be sent to investors. Of the 13 respondents, 10 were of the opinion that ‘pricing communication’ should be sent monthly, whilst the other 3 were of the opinion that it should be sent weekly. According to one respondent: “Daily and weekly may be too frequent especially in the case of fund of funds. Quarterly does not provide sufficient liquidity”

Question 12.2 required respondents to indicate how frequently reporting communication should be sent to investors. 8 of the respondents were of the opinion that reporting communication should be sent monthly, whilst the other 5 advocated quarterly communication. It was also noted that shorter turnaround times would be more challenging to fulfil for fund of funds as they have to consolidate numerous accounts across the globe.

In question 13, respondents were asked to scale whether current legislation restricts the ability of fund managers to educate private investors adequately about “hedge funds”.

Graph 11: Q 13 Restrictions on educating private investors



Although 7 of the respondents disagreed with the above statement, the general comments emanating from the 4 who agreed with the statement pointed to the view that the line between soliciting and educating potential investors was very fine, and thus there was a tendency by some managers to opt to err on the side of caution.

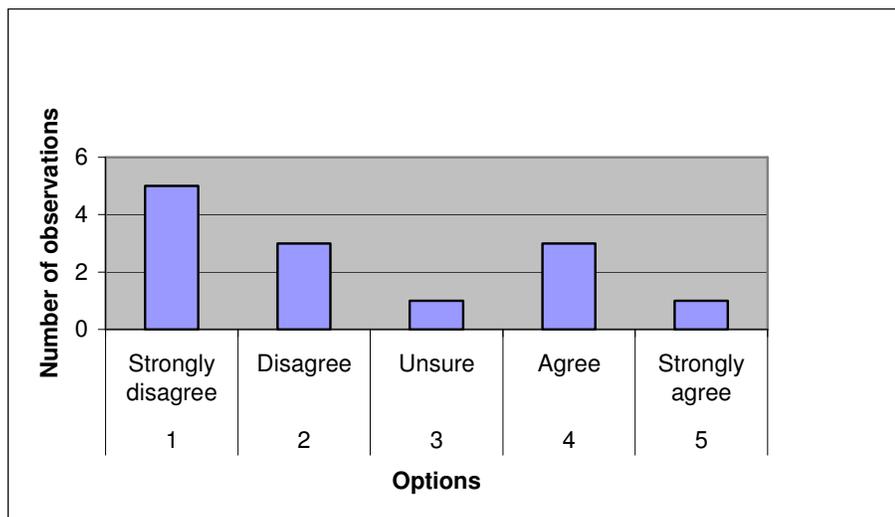
Section B of the questionnaire required respondents to answer questions regarding benchmarking.

Question 14: Respondents were asked to comment on the extent to which respondents agreed or disagreed with the establishment of standard benchmarking measures. Of the 13 respondents, 9 either disagreed (6) or disagreed strongly (3) with the above statement. It was noted that a pre-condition to answering the question required respondents to make an assumption regarding whether a standardised benchmark could practically be determined given the divergent objectives and mandates of the various funds.

“If, for example, all hedge funds were grouped into an index, and their combined performance was compared to say the ALSI TOP 40, this could be beneficial and relevant, but there are many criticisms of benchmarking, and unless the benchmark(s) chosen is perfectly specific and appropriate to its corresponding fund(s), then the benchmark could become insignificant.”

Question 15: Respondents were asked to determine whether in their opinion a standard benchmark could accommodate the difference in investment styles and strategies. Of the 13 respondents, 8 either disagreed (5) or disagreed strongly (3), whilst 3 agreed and 1 strongly agreed; 1 of the respondents was unsure.

Graph 12: Q 15 Accommodation of differences in styles and strategies within a single benchmark



“For a standard benchmark to be chosen, and then investment strategies/styles compared, all the funds would have to be investing in the same instrument(s). The ALSI TOP 40 index might be an appropriate benchmark for a Managed Futures fund (for example), which invests in ALSI 40 contracts. It might be an irrelevant benchmark for a property fund or small-cap equity fund, for example. Again, **I don’t think a standard benchmark for all funds would be useful, relevant or appropriate.** A fund’s chosen benchmark (if it has one), should be absolutely appropriate for that fund.”

Question 16: Respondents were asked to rank between the option of a fixed rate; a risk-free rate plus premium and a CPIX plus premium as benchmarking measures. 6 of the respondents were of the opinion that the above options were not applicable. The 7 respondents who did select ranked ‘CPIX + x%’ first; RFR + x% second, and Fixed rate third.

Question 17: Respondents were asked to indicate who should set the benchmark for the South African industry from a given list which included the Investment Managers Association, the Financial Services Board, fund managers and the Association of Collective Investments.

Master of Commerce - Business Management

The vote results, in descending order of preference, were as follows:

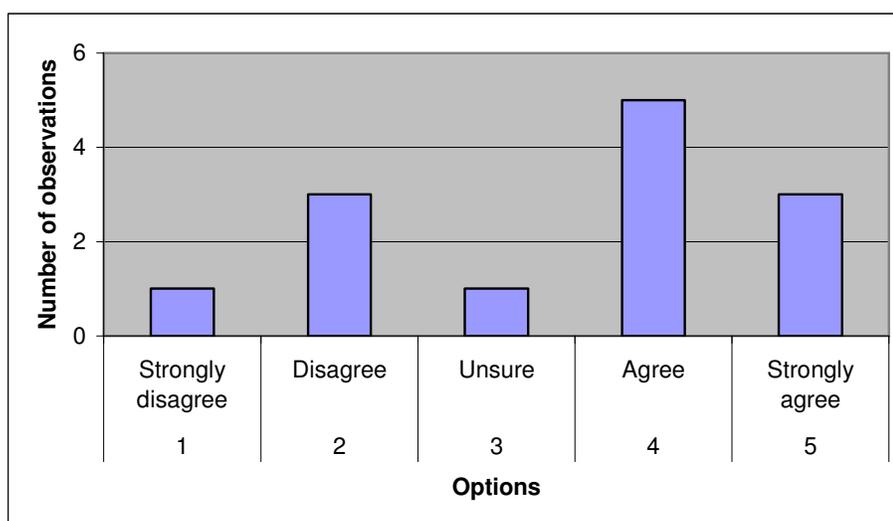
1. Association of Collective Investments (6 votes)
2. Fund Managers (5 votes)
3. Not applicable (4 votes)
4. Other (3 votes); here the main comment was that the investor has to set own benchmark.
5. AIMA (2 votes)
5. Financial Services Board (2 votes)

Section C of the questionnaire required respondents to answer questions regarding risk management.

Question 18: Respondents were asked which characteristics from a provided list they considered appropriate for risk management tools. 12 of 13 respondents were of the opinion that they should be both fund and style specific. One respondent elected 'fund specific'.

Question 19: Respondents were asked to declare the extent to which standardised risk measures must be introduced as per the scale. Of the 13 respondents, 5 agreed and 3 strongly agreed, whilst 3 disagreed and 1 disagreed strongly with the statement. One respondent was unsure.

Graph 13: Q 19 Introduction of standardised risk measures



Question 20: Respondents were asked to rank according to preference the risk measures deemed most appropriate from a provided list. Only options for which more than 5 nominations were made are discussed below. 7 respondents nominated 'Value at Risk'; 6 nominated 'leverage'; and 6 nominated 'volatility'. It is worth noting that value at risk, leverage and volatility also made up the Top 3 by ranking. In the comments provided, most of the respondents reiterated that the most important requirement was to ensure consistency so that managers are not able to "fiddle" by applying various measures that best present their current or past performance of the fund.

"Again, many risk measures are useful to various funds with different styles, investment areas and strategies; however standardized risk measures might not be appropriate to all funds. If there is a specific measure which an investor wants to know, and which is not stated, then he/she must ask for it."

"Clearly VaR is widely used but it also has drawbacks e.g. it does not work in extreme markets (EVT); it relies heavily on assumptions; it relies on historical correlations and volatilities, yet conditional correlations/volatilities can be different from unconditional (average) values; VaR only captures certain systemic risks and does not measure non-systemic risk such as model risk, liquidity risk, political risk, credit spread risk, which means Event Driven strategies such as Merger/Risk Arbitrage or Distressed Debt cannot rely on VaR."

