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Three-dimensional analysis for a broader perspective

The team at Mergence pride themselves on strong analytical skills, which have paid off for their R450m multi-strategy hedge fund, achieving a net 35.8% since inception without leverage

The Mergence Africa Hedge Fund is a growing part of the business at Cape Town-based Mergence Africa Investments, and with a year's track record in place it is certainly proving its worth.

One of few specialist investment managers in the country to be predominantly black owned and managed, Mergence currently has R3 billion in assets under management spread across absolute-return funds, specialist funds and the hedge fund.

The company was started in 2004 by Masimo-a-badimo Magerman, Izak Petersen and Luis Levy. Petersen, a chartered accountant, is responsible for property and capital solutions at Mergence Africa Capital, while Levy, a CFA who was previously with Old Mutual Investment Frontiers and PSG Investment Bank, is the company's portfolio strategist running R500 million in specialist relative equity mandates.

Magerman manages both the absolute return and the hedge fund at Mergence. Having grown up in Soweto and Alexandra Township, he completed high school in South Africa before studying in the United States, earning a B.MSc (Finance) from Kean University in New Jersey and an MBA (Finance) from Rutgers University. He joined the Merrill Lynch convertible bond desk in London in 1999, before returning to South Africa to run an equity derivatives book at Gensec in Johannesburg, which he did for two and a half years before co-founding Mergence.

The multi-strategy Mergence Africa Hedge Fund now has R450 million under management, after launching with seed capital in June last year.

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"We are expecting the fund to reach R600 million soon," says Magerman. "As a multi-strategy hedge fund, and given our investment approach, we can reach quite a fair size, but we will look at soft-closing at R1 billion. That is the level at which we will reassess matters. In a portfolio that uses derivatives, you need size to get the most opportune pricing."

Magerman is assisted on the hedge fund by Fabian de Beer (who covers asset allocation and investment strategy), and Brad Preston, a quantitative analyst. They make up part of Mergence's eight-strong investment team, housed at its recently expanded Mouille Point offices, on Cape Town's Atlantic seaboard.

MERGENCE AFRICA HEDGE FUND: AT A GLANCE

Inception date: June 2006
Portfolio manager: Masimo-a-badimo Magerman
Offices: Mouille Point, Cape Town
Strategy: Multi-strategy
Minimum investment: R10 million
Assets in strategy: R450 million
Prime broker: Cadiz Prime
Administrator: FinSource
Currency: Rand, plans for dollar structure
Open to investment: Yes

"Key to our performance is that Mergence has a team of eight individuals with strong quantitative, analytical and risk management skills as well as sound investment experience," says Magerman. "The hedge fund team benefits from the entire investment team's expertise and input and we tap into all our available resources."

The fund has done well in its first year – returning a net 35.8% since inception, comfortably beating both the South AfricaHedge Single Manager Composite and the South AfricaHedge Market Neutral & Quantitative Strategies Indices compiled by Hedgefund Intelligence. The returns were achieved with 6% volatility compared with the Alsi40's 19.7%, and with a low beta of 0.19 relative to the Alsi40.

The fund has been positive every month since launch, achieving its returns without leverage.

Given its more flexible mandate, the hedge fund has outperformed the company's R2 billion absolute-return portfolio, which has risen 23.2% in the past 12 months.

"The core process is the same, although the hedge fund can take a more concentrated view and be opportunistic. The absolute-return fund is more diversified and more defensive as it is governed by Regulation 28 of the Pension Fund Act [thereby falling outside the definition of an alternative investment, to which institutions may only allocate 2.5%]," says Magerman.

The investment process begins with a proprietary quantitative model, developed by the team and spearheaded by Preston –

who has a BSc (honours) with distinction from the University of Cape Town and is in the process of completing his Masters thesis.

"First, we take a bottom-up look at the entire universe of South African stocks on a quantitative basis – looking for discrepancies from historical PEs and other fundamental measures," says Magerman. "Basically the model will generate buy, sell and neutral signals on all stocks given strict criteria. We then apply qualitative evaluations – including running our in-house valuation models (such as discounted cashflow analysis)."

