IC Big Ideas

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Investment insights | Multi-asset strategy | Ghana

Fortune favours the bold

IN BRIEF

- The Russian-Ukraine war has exposed Ghana to new economic threats and intensified external headwinds
- Commodity price hikes globally have fuelled local inflation amid a currency blowout; the Ghanaian Cedi is witnessing its worst performance since December 2015
- Local financial markets continue to struggle as yields remain elevated with rates on both local currency and foreign currency treasury securities up by an average of 200bp and 450bp respectively since year open
- Despite the challenging economic backdrop and a significantly volatile outlook, we believe compelling opportunities exist
- We are convinced that in light of the ensuing apprehension across the markets, investments in structured quasi-government products will offer the best risk-adjusted returns in the near-term while gold-linked securities such as the NewGold ETF presents the best opportunity to generate alpha
- For the medium-term, we see several opportunities across the various businesses we operate
- We believe an exchange traded fund approach to investing in alternative assets is the best tactic to take advantage of the increased allocation of pension assets to alternative investments
- As institutional money continues to tip the pricing scale lower, several asset managers are diversifying more into retail investing but the brick-and-mortar distribution era is over
- A tech-enabled approach through strategic partnership with financial technology companies provides unlimited scale at a cheaper operating expense to the asset manager
- For the FinTech, it offers a new growth path as the ability to add investment options to their existing boutique of services (i.e. payments, remittances and trading) enhances annual recurring revenue
- In our maiden edition of IC Big Ideas, we invite you to explore the potential sources of attractive returns as we identify investment opportunities that will spur the next cycle of growth

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The year 2022 so far

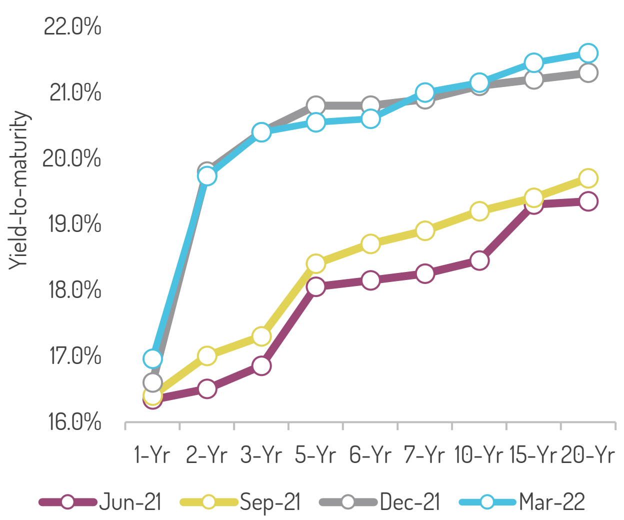
When the year commenced, our biggest concerns were the impact of policy normalisation on frontier markets like Ghana and how disruptive the emergence of yet another strain of COVID-19 will be to the fragile economic recovery. It has been nearly four months since then and the current threats to economic growth far outweighs what anyone may have envisaged.

The Russian-Ukraine war has exposed Ghana to new economic threats and intensified external headwinds. Embargoes on Russian crude oil and natural gas have seen the prices of both commodities spike by 12.7% since the war broke out in February this year. This has translated to a 35.4% increase in ex-pump prices here in Ghana. Consequently, the non-food basket of the consumer price index has gained 3.7% in just one month, resulting in CPI Inflation hitting 19.4% in March, the highest since it was last rebased in August 2019.

The Cedi has not been spared from the crisis as it has depreciated by 8.6% against the greenback since the war commenced and as much as 15.6% from the start of the year. While geopolitical tensions have exacerbated the weakness of the local currency due to increased demand for safe haven assets like the U.S. Dollar, restricted access to international capital markets and concerns about Ghana's ability to narrow its fiscal deficit have supported the currency blowout. The above notwithstanding, the recent announcement by the central bank to inject as much as USD 350m in periodic auctions to stem the slide has begun to see the local currency strengthen slightly, but for how long?

