Ai Emerging Managers Forum Report: The Business of Africa-US Emerging Manager Partnerships

africainvestor

The Business of US-Africa Emerging Manager Partnerships

special report

The Ai Emerging Managers Forum (AiEMF), is a unique international platform for emerging managers and investment leaders, to share industry best practice, improve governance standards and assist African and US asset owners connect with and support emerging managers through their international allocations and knowledge networks.

The AiEMF is a response to the growing demand from asset owners in Africa and the US to extend their programs and best practice, to support and engage emerging managers– especially local African emerging managers that can handle US international allocations and American emerging managers that can handle African international allocations

The AiEMF was inspired by and builds on the work of the Ai Sovereign Wealth and Pension Fund Leaders Forum, which brings together Africa's leading and largest asset owners, to engage with global asset owners and development finance partners on co-investments and institutional investment trends in Africa.

Increasing returns, access, and capital market liquidity in Africa

THROUGH FACILITATED US ALLOCATIONS TO AFRICAN EMERGING FUND MANAGERS

Wilmot Allen and The Africa investor Academy Report

Capital markets play a critical role in economic development by pooling domestic savings and mobilizing foreign capital for investment. Most of Sub-Saharan Africa's capital markets remain largely nascent, with low equity and bond activity across many markets.

This is driven by few listings, small ticket sizes, limited secondary activity, and a low level of savings to encourage investments. This report argues for a focus on coordination in regulatory policy, diversification of financial products and capacity building of Africa asset managers as key initiatives for supporting capital markets development in Africa. While these recommendations are part of the common currency of ideas on this topic, the proposal for the way to achieve these objectives represents a new approach: linking African and US emerging fund managers as partners.

As a structure, this report presents: i) a brief overview of recent insights regarding capital markets development and supporting international efforts focusing on Africa ; ii) summary of the profile of US and Africa emerging fund managers and the business environment in which they operate; iii) the opportunity set for an international emerging fund manager partnership; iv) an initial plan for structuring a US-Africa emerging fund managers program.

THEORY AND BEST PRACTICE FOR CAPITAL MARKETS DEVELOPMENT INVOLVE ALIGNMENT AMONG REGULATORY POLICY, INFRASTRUCTURE, DIVERSIFIED PRODUCTS AND EFFECTIVE INTERMEDIARIES

Several recent reports provide helpful insights on capital markets development strategies applicable to Africa. In a special report presented in 2016, the World Economic Forum highlighted factors such as a strong legal and regulatory framework, ensuring existence of suitable investment products, diversification of the investor base as well as education of investors and issuers. The McKinsey 2017 report on "*Deepening Capital Markets in Emerging Economies*" emphasized the infrastructure of capital markets in asserting a focus on strong institutions, transparent rule with effective enforcement and linking taxation policies with development goals. The Milken Institute in its 2017 "Capital Markets in East Africa Report" support strategies focusing on cultivating more buy side engagement among African local and regional institutional investors.

Various donors and multilaterals are playing an active and vital role to deepen, strengthen and enhance the offerings in capital markets across Africa. In 2012, the International Finance Corporation created the Next 50 Fund to facilitate more institutional investment into emerging and frontier markets which receive proportionally less in portfolio inflows, including Sub-Saharan Africa, and offered structured advisory support for market infrastructure development. FSD Africa, sponsored by the Department for International Development (DFID), provides resources to address market failures in Sub-Saharan

Africa. The African Securities Exchanges Association (ASEA) and the African Development Bank (AfDB) established the African Exchanges Linkage Project (AELP) to improve liquidity and information on African Capital Markets. Building on these initiatives and achieving strong returns will require even more significant investment in the infrastructure and capacity development of the fund managers.

Emerging fund managers in the U.S. can support these efforts.

