MERGENCE AFRICA

One of the genuine boutiques

The term boutique has been abused in the fund management industry. It is sometimes used by big managers to describe a franchise or silo (say a value boutique) still wholly owned by a life assurer. These "boutiques" usually have an incentive structure not very different from the days when the firm was still run as a supertanker.

A good example of a genuine boutique is Mergence Africa. Says MD and founder Masimo-a-badimo Magerman: "We do not want to become asset gatherers, we prefer to focus on a few areas of expertise, in which we can command higher fees rather than on generic mandates."

Magerman started the business in August 2004 with Luis Levy and Izak Petersen. Petersen runs the R600m Mergence property business and there is also Mergence Africa Capital, which structures derivatives and provides other financial solutions to its clients.

There are R3,2bn under management at Mergence Africa, with R650m in its two hedge funds, a further R600m in relative equity, and the balance in its absolute return portfolios. These aim for CPI plus 5%.

Magerman says that the firm will probably cap its assets under management at about R10bn.

Mergence has a broad skill set in a small team of nine. Magerman worked on the floor of the New York Stock Exchange and then moved to the convertible bonds desk at Merrill Lynch in London. He also ran an equity derivatives book at Gensec, which makes him perfectly placed to be the lead manager on Mergence's two hedge funds.

Levy started in product development at Old Mutual, and after a spell at PSG Investment Bank began running equity portfolios at Trilinear.

Fabian de Beer was brought in to bring asset allocation skills and knowledge of the bond market. He was responsible for asset/liability management at Standard Corporate & Merchant Bank and then was responsible for risk assessment, investment strategy, asset allocation and multimanagement at the Eskom Pension & Provident Fund. He also had a short stint as investment manager at the Brait fund of hedge funds.

There is a five-stage approach to picking equities — the Mergence Quant Model is an initial quant screen. This is maintained by quantitative analyst Brad Preston, who is completing a master's thesis on basket option pricing with non-normal returns.

Hetty Zantman

Masimo Magerman

The next stage is a valuation model based on discounted cash flow, followed by qualitative evaluation, which includes its own fundamental research as well as that from stockbrokers and regular company presentations and visits.

Mergence has just one full-time share analyst, Rowan le Roux, who was an analyst with SCMB Asset Management.

Magerman says the house makes intelligent use of computational power to sift through a universe of 160 shares and it then focuses on research where it can really add value.

"We are a pragmatic style agnostic house and look for opportunities in different types of shares."

The vital fourth stage of the process is the risk assessment. "As prudent investors we need to take into account the inherent and potential risk of investing and balancing this against the prospect of returns," says Magerman.

The fifth stage is to determine how a share fits with the investment outlook — aligning the top-down with the bottom-up. The process is used for the absolute return, hedge funds and equity-only mandates.

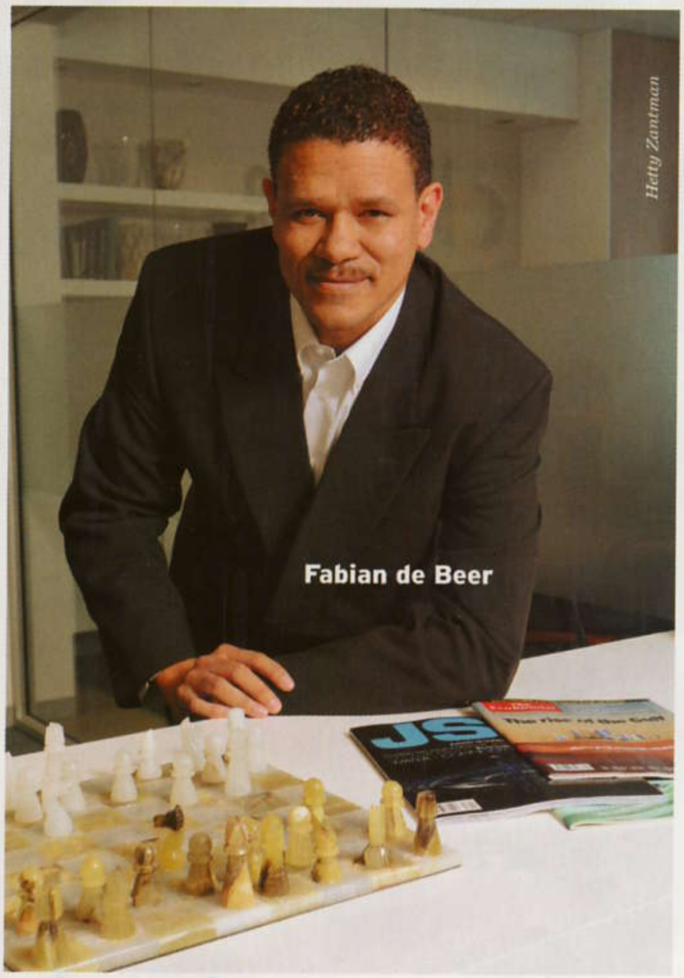
Magerman says that the core process is the same but the hedge fund can take a more concentrated view and be more opportunistic than the absolute return fund. Typically the hedge fund would hold 20-25 different shares, while the absolute return fund would hold 30-35.

In its debut year to June 2007 there was a net return of 35,8% from the Mergence Africa Hedge Fund (now called the Uvuno Fund), but conditions have become tougher and the return for the 12 months to March 2008 were just 4,5%.

But it is still the second-best performer in the multistrategy area and it has proved its claims to be strong on risk management are not idle talk. The volatility of 8,1% over 12 months is the best in the sector, while its maximum drawdown (worst monthly loss) has been the best at 4,7%. It has had positive months 72,7% of the time.

Hetty Zantman

Luis Levy



Hetty Zantman

Fabian de Beer

The Uvuno Fund has no borrowings. To cater for clients with a greater risk appetite, in November 2007 it launched the Lerumo fund, which can gear up to 2,5 times. It has had muted performance, returning 0,31% since inception — though this is relatively better than the 10%-17% losses experienced by other multistrategy funds over the same period.

De Beer says that the funds have an equity bias for now, but there is room to change asset allocation and focus if there are opportunities from bonds, cash or other assets classes such as commodities.

The Absolute Return Fund also has scope to move between asset classes. But it is constrained by regulation 28 of the Pension Funds Act, which restricts "other" assets (that are not cash, bonds, equity or property) to 2,5%. The R1,84bn Mergence Africa Absolute Return Fund exceeded its mandate of CPI plus 5% in 2007 with a 12,64% return. But over the 12 months to April 30 it has struggled with a return of just 2,64%, behind its peers for now.

Mergence is really shining right now in the relative return space. Its flagship fund, run by Levy, is the Mergence Africa SA Equity Fund, which is benchmarked against the capped all share index (Capi).

The house's quantitative disciplines as well as its ability to pick the right shares, has allowed Mergence to produce a return of 11,28% over 12 months, second only to Investec Active Quants.

It helped that Mergence was benchmarked against the Capi, which has performed better than the rival shareholder weighted index (Swix). But it has also generated a solid return over its benchmark, with an additional return of 1,32% (with a low tracking error of 2,13%).

It had the seventh-best return out of 23 benchmark cognisant portfolios.

Mergence is bidding for a mandate to run a specialist equity portfolio from the Public Investment Corp.

Its BEE staff and shareholder profile will count in its favour, as will a highly competitive equity performance.

Stephen Cranston

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