Alternative investments – unlimited potential in unlisted investments

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The South African investor looking to grow their capital whilst minimising the impact of uniquely South African risks is fortunate to have a wide range of options available.

With a little homework, an investor can gain offshore exposure through measures such as finding local equity shares with offshore earnings (covered by Vuyo in his article) or investing with strong global fund managers (covered by Renate in her article).

In addition, the South African investor who wants to put their money to work globally is well placed to benefit from a growing area in the investment landscape - alternative investments.

This article will not delve into the detailed discussion of what classifies as alternative investments – you can read a thorough review in the 2017 first quarter Mindset.

Broadly, alternative investments cover two segments:

1. Hedge fund strategies - funds that access traditional, listed capital markets with the added ability to use leverage and short selling
2. Unlisted investments, such as private equity, direct real estate and infrastructure projects

This article will focus on unlisted investments.

Why should an investor look at alternatives?

1. Increased opportunity set

A South African investor scouring the globe for opportunities may find a proliferation of traditional investment products and assets available. Investors considering alternative investments over and above this, find it a daunting and overwhelming task to identify robust opportunities in this seemingly complex segment of the market.

The alternatives industry has matured significantly, and there are a number of firms that have built solid reputations by providing customer-centric investment propositions backed by solid investment teams. Sourcing an appropriate alternatives' investment manager opens up a world of unique private market opportunities that are not available in traditional listed markets.

Strong private equity managers in particular, pride themselves on using their proprietary networks and deal sourcing capabilities to identify "hidden gems".

2. Access complementary and new sources of returns

The abovementioned alternative investments should not be seen as replacements for traditional asset classes, but rather as complementary assets within a broader portfolio, offering unique sources of returns that can provide various levels of diversification.

One of the reasons why the asset price behaviour of unlisted investments differs to their listed counterparts is their greater reliance on fundamental drivers of return as opposed to being subject to the vagaries and sentiments of the continuously traded, more liquid listed capital markets.

3. Alternatives fit into a goals-based approach

Private market investments lend themselves to longer holding periods compared to their public market equivalents. The illiquid nature of the investments contributes to the long-term nature of these investments. As the investment management industry moves to a solutions based approach, where investments are made with goals in mind, the ability to access truly long-term investments should prove highly attractive for patient investors with extended time horizons and long-term goals.

A number of unlisted assets inherently provide returns that are linked to inflation ("real" returns). For example, real estate rentals have pre-agreed consumer price index (CPI) escalating rents for five to 10 years, renewable energy has pre-contracted CPI-linked increases for 20 years and toll road assets have CPI linked increases for 30 years.

4. Historically, alternatives were out of reach

Alternative investments have typically remained the domain/experience of very large investors, such as institutions and wealthy family offices. However, the maturity of the industry has resulted in increased regulation and transparency. A benefit of higher levels of oversight, is that investments typically reserved for very large investors with higher risk tolerances, can now be accessed in smaller ticket sizes through tried and tested pooled investment vehicles. The newer solutions allow high net worth Individuals and mid-sized institutions to participate.

A key reason for greater access for end investors is that innovative "gatekeepers" of capital such as asset allocators and multi-managers are constructing multi-asset, multi-alternative portfolios. They engage in the groundwork and complete qualitative and quantitative manager research. This greatly reduces the governance burden of monitoring individual alternative fund managers on the end investor.

5. Retirement funds can make use of regulatory allowances

Investing in unlisted investments is an attractive way to use the additional 5% Africa allowance.

South African retirement savings vehicles that are bound by the limits of Regulation 28 are able to access alternative investments to maximum of 15%. In terms of offshore allowances set by the South African Reserve Bank, investors are able to invest 25% of their portfolios offshore, with a further 5% allowance for investments in Africa excluding South Africa.

African equity and fixed income markets are typically highly concentrated by sector and country and tend to exhibit high levels of volatility. This concentration makes for a challenging investing environment that is arguably not fully representative of the underlying economic activity across the continent. Hence the appeal of unlisted investments.

By investing in private market assets, investors may be better equipped to participate in Africa's real and diversified long-term growth opportunities.

Using alternatives to take advantage of investment themes in developed and emerging markets

In STANLIB Multi-Manager's 2017 third quarter Mindset Jennifer Henry touched on "Megatrends and thematic investing." She highlighted that an easy way to understand thematic investing is to observe "megatrends" shaping the world - long-term themes that significantly impact societies and economies. Important to note is that the megatrends impacting developed markets differ significantly from those impacting emerging markets.

Central to the rationale for thematic investing, is that it allows one to invest early in scenarios that are expected to have a dominant influence over socio-economics in the future. These scenarios have not yet fully materialised and are not yet "big" enough to be well represented in traditional listed markets.

By investing through private markets, investors can participate while themes are still gaining in prominence. This is no easy task. One needs to look ahead over extended time periods (typically 10+ years) to identify these tailwinds and benefit from their growth, prior to themes going mainstream.

Thankfully, the alternatives industry has evolved to the extent that there are a number of fund managers (primarily private equity managers, some of whom are already well established) that are meticulously applying their minds to exploit long-term demographic, economic and social themes impacting both developed and emerging markets.

