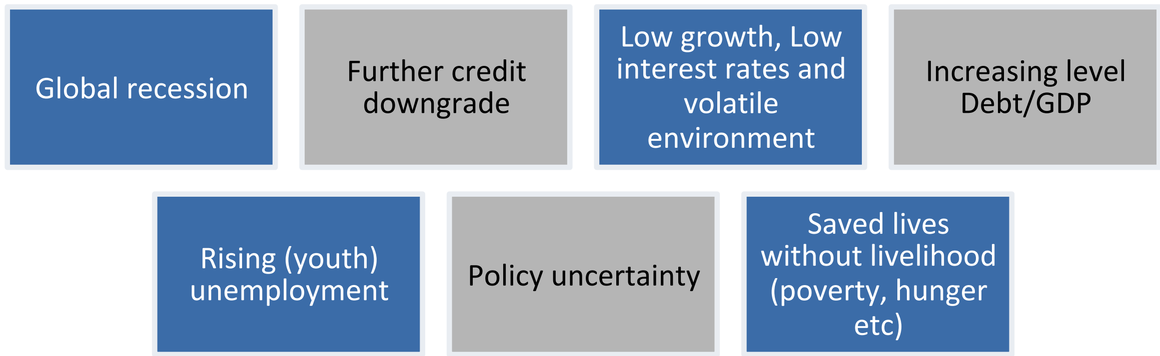
# AFROLOGUE Insight

REGIVE CAPITAL

OUR PURPOSE. OUR PEOPLE. OUR AFRICA.

## Is your investment strategy tuned-up?

Nov 2020




"Unemployment is like a headache or a high temperature – unpleasant and exhausting but not carrying in itself any explanation of its cause." – **William Beveridge**

**INTRODUCTION**

Since late last year, we have been sharing these concerning developments (refer to the blocks above) that are now materialising and may have huge impact on many investment strategies of institutional clients going forward if not finely tuned. One event that is keeping investors awake at night is the recent United States presidential election outcome where President Donald Trump refuses to concede to Mr. Joe Biden citing irregularity and vote rigging. This is unprecedented turn of events in a country such as the US, which has been deemed a model of democracy. If the farce goes unchecked and not speedily resolved, it will heighten global risk and market volatility. The same should be said about some of the developments in other African countries that have gone or are going through election campaigns; we strongly condemn tortures, killings and arresting of journalists in these countries. Lack of peace and instability will erode investor confidence in these countries.

COVID-19 pandemic not only taking lives, but continue to threaten the livelihood of the survivors when they loose jobs and/or go hungry. South Africa has reported yet another staggering unemployment rate of 30,8% in the third quarter of 2020. The number of unemployed people rose by 2,2 million to 6,5 million, with more people searching for work amid the easing of lockdown restrictions. It is well known that majority of South Africans are not saving enough and the only form of saving is through retirement funds which proven to be a large source of capital that has build industries that continues to pay taxes to the fiscus. However this source of capital is being eroded as more businesses shut down (and/or being restructured) and people in turn loosing jobs. Until the government, retirement funds and corporates take an intentional decision to address this unemployment issue; the livelihood of the people will come under threat with high level of inequality, poverty, hunger and many other consequential effects. Prolonged unemployment is a tragedy of broken lives, broken families and foreclosed homes. A mission related and a conscious capital must be directed through private market investments in order to safeguard the current and create new jobs, and this should not be done at the cost of investments returns.

On Friday the 20th November 2020, South Africans went to bed in a country that has been downgraded by both Fitch and Moody's rating agencies further into junk status. The reasons cited by these agencies such as high level of debt/gdp, unemployment rate, low growth environment, failing SOEs etc., may have been exacerbated by the pandemic but are not new. The response by parties concerned seems to be "wishy-washy" and lacks no urgency. There are very few countries in the world that have come out of junk status within a very short period and South Africa face a monumental task to return to an investable grade. A junk status will make it difficult for South Africa to borrow and/or service some of its debt thus increasing a chance of default in its debt obligation. Such outcomes will have aggravating impact to investors such as retirement funds.