Question 21: Respondents were asked whether they considered the difference between Mean-Variance, Sharpe Ratio and Value-at-Risk presented significant practical application problems in managing risk. 10 of the respondents either agreed or strongly agreed with the above statement.¹⁶

"They are still effective risk measurement tools despite the shortcomings."

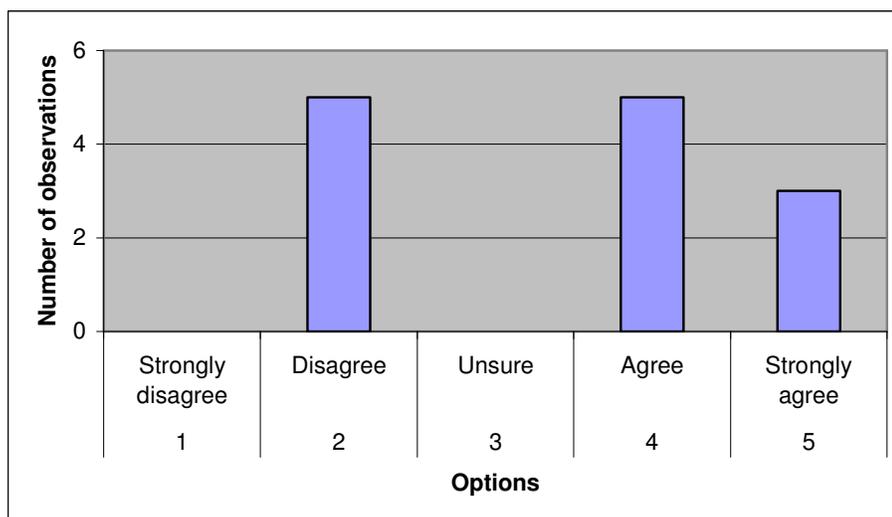
¹⁶ Most academic literature recognises that the normal distribution of returns can only be managed, but not eliminated.

Master of Commerce - Business Management

However, whilst 2 of the respondents were unsure, 1 respondent disagreed with the statement.

Question 22: Respondents were asked to declare the extent to which they agreed or disagreed with the statement that ‘fee structures should be further improved in terms of aligning manager and investor objectives’.

Graph 14: Q22. Fee structures should be improved in terms of aligning manager and investor objectives.



The general comment from the respondents who disagreed with the statement was that fee structures are already aligned in terms of hedge fund investors, especially because of the common use of high water mark principles which ensure correlation between manager and investor objectives.

“Different portfolios have different fee structures, but the fee structures should be appropriate relative to the active asset allocation as well as the alpha generation.”

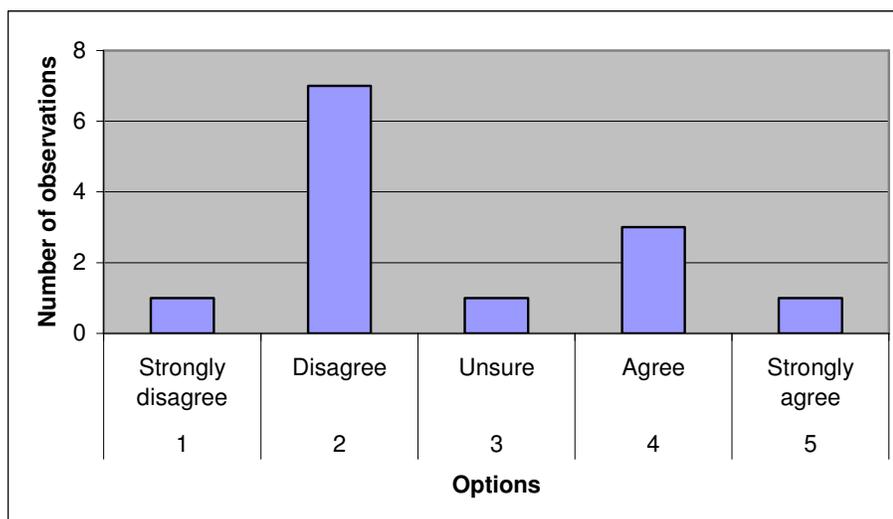
Section E addressed the issue of the role of index surveys as a reference for performance. Question 23: Respondents were asked to declare whether they currently participated in hedge fund surveys in South Africa (Q 23.1) and abroad (Q 23.2); and if not, whether they were planning on doing so in the next 12 months (Q 23.3). 8 of

Master of Commerce - Business Management

the 13 respondents indicated that they currently participate in the Nedcor Hedge Fund Review survey in South Africa, and 3 participate in surveys overseas. 2 of the respondents not currently participating in a South African hedge fund survey were planning to do so within the next 12 months.

Question 24: Respondents were asked to declare the extent to which they believed that participation in a performance survey hosted by an independent broker should be mandatory for all local hedge funds.

Graph 15: Q 24 Mandatory participation in independent survey



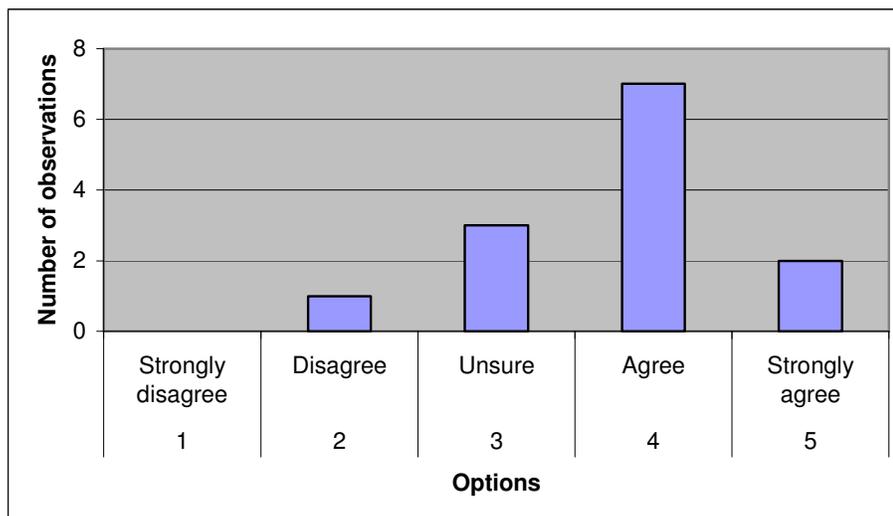
The 4 respondents who either agreed or strongly agreed noted that by making participating mandatory it would serve to identify troubled funds sooner and thereby serve to warn both investors and regulatory bodies of a problem in its infancy and thereby (hopefully) avoid the systemic risk impact of a blow-out. 8 of the respondents either disagreed or disagreed strongly with the statement with the general response being that because the industry is new at the moment, many funds are participating in surveys simply to market themselves indirectly.

“Participation in surveys is a marketing function. Some may not need this.”

Another respondent simply reiterated that:” This is not school.”

Question 25: Respondents were asked whether the South African market is large enough to make ‘retailization’ of hedge funds viable.

Graph 16: Q 25 Retailization of hedge funds in the South African market



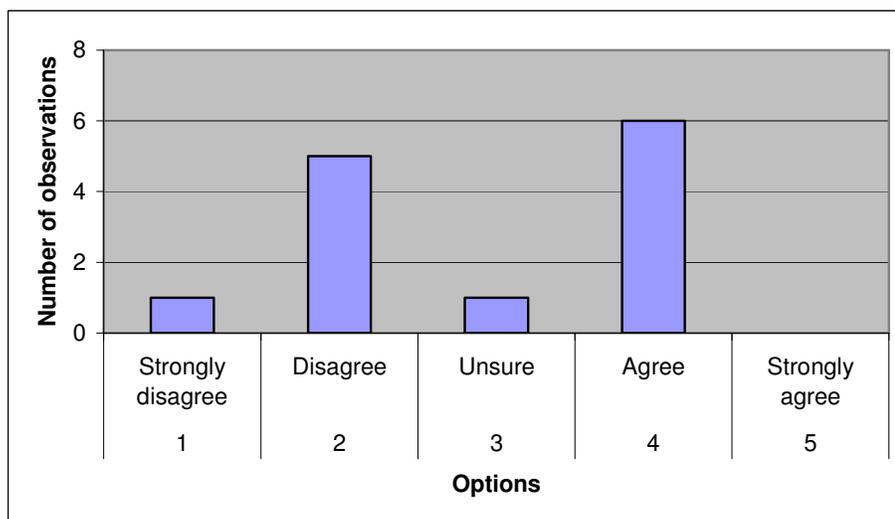
Although 9 of the 13 respondents believed that the retailization of hedge funds in South Africa was viable, most expressed caution regarding the rate of growth of hedge funds within the local market. Any significant increase in the level of regulation of the industry will no doubt spur increased influx of new funds. According to the August edition of the Nedcor Hedge Fund Review, of the Top 3 performing funds for the 12 months to 31 August 2004, only the third placed Peregrine Capital ‘Oakmont Fund’ is still open for new money. Over the same period, the top two performing funds; i.e. the Peregrine ‘High Growth Fund’ and the Peregrine ‘Performance Fund’, are both closed for new money. The view of one respondent who disagrees with the statement is taken in view of the mushrooming effect experienced in South Africa in the 1980’s and 1990’s with unit trusts.