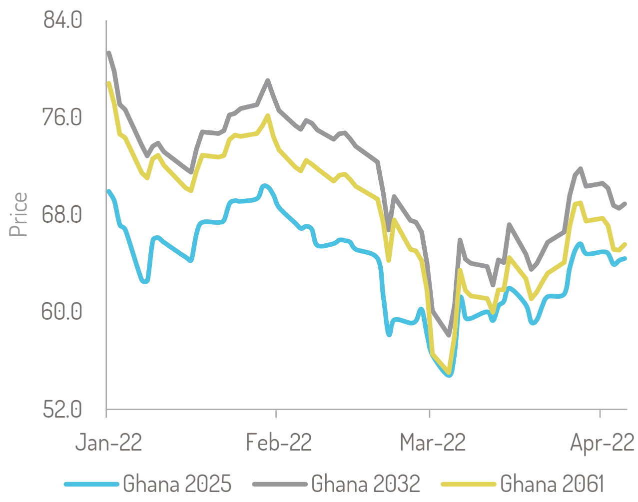
Amid the turmoil, local financial markets have seen a sea of red since the year began. Yields have spiked by an average of 200bp across the local currency yield curve with a much steeper spike on the foreign currency front.

Graph of local currency yield curve



Source: Standard Chartered Bank Ghana Plc

Ghana Eurobonds price chart

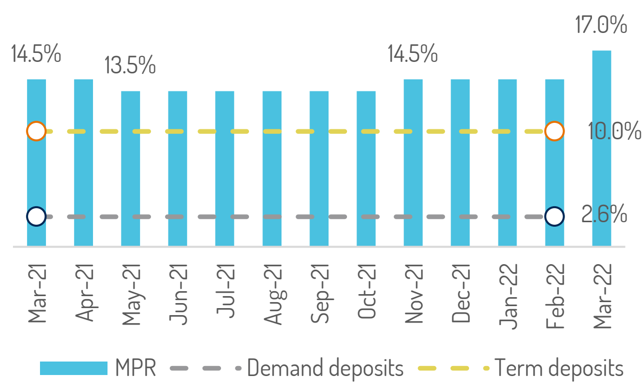


Source: Bloomberg

Apprehension continues to drive bearish sentiments on the Ghanaian equity market with the GSE Composite Index down by 1.7% as at the end of 1Q2022.

Risk-adjusted returns on money market securities continue to be distorted. Term deposits remain priced below risk-free rates as the lack of investable assets fuels a glut in cheap retail deposits amid hawkish monetary policy

12m historic evolution of demand vs term deposits vs MPR[1]



Source: Bank of Ghana

[1] Monetary policy rate

Despite the challenging economic backdrop and a significantly volatile outlook, we believe compelling opportunities exist. Many of them may be medium-term in nature while others provide near-term upside but whatever your investment horizon is, navigating the opportunities will require skill and close attention to market dynamics. In or maiden edition of IC Big Ideas, we invite you to explore the potential sources of attractive returns as we identify investment opportunities that will spur the next cycle of growth.

Idea #1:

Quasi-government structured products will offer better risk-adjusted returns but commodities are the alpha generator

Investment horizon: Short-term

By Lydia Adzobu
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In our opinion, both the fixed income and public equities market will remain depressed for a greater part of the year.

Money market rates are likely to adjust upwards on the back of hawkish monetary policy but inflation outlook suggests real return will continue to point south. From our analysis, both local and foreign currency treasury markets are oversold, but near-term correction is unlikely to be realised until fiscal data begins to reflect a narrowing of the budget deficit. We do not think this will happen until perhaps late 3Q2022 when investors begin to assess the impact e-Levy and the earlier announced austerity measures have had on government revenue and expenditure respectively. Furthermore, the impact of the Russia-Ukraine war on GDP growth is critical in investors' assessment of how sticky Ghana's post-COVID-19 recovery is and its implication for debt sustainability.