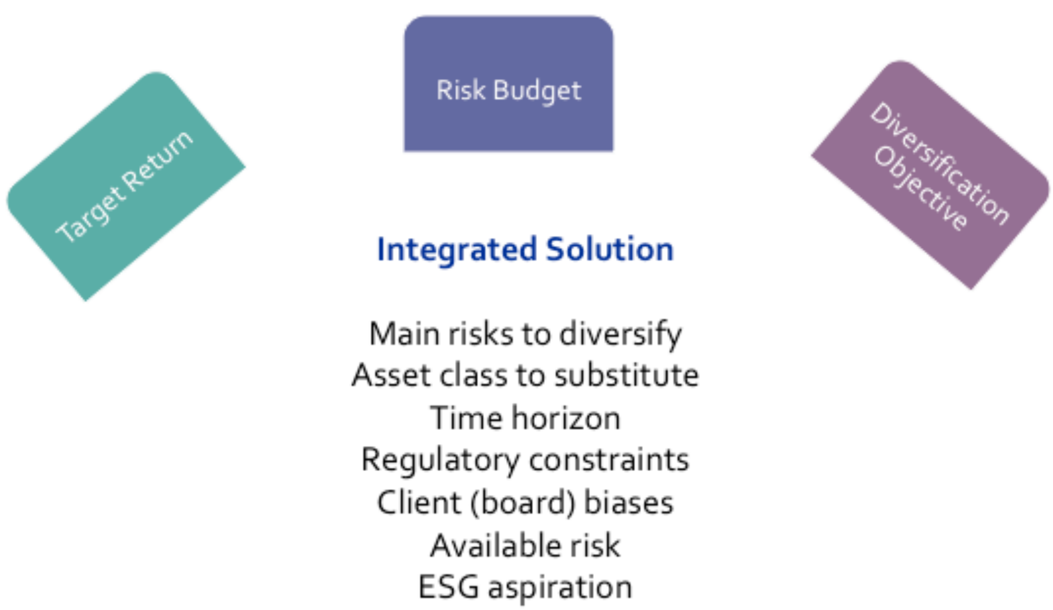
In addition to what has been highlighted above, major traditional asset classes have been giving investors negative real returns in the last 5 years or so. Members of the retirement funds are being retrenched and/or retiring when the market has dropped significantly thus locking these losses with lower pension money to take home. Investors are in unprecedented market conditions of low growth, low interest rates and heightened volatility. The fundamental question should then be asked of their investment strategy – is it tuned-up for these markets? Shouldn't they look at other alternative source of returns? Is their Environmental Social and Governance (ESG) policy relevant to the current dynamics?

“The duties of a board shall be to obtain expert advice on matters where board members may lack sufficient expertise” – **Pensions Fund Act, Section 7D (e)**

Board of Trustees together with their investment (sub)committees with the help of their advisors should really take a closer look at their investment strategy so gauge if it is really positioned to weather this storm. The strategy must be tuned in the following areas:

- **Diversification** – this is the first line of defense and alternative investments must be considered if not currently included. Institutional investors must do a dipstick analysis on their employed balanced funds and/or other multi-asset such as absolute returns to see if they have any exposure to alternatives.
- **Liquidity** – liquid alternatives such as hedge funds and open-end structures such as unlisted debt funds should be a consideration to Define Contribution funds and/or funds comprising of members closer to retirement. Defined Benefit funds, funds with younger members and/or investors looking for particular impact outcomes should consider private equity funds in addition to the liquid alternatives. A biggest test for liquidity is when you cannot access your investment or being forced to sell an asset at an undesired price to meet an obligation (liability).
- **Protection** – Structured products and/or any investments that protect the downside may be considered by cautions investors looking to deploy their capital in the market with some level of capital protection, return guarantee and/or market participation irrespective of the market conditions. This is also suitable for retirement funds of which their members are linked to a limited term in office that may not have a liberty to see market recover over a long-term.

Below is an illustration of a tuned-up strategy that integrates many factors to foster resilience in portfolios:



**Main risks to diversify**

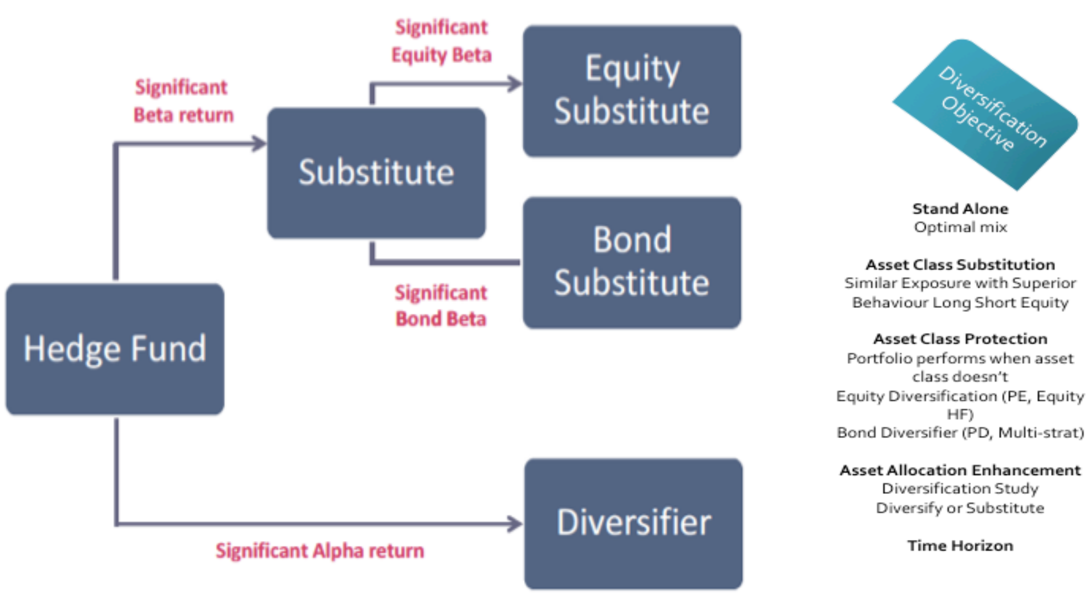
Growth is hard to come-by in South Africa in as far as listed equity investing in concerned. The earlier hard lockdown restrictions attempting to safe lives have had a material impact that will take a while to recover from as we see more companies delisting (or intending to) from the exchange. Furthermore, we have seen some of these companies being mismanaged and falling short on corporate governance matters, thus negatively impacting share prices. In every dark cloud there is a silver lining, and currently the silver lining is found in the unlisted equity investing where new industries are to be birthed. Furthermore good actively managed funds (such as equity hedge funds) should be considered. Hedge funds offer investors a more flexible approach to equity investing than traditional equity unit trusts. We believe that equity climate, specifically in SA, requires more agile approach to investing.

South African investors have been enjoyed above average yields, which also attracted global investors in our local bonds. However recent events and risks cited by the rating agencies, coupled with the cutting of the interest rate by the SA Reserve Bank in a curb for COVID19 impact has reduced our yields significantly. It is for these reasons that investors should start looking at alternative high yielding investments such as debt funds (listed and/or unlisted) and mezzanine funds. The advantage of debt funds is the predictability of cashflows (and/or returns) as compared to private equity funds. Other hedge funds within the fixed income space can also take advantage of the dislocated market opportunities and in the movement of the yield curve. It should be noted though that the ability for the issuer to pay debts in the current market condition could be severely compromised.

Flexible income funds are the best options to look at if one is investing for income. Structured products can be considered particularly if the investment is for a fixed term with predictable risk return profile.

**Asset classes to Substitute**

Below is the graphic illustration of how other alternatives such as hedge funds are allocated to traditional asset classes. We view alternative investments not necessary as separate asset classes but different investment strategies within the broader definition of an asset class. There are also investment strategies that do not look at the fair valuation of the listed stock prices to invest such as commodity trading advisors (CTAs), and they called diversifiers. Strategies that take into account fair valuation of stocks can be substituted interchangeably depending on whether one is in a bear, bull and/or volatile market. Private market funds are allocated as substitutes or asset class protectors.



## Our Vision

To be a leading investment platform of our clients' long-term capital, while providing modern financial tools, intellectual and human capital to solve some of the challenges faced by our clients and Africa today and in future.

**Time horizon**

Institutional clients are long-term investors; however there must be a balance between long-term and short-term focused strategies that are able to capture returns in all market conditions. The benefit of the long-term investment is usually the accumulation of good returns over time. Time horizon is equally important in determining the liquidity profile of any investment strategy.

**Regulatory constraints**

Investors should always be cognisant of the structures fund managers use to avoid breaching any regulatory constraints. The usage of combination of multi-asset portfolios is common threat to regulatory breaches because trustees have no control asset allocation decided by fund managers. There are some multi-strategy (and/or multi-asset) funds that may have exposure to alternative investments and such information should be considered before one invests in a specialist alternative funds.