“At the moment, (locally), there are very few 'credible' hedge fund managers and the market opportunities that exist for these managers to generate alpha are tiny. For example, our deal flow (in the South African market) in mergers and acquisitions is so small that a dedicated arbitrage fund is an impossibility. The only strategy that can have any capacity is long/short equity, but even there the limit is probably around the R500million mark for the manager to be in a position to run it efficiently.”

Section F dealt with issues regarding fund of hedge funds.

Question 26: Respondents were asked whether hedge funds attracted better skilled investment managers than Fund of Funds (FOFs). The responses to this question were evenly matched, with 6 respondents disagreeing with the statement; 6 agreeing with the statement and 3 'unsure'.

Graph 17: Q 26. Are management skill levels different between hedge fund and fund of fund managers?



”Maintaining excellent performance results for both Hedge Funds and FOFs, requires skills – slightly different skills, but astute ability nonetheless. There is a great deal of work which goes into selecting and correctly combing the funds chosen for a particular FOF.”

“Hedge funds attract managers with better traditional investment skills, i.e. buying/selling equities, bonds and derivatives; Fund of funds attract managers who have better skills in investing in the right people, i.e. more of a qualitative/psychological edge.”

Question 27: Respondents were asked whether there was a difference in the skills required by hedge fund and fund of fund managers. 11 of the 13 respondents agreed, whilst 2 disagreed with the statement.

“Very different investment profiles and objectives, requires a diverse range of skills and the techniques employed differ substantially.”

“I don't think that the skills are that different. Ultimately, both require an understanding of finance theory, economics and financial market mechanics. These are the foundations on which both skills are built.”

Question 28: Respondents were asked whether regulated Fund of Funds should be permitted to invest in unregistered hedge funds. As most jurisdictions, including South Africa, do not currently require hedge funds to be registered, the question was a hypothetical one.

Although 7 of 13 respondents agreed with the statement, (3 disagreed strongly and 3 disagreed) the following received comments are worth noting:

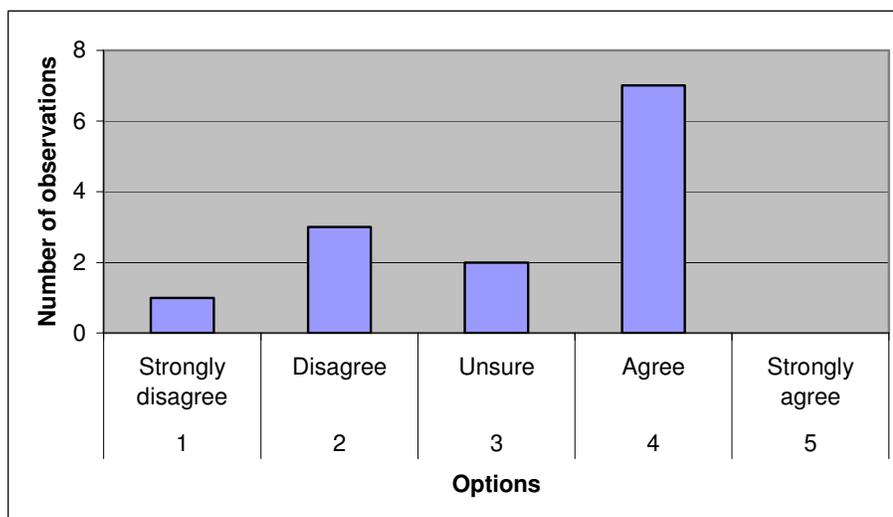
“This is a bit like the FSB's (Financial Services Board) stance on registered fund managers – you can be registered as a FSB approved fund manager, but be running an unregistered/unregulated investment. If the FOF team is competent, let them decide how and where to allocate their capital.”

“The FOF has better skills to assess the risks of an unregulated fund than any regulator will ever have”

Section G addressed general issues facing the hedge fund industry.

Question 29.1: Respondents were asked whether stricter regulation should be introduced to safeguard the industry, to protect investors and to ensure market integrity. The general sentiment of the 7 of 13 respondents who agreed with the statement was that given the stigma surrounding the industry at the moment:

Graph 18: Q 29.1 Stricter regulation to safeguard the industry



“If one SA hedge fund causes a scandal, potential investment in all other local hedge funds will be stunted.”

“For regulation to be effective the regulatory agencies need enough staff to ‘police’ HFs and if SEC has insufficient staff for this purpose I doubt the South African regulatory agencies would either.”

Question 29.2: Respondents were asked to comment on whether stricter regulation was required to protect investors. 9 of 13 respondents agreed (1 strongly agreed); 1 was unsure and another 3 disagreed with the statement.

“I agree, but not so strict/regulated that this contributes to the downfall/poor performance of the industry. It should *not* be regulated to the same degree as the pension fund industry.”

Question 29.3: Respondents were asked to comment on whether stricter regulation was necessary to ensure market integrity, 9 of 13 agreed, and 4 disagreed with the statement. Some of the comments received included:

“Especially as far as reporting and disclosure is concerned”

Another respondent was less optimistic:

“I don’t believe it would affect market integrity either way.”

Master of Commerce - Business Management

Question 30: Respondents were asked whether hedge fund investment training services should be provided and financed by the hedge fund operators for the benefit or private investors. Of 13 respondents, 7 did not agree with the statement; including 2 who strongly disagreed. 5 respondents agreed and 1 was unsure.

As noted above, 7 of the respondents were of the opinion that investment training was not the responsibility of hedge funds in rendering their services.

“HFs should concentrate on their core competencies rather than back office functions, IT or training. In addition it is up to the investors to pay for their own training.”

“This should be a process driven by IFA’s.”

Some of the comments made by those who agreed with statement included:

“People are more likely to invest in a product that they understand.”

Question 31: Respondents were asked whether a self-regulatory Surveillance/Intelligence Unit should be established to ensure due diligence. 7 of the 13 respondents agreed whilst 6 disagreed (4) or strongly disagreed (2) with the statement.

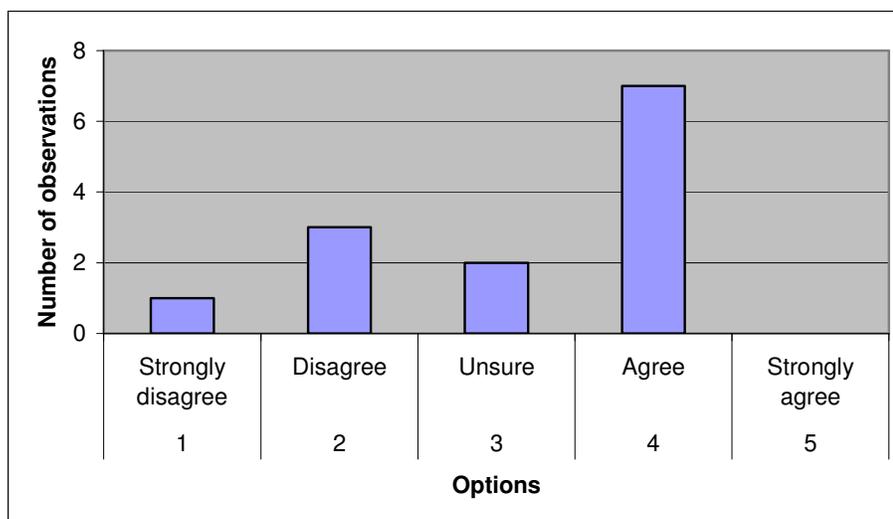
The inclusion of this question arose from the observation that in order for regulation to be effected, the regulatory body will need to have access to a pool of people with the requisite experience and expertise in the industry. A self-regulatory body would be better placed to determine guidelines before enacting legislation. Such a body would then only be effective if the funds were required to be registered with the body and if it had the power to reprimand, censure or prosecute individuals and/or funds and said body.