The Ghana Stock Exchange is likely to continue trading sideways as the macroeconomic backdrop restricts corporate earnings momentum and keeps cost of equity elevated. We think the market will see some respite when local pension funds begin to adjust their portfolios to reflect the higher allocation to variable income securities due to the constituent fund structure. Again, this is unlikely to be realised until 3Q2022. So, in the immediate term how do investors protect their portfolio and perhaps generate some alpha?

We are convinced that in light of the ensuing apprehension across the markets, investments in structured quasi-government products will offer the best risk-adjusted returns in the near-term.

With very limited fiscal space, we see government using structured financing as alternative sources of funding for state agencies without the additional pressure on the public purse. Investors are likely to see new issuances with similar structures used in the Energy Sector Levy Act (ESLA) and Daakye bonds. While these structures do not offer sovereign guarantees, cash flows are based on visible government receivables. Furthermore, pricing is often at a premium to other corporate debts with similar tenors on the market, thereby offering better risk-adjusted returns. With the gap created by the absence of road tolls, we could potentially see a securitised debt issued in favour of the road fund. Likewise, the push for government to reduce taxes or provide some subsidies on petroleum products as the Russia-Ukraine war fuels crude oil price hikes, could lead to a product ring-fenced by receipts from the Petroleum Holding Fund.

In our opinion, whether it is a new issuance or opportunities to pick up discounted ESLA or Daakye Bonds on the secondary market, ring-fenced government receivables will ensure better risk-adjusted returns in the short-term.

For alpha, we recommend trading commodities. Over the last six months, the price of Ghana's major commodities gold, crude oil, and cocoa have gained 6.0%, 36.1% and 3.8% respectively. While the outlook on all three commodities remains relatively positive, we are of the view that, the momentum for gold is much stickier than the remaining commodities.

We are aware that the shortfall in fertilizer supply could fuel a spike in cocoa prices due to a potential decline in production. However, we are also cognizant of the prospects of increased precipitation in West Africa and how this together with the commissioning of Dangote's fertilizer plant (the second largest in the world) could normalise production and keep cocoa prices moderated.

For crude oil, the sharp rally is being largely driven by geopolitical tensions. Since the war in Ukraine, crude oil prices have gained 12.7%, accounting for 42.6% of the price rally in the past six months. Consequently, the price could revert to the USD 90 per barrel levels should cease fire be achieved.

Gold on the other hand is likely to remain a safe-haven asset of choice as uncertainty remains the theme in a world recovering from a pandemic and rife with geopolitical tensions.

Consequently, in the immediate-term, we recommend buying quasi-government securities as a defensive play while generating alpha via gold-linked securities such as the NewGold ETF.

Idea #2:

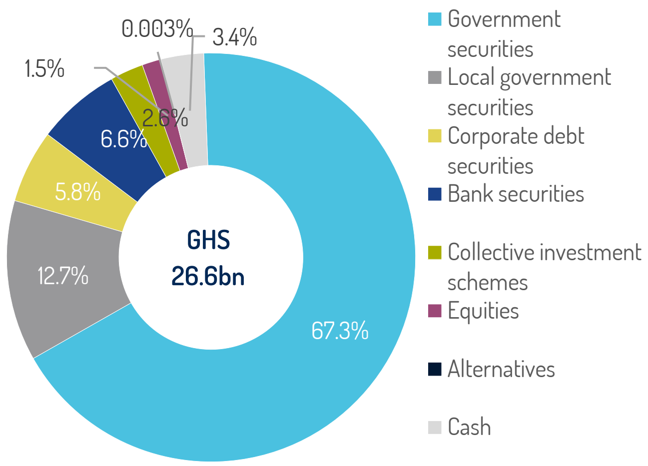
ETF is the key to unlocking value in alternatives

Investment horizon: Medium-term

By Derrick Mensah

On 14 September 2021 the National Pensions Regulatory Authority (NPRA) introduced new guidelines in investing private pension assets. In this new guideline, allocation to alternative assets (i.e. real estate funds, private equity and debt) increased from 15% to 25%. This implies that about GHS 6.6bn is available for investments in the alternative asset class. Despite the increase, allocation to alternative assets remain insignificant.

