ELECTUS
FUND MANAGERS

Neil Brown & Richard Hasson
Co-Heads

Quarterly Strategy Note | April 2017

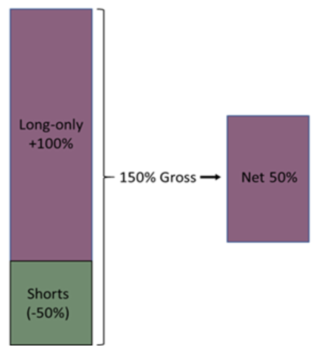
THE CASE FOR SHORT SELLING IN HEDGE FUNDS by Richard Hasson

Brief Overview of South African Hedge Funds and the Regulatory Environment:

Hedge Fund regulations in South Africa have evolved significantly over the last few years, and in the medium term we believe that numerous hedge funds will be available not only to the institutional investor, but also to retail investors. From 1 April 2015, Hedge Funds can become collective investment schemes (CIS), just like any Unit Trust Fund in South Africa, and these hedge funds are regulated by the Collective Investment Schemes Control Act 2002 (CISCA), as either Retail Investor Hedge Funds (RIFs) or Qualified Investor Hedge Funds (QIFs). Concerns have been raised by investors about the increased risk that exists in hedge funds and while this may exist in some overleveraged funds, the RIFs have stringent regulated risk requirements which will result in more oversight by the regulator which should result in lower risks. According to the Novare Hedge Fund Survey 2016, Hedge Fund Industry Assets in South Africa totalled R68.6bn. This compares to the current Johannesburg Stock Exchange (JSE) Market Capitalisation of R13.8tn, so hedge funds in South Africa are very small currently at around 0.5% of the JSE. Even excluding foreign investors in the JSE, hedge Funds are only around 1% of domestic equity assets.

As the founders of Electus Fund Managers (Electus), Richard Hasson and Neil Brown have managed hedge funds for over 6 years and have built up the necessary knowledge and systems to reduce the risk in short selling. There are numerous hedge fund strategies that can be employed and at Electus we launched a **Long/Short Equity Hedge Fund** on 1 July 2016. Our fund focuses on South African Equities only and leverages off the 110 companies we understand and analyse daily, so this product causes no deviation from our core focus area. The mandate of our Long/Short Equity Hedge Fund is being managed within the investment parameters of the CISCA RIF regulations whereby levels of risk are maintained at relatively low levels, by example Gross Exposure in RIF funds is capped at 200% with no individual holding being greater than 10% of the portfolio. Electus has recently received its Cat IIA licence and the fund is in the process of being registered as a RIF with the FSB. Through time, and depending on opportunities, we expect the fund to hold on average 100% long positions and 50% short positions – refer Chart 1 for this structure. These positions will result in 150% Gross exposure (the sum of our long exposures and our short exposures), while Net exposure (our long exposures less our short exposures) will be 50% to the JSE equity market and is likely to vary between 30-70%, depending on the underlying opportunities in the equity market. The objective of this fund is to deliver annualised returns of cash (STEFI) +7% over rolling 3-year time periods so can be viewed as **an absolute return targeted fund.**

Chart 1:

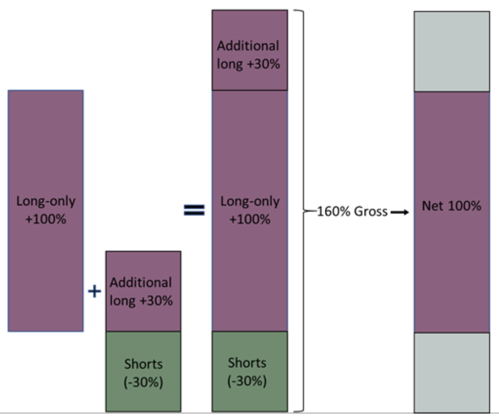


Overview of the Long Short Equity Hedge Fund Structure

Source: Electus

There are also hedge funds where the objective is to beat market indices such as the JSE Shareholder Weighted (SWIX) Index, and these funds are typically known as **Short Extension Funds or 130/30 Funds**. As per Chart 2, these funds would typically be structured to have 130% of long positions and 30% of short positions resulting in a fund that has 160% of Gross exposures and **100% of net exposure to the JSE equity market**.