Question 32: Respondents were asked whether the hedge fund operators should meet the costs of operating such a surveillance unit if one was to be established. 7 of 13 respondents agreed; 4 disagreed (1 strongly disagreed) and a further 3 were unsure.

Master of Commerce - Business Management

This question arose from the observation that, the threat of systemic risk aside, hedge funds still represent a small portion of total savings assets of investors; subsequently it would be a great ask to expect the regulatory body, for example the Financial Services Board, to set aside sufficient budget to attract enough experts from the various sectors to effectively supervise the industry. In one of the interviews that were held as part of the survey, it was suggested by one of the principals that it could be proposed to hedge funds to pay a certain percentage of their fees towards the financing of such a unit. In the absence of such resolve, the creation of such a unit and subsequently effective regulation of the industry will remain on the drawing boards, gathering dust.

Graph 19: Q 29.3 SRU operating costs to be met by hedge fund operators



“If such an agency was set up I can see the value of hedge fund managers contributing to its cost, as long as fees are sensible.”

“If hedge funds are surveyed by the FSB, industry participants could meet the same portion of costs as Mancos currently do for unit trusts.”

Question 33: Respondents were asked to provide comments, suggestions and views on what they considered to be the three biggest challenges facing the hedge fund industry. The question was open-ended and no selection list was provided. Unsurprisingly there were many responses that were elected, at times, by only one respondent. The two most frequently noted responses were from the 8 respondents who nominated the establishment of effective regulatory infrastructure and the 9

respondents who nominated the education of investors as one of the 3 biggest challenges facing the industry.

5.3 Summary

The 13 respondents whose results were received and included in this study provided unpredictably different answers to some of the questions with no clear trend observable between them. The clarification and insight provided in the additional comments supplied by the respondents were invaluable as they greatly improved the quality of the feedback analysis. The summary of the findings and conclusions is presented in Chapter 6.

Chapter 6 Conclusions and Recommendations

“If you have an important point to make, don’t try to be subtle or clever. Use a pile driver. Hit the point once. Then come back and hit it again. Then hit it a third time - a tremendous whack.” – Sir Winston Churchill

6.1 Summary of findings and conclusions

This study recognises that for statistical purposes, the number of survey respondents is very small (13). Several contributory factors have been identified, namely:

- There are some closed funds that are not willing to participate in this, or any other, survey.
- Some funds are still in their incubation phase and are still establishing track records before they will be prepared to participate in the survey.
- The South African hedge fund industry is still in its infancy and the number of significant players is still small. To put this into perspective, it is worth noting that as at June 2004 the South African chapter of AIMA (Alternative Investment Management Association) – the largest association of alternative investment managers in South Africa, had 33 confirmed members. The Joint Discussion Paper on Hedge Fund Regulation received input from a notable 40 respondents from across the financial and legal spectrum, the results of which have been collated into a 150 page document.

Both from the divergence and converge of views on approaches and opinions on the matters conveyed in the survey questionnaire, this study has been able to shed light on what has thus far been labelled as a fairly closed and non-transparent industry. Some of the pertinent issues highlighted by this study are discussed below:

- The commonly quoted estimate of the size of the South African hedge fund industry is R7 billion; this study would suggest that this figure is a gross underestimation for several reasons; most notably;
 - Asset management firms like Gryphon Asset Management, for example, have R3,7 billion assets under management, yet only one of their funds (i.e. the Market Neutral Equity Fund) is included in the

Nedcor Hedge Fund Review, and as at 31 August 2004 this fund's size was mere R2,6 million.

It is not suggested here that the R3.7 billion is invested in hedge fund vehicles, but highlights the difficulty in estimating potential systemic risk in the absence of registration (and accreditation) of hedge funds and disclosure of hedge fund asset exposure.

- Similarly, Allan Gray Asset Management's Optimal Unit Trust holds R1,8 billion of assets. According to Allan Gray Asset Management's Executive Director, Mr Edgar Loxton, there are enough similarities between the unit trust's investment philosophy, approach and mandate for it to be classified as a hedge fund. This study then suggests that it can reasonably be expected that there are other 'hedge funds' that are currently operating under the banner of unit trusts and other special investment vehicles.
- Although 11 of the 13 respondents agreed that there is a need to greatly improve the quality of communication sent to private investors, the onus for investor education was squarely placed on the investors themselves. For their part, the respondents advocated for a reduction in the use of industry legalese and jargon in communication materials as it was, at times, not understandable even by other experienced managers. Further more, hedge funds were encouraged to detail as accurately as possible their investment philosophies and approaches and to highlight this in the prospectuses against the tendency of certain funds to be as vague as possible in order to allow themselves greater flexibility in switching between approaches. Even where this is the funds' intended approach, it should be thus stated in the communication material.
- On the question of introducing a minimum disclosure criteria for inclusion on a fund's prospectus fact sheet which was supported by all 13 respondents, the following were identified as the most important issues that need to be disclosed:

Master of Commerce - Business Management

- Fees charged and scales applied (10 of the 13 respondents indicated that this is important)
 - Exit penalties and other clauses (7 of the 13 respondents indicated that this is important)
 - Leverage strategy (and limitations) applied by fund (7 of the 13 respondents indicated that this is important)
 - Expected volatility of strategy (6 of the 13 respondents indicated that this is important)
 - Details of investment/management personnel (6 of the 13 respondents indicated that this is important)
- The setting of thresholds for both hedge funds and fund of funds did not receive the support of at least 8 of the respondents for various reasons ranging from the assertion that hedge funds, like all other asset classes should not be available to the exclusion of any potential investor. Other views called for as much as R500000 threshold minimum for hedge funds and R100000 threshold minimum for fund of funds. Convergence of the two views was expressed by respondents who pointed out that; thresholds, where set, should not be set to exclude any group of investors, but rather should be influenced by the fund's requirements in order to optimize its operating efficiency and to provide the best service possible to clients.
 - The majority of respondents (10 of 13) indicated that pricing communication should be sent on a monthly basis, whilst 8 of the respondents were of the opinion that monthly reporting communication was also desirable; a further 5 preferred quarterly reporting. The challenge is of course to allow sufficient time to make the compilation of the necessary data possible. Another factor to be considered is the influence of the specific fund's investment strategy and time horizon. Investors in shorter time horizon vehicles could arguably be expected to require greater frequency of communication from the fund. On the other hand, the investment positions held by the funds would probably have greater influence on the communication frequency decision. Further, unlike mutual funds, most hedge funds are small operations in terms of personnel and therefore the labour resources necessary to provide more frequent

Master of Commerce - Business Management

communication might require increased personnel and a resultant cost that would inevitably be added to the management fee charged by the fund.

- The introduction of a standard benchmark was a question that solicited a divergent array of responses, notably because there was also divergence of views on whether the existing differences between investment styles and strategies adopted by the various funds could actually be accommodated in a standard benchmark. In general, respondents do agree on benchmarking - but specific benchmarks for specific types of funds must exist. As one respondent noted; “a fund’s chosen benchmark (if it has one), should be absolutely appropriate for that fund.” Without a standard benchmark, the ability to compare between the myriad assortments of funds becomes even more difficult for investors.
- The Association of Collective Investment Managers (together with the respective fund managers) was the preferred body nominated for setting benchmarks, over the Financial Services Board, the regulatory body. This choice was due to the greater expert and situational knowledge available to the ACI and the specific fund manager of the fund’s strategy and mandate. Equally, the investors themselves were the ultimate recipients of the performance, and therefore the setting of a benchmark should probably be set by them.
- Although the respondents acknowledged that most risk measurement tools in common use had short-comings, they were - in the absence of better tools, still considered effective risk management tools. One of the main concerns highlighted by the respondents was the need for funds to be consistent in their use of selected tools to guard against “fiddling” to better reflect the experienced performance. The other concern highlighted the limitations of the risk measurement tool currently in use such as that value at risk (VaR) only captures certain systemic risks and does not measure non-systemic risk such as model risk, liquidity risk, political risk, credit spread risk, meaning that Event Driven strategies such as Merger/Risk Arbitrage or Distressed Debt cannot rely on VaR.

