SUSTAINABLE ALPHA

Market conditions over the past two years have provided high volatility and commensurately good opportunities for patient stock pickers in Africa to benefit from irrational market prices

BY GREG BARKER, HEAD OF RESEARCH, SUSTAINABLE CAPITAL

Sustainable Capital continues to encounter compelling valuations and meaningful opportunities to generate stock-specific alpha. The firm's flagship Africa Alpha Fund has returned 45.3% (USD total returns, net of trading costs) since its inception in February 2012, an outperformance of 26.9% over the S&P Pan-Africa ex-SA index, which closely matches the fund's investment opportunity set of Africa ex-SA dominant companies.

Most of this outperformance (23.2%, or 86% of total alpha) is attributable purely to stock selection, which is the component of outperformance that Sustainable Capital believes it can replicate over long-term time horizons through diligent research and a disciplined investment process in Africa's imperfect information environment.

The Africa Alpha Fund is a concentrated, long-only equity portfolio of 15-25 stocks. The investment process is driven by fundamental, bottom-up research conducted on the ground in African countries. Stock selection and buy-sell discipline is led by a valuation-driven investment process using a 'fair value' methodology, which leads to investments in companies where the team encounters the greatest discounts to fair value, providing a wide margin of safety.

Portfolio construction is company-focused and entirely agnostic to country, industry and benchmark exposure, although at a portfolio management level, exposure to any single risk factor is limited to 35% of the fund (for example, a particular geography, industry or commodity). Despite the long-term research outlook underlying the fund's valuations (a 5-10 year view), the investment team is able to take advantage of perceived short-term mispricings, which emerge when cycles of irrational exuberance and short-term pessimism become reflected in listed equity prices. Valuations and investment decision-making are led by in-house research with a strong emphasis on downside risk protection.

Downside Risk

Sustainable Capital's philosophy is that downside investment risk in African equity markets stems from the combination of 'not knowing what you are doing' (not knowing enough about the companies that you are investing in) and the price paid for a stock. The team mitigates the risk of poor company knowledge through detailed research and due diligence. The risk of overpaying is best managed through a disciplined valuation process. The Alpha Fund's high concentration necessitates a strong investment discipline, as each position demands the level of detailed research that leads to high-conviction investment decisions.

This philosophy is reflected in the fund's risk-adjusted performance to date (with a portfolio beta of 0.8 and a Sortino ratio of 3.1). From a pan-African asset allocator's perspective, the fund has a relatively low correlation to the Africa ex-SA benchmark of 0.60, providing a diversification benefit in a portfolio context. In terms of liquidity risk, the fund has been managed since its inception on the basis of a $250m portfolio size (although it currently stands at only $20m), with clear liquidity exposure limits leading to an underlying portfolio-weighted average market capitalisation of $3.3bn. This implies that the fund has not been generating the core of its performance from illiquid small- or micro-cap stocks in which it would no longer be able to participate as the fund grows in size.

Owner-manager culture

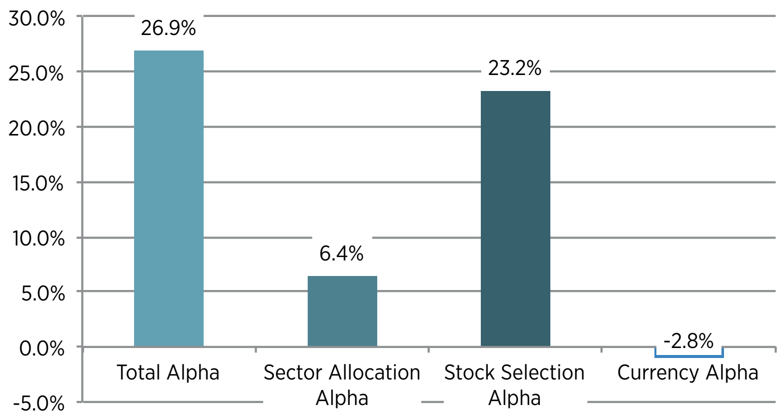
History has taught us that the single biggest threat to a fund investor's returns in performance-orientated asset managers is high turnover of key people within the senior investment team. Team stability is particularly important in 'imperfect information markets' such as Africa ex-SA, where intimate company knowledge is a core part of an asset manager's intellectual capital advantage and research edge. Sustainable Capital's owner-manager culture plays an important role in allowing its people to take a long-term perspective, with no turnover of full-time employees since the firm's inception over five years ago.

The Africa Alpha Fund's returns are ultimately driven by the quality of fundamental research that informs our valuations and portfolio construction. In this respect, we believe that the quality of information that we derive from management interviews, stakeholder research, operational due diligence and financial analysis is enhanced by having local knowledge and experienced first-language speakers in Arabic, French and English within our senior investment team.

As a boutique asset manager, Sustainable Capital has no commercial pressure to gather assets beyond the level that is optimal for our fund investors. The Africa Alpha Fund will be capped at a level that allows us to sustain outperformance by seeking out exceptional investment opportunities, including small- and medium-sized companies. Under current market conditions, the fund would be capped at $300m. It is a mathematical certainty that the ability to generate stock-specific alpha is progressively eroded as fund size grows beyond these levels (in a dynamic, actively managed Africa ex-SA fund with a similar investment process). This is confirmed by a simple analysis of the investable universe of 850 Africa-dominant companies. As the starting point for the investment process of the Africa Alpha Fund, this universe is reduced to 250-300 stocks based on liquidity parameters such as free float market cap and tradability. Each stock is rated according to how many days it would take to exit 50% of a position if we took 30% of the daily market volume based on our target fund size.

These controls allow the fund to remain sufficiently nimble to take full advantage of market inefficiencies. For example, the fund has reduced its exposure to Egyptian equities from a peak of 34% in 2012 (a year in which that market returned 51% in USD terms) to less than 18% currently, most of which is in local currency hedges. Investments in commercial banks have declined from 35% of the fund in September 2012 to 20% currently, with high-quality insurance and resource companies growing from 4% to over 25% of the fund over a similar period.

AFRICA ALPHA FUND: ALPHA ATTRIBUTION
Source: Sustainable Capital



Sustainable investment

We incorporate environmental, social and governance factors into investment management practices with the conviction that they will have a material effect on the long-term financial performance of companies and, ultimately, on shareholder value. Some would argue that 'sustainable investment' simply amounts to the forgotten art of true long-term investing. They would be mostly correct. However, we see clear evidence that these long-term factors are materially mispriced in African equity markets.

For example, we have seen real estate companies with contaminated groundwater liabilities equivalent over 50% of their market values, resource companies where the 30-year geological mine life has been rendered irrelevant by the lack of ethical backbone in the management team (with subsequent loss of the company's title), industrial manufacturers where poor labour practices and subsidised energy costs have later unwound in material cash cost escalations and margin compression and commercial banks where differences in the quality of corporate governance have been chronically mispriced.

We integrate these long-term factors into our estimate of fair value for each company, and thereby into our portfolio construction, an approach that we see as mutually inclusive with long-term investment outperformance. This 'integration approach' should not be confused with simple negative screening, which often detracts from long-term sustainability outcomes through unintended negative impacts on stakeholders (including investors). In selected cases where significant value can be unlocked by addressing material sustainability risks and opportunities, we enter into collaborative, constructive engagement with companies in which the fund holds material positions.

Discounts to fair value in some of the fund's early investments have narrowed, which has led to profit taking in these counters. Fortunately, there is no shortage of excellent investment opportunities in African companies where discounts have widened over the same period.