Chart 2:



Overview of the Short Extension (130/30) structure

Source: Electus

Since this level of net exposure is identical to the 100% net exposure of JSE indices such as the SWIX, **performance of these Short Extension funds is usually measured relative to JSE indices such as the SWIX**. While Richard Hasson and Neil Brown previously managed a Short Extension fund for 4 years, there are currently no Short Extension RIFs in South Africa. We expect to see these being launched on a medium-term view due to the regulation of hedge funds and the benefit to typical long only portfolios from short positions which can be used to enhance returns without increasing risk within South African Equity portfolios, which we will now discuss below.

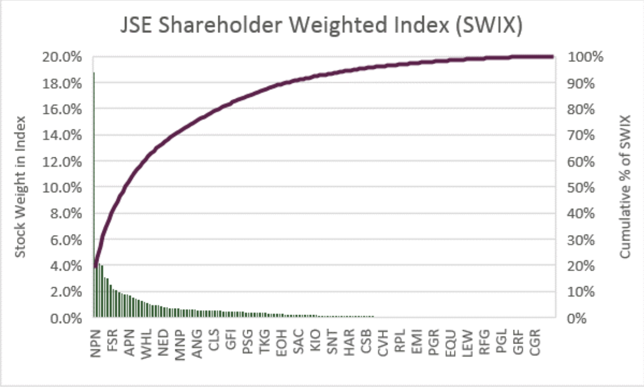
The Case for Short Selling

Below, we will try to dispel some of the hedge fund concerns on short selling, and in fact motivate the case for short selling and why **short selling can reduce portfolio risk and enhance portfolio returns** when executed correctly.

1. ***The biggest constraint that is placed on long only managers is the long only constraint***. This is a profound statement so feel free to read it again as it gets to the heart of active portfolio management which we strongly believe in at Electus Fund Managers. Two key ingredients are needed to outperform the equity market. Firstly, the manager needs to have **investment skill** to generate investment ideas. Secondly, the manager must have the **ability to execute** these ideas. Despite numerous debates locally and globally over the first ingredient (manager investment skill = active vs. passive debate), over 16 years managing the Nedgroup Investments Growth Fund we have an unbroken track record of outperforming both General Equity Peers and the JSE All share Index (ALSI) by around 2% per annum. Therefore, for the purpose of this Strategy Note, we will assume this first ingredient as a given and discuss in further detail the second ingredient, being the **ability to execute on this level of investment skill**.

2. **South Africa has a very concentrated equity market** dominated by large companies such as Naspers (NPN), which contributes over 18% of the JSE Shareholder Weighted (SWIX) Index and over 15% of the JSE All Share Index (ALSI). In fact, per the Purple Line and Right hand axis in Chart 3 below, the Top 20 shares make up 62% of the SWIX Index, while the Top 40 shares make up 77% of the SWIX Index. Due to this index concentration, when the SWIX Top 40 shares are performing strongly and outperforming the other 120 shares in the SWIX, it can be very difficult for long only managers to outperform the SWIX Index as they can hardly go much above the 77% index weight in the outperforming Top 40 shares. It also means that any active risk (deviations from benchmark weights) they take away from the index will likely result in allocations to the underperforming (by default) mid and small cap shares.
   Through time it is therefore no surprise that active managers in South Africa prefer markets where mid and small caps outperform the large caps, as managers can take reasonably large active positions in these mid and small caps and are appropriately rewarded with a suitable payoff for the outperformance of their investment ideas.

Chart 3:



Source: FactSet/JSE data/Electus

What Chart 3 also shows is that **more than 50% of the constituents of the SWIX index have a weight of less than 0.3% in the index.** Therefore, if a manager has skill in deciding that a share such as Nampak (which is 0.2% of the SWIX) is 20% overvalued and likely to underperform the market, then the lowest weighting that can be held in Nampak in a long only portfolio is 0%. If the manager is right and Nampak underperforms the market by 20%, then this will add 0.04% (0.2% underweight x 20% underperformance) to portfolio performance when compared to the benchmark. This 0.04% outperformance of the index is hardly a payoff for what was a very good investment idea, and shows that the **key reason for such a low payoff was the inability to execute this investment view meaningfully enough due to the long only constraint on the manager of this long only fund.**