- 8 of 13 respondents disagreed with mandatory participation in hedge fund performance surveys, although it was generally held that such participation was an accepted platform for marketing the fund's performance.
- The responses to the question of whether hedge fund managers were better skilled than fund of funds managers showed that most respondents (11) could agree that the two sectors required different sets of skills, although a professional level of financial acumen was necessary to be effective in either role.
- Despite the current stigma surrounding the industry, stricter regulation was advocated for by the respondents only in as far as it did not unnecessarily restrict the agility of funds to execute their strategies. However, a scandalous blow-out by a large player in South Africa's relatively small market could be a death knell for the industry as it is still in its infancy.
- The creation of a self-regulatory intelligence unit similar to that which operates at the stock exchange and the suggestion for the hedge fund operators to finance the associated costs received mixed responses. The acknowledgement that currently the government regulator does not have a large enough pool of experts who can lend their experience and expertise to such a venture implies that the improved regulation that most respondents indicated would identify mismanaged and fly-by-night funds will not come into place in the near future. Focusing strictly on the disparity between remuneration packages available in the private sector with those at the FSB would infer that the former would retain the advantage in attracting qualified personnel.
- Yet, the challenges of implementing effective regulation and ensuring adequate investor education were nominated as the most pertinent challenges facing the industry by the respondents.

In conclusion, this study has contributed to shedding light on the issues and challenges facing the hedge fund industry operators, regulatory bodies and current and potential investors. In the absence of improved transparency into the investment operations of hedge funds, regulators may have little choice but to ban them entirely—an unlikely option given the growth of hedge fund activities in other international markets; or to impose stricter entry restrictions in an attempt to offer increased protection to investors. However, to date hedge funds have survived on the strength of their ability to adapt and to exploit opportunities; two characteristics which they will need to retain in order to overcome regulatory obstacles.

6.2 Recommendations

“Soft you, a word or two before you go” – Shakespeare’s Othello (Act V, ii)

South Africa’s hedge fund industry, though still in its infancy, enjoys the benefit of learning both from its own as well as the experiences of other countries where hedge funds have longer track records. In addressing the two main challenges to the industry identified by this study, namely implementing effective regulation and ensuring adequate investor education, the participants in the industry have an opportunity to create an environment on which sound business architecture can be established and developed.

It may be said that the establishment of an a semi-independent self-regulatory unit, falling under the auspices of the Financial Services Board (FSB) with delegated powers to censure and prosecute offenders, should be recognised as the gateway to introducing improved regulation. At the moment it seems apparent that most of the skilled personnel are currently employed in the hedge fund, asset management and law firm. The remuneration gap between the private and the public sector is significant and would need to be addressed in order to attract qualified personnel to any supervisory or regulatory body. Even if the FSB could acquire and train candidates with the requisite skills, the growing demand in the market would probably render it a futile effort as the skills shortage and the better remunerated opportunities in the private sector would no doubt absorb a significant portion of the personnel. In light of this prevailing situation, the staff complement of such a body could be met by rotational secondment of individuals recommended from such organisations such as

Master of Commerce - Business Management

the Association of Collective Investment Managers, the Alternative Investment Managers Association and the Financial Services Board.

This study suggests that in view of the fact that the hedge fund operators stand most to gain from improved regulation, they should take a leading role in providing skilled personnel for such bodies. The hedge fund operators could further enhance to the success of such a mission by committing a percentage of their turnover to contribute towards the bridging of the remuneration gap in order to attract the requisite skills.

The Panel on Takeovers and Mergers is a non-statutory body responsible for overseeing the operation of the practice code known as ‘the City Code on Takeovers and Mergers’ in the U.K. It is a functional model that could serve as an apt blue-print for a self-regulatory unit. Sir John Donaldson MR in the *Datafin*¹⁷ case made the following comments regarding the Panel:

“The Panel on Takeovers and Mergers is a truly remarkable body... [It] oversees and regulates a very important part of the United Kingdom financial markets. Yet it performs this function without visible means of support...It has no statutory, prerogative or common law powers and it is not in contractual relationship with the financial market or with those who deal in the market...[It is] a system whereby a group of people, acting in concert, use their collective power to force themselves and others to comply with a code of conduct of their own devising...Lacking any authority de jure, it exercises immense power de facto by devising, promulgating, amending and interpreting the City Code on Takeovers and Mergers, by waiving or modifying the application of the code in particular circumstances, by investigating and reporting on alleged breaches of the code and by the application or threat of sanctions. These sanctions are no less effective because they are applied indirectly and lack a legally enforceable base.’

Such an undertaking could only be successful with the participation of most, if not all, the stakeholders. What still reserve to be seen is whether a similar structure can be recreated beyond Canary Wharf.

¹⁷All ER 564. 1986. Court of Appeal: R v Panel on Takeovers and Mergers, ex p *Datafin* plc [1987] 1

6.3 Suggestions for further research

It is evident to this study that despite the relatively small number of respondents who participated, numerous contentious issues that are of import to the development of the hedge fund industry were raised and would need to be addressed to the satisfaction of the stakeholders, namely: the hedge fund operators; the regulatory authorities and investors - both private and institutional. A subsequent study involving a larger pool of stakeholders would not only present a platform for wider participation in the brainstorming process, but would potentially allow for greater acceptance of the findings.

Solutions that need to be found include those to ensure that the supervision and regulation can be adequately constituted, and how it can effectively and practically be implemented. The current shortage of personnel with the requisite skills to effectively supervise the hedge fund industry seems set to continue, and that situation does nothing to advance the cause of hedge funds in terms of seeking FSB approval. This study suggested the possibility of the secondment of personnel from the hedge fund operators and other stakeholders to a surveillance unit in order to facilitate self-regulation of the industry. The feasibility of such a project with special emphasis on how the surveillance unit nominees would be remunerated would be of interest to the industry. The surveillance unit issue raises other pressing questions that would need to be answered by future studies. Should the hedge funds contribute a portion of their fees towards the financing of the surveillance unit's operating expenses? If so, how much should they contribute? Should membership to such an association be made mandatory for all hedge fund operators? Should all hedge funds be registered?

Also of concern for the industry is whether the South African market is large enough to continue offering sufficient investment opportunities to enable hedge funds to be viable into the future. Recent trends from US and EU markets would suggest that even in these larger markets, hedge funds are invariably adopting more regular buy and hold and long/short investment strategies as the pool of more exotic investment and arbitrage opportunities dwindles. The economic phenomenon of 'too much cash chasing too few goods' may yet become a reality in the near term for hedge funds.

Annexures

Annexure 1: The CSFB/Tremont Hedge Fund Index values for June 2004

Data as of June 30, 2004

Click on an index for thorough statistical analysis, sector commentaries, and constituent fund listings.

Index	Value	Jun 04	YTD	1 Year	Avg Annl*	Std Dev**	Sharpe***
CSFB/Tremont Hedge Fund Index	295.30	0.34%	2.93%	10.08%	10.86%	8.31%	0.83
HEDG Convertible Arbitrage	272.50	0.76%	-0.47%	4.88%	10.02%	4.74%	1.27
HEDG Dedicated Short Bias	72.16	1.25%	0.36%	16.59%	-3.06%	17.67%	-0.40
HEDG Emerging Markets	201.38	0.87%	1.38%	15.46%	6.89%	17.41%	0.17
HEDG Equity Market Neutral	281.30	0.84%	2.21%	6.07%	10.35%	3.04%	2.10
HEDG Event Driven	309.67	0.96%	5.23%	13.74%	11.37%	5.91%	1.25
HEDG Distressed	372.52	1.06%	6.00%	16.22%	13.34%	6.84%	1.37
HEDG E.D. Multi-Strategy	279.13	0.93%	4.74%	11.89%	10.27%	6.23%	1.01
HEDG Risk Arbitrage	229.35	0.25%	2.17%	7.63%	8.23%	4.37%	0.97
HEDG Fixed Income Arbitrage	201.56	0.71%	4.36%	6.63%	6.90%	3.88%	0.75
HEDG Global Macro	403.65	0.48%	4.35%	11.54%	14.21%	11.83%	0.87
HEDG Long/Short Equity	323.84	0.66%	2.83%	12.50%	11.84%	10.78%	0.73
HEDG Managed Futures	190.82	2.84%	3.67%	-0.50%	6.35%	12.26%	0.19
HEDG Multi-Strategy	254.28	0.09%	2.69%	10.27%	9.53%	4.46%	1.24

* Index data begins January 1994. ** Monthly standard deviation annualized.