US EMERGING FUND MANAGERS OFFER DIVERSIFICATION AND NICHE INVESTMENT FOCUS

In U.S., emerging or diverse managers are defined often as asset management firms with less than $2 billion in assets which are controlled by minority and women professionals. According to a 2017 study by the Bella Research Group and Harvard Business School professor Josh Lerner on the state of diversity among asset management firm owners, minorities and women control about 1% of the $71trillion AUM globally. Emerging fund managers or diverse asset managers remain disproportionately less capitalized compared to their majority counterparts: among mutual funds, hedge funds, private equity or real estate trust, minority and women-owned firms manage no more than 5% of assets committed to each individual category. However, the rationale for diversity in the asset management business has evolved from social advocacy to an estimable business case in the U.S., as more best-in-class diverse fund managers are provided an opportunity to manage more capital.

The impetus for Bella Research study was the discovery by the Knight Foundation that the performance of these managers matched or exceeded their traditional returns when the institution decided to increase its allocation to diverse fund manager's from 3% to 22% over a three year period. The Knight Foundation controls $2.2 billion in assets. According to the Knight Foundation CEO Mr. Ibarguen, "not everyone succeeded brilliantly. But our experience convinced us that contrary to conventional wisdom, any investor can pursue diverse management strategies without sacrificing profits." The Knight Foundation achieved this success by carefully selecting diverse managers based upon talent and individual versus firm track records, particularly in cases where the diverse firm ownership was not long. The Bella Group study which the Knight Foundation commissioned concluded that "there is no discernible difference in how diverse and non-diverse funds perform. There is no performance gap to justify the substantial representation gap in fund ownership and management."

The Bella Group report presents trends in number of firms, amount of assets controlled and performance among asset classes of mutual funds, hedge funds, private equity and real estate. **In the mutual fund and hedge fund asset classes, the report highlights the following characteristics of diverse asset owners:**

- **IN THE MUTUAL FUND ASSET CLASS:**
  - o women and minority owned firms represent less 10% of the firms and manage less than 1% of total assets
  - o about 25% of women and 28% of minority owned firms on average have top quartile returns

- **IN HEDGE FUNDS:**
  - o women and minority owned firms represent less 10% of the firms and manage less than 1% of total assets
  - o about 24% of women and 28% of minority owned firms on average have top quartile returns

In the U.S., beginning in 1990s support and funding for emerging fund managers was provided by California Public Employee Retirement System (CalPERS), California State Teachers' Retirement System (CalSTRS) and New York State Common Retirement Fund (NY Common). As a manager of emerging managers, Progress Investment Management has worked successfully to increase allocations to these firms for 17 years.

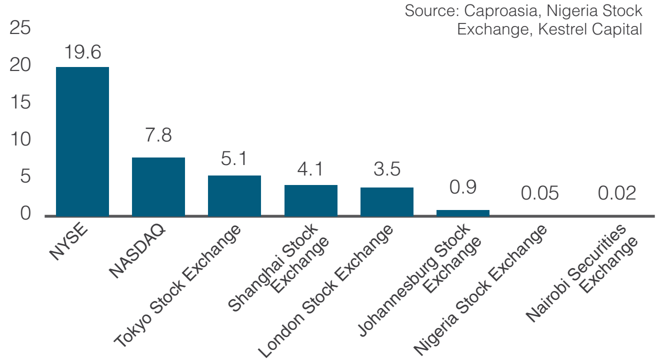
While diverse asset managers in the public markets typically perform on par (or better) with traditional returns across mutual funds, hedge funds, private equity and real estate according to the Bella Group report, they do face several challenges. Blackrock Managing Director, Obie McKenzie, sees a major hurdle for these companies as growing from small to larger asset managers, "at some point emerging fund managers have to emerge". This evolution involves their long term sustainability in receiving more capital to deploy and graduating to invest more capital in more asset classes. For diverse fund managers, their smaller teams and infrastructure can draw out the timeline to meet compliance requirements in some cases compared to larger asset management companies. However, their smaller teams and pool of capital can offer the benefits of flexibility in investment approaches and more direct contact with senior executives. Diverse asset managers in the U.S. often engage the markets as niche investors. This approach and their proven ability to achieve respectable returns makes their potential engagement with Africa intriguing, where there this a need and opportunity to offer more diverse products with a niche focus for the capital markets.