Now let us assume that the manager could short sell Nampak in the portfolio. By taking a 2.5% short position in Nampak, which by its size is not an unrealistically large short position, then this would have translated into an active positon that was 2.3% below Nampak's SWIX weighting. If Nampak was to underperform the SWIX by 20% then this would result in 0.46% (2.3% underweight x 20%) outperformance of the index, which can be considered an appropriate pay off for a good investment idea. This example is one way in which **short selling can enhance portfolio returns** both in relative terms if attempting to outperform an index, or using this information when a manager believes that businesses are overvalued in absolute terms, and looks to profit from the 20% decline in the Nampak share price. Considering the potential for low returns from the JSE going forward, managers that have the ability to earn returns on all investment ideas will enhance the ability of funds to earn additional returns relative to the overall market.

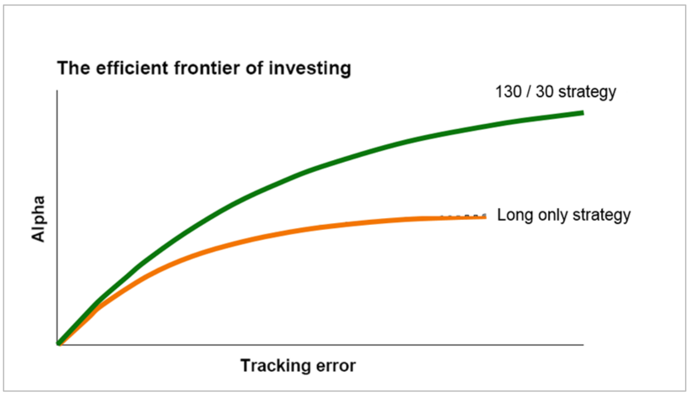
3. Based on studies done by Grinhold & Kahn (2000), as well as Clarke, da Silva et al (2002) in the USA and using the S&P Index as a benchmark, up to 40% of manager skill is not able to be appropriately implemented in portfolios in the

USA due to the long only constraint. Professor Bradfield, Munro et al of Cadiz Securities, in a 2009 report, ran similar simulations for the South African equity market and concluded that **44% of fund manager skill is lost (i.e. only 56% implemented) in the SA equity market due to this long only constraint**. Cadiz Securities also found that by introducing 10% short positions to a long portfolio could enhance skill transfer by 13% from 56% to 69%, and by adding 30% short positions to a long portfolio could enhance skill transfer by 33% from 56% to 89%. The optimal amount of short positions in a fund is based on levels of manager skill, the volatility of stock returns, the correlation between stocks, the borrowing costs for short positions and the transaction costs such as brokerage fees. In general, it has been found that above this 30% level of shorting in Short Extension funds, the marginal utility of short positions is eroded and hence the majority of Short Extension funds globally have gravitated towards the 130/30 structure as per Chart 2.

4. Portfolio breadth is another reason for implementing short positions in a portfolio. **The larger the number of independent bets and sources of return in a portfolio the better the quality of risk**. This is especially true in South Africa where a few key macroeconomic drivers such as commodity prices, interest rates, inflation, political and rating agency influences can cause large divergences in stock performances, as evident over the recent past. Short positions create different sources of risk and investment returns and the proceeds received on the sales of these short positions creates funding that can also be employed into new long positions, again providing additional sources of risk and investment return. At Electus we have always **built diversified portfolios across all macroeconomic drivers** for exactly these reasons, as we believe the macro environment can be difficult to predict and is an area in which we have limited skill. Instead we focus our efforts on where we believe we have a **competitive advantage, which is fundamentally based bottom up stock picking for both long and short positions**. We also believe in **diversified stock specific risk,** which means that no one or two stock specific investment decisions should drive portfolio returns, and that stock specific risk should also be diversified across numerous positions, with a fairly even distribution profile.

Therefore, based on the above points, introducing short positions to portfolios should result in better risk adjusted returns and an upward shift in the efficient frontier of investing – refer Chart 4. This is due to the ability to appropriately execute and be rewarded for good investment ideas, while the greater breadth in the portfolio results in more diversified risk, which is better quality risk. This results in better levels of returns being earned at the same levels of risk (measured by tracking error) or similar returns being generated with lower level of risk. Either scenario means **better risk adjusted returns and better Information Ratios** (Alpha/Tracking Error) can be earned by funds employing short selling strategies.