Members of the Mergence investment team, from left: Fabian de Beer, Brad Preston, Masimo-a-badimo Magerman, Josephine Esau, Chuma Qongqo, Rowan le Roux, Olwethu Mafanya

"We take a three-dimensional perspective with the fund," adds De Beer. "The fundamental bottom-up approach is just one dimension. But being a multi-strategy fund, over time the portfolio can shift depending on market conditions. We can also use different instruments as conditions change – currently we are equity biased, but that could change on an asset allocation basis. We can use different instruments, from index exposures to equities, derivatives, bonds and cash. You need flexibility in this market to generate meaningful returns while hedging the downside."

Despite using quant models, the Mergence team does not use a black-box approach, nor are they momentum players. "Our quant processes use fundamental analysis from a holistic universe of factors," says Preston. "As a small team we benefit from computing power to maximise our time. It takes a lot of effort to ensure our data is rigorously checked. Broadly, we are looking for value and that won't change."

The team also benefits from in-house research generated by investment analyst Rowan le Roux, in addition to reviewing annual reports, broker research and attending company presentations.

The hedge fund currently has 24 positions, with around 65% invested in equities and the rest in cash/money market instruments (by comparison, the absolute-return fund has 32 equity positions). Magerman has yet to use shorting in the portfolio, preferring instead to switch to cash given current market conditions. Nor has he leveraged the fund, despite having a mandate that allows the portfolio to be geared up to two times.

"We won't easily short stocks over the long term. We would rather short via cash and/or derivatives. But if the right opportunity arose, we would short," he says. "We also haven't leveraged the portfolio. At the core of our process is that returns must be generated in the context of risk. There must be compelling reasons for us to do what we do at any stage. We see ourselves as investors – we don't agree with the idea that all hedge funds are synonymous with high-risk – we have a fiduciary obligation to our clients to protect and grow their cash."

> **"We tell all our clients: 'Guys, we are not traders.' We're investors and we like to do it on a sensible basis. At the end of the day we have invested our savings in the business, and co-invest in our hedge fund. We need to apply prudence"**

Given his background as a proprietary trader, Magerman goes out of his way to point out that the hedge fund is not a high-turnover portfolio.

"For us, the risk-return/reward ratio is very important. Risk taken must be compensated for by commensurate returns," he says. "We tell all our clients: 'Guys, we are not traders.' We're investors and we like to do it on a sensible basis. At the end of the day we have invested our savings in the business, and co-invest in our hedge fund. We need to apply prudence."

The asset allocation process has become more of a focus since De Beer joined the firm late last year, taking into account broader economic and global themes that have a bearing on the local markets and, therefore, also potentially on the Mergence portfolio. De Beer was previously with Brait Specialised Funds and before that head of the multi-manager function at the Eskom Pension and Provident Fund, where he spent 10 years.

"On top of the quantitative and qualitative approach, we have another layer of risk-managing positions within the context of asset allocation," adds De Beer. "It is an overlay that plays a key part in exposure positioning."

He adds: "Our bias is to the South African equity market and derivatives – we are a multi-strategy fund, so we are not ignorant of opportunities that may present themselves in other asset classes and will exploit those when opportune. In brief, we take a thematic view (long and short term) on a macro basis and then position the portfolio for that potential market scenario while being cognisant of possible risks. Our portfolio reflects what we believe are investment positions with the best risk-reward ratios, individually and as a whole."

Magerman looks forward to another successful year with the Mergence Africa Hedge Fund, and plans to offer a Cayman structure aimed at accommodating growing interest from offshore investors. Currently, the fund's assets are primarily from domestic institutions. He acknowledges that stock-market returns could taper off given strong growth in recent years, and has taken some risk off the table but remains selectively positive.

"Fundamentally we believe that the South African environment has strong macro underpinnings that would be supportive of the market in the longer term. We remain positively cautious and, given our mandate, we can use whatever strategy we deduce will deliver the best returns, balanced against risk, over time."