ENGAGING EMERGING FUND MANAGERS IN AFRICA PROVIDES A NEW OPPORTUNITY TO INCREASE YIELD VIA DIVERSIFICATION AND NICHE INVESTMENT FOCUS

As Figure 1 indicates, the market capitalization of security exchanges in Sub-Saharan Africa pales in comparison to those in developed countries. Johannesburg, Nigeria and Nairobi represent the largest exchanges in Sub-Saharan Africa.

Figure 1. Selected Stock Exchanges by Market Cap
(US$ trillion, as of 2016)

Source: Caproasia, Nigeria Stock Exchange, Kestrel Capital



Public market investment typically focuses on listed equities and fixed income securities in Sub-Saharan Africa. Regulation remains a key determinant informing how African fund managers invest across different asset classes, which in part explains why many countries experience a faster growth in assets than a corresponding growth in products. Increasing portfolio allocations to more qualified local asset managers holds promise for broadening the array of financial products and asset classes in Africa. Emerging fund managers or local asset managers could potentially help achieve these outcomes.

Compared to other countries and regions in Sub-Saharan Africa, South Africa has perhaps the best structured emerging manager network. This network was created primarily to redress the underrepresentation of black fund managers as a result of apartheid. Hence, emerging fund managers are characterized chiefly by their black racial-ethnic designation. The Association of Black Security and Investment Professionals (ABSIP) is a longstanding advocate for emerging fund managers and tracks progress in the industry. According to the 2017 BEE.conomics Annual Transformation in South African Asset Management Survey report by 27four Investment Managers, there are 45 black asset managers (black-owned firms), representing 9% of total industry assets.

The study presents other noteworthy facts about emerging fund managers in South Africa and the business environment in which they operate:

- **22** of the black asset management firms are less than five years old and 13 are greater than ten years old
- The number of black asset managers has grown by **221%** since 2009
- The majority of firms have less than **20** institutional investors and so diversification of the client base is still an issue
- Majority of firms manage between **0-5 products**
- **62%** of firms have 5 or fewer clients making up over 80% of their AUM
- **73%** of firms use an external and independent fund administrator, while 89% of the firms use an external compliance officer
- **29%** of the firms have been profitable (NPAT) for three consecutive years
- **18%** of the firms administer ESG mandates
- The three firms with the largest AUM among the **45** participants in the survey include Taquanta Asset Managers, Aluwani Capital Partners and Mazi Asset Management
- According to the Association for Savings and Investment (ASISA), the pool of assets available to private sector asset managers is R4.6 trillion or about **$355 billion** (black firms manage 9%)

Most emerging managers in South Africa invest long only and source from retirement funds which allow little flexibility for investing in alternative assets. An increasing number of managers have an appetite for alternatives such as private equity, infrastructure and hedge funds. These emerging managers typically build their business around a discrete strategy and offer a few select products based upon this focus. South Africa's largest asset manager (R1.8 trillion/$138 billion AUM), the Public Investment Corporation (PIC) has supported black-owned asset managers through allocation of R57 billion/$4.4 billion to 14 firms (PIC 2016 Annual Report).

While South Africa's emerging manager program initiatives is putatively the most advanced in Sub-Saharan Africa, there are other efforts to support and develop local fund managers outside of the region. According to RisCura's Business Development Executive in Africa, Gerald Gondo, Botswana and Namibia are contemporary examples of countries also making progress with structured support for emerging fund managers. These emerging managers include indigenous firms staffed and led by nationals with local and international investment experience being afforded the opportunity to establish their own track record. For example, the Botswana Public Officers Pension Fund (BPOPF) is seeding start up fund managers across all asset classes for investment only in Botswana. Two private equity and one public equity fund manager have been selected. In 2016, the Government Institutions Pension Fund (GIPF) made an investment in Musa Group's Namibia Mid-Cap Fund. In the **increased investment interest** in Africa suggests that the perception of political risk there has improved. However, many of these investors seek **political risk insurance** to become comfortable moving a deal forward

East Africa, broadening the definition of emerging manager to include first time managers, DFIs such as the IFC and CDC have made a significant contribution in funding first time private equity managers, such as Ascent Capital, Kibo Capital, and Catalyst Principal Partners.