*** Calculated using the rolling 90 day T-bill rate.

Source: <http://www.hedgeindex.com>

Annexure 2: The Hurst Index

Mean-Variance

Lavinio (2000) suggests that the Hurst Index be used to circumvent the problems resulting from the dependency on the normal distribution when performing numerical analysis of hedge funds. The index is reportedly used to obtain information about a fund's track record's tendency to fluctuate around a certain average value, without the need to make any assumptions about the behaviour of the underlying variables. Data is renormalized using a logarithm in order to make it consistent and comparable across managers by dividing the manager's track record into series of smaller time periods (N) to make it.

R(t) is defined as the range (difference between the maximum and the minimum values of the selected period). R(t) is thus $\max(t) - \min(t)$

Re-normalized data is given by $M(t) = R(t) / S(t)$

Where S(t) the standard deviation of the data over the selected period t

Hurst Index : $\log(M) = \log(a) + H \cdot \log(N)$

Where $\log(M) = \log[R(t) / S(t)]$

$\log(a) = \text{constant}$

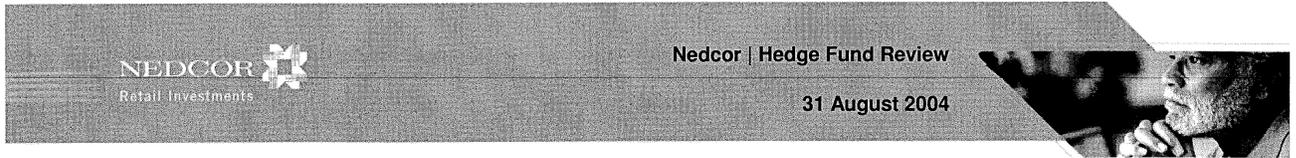
$\log(N) = \log \text{ of length or number of observations in data series } t$

Therefore, solving for H = $\frac{\log(M)}{\log(N) - \log(a)}$

$\log(N) - \log(a)$

It is suggested that for hedge funds with track records 5 years or less, $\log(a)$ can be assumed to be significantly negligible to be ignored.

Annexure 3: Nedcor Hedge Fund Review



Nedcor | Hedge Fund Review

31 August 2004

Asset management house	Fund name	Fund strategy	Inception date	Maximum total gross exposure	Open for new money?	Fund size in R'm	1 Month Return to 31/08/04	3 Month Return to 31/08/04	6 Month Return to 31/08/04	12 Month Return to 31/08/04	Rank	Standard deviation over last 12 Months	Sharpe Ratio	Sortino Ratio	Rank	
Cadiz	Sapphire on Commodities Partnership Fund	Long/short equity fund with no directional bias	Nov-02	400%	Yes	168.7	1.4	4.4	6.2	17.6	9	5.9	0.4	11	1.1	10
Coronation	Domestic Multi-Strategy Arbitrage Fund	Long/short Equity	Jul-03	300%	Yes	39.5	1.8	4.2	9.1	17.3	10	2.4	1.0	5	3.0	8
Decillion	Big Rock Capital Fund	Long/short Equity	Jan-99	350%	Yes	219.0	1.2	3.0	4.9	12.2	13	1.6	0.7	8	5.7	6
Decillion	Fairtree Capital Fund	Long/short Equity	Oct-03	350%	Yes	41.0	0.8	1.4	4.0							
Decillion	Granite Fixed Income Fund	Fixed interest opportunities	Oct-02	1000%	Yes	178.0	0.1	0.8	2.1	7.4	18	1.3	-0.1	19	-0.2	19
Decillion	Headland Capital Fund	Long/short Equity	Oct-02	350%	Yes	238.0	1.4	3.6	4.9	12.8	12	4.6	0.3	13	0.7	13
Future Tactics	Garden Hedge Fund	Short term long/short futures trading	Jan-04	200%	Yes	0.3	1.0	-0.6	5.6							
GP Jubert & Company	GRJ Segregated Hedge Fund	Long/short Equity	Jun-03	150%	Yes	2.3	2.0	5.1	12.0	24.4	5	9.0	0.5	9	1.0	11
Gryphon	Market Neutral Equity Fund	Focused equity pair trading on a market neutral basis.	Jan-03	200%	Yes	2.6	1.5	3.7	7.0	13.9	11	1.6	0.9	6	4.7	7
Huysamer Capital Investments	HG Conservative Hedge Fund	Market neutral equity fund	Jun-04	160%	Yes	20.8	-0.7	2.0								
Interneuron	Dynamic Hedge Fund	Global-macro geared equity fund	Dec-02	600%	Yes	3.0	-2.6	4.8	-7.1	1.5	20	19.2	-0.1	18	-0.1	18
Interneuron	Freestyle Fund	Absolute returns through asset allocation	Mar-02	100%	Yes	118.0	4.1	4.7	2.9	22.8	7	9.0	0.4	10	2.2	9
Peregrine	Oakmont Fund	Long/short equity based on fundamental research	Jun-03	500%	Yes	154.2	2.6	8.9	12.5	33.8	3	4.6	1.2	4	6.1	5
Peregrine	Pacific Dunes Fund	Fixed interest opportunities	May-03	1200%	Yes	56.5	1.3	2.3	3.5	9.4	16	2.9	0.1	15	0.3	15
Peregrine	Fine Valley Fund	Long/short strategies in equities and derivatives	Nov-02	300%	No	40.6	-0.8	-3.2	-7.3	-4.5	22	7.5	-0.5	22	-0.6	22
Peregrine Capital	High Growth Fund	Long/short equity	Feb-00	500%	No	42.4	1.8	12.1	17.6	44.8	1	5.8	1.5	2	25.3	1
Peregrine Capital	Performance Fund	Long/short equity	Jul-98	500%	No	88.5	2.9	9.7	15.1	38.3	2	4.2	1.7	1	19.6	2
Peregrine Capital	Pure Hedge Fund	Long/short equity	Jul-98	400%	No	85.2	1.8	6.8	10.7	23.8	6	2.8	1.4	3	8.3	3
Prasidium	Prasidium SA Hedge fund	Directional long/short equity	Dec-03	200%	Yes	16.4	0.3	3.4	9.5							
PSG Capital	Tanzanite Capital Limited Fund	Long term value investment and short term trading strategies	Apr-03	300%	Yes	11.7	5.3	8.2	9.7	27.3	4	5.8	0.9	7	7.0	4
Signal Futures	Signal Swing Trading Fund	Directional short term trading	Feb-03	200%	Yes	2.0	1.6	3.9	3.6	7.8	17	7.1	0.0	17	0.0	17
SIM	SIM Hedge Fund	Market neutral pairs	Jun-02	200%	Yes	201.4	1.3	3.5	6.3	11.1	15	2.0	0.4	12	0.8	12
Stanlib	Quasar Fund	Market neutral long/short equity	Sep-02	200%	No	74.5	1.8	6.7	9.7	11.7	14	7.2	0.1	16	0.2	16
Strategy Securities	Mechanical Fund	Managed futures	Oct-01	400%	Yes	3.0	1.3	3.5	7.7	-2.6	21	13.3	-0.2	20	-0.3	20
Taquanta	Hedge fund composite	Long/short equity. Tactical asset allocation.	Dec-02	300%	No	1.0	-1.6	-2.4	-0.6	3.9	19	5.1	-0.2	21	-0.3	21
Trendline	Trendline Hedge Fund	Systematic trend following	Jun-00	350%	Yes	1.7	-0.2	12.7	-0.3	22.2	8	22.6	0.2	14	0.4	14
Total:						1,810.3										
Average:							1.20	-4.35	5.62	16.08		6.62	0.50			
<i>(All returns are published net of fees)</i>																

Annexure 4: BJM Equity Fund

BJM GLOBAL FUND RANGE

BJM Global Equity Fund
As at 31 March 2004



Barnard Jacobs Mellet - Private Client Services

Geographic Spread



- US Large Cap Equity 42.06%
- US Small Cap Equity 3.17%
- Global Developed Markets 20%
- Pan European Equity 24.58%
- Japan Equity 7.48%
- Pacific ex-Japan 2.71%

Investment Objective

The objective of the BJM Global Equity Fund is to provide long-term growth of capital through a diversified global equity fund. The fund is suitable for investors with an investment horizon of five years and longer who want to invest in global equities.

