Peregrine Capital takes stock of proven record and looks to the future

David Fraser and Jacques Conradie talk about their business philosophy and how it has served the firm over its 20 years in the hedge fund industry

Peregrine Capital is the oldest hedge fund manager in South Africa, with a solid 20-year track record, having launched its first two funds in July 1998.

Today, the company continues to focus only on hedge funds in South Africa with four strategies and a team of 15 people, including nine on the investment team.

HedgeNews Africa sits down with founding partner David Fraser, executive chairman and portfolio manager, and Jacques Conradie, managing director and portfolio manager, to talk about the genesis of the firm, the journey thus far, and the road ahead.

David Fraser

Jacques Conradie

What led to the creation of Peregrine Capital?

Fraser: Clive Nates, Peregrine Capital co-founder, and I were both at Liberty Asset Management. We felt the traditional institutional model in South Africa needed to be challenged. We found that advancing our careers within an institution effectively took us further and further away from the research process. You start as an analyst and you progress to fund manager and this progression meant you did a lot of marketing and client presentations, with less time for research. That was something that I resisted.

We felt that a far bigger focus on research, and keeping the most experienced people doing the research, would give us a competitive advantage over time. We also observed the inefficiencies within traditional institutions as far as speed of decision-making is concerned. We set up Peregrine Capital as a business without red tape - the inhibitors that we found in a traditional institution. That said, we loved our time at Liberty. It taught us our trade. It was, in our day, a great place to work and learn.

Peregrine Capital was always going to be a hedge fund business. It was in the beginning stages of hedge funds in this country. It was a different animal and something that we were excited about. The ability to short shares opened a whole new world for us.

Conradie: That focus on fundamental research is core to our ethos. We try to find quality companies managed by good management teams who have the ability to produce good returns over an extended period, at reasonable prices. Today we run four major strategies – Pure Hedge, Dynamic Alpha, High Growth and Flexible Opportunity. We have a dollar version of the Dynamic Alpha and High Growth funds. We have a very similar investment philosophy across all the funds, with adjustments when it comes to position size and net exposure. So an attractive position will find its way into all of the funds, adjusted for the risk profile.

How did the prime broking environment work back in the day?

Fraser: For probably six to seven of our 20 years there was no such a thing as a prime broker in this country. We were lucky in that there was already an established scrip lending market between brokers and institutions. Active scrip lending was required for settlements due to the fact that people were scrambling for scrip to settle normal trades. It was readily available, not for shorting but for settling trades. So we could tap into an established market as far as borrowing shares was concerned. To extend the period of scrip borrowing from weekly settlement to a longer-term borrow really wasn't a major challenge. We did all of our admin in-house before the prime brokers came along. Not because we wanted to, there was just no other option at that point.

What have been the biggest changes in the hedge fund industry over the years?

Fraser: There are significantly more funds and more people in the industry today. I certainly believe that the better talent and analysis still resides in the hedge fund industry. It's become a well-respected and well-developed part of our market that people understand and acknowledge. Our space is pretty much entrenched.

The industry has been taken seriously and has grown to a relevant size. It has carved out a space in the market, it's here to stay. I'm obviously disappointed like everybody else that the industry has shrunk over the last two years. It hasn't grown as well as it did before.

Is the industry still relevant? I absolutely, firmly believe that it is. The reason that we started this business is as valid today as it was 20 years ago. The opportunities are still there and with a proper fundamental research effort, you can still find great investment opportunities.

I don't believe that the research effort of our competitors – by which I mean either sell-side analysts or long-only fund managers – is significantly better than it was 20 years ago. I still feel that having experienced professionals analysing companies can give you a competitive advantage over an extended period.

We must also take into account that the current economic environment is one of the toughest SA-specific growth environments in the time we have been in business.

Conradie: It's been a very tough market for an extended period.

In 2008, you had quick drawdowns and quick crashes but a relatively quick reset and bounce back to normal. But 2018 is proving to be Chinese drip torture.

This has largely been driven by how tough the South African economy is. It has surprised us how tough it's been after the good news we had in December with the change of leadership. The economy has just kept slowing and this tells you that consumers are in a very bad space and that is feeding through into most of the industries and companies we cover.

Can you talk us through your most challenging time as a hedge fund firm?

Fraser: We hit the Asian crisis shortly after we started our business and there have been plenty of other potholes along the way.

The global financial crisis in 2008 was obviously a tough time. We came out of it okay given that the market was down more than 23% for the year. Our Pure Hedge fund was up slightly but our High Growth fund was down half as much as the market.

In retrospect, we could have done things differently. We may have performed better than most, but we didn't excel and felt particularly disappointed with our performance in that year.

Conradie: If we look back, we could have saved another 3-5% by doing some things better. So we would never have been up but I think we could have been down less.