AN EFFECTIVE PARTNERSHIP BETWEEN EMERGING FUND MANAGERS IN AFRICA AND US CAN ADDRESS MAJOR GAPS IN CAPITAL MARKETS DEVELOPMENT OVER TIME

A potentially promising approach for capital markets development in Sub-Saharan Africa is linking emerging US and African fund managers to deploy more capital into the region and to facilitate regulatory reform, diversification, and capacity building. Success in these efforts could yield respectable returns, greater access to capital markets in Africa and eventually increase liquidity.

• INVESTMENT FACILITATION OF REGULATORY REFORM

U.S. diverse fund managers are estimated to control $7.1 billion in AUM. The allocation of some of this capital to asset managers investing in public markets or other asset classes can potentially help expedite needed regulatory reforms to encourage more domestic and international investment and increase liquidity. In East Africa, over the last decade, foreign investment has supported the development of improved policies for investing and returning capital. Africa has a lot of progress to make in strengthening the regulatory environment to attract public and private capital. The interdependence of increasing investment and improving the regulatory environment requires that better alignment be achieved.

• INCREASING DIVERSIFICATION WITH NICHE EXPERTISE

Another potential positive consequence of a partnership between US and African emerging managers is increasing diversification of products offered across markets through asset managers who possess or can develop niche strategies. Many factors bear upon launching new products in the market. However, several opportunities merit a real commitment to exploration, including greater investment in infrastructure, REITs, asset-backed securities, commodities and other alternative strategies, such as co-investment with Sovereign Wealth Funds.

Africa50 estimates there is an infrastructure deficit of US$130 billion annually in Africa. Findings from a recent survey by the Milken Institute of 44 institutional investors in four East African Community (EAC) countries—Kenya, Rwanda, Tanzania, and Uganda—indicated that most institutions expressed interest in a regional infrastructure "fund of funds" that would invest in cross-border projects in the region. There are only 32 REITs in Africa with South Africa as the largest REIT market having 27 REITs and Nigeria second with three REITs listed. Asset-backed securities based upon trade receivables and mortgages could address the huge demand for working capital among African SMEs and loans for aspiring homeowners.

Similarly, agriculture is strategic sector which is the leading economic driver in the overall region. Most of Africa's commodity trading is based on agricultural commodities with South Africa leading in this category. Other agricultural commodity exchanges, such as those in Kenya, Nigeria, Ghana, Ivory Coast and Uganda, are underdeveloped. Alternative investments into or with Sovereign Funds is also largely untapped by U.S. emerging manager. African Sovereign Wealth Funds typically invest (e.g. reserves from natural resource wealth) for future savings, market stabilization and domestic economic development. It is estimated that African SWFs now command an asset base of about US$159 billion. Sovereign Wealth Funds such as the Nigeria Sovereign Investment Authority could offer opportunities for co-investment into infrastructure or serve as a client for potential US emerging fund managers.

• CAPACITY BUILDING AND MUTUAL EDUCATION

Capacity building of African managers through support from the US emerging managers and mutual education between emerging managers from both regions could push the needle forward on capital market development. In a Milken Institute survey of East Africa Community of institutional investors, the ability to assess price-volatility risk was cited as area of relative weakness among African institutional fund managers. Gerald Gondo of RisCura observes the importance of effectively structuring an emerging manager partnerships, in stating, "in terms of emerging manager (EM) partnerships, if we can 'twin' a US EM with an African EM, it's important to ensure that they share similar investment philosophies and investment strategies (as a point of departure). These ingredients will be critical to putting together a cogent business model that integrates all of the requisite governance processes and manages local market risks in order to deliver for the asset owner." Any substantive engagement by U.S. emerging managers would require a significant amount of education from their African counterparts on regulation, macro-economic trends, local markets and currency risk in Sub-Saharan Africa.

• THE BIG PICTURE ON INCREASING RETURNS AND LIQUIDITY

Investing in Africa represents a challenging but potentially rewarding opportunity for institutional asset managers because of the risk-return dynamics of the markets. U.S.-based fund manager Alliance Bernstein (AB) has a long history of emerging markets investing over the last 30 years. AB manages $526 billion in assets and has $9.5 billion in equities and $13 billion in fixed income as its dedicated pool for emerging markets.