Fund Strategy

The BJM Global Equity Fund seeks to provide its investors with broad exposure to the developed US, European and Pacific equity markets. The fund maintains a style-neutral position, with similar diversification between value and growth securities. The fund uses both regional and industry focused management sub-styles to deliver risk control and active management performance within the developed markets. The combination of both quantitative and fundamental investment styles allows the fund to maximise stock selection while minimising uncompensated style risk. The fund combines risk-control with active management performance from very specialised global equity managers.

Benchmark
MSCI World Index

Advisors

The advisor to BJM is SEI Investments Management Corporation, a wholly owned subsidiary of SEI Investments. Founded in 1968, SEI Investments has been a leading provider of asset management services for institutional investors and financial intermediaries for more than 25 years.

General Information

Domicile : Guernsey
Denomination : USD
Investment Style : Active
Minimum Investment : USD 5 000
Maximum Annual Management Charge : 2.00%

Sub-Advisors

Global Developed Markets Equity Fund

Capital Guardian Trust Co.	Non-US Growth At Risk Price
Lazard Frères & Co.	Relative Value
Alliance Capital Management	Earnings Driven

US Large Companies Equity Fund

Goldman	Relative Growth
Transamerica Investment Management	Emerging Growth
LSV Asset Management	Contrarian Value
Sanders L. Samsen & Co.	Deep Value
Peregrine Capital Management	Long-Term Growth
Arsson Johnson Ortiz	Relative Value
Montag & Caldwell	Quality Growth
MS&W	Momentum Growth

US Small Companies Equity Fund

Boston Partners Asset Management	Intrinsic Value
David J Greene and Company	Earnings/Price Momentum Growth
Nicholas Applegate Capital Mngt	Contrarian Value
LSV Asset Management	Disciplined Growth
Seagrass Asset Management	

Pan European Equity Fund

Capital International Limited	Growth At Risk Price
Acadian Asset Management	Deep Value
BancRock International	Growth
INVESCO Asset Management	Pan Europe

Pacific Basin ex-Japan Equity Fund

Jardine Fleming International	Pacific Basin ex-Japan
Lloyd George Investment Mngt	Pacific Basin ex-Japan
ALLIANCE CAPITAL MANAGEMENT	Growth
Martin Currie	Growth at risk price
Boston Company	Relative Value

Performance as at 31 March 2004 - Gross of fees per annum

Portfolio Returns (US Dollars)						
	1 Month	3 Months	Year to date	1 Year	3 Year	Since Inception 30 Sep 00
Total Return %	(0.14)	3.89	3.89	44.79	2.31	(3.77)
Market Cap Benchmark %	(0.66)	2.61	2.61	43.86	1.46	(4.41)
Out-Performance%	0.52	1.28	1.28	0.93	0.85	0.64
Portfolio Returns (SA Rands)						
	1 Month	3 Months	Year to date	1 Year	3 Year	Since Inception 30 Sep 00
Total Return %	(5.38)	(1.91)	(1.91)	15.94	(5.56)	(7.49)
Market Cap Benchmark %	(5.87)	(3.11)	(3.11)	15.19	(6.34)	(8.11)
Out-Performance%	0.49	1.20	1.20	0.75	0.78	0.62

Market Cap Benchmark

Equity MSCI World

For more information on the "Manager of Managers" strategy, SEI Investments Corporation has the ultimate responsibility for the investment performance of the Mutual Fund being to its responsibility to ensure the fund achieves the investment objective. The information should be considered as appropriate to a prudent judgment of each of the funds in the strategy. Please read the prospectus carefully before investing in any of these funds. The SEI US Fund Investor Fund and the SEI US Dollar Money Market Fund Limited are not registered funds with the South African Financial Services Board. Accordingly, these funds are not subject to regulation by the South African Reserve Bank.

Annexure 5 : Survey questionnaire

Dear Respondent

The aim of this survey is to collect and assess the views of participants involved with and/or in the hedge fund industry with the aim of highlighting views and concerns surrounding the issue of disclosure requirements and regulation.

Instructions:

Please complete the sections below by selecting a single or multiple option(s) as required and by marking your choice with an “X” or a number, as required. To make your selections as comprehensive as possible, I strongly encourage you to add any additional views and comments that you may have in the text boxes provided.

Please note that unless stated otherwise, the term “Hedge Fund” has been applied to include “Fund of Funds”.

.....

PART 1: Respondent background and profile

Instruction: Please evaluate the following statements below by selecting the most appropriate **SINGLE** answer. Qualify with comments wherever necessary/ appropriate

1. **You are a(n)**

1	Hedge Fund	
2	Fund of Funds	
3	Intermediary which invests in Hedge Funds	
4	Intermediary which invests in Fund of Funds	
5	Asset management firm	
6	Law firm	
7	Investment advisor	
8	Other (Specify).....	

2.1 What is the size of your assets under management in the above investment(s) (HFs or FOFs) in SOUTH AFRICA ?

1	Not applicable	
2	Less than R50 million	
3	Between R50 million and R250 million	
4	Between R250 million and R750 million	
5	Between R750 million and R1.2 billion	
6	More than R1.2 billion	

R/\$ 6.26 R/Euro 7.61 R/£ 11.52 (As at 27 July 2004)

2.2 What is the size of your assets under management in the above investment(s) (HFs or FOFs) ABROAD ?

1	Not applicable	
2	Less than R50 million	
3	Between R50 million and R250 million	
4	Between R250 million and R750 million	
5	Between R750 million and R1.2 billion	
6	More than R1.2 billion	

R/\$ 6.26 R/Euro 7.61 R/£ 11.52 (As at 27 July 2004)

3.1 How long has your enterprise been investing/advising (as applicable) in hedge fund assets in SOUTH AFRICA?

1	Not applicable	
2	Less than 3 years	
3	Between 3 and 5 years	
4	Between 5 and 7 years	
5	More than 7 years	

3.2 How long has your enterprise been investing/ advising (as applicable) in hedge fund assets ABROAD?

1	Not applicable	
2	Less than 3 years	
3	Between 3 and 5 years	
4	Between 5 and 7 years	
5	More than 7 years	

4.1 What is the size of your dedicated Hedge Fund and/or Fund of Funds professional investment team in SOUTH AFRICA?

1	No dedicated team	
2	Between 1 and 5	
3	Between 5 and 10	
4	Between 10 and 25	
5	More than 25	

4.2 What is the size of your dedicated Hedge Fund and/or Fund of Funds professional investment team ABROAD?

1	No dedicated team	
2	Between 1 and 5	
3	Between 5 and 10	
4	Between 10 and 25	
5	More than 25	

5. Do you have a dedicated member of staff responsible for regulation compliance?

1	Yes	
2	No	

6. What is the size of your dedicated Hedge Fund and/or Fund of Funds regulation compliance team in SOUTH AFRICA?

1	No dedicated team	
2	Between 1 and 5	
3	Between 5 and 10	
4	Between 10 and 25	
5	More than 25	

PART 2:

Instructions: Please evaluate the following statements below by selecting the most appropriate **SINGLE** answer. Qualify with comments wherever necessary/ appropriate

Section A: Transparency

- 7.1 The quality of communication provided by “hedge funds” needs to be greatly improved.

1	Yes	
2	No	

7.2 **Hedge fund communication to private investors should be improved so as to make it more:**

7.2.1 **Relevant to the investment decision.**

1	2	3	4	5
Strongly disagree	Disagree	Unsure	Agree	Strongly agree

Comments/ reason for the above answer:

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7.2.2 **Understandable to private investors.**

1	2	3	4	5
Strongly disagree	Disagree	Unsure	Agree	Strongly agree

Comments/ reason for the above answer:

.....

7.2.3 **Comparable between hedge funds for private investors.**

1	2	3	4	5
Strongly disagree	Disagree	Unsure	Agree	Strongly agree

Comments/ reason for the above answer:

.....

8. A standardised prospectus fact sheet stating minimum disclosure requirements should be introduced.

1	2	3	4	5
Strongly disagree	Disagree	Unsure	Agree	Strongly agree

Comments/ reason for the above answer:

.....