Fraser: Having an extended tough market gives you an opportunity to re-examine things, to analyse and assess your process and identify where further improvements can be made.

Conradie: And a tough market gives you opportunities to make the investments that will give you the returns in the next two or three years. After a tough 2009 and 2010, we had a great 2011-2014.

That's where we see things now. A lot of shares in our funds are exceptionally cheap at the moment so you've got to say the forward-looking returns of many of our big holdings are really high.

Fraser: We're not a trading fund. We really do want to find the compounders over an extended period. We've generally made our biggest returns on positions that have been in the fund for a three- to five-year period. We like researching the fundamentals, taking a view and watching it pay off in the medium term as opposed to looking for 3%-5% on a quick trade.

Has your investment philosophy changed over the years?

Fraser: No. Our fundamental philosophy of finding quality companies who can produce good returns over time remains. That's what we still stand for.

Conradie: Our business philosophy is to consistently improve every part of what we do. Over the years, new market situations get thrown at you, from issues with management teams, companies, the economy, the overall market. What we've done over time is build those scenarios into our investment philosophy. How have we dealt with them in the past and therefore, what's the best way of dealing with them in the future. So our philosophy is a live document. But being a bottom-up stock-picking business that finds good risk-adjusted returns through fundamental research is the core.

You have been known to soft-close to new investors at various points What is your reasoning?

Fraser: We've always understood the size-return profile. We are all individually quite big investors in our funds, so we align ourselves with our investors. We understand that it's difficult to get the same returns with a significantly bigger fund than it is with a smaller fund. We've never wanted to be the biggest. Our objective has always been about the best risk-adjusted returns. At certain stages we found that if we kept taking in money, we may have suffered some indigestion.

Sometimes, particularly when there is a lot of money being pushed at you, you need to grow into it and make sure that you still have the same discipline that you would have with a smaller fund.

We also have never been tempted into the long-only side in South Africa despite being asked on several occasions. That sets us apart from many competitors who run a hedge fund next to a long-only business. We feel that you need to put your best ideas in your portfolio, and the bigger your portfolio the less concentrated those ideas can be.

Conradie: We do an analysis where we track our fund size over time versus the market capitalisation of the JSE All Share Index, and also versus the liquidity of the overall market. This is one of the inputs into the decision on when we would soft-close the funds. Our current fund size versus liquidity is almost the same as it was in 2004. So despite us having grown, liquidity in the market does trend up over time. On a 15-year view, we are at the average of where we've been on size versus liquidity. We've kept a close eye on it and obviously it means you sacrifice profits in your business, but returns are the number one priority for us and not size. We're happy to make that trade-off.

Fraser: All of our funds are open at the moment. Like everybody else, we've had some withdrawals, but we've been lucky to have had some inflows as well. So we are in a relatively good space from that perspective.

How has your team changed over the years?

Fraser: Our team has been remarkably steady and is currently the biggest it has ever been. We have had four team changes at senior level in the past 20 years.

One of the fundamentals of our business is to have a flat structure. We intensely debate ideas as a team to try to make us all better investors. Having ideas challenged or concerns aired is a great advantage.

When you have an inclusive management concept, now and again there are differences around investment ideas. Our model is a contact sport. People need to argue their ideas and when there are mistakes, there is an interrogation of those mistakes. It is a robust and constructive environment for the right people.

I would hope that anyone who left us would look back at their time here as being constructive and that they left knowing more than when they came in. I certainly think anyone who left us would say our company deserves respect.

We've taken on two new hires this year. A.J. Snyman joined in September, after two years with Capricorn Fund Managers as an equity analyst. Before that he was an investment analyst at Rand Merchant Investment Holdings.

Matthew Thomson joined us earlier in the year. He is a CFA charterholder and was previously an investment analyst at Rezco Asset Management.

Conradie: The hardest discussions to have as a team are when you have loss-making positions that aren't working. But these are also the most important ones to have for the funds. You've got to be able to debate the position, get to the right answer, discuss the difficulties and then move on to the next idea. We are very open to bringing these things up. The moment you let positions lie in the portfolio that shouldn't be there, the possibility of these positions becoming big losers increases.

Q: How are the funds positioned at the moment, and what is your view of markets currently?

Conradie: We've seen this pullback as a good opportunity to add exposure. We see great value in the market, based on history. When shares are way too cheap versus where they should be trading in the long run, you have to own them. Based on current market valuations, we are relatively net long positioned and generally more so than in recent periods. Also some sectors have been specifically hurt, such as China technology. We think this is way overdone, so we are more exposed there than in the past. We are using this time to add exposure to positions that we think are mispriced, due to some extent to the emerging-market and China panic over the last three to six months.