Christine Phillpotts, Senior Equity Analyst at AB, is a member of the investment team managing equity funds dedicated to frontier markets. In assessing the Africa opportunity, she holds that "although the return volatility of individual African markets can be quite high, the continent as a whole can yield attractive risk-adjusted returns given African markets' low correlation with each other, and with developed and emerging market equities. Indeed, stock market returns across African markets can vary widely. For example, whereas the Nigerian stock market has declined 36% over the last 5 years (in USD terms), the Kenyan stock market is up 56% over the same time horizon."

Given the low base of investors and products, liquidity continues to be a challenge even for more developed capital markets in Africa. IFC recently invested in Britam, a diversified financial services company with headquarters in Kenya. The company is listed on the Nairobi Stock Exchange but, due to limited liquidity, it is estimated that it would take ten months for IFC to exit through the market.

Investors will also have to consider how political risk factors into their Africa strategy. According to Marlena Hurley, OPIC Political Risk Insurance Director, "the increased investment interest in Africa suggests that the perception of political risk there has improved. However, many of these investors seek political risk insurance to become comfortable moving a deal forward". Based upon the current regulatory context, thin capital markets, risks and infrastructure, investing in African requires a longer term view for institutional investors. Those who are patient and commitment could realize significant gains.

A WELL-STRUCTURED EMERGING MANAGERS PROGRAM FOR AFRICA AND US FOCUSES ON BEST PRACTICES AND PROJECTED SOLUTIONS FOR MARKET FAILURE AND NEW OPPORTUNITIES IN AFRICA

Successful emerging fund manager programs and supportive partners already exist in the US and South Africa. Professional associations in the U.S. such as NASP and NAIC have provided outstanding assistance to these fund managers for decades and their member institutions comprise leading diverse-owned firms among asset managers and private equity companies, respectively. ABSIP is well regarded for its work in promoting black fund managers in South Africa to redress imbalances in ownership and capital investment for black security professionals. NASP and USAID are partners in a new enterprise, MIDA, which aims to strengthen the business case for investment into strategic sectors in Africa, primarily infrastructure.

This report proposes a broader collaboration among US diverse-owned firms and African emerging fund managers towards creating structured alliances and a vehicle to support investment collaboration between their constituencies - an International Emerging Fund Managers program. Some of beneficial components of such a program should include: knowledge sharing, two-way investment allocations, capacity building and an investment vehicle.

africainvestor EMERGING MANAGERS FORUM

KNOWLEDGE PLATFORM

- **ONLINE PORTAL FOR ASSET MANAGERS AND RELEVANT STAKEHOLDERS FEATURING**
  - o Database of emerging fund managers in the US and Africa, highlighting specific firms which choose formally to engage in the international partnership as members
  - o Survey of fund managers on investment strategy, available capital to deploy or targeted investment amount, return and yield expectations and track record
  - o Knowledge area presenting capital market updates from leading African and global exchanges, sector trends, updates on relevant regulatory and policy information, and key deals across selected asset classes

TWO-WAY INVESTMENT ALLOCATIONS

- **CURATED MATCHING FOR NEW INVESTMENT OPPORTUNITIES BETWEEN THE U.S. AND AFRICA**
  - o Support in pairing US and Africa fund managers for allocations to Africa
  - o Recommendations of US fund managers to potential client African Sovereign Wealth Funds
  - o Development of partnerships to facilitate investments from African High Net Worth Individuals to US fund managers through African intermediaries

CAPACITY BUILDING AND TRAINING

- **ONLINE TRAINING MODULES AND SPECIAL CONFERENCE EVENTS**
  - o Targeted areas of education and training, particularly with regards to new products to offer in the Africa market
  - o Exploration of short-term executive exchanges for capacity-building and knowledge sharing between fund managers from both regions
- **COLLABORATION AMONG US AND AFRICA EMERGING MANAGER FIRMS, PROFESSIONAL ASSOCIATIONS AND RELEVANT RESEARCH INSTITUTIONS ON CONTENT**

INVESTMENT VEHICLE(S)