9. If a standard prospectus was introduced, which of the following requirements should be made mandatory?

TICK AS APPROPRIATE and YOU MAY SELECT MORE THAN ONE

ALSO, RANK ONLY YOUR TOP 5 IN ORDER OF PREFERENCE .

(1 = most preferred)

	REQUIREMENT	TICK	RANK
1	Leverage strategy applied by fund		
2	Details of investment/management personnel		
3	Fees charged and scales applied		
4	Expected volatility of strategy		
5	Tax status of structure		
6	Maximum allowable gearing		
7	Maximum Long/ maximum short		
8	Maximum directional (NOT amount of trade)		
9	Pricing frequency		
10	Exit penalties and other clauses		
11	Benchmark		
12	Not sure		

10. Investment thresholds for hedge funds should be set so as to exclude all but the most sophisticated and affluent investors.

1	2	3	4	5
Strongly disagree	Disagree	Unsure	Agree	Strongly agree

Comments/ reason for the above answer: (**Please suggest a Rand minimum, as applicable**)

.....

.....

.....

11. Investment thresholds for FOEs should be set so as to exclude all but the most sophisticated and affluent investors.

1	2	3	4	5
Strongly disagree	Disagree	Unsure	Agree	Strongly agree

Comments/ reason for the above answer: (**Please suggest a Rand minimum, as applicable**)

.....

.....

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.....

12.1 How frequently should pricing communication be sent to investors?

1	Unsure	
2	Upon request	
3	Daily (NAV)	
4	Weekly	
5	Monthly	
6	Quarterly	

Comments/ reason for the above answer:

.....
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.....

12.2 How frequently should reporting communication be sent to investors?

1	Unsure	
2	Upon request	
3	Daily (NAV)	
4	Weekly	
5	Monthly	
6	Quarterly	

Comments/ reason for the above answer:

.....
.....
.....
.....
.....

13. Current legislation restricts the ability of HFs/ FOFs/ Asset managers etc. to educating private investors adequately about “hedge funds”

1	2	3	4	5
Strongly disagree	Disagree	Unsure	Agree	Strongly agree

Comments/ reason for the above answer:

.....

.....

.....

Section B: Benchmarking

Instruction: Please evaluate the following statements below by selecting the most appropriate **SINGLE** answer. Qualify with comments wherever necessary/ appropriate.

14. A standard benchmarking measures for hedge funds should be established

1	2	3	4	5
Strongly disagree	Disagree	Unsure	Agree	Strongly agree

Comments/ reason for the above answer:

.....

.....

15. In your opinion, if a standard benchmark was to be introduced, the difference between investment styles and strategies could be accommodated in a standard benchmark.

1	2	3	4	5
Strongly disagree	Disagree	Unsure	Agree	Strongly agree

Comments/ reason for the above answer:

.....

.....

.....

16. Rank from the following benchmarking measures in order of preference, from 1 to 3 (1 = most preferred)

1	Fixed-rate	
2	Risk-free rate + x %	
3	CPIX + x %	
-1	None of the above	

Comments/ reason for the above answer:

.....

.....

.....

17. In your opinion, if a South African benchmark was to be set, who should set it?

(YOU MAY SELECT MORE THAN ONE OPTION HERE)

1	Not applicable	
2	Investment Managers Association of South Africa	
3	Financial Services Board	
4	Fund Managers	
5	Association of Collective Investments	
6	Other.....	

Section C: Risk Management

Instructions: Please evaluate the following statements below by selecting the most appropriate **SINGLE** answer. Qualify with comment wherever necessary/ appropriate

18. You consider appropriate risk management tools to be:

1	Fund specific	
2	Style specific	
3	Both fund and style specific	
4	Neither fund nor style specific	

19. In your opinion, standardised risk measures must be introduced.

1	2	3	4	5
Strongly disagree	Disagree	Unsure	Agree	Strongly agree

Comments/ reason for the above answer:

.....
.....
.....

20. Rank from the following risk measures in order of preference, from 1 to 5 (1 = most preferred)

1	Not applicable	
2	Mean-Variance	
3	Sharpe Ratio	
4	Value at Risk (VaR)	
5	Leverage	
6	Volatility	

Comments/ reason for the above answer:

.....

.....

.....

21. Because Mean-Variance, Sharpe Ratio and Value-at-Risk all assume a normal distribution of returns, this presents significant practical problems in managing risk.

1	2	3	4	5
Strongly disagree	Disagree	Unsure	Agree	Strongly agree

Comments/ reason for the above answer:

.....

.....

Section D: Remuneration

Instructions: Please evaluate the following statements below by selecting the most appropriate **SINGLE** answer. Qualify with comment wherever necessary/ appropriate

22. Fee structures should be further improved in terms of aligning manager and investor objectives.

1	2	3	4	5
Strongly disagree	Disagree	Unsure	Agree	Strongly agree

Comments/ reason for the above answer:

.....
.....
.....

Section E: Index Surveys

Instructions: Please evaluate the following statements / questions below by selecting the most appropriate **SINGLE** answer.

Qualify with comment wherever necessary/ appropriate

23.1 Do you currently participate in a hedge fund index survey in South Africa?

1	Yes	
2	No	

23.2 Do you currently participate in an index survey abroad?

1	Yes	
2	No	

23.3 If you answered “No” to Question 23.1 above, are you planning on participating in a South African survey in the next 12 months?

1	Yes	
2	No	

24. Participation in a performance survey hosted by an independent participant / broker should be mandatory for all local hedge funds?

1	2	3	4	5
Strongly disagree	Disagree	Unsure	Agree	Strongly agree

Comments/ reason for the above answer:

.....
.....
.....

25. The South African market is large enough to make ‘retailization’ of hedge funds viable.

1	2	3	4	5
Strongly disagree	Disagree	Unsure	Agree	Strongly agree

Comments/ reason for the above answer

.....
.....
.....

Section F: Fund of Funds

Instructions: Please evaluate the following statements / questions below by selecting the most appropriate **SINGLE** answer. Qualify with comment wherever necessary/ appropriate

26. Hedge Funds attract better skilled investment managers than Fund of Funds.

1	2	3	4	5
Strongly disagree	Disagree	Unsure	Agree	Strongly agree

Comments/ reason for the above answer:

.....

.....

.....

27. The skills necessary for a hedge fund manager to be successful are very different from those required for FOFs manager to be successful.

1	2	3	4	5
Strongly disagree	Disagree	Unsure	Agree	Strongly agree

Comments/ reason for the above answer:

.....

.....

.....

28. Regulated Fund of Funds should not be permitted to invest in unregistered hedge funds.

1	2	3	4	5
Strongly disagree	Disagree	Unsure	Agree	Strongly agree

Comments/ reason for the above answer:

.....
.....
.....

Section G: General issues

Instructions: Please evaluate the following statements / questions below by selecting the most appropriate **SINGLE** answer. Qualify with comment wherever necessary/ appropriate

29. There is need for stricter regulation of hedge funds in order:

29.1 To safeguard the industry.

1	2	3	4	5
Strongly disagree	Disagree	Unsure	Agree	Strongly agree

29.2 To protect investors.

1	2	3	4	5
Strongly disagree	Disagree	Unsure	Agree	Strongly agree

29.3 To ensure market integrity.

1	2	3	4	5
Strongly disagree	Disagree	Unsure	Agree	Strongly agree

30. Investment training service for private investors should be established and financed by the industry participants (i.e. Hedge Fund operators).

1	2	3	4	5
Strongly disagree	Disagree	Unsure	Agree	Strongly agree

Comments/ reason for the above answer:

.....
.....

31. A self-regulatory Surveillance/Intelligence Unit should be established to ensure due diligence.

1	2	3	4	5
Strongly disagree	Disagree	Unsure	Agree	Strongly agree

Comments/ reason for the above answer:

.....
.....
.....

32. Staffing requirements and costs for such a Surveillance Unit should be met by the industry participants (i.e. Hedge Fund operators).

1	2	3	4	5
Strongly disagree	Disagree	Unsure	Agree	Strongly agree

Comments/ reason for the above answer:

.....
.....

33. Please state your comments, suggestions and views on what you consider to be the 3 biggest challenges facing the hedge fund industry?

1.
.....

2.
.....

3.
.....

THANK YOU FOR YOUR TIME AND CO-OPERATION IN COMPLETING THIS QUESTIONNAIRE.

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