1st Floor, 9 Fricker Road, Illovo Blvd, Illovo, Sandton, 2196, South Africa
PO Box 78608, Sandton, 2146, South Africa
Telephone: +27 (0)11 759 5300 / Facsimile: +27 (0)11 759 5500 / E-mail: info@strate.co.za / www.strate.co.za

strate
Central Securities Depository

ARTICLE

Business Report, 1 September 2006

Hedging market bets in SA's R80-bn securities lending industry

By Grant Nelson, chairman of the South African Securities Lending Association

There's nothing wrong with securing a profit, which action you would no doubt take if you thought the shares in which you invested had gone too high.

But your scope for profiting from share price movements need not end there, since additional benefits might accrue from, for instance, the shares that you sold continuing to appreciate. If the share you disposed of was overpriced when you sold, you obviously consider it even more overpriced at the new, higher, level.

You'd want to sell again, but you no longer have the shares. What to do? Borrow them, sell again at the higher level and then wait for the price to fall. That's when you buy them in the market and return them to the party from which you borrowed them.

You'd have made money on the downside simply through adding another dimension to your investment profile. This is the gist of securities lending and borrowing (SLB).

In 1998, the industry was worth R6 billion; today its value is R80 billion, of which R60 billion comprises equities and R20 billion bonds.

Ten years ago several corporations were issuing convertible bonds, thereby encouraging an inflow of funds into the country.

The overseas borrower could buy those bonds and later convert them into equities for a platform to buy them at a reduced price in the future. If the shares were trading at above the notional future price, they'd borrow the shares and sell them now, thereby locking in their profit – a process called convertible bond arbitrage.

It's human instinct to want the market to go up. Yet borrowers borrow for only one reason – to sell; hence the antagonism toward SLB.

The critics failed to understand that when an investor borrows a particular share to sell, he buys another, because it is too risky to expose oneself to just one side of the market.

If we buy SAB at R130, our maximum loss is R130 a share. If, however, we sold borrowed SAB shares because we thought they were too high, we could lose infinity if the share kept going up. This is called a naked short.

What usually happens is that investors sell SAB if they think SAB is overvalued and buy, say, Bidvest, thereby hedging their position. Crucially, hedging is not a gambling activity; a naked short is.

In 1997-98, SLB was blamed for JSE's mini-crash. To lay that ghost to rest, independent researched found that the then R6 billion worth of lending equated to as much as 0,40% of the JSE's liquidity and only 0,7 of 1% of the market capitalisation.

In 2000, settlement and custody evolved from a paper to an electronic environment. The SLB model designed for the STRATE environment went live in August 2001.

Since then, and as a result of STRATE, there has never been a failed trade in the market.

In the paper environment, people could sell stock they never had – and could keep rolling that position. Under STRATE, stock must be produced five business days after the sale (T+5).

STRATE also helped the industry in eliminating the many borrows for failed trades. .

Electronic settlement and the absence of failed trades have manifestly given SLB and, in turn, market liquidity, a considerable boost, as has foreign SLB activity in our market, since in the old paper environment foreign investors were loath to invest in a market where failed trades frequently occurred.

For further information please contact:

Tanya Knowles, Head of Marketing and HR
Telephone: +27 (0)11 759 5317, E-mail: tanyak@strate.co.za