Chart 4:

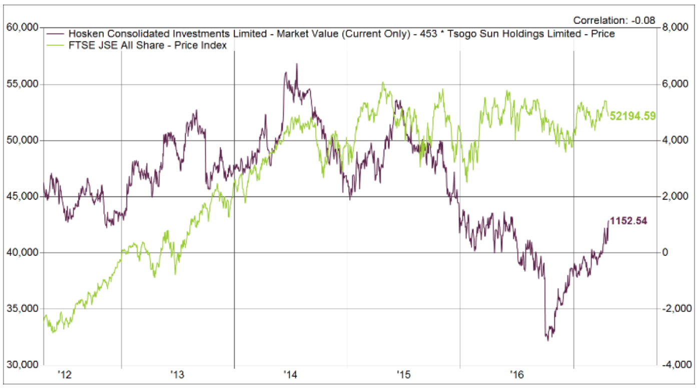


Source: Electus

Short Selling in Rump Trades Opportunities

Another area where portfolios can benefit from short selling is in Rump trades. Rump trades occur when there are cross holdings in assets, or holding company structures exist whereby exposure can be gained to the value of one asset at the expense of another. An example of a Rump Trade we have in the Electus Long/Short Equity Hedge Fund is exposure to the Rump assets within JSE listed Hosken Consolidated Investments (HCI). HCI is an Investment Trust with exposure to a broad range of assets with the largest asset in the HCI portfolio, and making up 60% of its valuation, being JSE listed Tsogo Sun which is one of South Africa's largest Gaming and Hotel companies. The other 40% of HCI's assets include properties, transport companies, eTV media company and others, which combined are worth, in our opinion, R7.5bn net of R2.5bn of debt. Therefore, to see what the market is implying for the value of these other 40% of assets you can simply take the HCI market capitalisation and subtract the value of HCI's shareholding in Tsogo to get an implied valued of the Rump (Green line in Chart 5 below). In a Hedge Fund portfolio context, you would implement this trade by going long HCI and short Tsogo in the appropriate ratios to replicate this Rump opportunity. From Chart 5 below, you can see that the market is currently valuing these Rump assets at R1 152m which is well below the R7.5bn that we believe they are worth. When we launched the fund in mid-2016 we put this HCI rump trade into the portfolio when the value implied by the market was around -R1bn (i.e. we were being paid R1bn by the market to take assets we thought were worth R7.5bn) and we continue to hold this trade as we still believe the HCI Rump assets are not being fairly valued by the market. Another benefit of rump trades is that in general they are uncorrelated to the movement of the JSE (HCI rump has a correlation to the JSE of -0.08 per Chart 5), and Rump trades are therefore very good uncorrelated assets to own in the context of an absolute return targeted fund. As these Rump trades involve short positions and with over 99% of SA Equity funds being long only funds, competition to implement these trades is far lower than a normal long only trade. So, in our opinion, the probability of a profitable outcome is much higher.

Chart 5: Value of HCI Rump Assets & JSE All Share Index



Source: FactSet/JSE/Electus

SUMMARY:

Short positons enhance an investment manager's ability to execute better on their level of investment skill and be appropriately rewarded for their investment ideas in a very concentrated South African Equity market. Short positions, when added to a portfolio, result in more portfolio breadth and better risk adjusted returns for clients. At Electus we believe we have the necessary skills, systems and experience to manage South African Equity Hedge Fund products and are well positioned in an industry that is going through positive regulatory changes for the benefit of investors.

ELECTUS FUND MANAGEMENT OVERVIEW

by Neil Brown and Richard Hasson

Electus managed equity Funds only invest in SA listed shares and are managed as style agnostic and diversified Funds, with the goal of strongly growing Clients invested capital over the long-term. In order to deliver this strong capital growth, we have a positive bias towards investing in best-in-class companies that are managed by proven management teams, where the business models can deliver profit and dividend growth rates above their sector averages. The Funds are market cap indifferent in their share selection, targeting meaningful exposure to high Quality, mid-sized, market leading businesses and our Long Funds have a high level of Active Share risk. Importantly, the shares held in the Long Funds should offer reasonable margins of safety to their fair Valuations.