For an example, a segregated balance fund may invest in multiple hedge funds and a look through will be applicable to ascertain that each hedge fund allocation is below 2.5% and their combination is less than 10% of the overall retirement fund, as per Regulation 28 prudential guidelines. However a look through is not applicable for Fund of Hedge Funds to check if there is any breach on the underlying single hedge funds. The same is applicable to investments in private equity funds. It should be noted that currently multi-asset unit trust funds are not allowed to invest in hedge funds even though hedge funds are classified and regulated as unit trust.

**Avoid client biases**

Biases usually happen when investors give preference to particular service providers, usually after having a long-term relationship with such providers. It can easily be tested when the same service provider like asset manager having multiple portfolios from one retirement fund. Unfortunately this can also create irrationality on the board of trustees' side, considering that not all asset managers are good at all things thus a need to appoint specialists and diversify to other asset managers and/or service providers.

The same can be said when there is fallout with particular service providers, usually after bad performance or consistent bad service received from such service providers that compel trustees not to appoint them. Such negative biases are retained due to trustees and/or principal officers having been in these funds for a while or if such bad experience is widely published and having reached court of law or involving the regulator such as the FSCA. These biases should also form basis of fine-tuning the investment strategy of a retirement fund particularly around manager research and strategy selection.

**Available risks**

No investing is without risks and below is the amalgamation of such risks that remain in the portfolio and to be consistently monitored:

- Investment risk;
- Liquidity risk;
- Operational risk;
- Organisational risks.

**ESG aspiration**

There are many avenues that investors can explore in incorporating ESG aspirations in their investment strategy. It can be an extension of an existing ESG policy or guidelines taken from available structures such as United Nations Principle of Responsible Investing (UN PRI), Code for Responsible Investing in SA (CRISA), UN Sustainable Development Goals (UN SDGs) etc. However there are standard and easy to follow principles to incorporate and measure such as good corporate governance, voting rights disclosure and transformation. Service providers should represent demographics of the country in as far as the ownership and management; and transformation must be intentional, direct and measurable. These service providers should demonstrate a cultures of tolerance, acceptance and equal opportunity for all – more so to people who have been previously disadvantaged such as black people and females.

In as far as saving livelihoods of the people who are loosing jobs and going to pension, with some having to move out of the cities to rural areas and townships with their cash-out pensions – we can draw lessons and ask some hard questions from there:

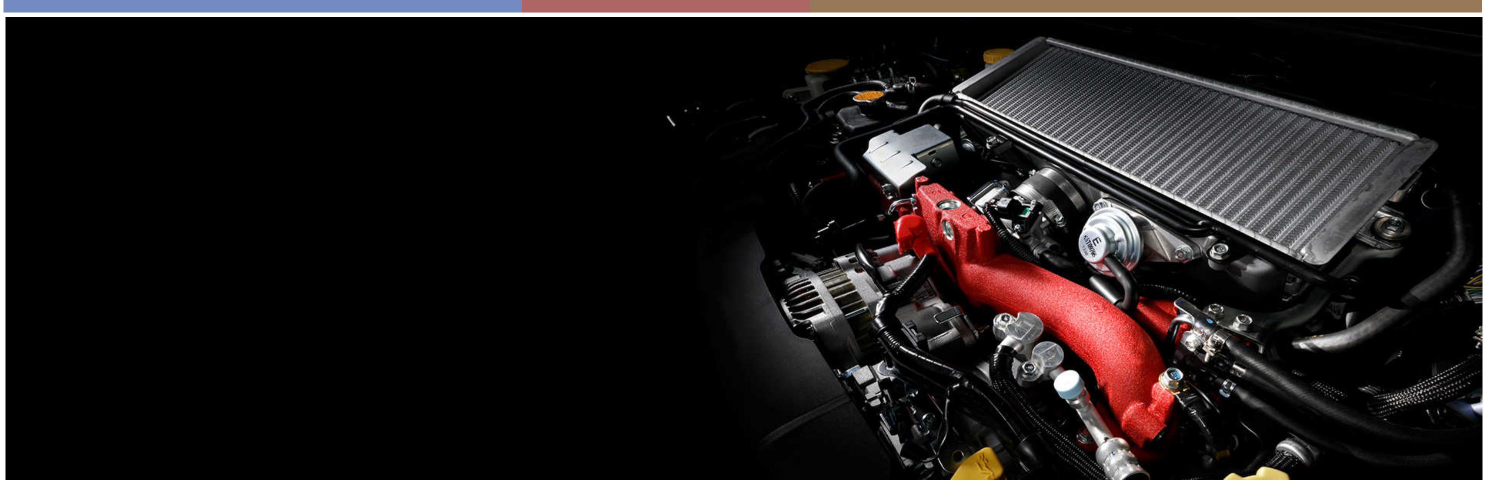
- Has the retirement fund that they belonged to invested in those townships and rural economies and/or infrastructure?
- In case of retrenched members, have they acquired skills that are transfereble and ready to be used when such places are developed?