- **ASSESSMENT OF POTENTIAL STRUCTURES FOR INVESTMENT VEHICLES/FUNDS TO FACILITATE THE PROPOSED TWO OR ONE-WAY FLOW OF CAPITAL**
- **CONSULTATION WITH POTENTIAL FINANCIAL PARTNERS INCLUDING DFIs AND COMMERCIAL INSTITUTIONAL INVESTORS**

AS 2017-2018 PROGRAMME

Ai ratings

Assessing the Risk of Entrusting Your Capital to an Emerging Manager

A Partnership with South African Pension Funds to Empower Emerging Managers to Attract Greater International & Domestic Allocations

As competition quickly escalates on the mutual fund and investment manager front of emerging markets, Africa investor (Ai), in cooperation with leading South African pension funds, is offering a new catalyst to stimulate international allocations to the local market through an innovative experience of risk rating.

A UNIQUE PILOT PROJECT: The pilot project focuses on a sample of emerging investment managers with great experience, remarkable practices, persistent returns, but yet very few assets under management and little recognition in the continental and international market place. The pilot involves the process of undergoing an Ai Fiduciary Rating; the assessment of enduring practices of investment organisations through a mix of questionnaires, interviews and onsite visits. Unlike most ranking services (Lipper, Morningstar, etc.), Ai's system centres around professional practices more than returns, because practices are likely to be more consistent than performance or return volatility. Once practices are evaluated, according to asset classes and investment strategies, coherence tests are made with performance results. The rating will reflect the link consistence between both factors (practices) and result (performance), regardless of benchmarks or tracking error.

25 INDICATORS: The overall process is based on 25 key indicators, 15 of which focus on governance issues from leadership, compliance and risk control to human resources, technology support, compensation and back to middle office quality management. The remaining 10 outline the reliability of systems, from the investment team and strategy to financial analysis and forecasting, portfolio construction, trading, transaction cost analysis, performance measurement and quality oversight. The outcome generates two rating scores on both governance and systems, helping institutional investors, consultants and financial advisors to tailor their risk and performance appetite with the profile of each portfolio management organization.

BENEFITS FOR THE MARKET: The main advantage for managers is to share the findings of the rating process through an in-house seminar reviewing various strengths and weaknesses of their organisation. For investors or their representatives, the benefits are to gain a standardised approach to the functioning of several organisations and being able to compare them in relationship with their capital accumulation and risk tolerance needs. Since both sides of the market contribute financially to the exercise, it reduces the asymmetry and conflicts of interests that often contaminate standard credit risk rating practices. The general public may also profit freely from the exercise by having access to summary results (the two ratings, size, products and leadership).

SPECIAL FEATURES: The rating is reviewed each year, thus providing continuous tracking to investors (pension funds, life insurers, family offices, corporate treasuries, endowments) and their representatives (financial advisors, brokers, dealers, small collective saving plans, etc.). A standard rating takes approximately three calendar weeks to be completed, once questionnaires are filled by the management firm. Each rating is released and broadcast through Ai's financial media platforms and networks. A management firm has the option of keeping its rating confidential for up to one year, in order to adjust for a public update on the second year. Ai

ABOUT THE AUTHORS

Wilmot Allen is a senior Advisor to the Ai Emerging Managers Forum. He is an experienced emerging market investor, transaction advisor and entrepreneur. Mr. Allen is founder of the Partnership for Urban Innovation which supports alternative financing and value-added resources to scale African S.M.Es. He has previously worked as Director of East Africa with CrossBoundary LLC in Nairobi, with the private equity team at IFC and in M&A Investment Banking at JPMorgan H&Q. He holds an MBA from the Wharton School of Business, MPA from Harvard University and BA from Yale University.

*Research assistance was provided by **Shadrack Nyobii.***

The **Africa investor (Ai) Academy** is Ai's thought leadership platform that exists to help investment leaders and policy makers create networks to facilitate knowledge and partnerships on emerging and underserved issues and industries, and provides a fact base for decision-making at the continental level. The Ai Academy hosts the Ai Emerging Managers Forum, the Ai Project Developers Forum and the Ai African Sovereign Wealth and Pension Fund Leaders Forum.