

## Risk in Africa

Not simply a number

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In calls with investors, we are usually thrown a question on risk, generally along the lines of 'how do you measure risk in your African portfolios and how do you account for it in your valuations?' While we think we understand the question, we are at a loss as to how to answer it in the way that the person asking the question probably wants. It's a bit like 'define the universe and give two other examples'.

Clearly, investing in Africa carries additional risks to those which investors typically encounter in more developed markets. The risks that we'll discuss in more detail include:

- Markets are small and illiquid
- Government is often inefficient and immature
- Reporting and governance levels can be inadequate

Kenya and Nigeria are two key markets for us and it is worth remembering just how small they are. Nigeria has a total market capitalisation of \$56 billion and trades around \$450 million per month, while Kenya has only a \$15 billion capitalisation and trades \$100 million per month. By developed world standards these are tiny markets and illiquidity can be a real killer - we know of one fund that went under during the 2008 financial crisis and both Egypt and the Ivory Coast have been closed for periods this year as revolution rages. We naturally measure and track liquidity and have liquidity limits in our portfolios, but the reality is that when we need it most liquidity in these shallow markets is likely to dry up considerably. And, as recent events have shown, markets in which we invest can close for long periods.

The countries we can invest in cover the spectrum from ill-tempered and fragile unity governments (Kenya and Zimbabwe), monstrously inefficient and corrupt 'democracies' (Nigeria and The DRC) to dictatorships (Egypt and Tunisia, until recently). Even where we invest in supposedly stable and democratic countries (Zambia and Ghana), it is only a few decades since they too were military/socialist dictatorships. Further, while state control of the economy is being lifted in many countries (Zambia and Ghana), some countries are moving the other way (Zimbabwe). Of course we have country limits in our portfolios and closely monitor developments. But, the reality is that we invest in lively neighbourhoods and while Africa as a whole is developing, this advancement is unlikely to be linear. Surprises are almost guaranteed.

Finally, many of the businesses we come across do not meet what would elsewhere be considered minimum standards of financial reporting. Disclosure can be poor and reports many months late. The idea of good corporate governance is an emerging concept in many countries, as is interacting with investors. This is not to say that businesses are poor quality or their accounts dodgy but, getting comfort on the quality of a business, its management and its numbers, can take a lot of effort.

So, to return to the question of 'how do we measure risk in our Africa portfolios and how do we account

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for it in our valuations?' We measure those risks that we can and apply what we consider prudent limits on where we invest. And, implicit in the ratings we apply to companies and in our valuations, is a country and company discount factor. By some commonly used measures, investing in Africa is less risky than you might think. For example, the standard deviation on our Africa Fund is 26%, substantially lower than the 34% of the MSCI Emerging Markets Index.

But, risk is a very broad term, not a number. In its simplest form as applied to what we do, we would agree with James Montier, that risk is the permanent loss of capital\*. And that is the risk that we try to manage for our clients. The best way that we know of doing this is to invest in high quality businesses, occupying dominant, defensible, market positions and with good management and governance standards. These characteristics give us higher conviction in our valuations. Most importantly, we then look for a wide margin between this valuation and the market price.

The very issues raised in this article often result in potential investors overlooking the opportunities available. Comments such as 'I don't need to own Zimbabwe' by competing investors are music to our ears. In a world flush with liquidity competing for very limited investment opportunities, finding a neglected neighbourhood with extremely attractive valuations cannot be ignored, in our view. We make no pretences as to the potential volatility investors might experience, but we do think we offer up interesting opportunities for investors who can stay true to the mantra of 'long term'.

Given our limited universe of investable companies, not all companies in which we invest meet all of these criteria all of the time. But that is our benchmark and we seldom stray far from it. Economies will remain cyclical, Africa will continue to throw up nasty surprises and exchanges will be disrupted. But, by sticking to our value philosophy and investing for the long term, we think we will do an acceptable job of managing what we define as risk.

\* James Montier - *The Seven Immutable Laws of Investing*

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