Employment and Labour Ministry should make available list of retrenched members in their regional offices, which can be accessed by companies willing to invest in such regions to access potentially skilled and/or experienced employees. Members should also through the board of trustees be given an opportunity to recommend projects that may be beneficial to preserving and creating new jobs in their sector or related sector. However this must be done in a well-structured and transparent way to avoid corruption and conflict of interests. Ultimately retirement funds should make decisions at the best interest of its members to retire anywhere comfortably, and also create an opportunity for others to benefit even when they are no longer members of these funds. Thus doing good while doing well.

**CONCLUSION**

Institutional clients such as retirement funds have a responsibility and duty of care in how their investments strategy is crafted and implemented. The after effects of the COVID19 pandemic are to be with us for a while and trustees should be proactive in managing these challenges. The government has played its part by creating a tax incentive for members saving for retirements. The reason there is such a huge interest to retirement funds at the moment including a discussion around prescribed assets, is because these funds command such a huge pool of capital that is also locked in stock exchanges and bonds. There is no need for prescribed assets at all, as investments into high impact alternatives (listed or unlisted) should still give everyone the desired outcome in the most balanced and structured way. However trustees should cautiously tune-up their investment strategy as there are no readily, frequently and comparable returns with the conventional investments, particularly in private markets.

In cases where investors are not confident to investing in alternative investments, specialists should be called up to educate trustees in order for them to make informed decisions. Some of these investments are long term in nature, not easy to unwind and if proper care is not exercised; future generation of trustees will be left with a mess to clean. It is far better for trustees to rely on evidence of sustainable skill than chase historic returns that no longer exists in traditional asset classes.



"Design is a funny word. Some people think design means how it looks. But of course, if you dig deeper, it's really how it works " – **Steve Jobs**

**ABSOLUTE RETURN**

We offer market uncorrelated SA Absolute return fund of funds on pooled and segregated basis. Additionally we offer traditional multimanager services across all asset classes and strategies.

Target return: Cash + 4% p.a. over rolling 3 years

Liquidity: 30 days

**PRIVATE EQUITY**

We offer pooled SA and Pan Africa private equity fund of funds solutions to institutional clients denominated in ZAR and/or USD. These portfolios invest in diversified private equity fund with a regional focus.

Target return: CPI + 10% over rolling 5 years

Liquidity: limited, subjected to the underlying manager terms

**PRIVATE DEBT**

We offer pooled SA and Pan Africa private debt (including mezzanine) fund of funds solutions to institutional clients denominated in ZAR and/or USD. These portfolios invest in diversified private debt funds with a regional focus.

Target return: CPI + 7% over rolling 5 years

Liquidity: limited, subjected to the underlying manager terms

**STRUCTURED SOLUTIONS**

We create bespoke structured solutions for our clients to enhance returns and/or hedge out any risk possible, i.e. currency hedging in some of our private market solutions.

Target return: variable  (normally linked to some index/basket of shares)

Liquidity: Fixed for a period

Please reach out to our team to discuss options available to implement your fund's investment strategy.

## TRUSTEE EDUCATION

REGIVE Capital takes trustee education serious. The financial services industry is a dynamically changing environment; hence it is critical that our clients are kept informed of any developments to ensure that they make informed decisions. We facilitate trustee education in the following ways:

- We provide on-site training on topics such as: alternative investments, investing in Africa, private equity, private debt, hedge funds, pension fund reforms, asset liability modeling, transformation and manager incubation programs. Where necessary, the industry expert and policy makers are invited where necessary.
- Our "AFROLOGUE Insight" newsletter that deals with African socio-economic matters that are current such as new investment products, changes in regulation, major development in the African continent, views from experts etc.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