Asset class split of private pension assets as at 3Q2021



Source: National Pensions Regulatory Authority

In our opinion, relatively high rates on risk-free securities, restricted exit options as well as insufficient deal pipelines have been the major bottlenecks in the low allocation to alternative investments.

Historically, risk-free assets have averaged 19.8% in the last seven years (i.e., average holding period for private equity transactions) which implies that, risk premium must be well in excess of 6.0% in order to have a desirable internal rate of return. In addition, multiples on invested capital have not compared favourably to similar tenors on foreign currency risk-free assets.

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With the poor liquidity and lack of depth in Ghana's public equities and corporate debt markets, exits continue to be heavily reliant on a feeder fund structure or sale to a larger private equity or debt fund. This makes the asset class unattractive particularly to local pension fund managers.

In our opinion, we believe a bulk of the challenges with the alternative asset class can be solved using an Exchange Traded Fund (ETF) approach. An ETF replaces the private fund structure used by alternative asset managers. This means, investors are pooled into a fund but instead of waiting for the fund to unwind at maturity, the ETF structure allows investors to exit and enter at any point during the life of the fund. Essentially, concerns regarding exit strategies will be resolved.

In addition, the ETF approach can improve deal sourcing while providing a higher rate of return. Historically, private equity or debt funds have been sector focused. This is because, organising around particular industries help to optimise resources and generate higher returns. In our opinion, this is true for developed markets but in illiquid frontier markets like Africa, the need to be sector agnostic is critical to improving deal pipelines and fund performance; the ETF approach offers exactly that.

Fund managers of alternative investments using an ETF approach can aggregate assets across sectors to generate a higher risk-adjusted return or multiple as diversification helps to limit volatility.

We admit that, this approach may be wading into unchartered waters and local regulations may have to play catch-up. However, we are convinced that the fund that cracks this approach will open the door to a new asset class with an existing pent-up demand of nearly GHS 6.6bn.

Idea #3:

As money gets personal again, technology-led distribution for retail investing products will thrive

Investment horizon: Medium-term

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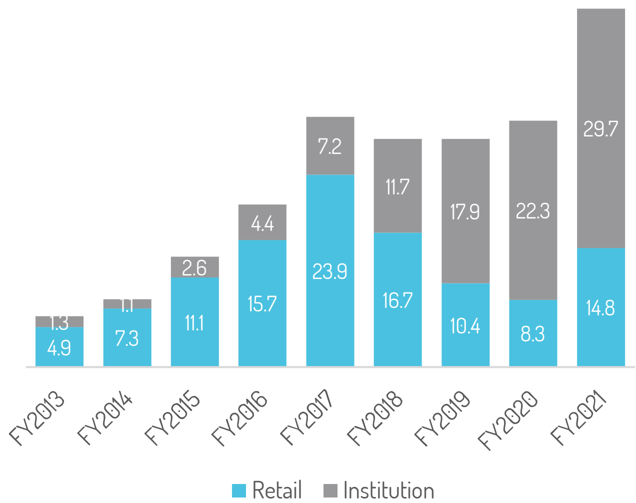
According to the SEC annual reports, the aggregate value of retail investments grew by 54.0% between the year 2016 and 2017. This declined significantly following the clamp down of unsanctioned "guaranteed returns" investment schemes in 2018 and the subsequent revocation of the licence of 53 fund managers in 2019.

