



Alquity Africa Fund

Duncan Goose, Founder of The One Foundation, talks to David McIlroy, Fund Manager

The fund is an absolute return fund; does that mean it is a hedge fund?

No. The two main characteristics of hedge funds are that they borrow money to increase their market exposure (and risk) and in addition also usually sell stocks short, meaning they sell stocks they don't own. The Alquity Africa fund will not borrow and will not short stocks.

The Alquity Africa fund will be a relatively straightforward investment fund. It will invest in equities or bonds with the aim of generating attractive absolute returns rather than trying to match or outperform a particular benchmark index. The aim therefore is for absolute returns rather than returns relative to an index.

Why should I invest in Africa?

As a general rule the best investment opportunities exist where there are major differences between perception and reality. This is especially true for Africa where investor perceptions are dominated by images of disease and famine or civil wars and conflict. Clearly these problems are real and are major issues in some countries but the African continent is about much more than this.

Africa comprises fifty three countries and is arguably the most diverse of any continent, containing as it does, countries with a range of land and resources, political freedom, levels of economic development and wealth. The truth is that there are some countries in Africa which don't currently look attractive as investment destinations and may not be attractive for the foreseeable future. However that should not colour the outlook for the continent as a whole. There are states in India or indeed provinces of China which don't look too promising at the moment either but this does not spoil the overall investment case for either of these countries.

Give me some idea about the investment potential of Africa

The attribute that most people will be familiar with in terms of Africa is commodities. Africa's mineral wealth puts it among the world's richest continents with significant deposits of a range of commodities including platinum, gold, copper and oil, making Africa a prime beneficiary of China's voracious appetite for resources. This is illustrated by the explosion in the growth of trade between China and Africa which has increased tenfold since 2001 to over US\$100bn in 2008. If you are bullish about China's growth then it is hard also not to be bullish about Africa's.



Land and resources aside, Africa's major asset is arguably its people. The continent has a combined population approaching one billion and, unlike the developed world, a large proportion of these people are of working age making Africa the youngest continent in terms of age structure. Although much of the population remains very poor perhaps the most significant development taking place in Africa today is the growth in the emerging consumer class. The growing wealth is illustrated by the explosion of mobile telephony throughout the continent with Africa estimated to now have as much as five hundred million mobile telephone users.

This increase in wealth has not gone unnoticed by the world's leading multinationals such as Coca-Cola, Unilever and Guinness developing significant and very profitable operations throughout the continent. For example, today more Guinness is consumed in Nigeria than in Ireland making Nigeria the second largest market in the world, after the UK, for the Irish stout.

Isn't Africa a risky place to invest?

There is no denying that investing in emerging markets, including Africa, has tended to be riskier than investing in developed markets in terms of the volatility of returns. This simply means that the upswings and downturns tend to be larger in emerging markets compared to those in more developed markets. It is important however to put this in some perspective.

The economic crisis, which largely grew out developed markets, is, I believe, leading to a re-appraisal of risk in terms of developing markets as opposed to developed. For example a couple of years ago if you had a portfolio consisting largely of UK or US banks and property stocks that would have been considered a relatively low risk portfolio but this obviously proved not to be the case.

In addition, at the risk of sounding clichéd, volatility is opportunity. If a long term approach is taken then you can use volatility to your advantage by selling when a particular market is excessively optimistic and buying when a market is excessively pessimistic. Volatility is only a problem if you are forced to be a seller during a market downturn which, if you are a long term investor, shouldn't be the case.

How do you manage risk at the portfolio level?

Firstly the fund will be run without the use of borrowing thus removing a major source of volatility present in many funds. Meanwhile, at the overall portfolio level, positions will be tracked to ensure no individual stock exceeds 10% of the fund. Furthermore to ensure prudent diversification, sector and country exposures are also closely monitored although no formal sector or country limits are set



What about the risk of currency depreciation?

Emerging markets have a long and chequered history of debt defaults and/or currency devaluations including Mexico in 1994, Asia in 1997, Russia in 1998 and in Zimbabwe over the past few years. This often gives investors the erroneous impression that emerging market currencies are chronically weak.

Within the African continent, the five main countries from an investment point of view are; South Africa, Egypt, Morocco, Nigeria and Kenya. If we look at performance of their respective currencies against the US dollar over the past six years we see that three, South Africa, Morocco and Kenya have actually appreciated against the dollar, by approximately 16%, 34% and 4% respectively. In addition, while the currencies of the remaining two countries, Nigeria and Egypt both depreciated by around 16% against the US dollar, this was dwarfed by the advance in both markets over the period. This meant that the cumulative return over the past six years in US dollar terms, was approximately 50% for Nigeria and a massive 790% for Egypt.

Can you describe your investment style?

I would describe my investment style as fairly pragmatic; I tend to steer clear of labels like growth or value as it implies an overly narrow focus in that a growth investor is only interested in growth to the exclusion of everything else. The overriding factor is that the outlook is unapologetically long-term and the holding period for stocks in the portfolio is expected to be in years rather than weeks.

Conceptually I also try to keep things relatively simple. The intention is to invest in countries where the macroeconomic outlook is stable and/or improving, in sectors which have attractive growth prospects and in well-managed companies trading at a reasonable valuation.

How do you go about selecting stocks?

The goal is to invest in growing African businesses that offer investors outstanding financial value, whilst also addressing the challenges of sustainability. The investment team has freedom to invest across sectors and geographies and the portfolio is unconstrained and is deliberately focused. The investment process is orientated towards bottom-up stock selection based on a fundamental analysis of companies, underpinned by a strong valuation discipline and overlaid by sector and country analysis.

I place particular emphasis on identifying companies that have sustainable business models that are able to maximize financial returns to the investor over the long term. This means analysing the operations of companies to ensure that they are not based on a short term exploitation of new markets or resources. Sustainable investment features are integrated into the investment process at various stages and done in partnership with the Riskmetrics Group, a leading risk management and corporate governance specialist.



The process starts with an investment theme. As an example increasing consumer wealth should feed through to an increased demand for banking services. The next step would be to consider each of the listed banks in the country on a range of criteria. In terms of the selection process, I try to take a common sense approach. I look for banks which are proper banks and generate the majority of their earnings from lending money rather than stockmarket trading or investing in Government Bonds. I look for a well diversified loan book with healthy growth prospects but where the bank is not being overly aggressive in terms of the proportion of their deposits lent out. I would also look for good asset quality in terms of the bad debt ratio and a generous level of provisions for any doubtful loans. Finally, I am looking for all of this at a reasonable valuation multiple.

Don't socially responsible funds tend to underperform because they have a restricted universe of stocks?

No. Socially Responsible Investing (SRI) has moved on from the early days of negative screening when a stock was simply excluded on ethical grounds. There is a growing view among investment professionals that environmental, social and corporate governance (ESG) issues can affect the performance of investment portfolios and the majority of studies have shown that integrating sustainable investment into the investment process can actually have a positive effect on performance.

For this reason we, along with a growing number leading investment groups globally, such as CALPERS (California Public Employees Retirement System), the world's largest pension fund, are proud to be a signatory of the United Nations Principles for Responsible Investment.

How will you promote economic development and job creation?

The fund management company, Alquity Investment Management, will donate 25% of its annual management fee and 25% of any performance fee earned to fund micro-enterprise projects throughout Africa. This will be done in conjunction with the One Foundation, a leading UK charity specializing in development projects in rural communities in Africa. It should be noted that this donation will be coming from the revenue of the fund management company and will therefore have no impact on the performance of the fund itself.