Since November 2016 we have been stating that Rand weakness seemed possible and that, with the high level of financial market and political uncertainty, we would remain very cautious and disciplined in following our Investment Strategies. Sadly, now that we are deep into this very poor environment in SA, with the current political uncertainty and a volatile currency and equity market, we continue to believe that good share selection is critical for success in 2017 and 2018. We believe that several quality, mid-sized, SA financial and industrial businesses offer the best risk adjusted returns, together with quality Rand Hedge industrials. Therefore, we remain focused on investing in best-in-class businesses with zero tolerance for poor businesses that have high financial risk.

Based on our Electus "bottom-up" aggregation of valuations for SA's 110 largest companies, the main JSE indices are trading 8% below their appropriate price levels. In contrast, our well diversified Long Funds and Long/Short Equity Hedge Fund are undervalued with current upsides of 26% and 36% respectively, which would suggest above average absolute and relative prospective returns. This level of upside makes us very positive for the future and we remain confident that the Long Funds are well positioned and diversified across 30 shares. As we wish to maintain a high level of Active Share risk in our Long Funds, all shares have a targeted weight of >2.0%. Our Hedge Fund is similarly well diversified across 34 long positions and 21 short positions, with the largest long position having a weight of 5.3% and the largest short position having a weight of -3.6%. This clear focus and positioning, with suitable diversification, enables us to target excess returns for Clients from specific share selection and not from sector selection.

This above-mentioned risk managed approach for Clients has been consistently applied by Electus and is how we have obtained excess returns in our Long Funds of 2% per annum for our unbroken 16-year track record vs our SA Equity peer group and the major JSE indices. Importantly, this excess return has come with best-in-class low levels of Fund volatility.

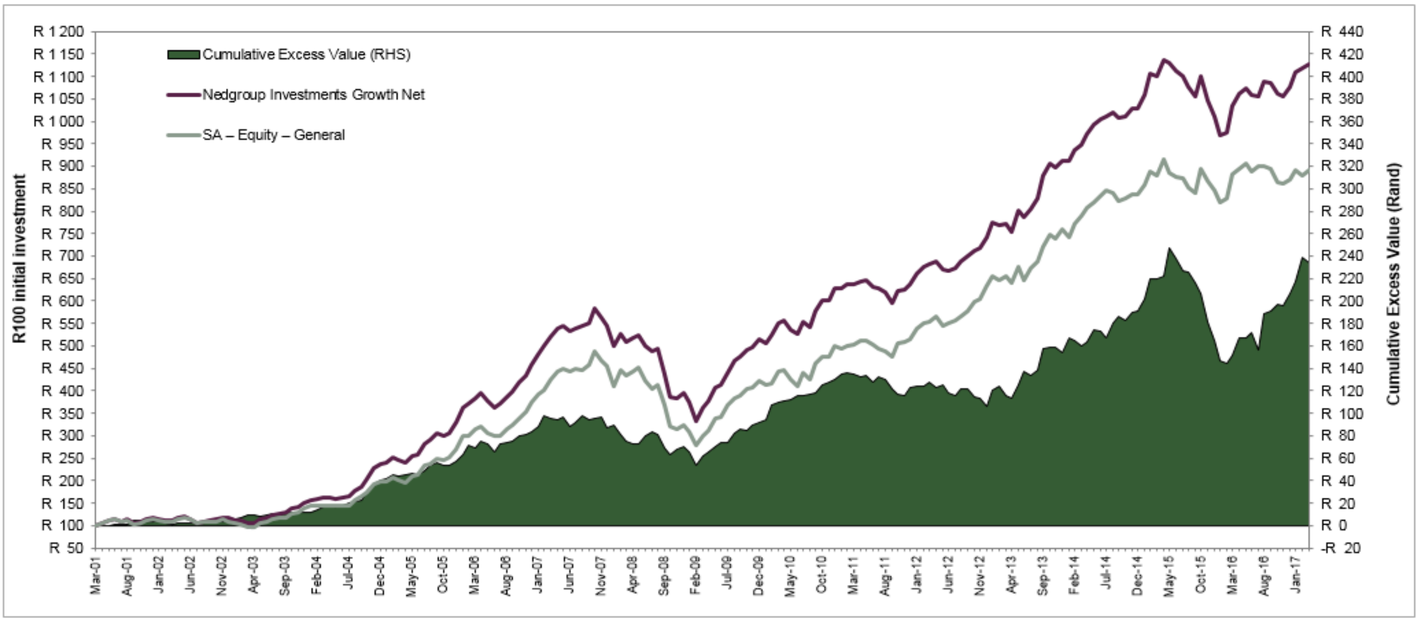
Pleasingly, our SA Long Short Equity Hedge Fund has had a reasonable start in a difficult equity market since its mid-2016 launch, with a positive 9-month absolute return of 5.0%, which was ahead of the JSE SWIX return of 0.3% over the same time period, but below the SA Cash return of 5.7%.