Historic evolution of industry assets under management

All amounts in GHS 'bn



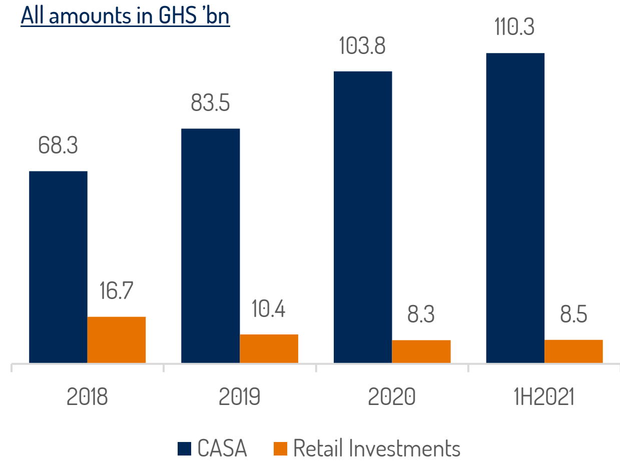
Source: Securities and Exchange Commission & National Pensions Regulatory Authority

Since these two events, we have observed a significant flight to quality as retail investments exited the securities industry and found its way into the banking sector as cheap retail deposits. From our analysis, an estimated GHS 8.1bn was lost in retail investments of which GHS 1.5bn filtered through to banks and GHS 6.7bn is estimated to be locked up under receivership.

In mid-2021, we begun to observe a pick-up in retail investments as funds moved gradually from the banking sector to the securities industry.

Banking sector CASA[1] deposits vs retail investments

All amounts in GHS 'bn



Source: Bank of Ghana, Securities & Exchange Commission
[1] Current account & Savings Account

In our opinion, the estimated GHS 1.4bn is not sticky given the negative real return on investment and we view the flight to banks as a knee-jerk reaction.

As investor confidence returns to the securities industry, we expect some level of savviness to accompany it. Investors are likely to become more knowledgeable of the various asset classes as improved regulations provide better guidance. Consequently, we see significant growth in retail investments in the medium-term, however, the brick-and-mortar distribution era is gone.

For us, we see a strong opportunity for financial technology companies (FinTechs) to drive the distribution of retail investment through strategic partnership with key industry players. On one hand, the innovation breaks down the market segmentation created by the numerous distribution channels organised by fund managers, banks, and brokers, allowing for unlimited scale at a cheaper operating expense.

On the other hand, the partnership offers FinTechs a new growth path as they add on investment options to their existing boutique of services (i.e., payments, remittances and trading) to enhance their annual recurring revenue.

In addition, huge data and analytics can be gathered offering FinTechs and investment managers the opportunity to create tailored investment solutions that better suits the idiosyncratic behaviours of investors.

Investor behaviour is changing. In our opinion a new generation of retail investors are emerging; Generation X and Millennials, characterised by new thinking patterns, standards, and expectations. This new generation of investors desire more proximity with asset managers and a better ability to manage their investments from anywhere in the world with just a few clicks.

As institutional money continues to tip the pricing scale lower, retail investment offers the best opportunity to improve fee run rate. However, the approach must be tech-enabled to ensure margin expansion

Conclusion

The macroeconomic outlook is not encouraging as the resulting drag on spending arising from a spike in inflation could very likely slowdown the pace of economic growth particularly in the second half of the year. However, monetary policy has been a step ahead in averting hyperinflation and curbing further depreciation of the Cedi but fiscal management is yet to restore investor confidence.

Despite the grim outlook, we believe fixed income still offers a defensive play during periods of market turbulence and investors would be wise to maintain exposure through a more active approach as rates grind higher. Inflation protection and currency hedging must be critical tactics in any short-to-medium term strategy and we believe our quasi-government structured products and commodities play offer that.

For late cycle growth, we are convinced that investors can find ample risk premia to harvest if they are prepared to look beyond traditional asset classes. Alternative investments in infrastructure, energy and tech-enabled asset managers will differentiate today's winners from tomorrow's champions.

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