Fraser: We've added some exposure to South African positions, but we're somewhat cautious because we're just not seeing the signs on the ground that the economy is turning around at this stage. Our view is that it's probably going to take a bit longer. So, you can buy quality companies when they get to the right valuations, but we are more cautious of cyclical shares because it could get a bit worse or stay at this level before it gets better.

We are still paying the cost of the Zuma era, and will be for the next few years. Now the country is looking under rocks and uncovering skeletons. Hopefully that gives us a basis to move forward in a more constructive way. But unfortunately the legacy of the past remains and there are some significant holes that need to be filled. So it's not going to be an easy ride for the South African economy. But from a policy point of view at least, our feeling is the ship is now pointing in the right direction.

Do you see opportunity to make money in this environment?

Fraser: We do. Our equity exposure is at the higher end of the band, so we are seeing real value but it is difficult to predict when that value will come through. That's what we do. We are not good at timing the market. But history has always shown us that when you buy good companies with good management teams with a good product set in tough times at very reasonable valuations, your patience is often significantly rewarded down the line. We continue to focus on companies with good balance sheets and good cash flows. That becomes even more important in tough times. You don't really want to go into an extended downturn with significant debt. We look at companies with relatively low financial risk. But there's certainly a pretty good opportunity set out there at the moment.

Conradie: Often when there is panic in the markets – and we are pretty close to that in China and other emerging markets right now – you'll find that business hasn't slowed but shares are sold down anyway. These are the types of opportunities we love because you effectively get to buy the same performing company at 15-20% cheaper than you could have three or four months ago.

Fraser: Investors also need to have patience. Hedge funds should not be singled out as the worst asset class at the moment. Clearly anyone who has had any exposure to equities is feeling pain. But I still believe in equities as the correct class over any extended period.

Conradie: When we have a discussion with a new institutional or retail investor, we tell them upfront that if you don't want to look at net returns over three to five years, then this is not the right product for you.

We always try to be down significantly less than the market in a tough year, but our goal is to outperform substantially on a three- to five-year basis and for that, you need to take some risk when the market is down. Investors must buy into that strategy. So in a very tough year for us, it is pleasing to see a lot of our long-term investors being very comfortable and some even allocating more money to us.

Fraser: It's times like this where you are going to make the right investment decisions for the next three to five years. We don't get scared in a year like this, we try to engage and understand. We will always be judged over a five-year period and that's what we need to take accountability for.

If an investor had put R1 million with you 20 years ago, what kind of return would you have generated for them?

Fraser: A R1 million investment at our High Growth fund's inception would have grown to about R80 million today, after fees. That's an annualised return of 26%, beating the Johannesburg All Share Index by 12% per year with lower volatility.

What is your advice to new and existing hedge fund managers?

Fraser: It's a particularly difficult time for new entrants. You need to know what you stand for, where you believe you have a market advantage and you need to stick to it. You have to be consistent. Some of the best funds start in the tough times. That's when you really learn about investing and about yourself. It's been a wonderful journey for us. Every day I come to work and I learn a little bit more. So there are no regrets about starting this business, and you've got to encourage people to do the same.

Conradie: You have to rigorously apply your investment philosophy despite the market conditions. You've got to work hard. One thing I love about our business is the extremely smart and driven people we get to work with. Interacting with highly intellectual people, with good ideas, every day makes the job absolutely worthwhile.

Fraser: We've also always taken back office very seriously. We've always over-resourced, even before the new regulations. If there's any doubt, rather over-invest than under-invest because this is very important as any balls dropped on that side can be costly.

What are your views on hedge fund fees?

Fraser: We always look at returns net of fees. We need to deliver good net returns to investors, and we have done that over any extended period. It has to be a win-win situation for both us and our investors.

Do you think the regulations have helped or hurt the industry?

Fraser: I believe people will invest in hedge funds if the risk-reward profile is right for them, whether the product is regulated or not. Regulation obviously does put the bedrock in place for a bigger industry. So we're positive on it and over the medium to long term it will probably lead to a bigger industry.

Conradie: You've got to think that five or 10 years down the line hedge funds will make up a bigger proportion of the average retail client's portfolio, where now it's literally zero for the vast majority. There's definitely a mid- to high-income spectrum of clients where a 5-10% allocation to hedge funds makes sense as diversification improves expected return. So the door has been opened, but it will be a journey to get there.

Where do you see Peregrine Capital in the next 10 or 20 years?

Fraser: I would certainly like to see the existing philosophy entrenched and maintained. It is a philosophy that has seen the company through some incredibly volatile markets over the last 20 years. Our model, consistently applied, has produced exceptional results over an extended period. I certainly hope that this will be a place of choice for smart people to work, with a consistent investment philosophy and good returns.

Conradie: My main hope would be that we can deliver similar returns to what we have done in the last 10 or 20 years. If we can do that, then other things will take care of themselves. We'll have the right staff, we'll have happy investors, and we'll have a great business.