Chart 6:

Long-Term Performance History vs Peers

Nedgroup Investments Growth Unit Trust to 31.03.17

Excess Return pa vs General Equity Unit Trust Peer Group of 1.8% (Net vs Net)



Source: Morningstar and Electus

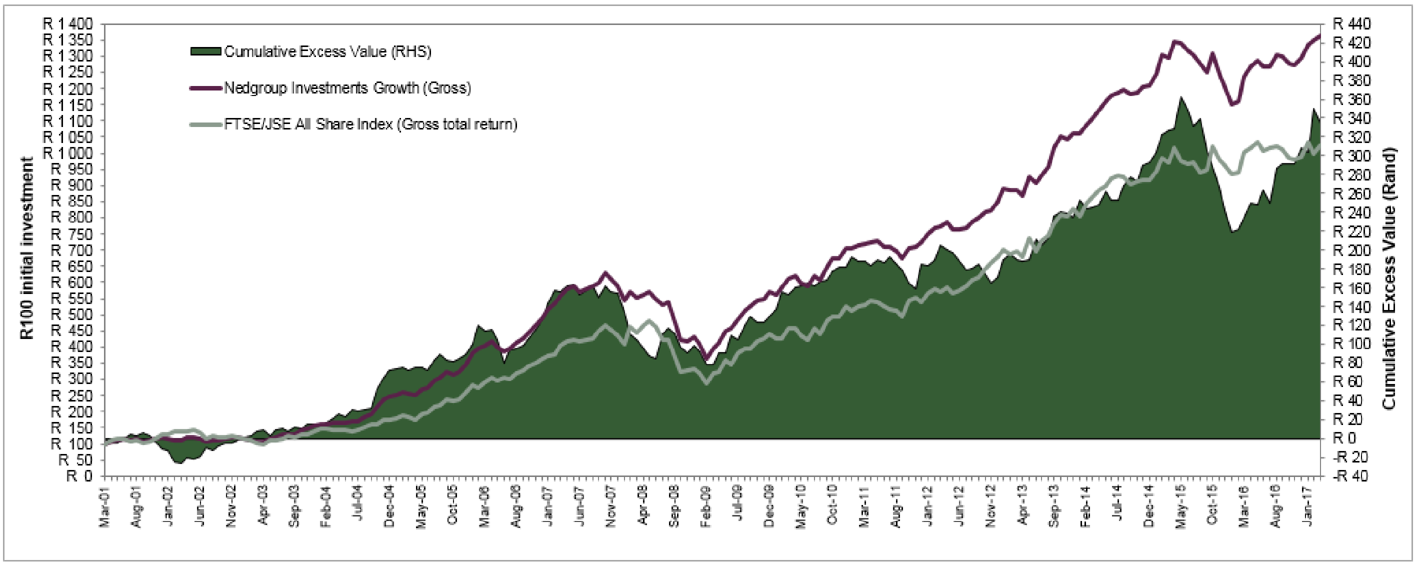
Since managed by Neil Brown and Richard Hasson

Chart 7:

Long-Term Performance History vs JSE

Nedgroup Investments Growth Unit Trust to 31.03.17

Excess Return pa vs FTSE/JSE All Share Index (ALSI) of 2.1% (Gross vs Gross)



Source: Morningstar and Electus

Since managed by Neil Brown and Richard Hasson

CONTACT DETAILS:
GREAT WESTERFORD BUILDING, 240 MAIN ROAD, NEWLANDS, CAPE TOWN 7700
TELEPHONE NUMBER: +27 21 680 7500

WEBSITE ADDRESS
www.electus.co.za

ELECTUS FUND MANAGERS