A South African investor with an allowance to go offshore (with particular focus on Africa) should focus their long-term thinking on some of the themes highlighted below:

- **Digitalisation**

  The role of technology is increasing in the accelerating digital era we live in. The digitalisation trend, particularly in developed markets, is characterised by increasing revenues in information technology (IT) service markets and total IT infrastructure spending such as servers, networking and storage, despite falling average costs in terms of efficiencies.

  In developed markets, there are enormous strides being made in robotics, artificial intelligence and machine learning. However, digitalisation is not limited to developed economies. A particular area of interest within Africa is the growth and development of FinTech (financial technology). FinTech encompasses areas such as payment processing, peer-to-peer lending, mobile financial services and the popular blockchain structure. In developed markets, the rapid advancement of FinTech is often perceived as a potential "disruptor" to traditional financial service providers.

  It could be argued that the growth of FinTech in Africa would not be considered as a threat, but rather a valuable tool to achieve universal access to finance for the largely under-banked, under-insured and under-invested majority of the population.

- **Education**

  Another constantly evolving theme is education. In developed markets there is increased focus on early childhood education and care. Education is considered a lucrative industry for providers, where companies in this space benefit from government subsidies. In emerging markets, and Africa in particular, there is a critical need for further investment in education, as the benefits of a skilled labour force are well demonstrated in more developed economies.

  Interestingly, according to a recent United Nations Educational, Scientific and Cultural Organization (UNESCO) report, Sub-Saharan Africa spends 5% of gross domestic product (GDP) on education, the second highest regional proportion after North America and Europe at 5.3%.[1] Despite significant strides in improving access to education, there is still a lot of room for improvement to ensure retention of children from primary to secondary schooling.

  Private equity managers with the willingness to add value by directing capital to improving school facilities, processes and faculty staff, should be able to have a direct impact on building quality, affordable, educational institutions. In turn, they will be compensated for this investment through the anticipated long-term wealth creation across the African continent.

- **Healthcare**

  Developed markets have traditionally allocated large amounts of capital towards healthcare. The industry also encompasses frail care and pharmaceuticals, two lucrative industries in an age of increasing longevity. In Africa, similar to the educational needs, there is a need for quality, affordable and accessible healthcare and healthcare services. The differences in demographics between developed and emerging markets dictates the needs for future investment in healthcare.

- **Renewable energy**

  The area of renewable energy is a particularly controversial topic in developed markets. The debate rages between solar and nuclear energy in efforts to move the world to more sustainable sources of energy. Climate change has a significant influence on where energy investment is directed in developed markets. Increased energy demand in some of the faster growing African economies highlights a need to use newer and more efficient technology to improve access to electricity in households and community centric small- to medium-sized businesses.

- **Agriculture**

  Continuing on the topic of climate change - the negative impacts of global warming in emerging markets are expected to be more pronounced in the area of basic agriculture. Thankfully in Africa, there is a large bulk of arable land that is unutiised. However, there is much room for improvement, as the opportunity exists for new technology and

1 https://www.africa.com/building-a-skilled-labor-force-private-equity-investment-in-africas-education/.

methods to improve on archaic farming methods. This is evident from the high focus placed on food production, packaging and logistics by specialist private equity managers, based in South Africa with a focus on Pan Africa.

- **Water**

  A related theme to the issue of climate change, is the risk of future water scarcity. According to the UN[2], water scarcity is an issue that affects both developed and emerging markets.

  Nearly one-fifth of the world's population live in areas of physical scarcity. Nearly one quarter of the world's population face economic water shortage where countries lack the necessary infrastructure to take water from rivers and aquifers.

  Potential methods to invest in this theme are purchasing water rights, investing in water-rich farmland and investing in water utilities, infrastructure and equipment.

- **Real estate**

  Real estate private equity is a large and well developed investment offering in first world economies. In Africa, where most business is conducted informally, there is a need for improved commercial locations as well as affordable housing. The inherent limited supply of property makes for an attractive investment in areas with young populations becoming more urbanised and mobilising into higher income socio-economic classes.

- **Transport**

  Tied to the above is the need for transport infrastructure in Africa: highways, ports, railroads, public transport and airports are in high demand and can be a key enabler to a productive economy.

  It can be argued that developed economies, particularly the US, are looking to increase spending on old and worn infrastructure, allowing for further opportunities for private market fund managers to allocate capital towards these projects.

Conclusion

The above are only a handful of structural themes that are expected to play out over the long-term. There are potentially other disruptors that may take place, and it can be expected that high calibre managers of long-term capital will continuously explore ways to access and benefit from these opportunities in the private markets, and more importantly, exploit these opportunities before they become mainstream in traditional markets.

A blended portfolio of underlying strategies, using a specialist multi-asset, multi-alternative fund manager, can provide investors with an accessible single entry point to the alternatives universe. This approach should mitigate the key risks associated with alternative strategies such as the concentration, asset class and manager selection risk.

The alternatives industry is gaining in sophistication and maturing, becoming more regulated and institutionalised. The growth of the industry is a positive development for South African investors willing to take a long-term view, as they stand to benefit greatly from including offshore alternative investments as a part of their overall portfolio.

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2 http://www.un.org/waterforlifedecade/scarcity.shtml.