AlphaQ

August 2017

FOR INSTITUTIONAL INVESTORS & ASSET MANAGERS

INDUSTRY & LOGISTICS
New programme from Investcorp

SLOANE ROBINSON
Emerging market roots

IMPACT INVESTING
The rise of activist shopping

CHINA OPENS UP
Market access improves

GO EAST!
LA Capital expands

GO SOUTH!
South Africa's growth story



Northleaf Capital maintains mid-market focus

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Photo: Daniel Dupont, Northleaf Capital



ELEANOR ROSTRON

This month's cover story is an interview with Northleaf Capital, a USD9 billion Canadian investment firm that focuses on private equity, infrastructure and private credit managers in the mid-market space, targeting PE funds with less than USD1 billion under management.

Elsewhere in the August issue of AlphaQ, we have something of an emerging markets' feel, with interviews with Sloane Robinson, which is revisiting its emerging market roots with the launch of a new emerging market fund, and an interview with Capricorn Fund Managers, an emerging markets specialist with assets of USD500 million that combines its South African heritage with global reach.

We also look at China, examining the likely impact of the news in June of the inclusion of China A shares in the MSCI emerging market index, and the launch of Bond Connect, a programme designed to allow investors operating in Hong Kong to trade Chinese bonds.

It is believed that China's bond market could double in size from the current USD9 trillion over the next five years, overtaking Japan's to become the world's second largest behind the United States.

Whether you are the last person in the office or reading this on a beach, enjoy the August issue of AlphaQ.

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- Capricorn Fund Managers
- Capricorn Investment Group
- Disrupt!
- eVestment
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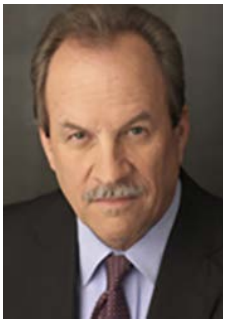
Los Angeles Capital expands London office

News came earlier in the summer that USD27 billion asset manager Los Angeles Capital had expanded its London subsidiary, LACM Global, with the hire of Edwina Acheson as a Managing Director.

Los Angeles Capital Management's CEO Tom Stevens explains that the firm is 16 years old and came from a buyout from Wilshire Associates where Stevens was the head of the asset management company for 16 years prior to that. The firm started with Stevens and eight others from Wilshire with USD1 billion under management, and has built its business servicing the needs of the institutional investment arena.

"We are calling on large asset owners in three primary categories," Stevens says. "US pension funds, endowments and foundations, European pension funds particularly in the Netherlands and the UK, and we have sub-advisory clients where the firm sub-advises on up to 20 funds for entities like Vanguard, Wells Fargo and Principal."

The firm built a UCITS platform in Dublin and the London office focuses on building that business. "As we marketed in the UK and Europe, people kept saying if you had a UCITS fund we would be interested. The whole industry is shifting more to defined contribution, so it makes sense to have vehicles that can be used in those situations, it fits with our existing business," he says.



Tom Stevens, CEO of Los Angeles Capital Management

Stevens says that the firm was one of the first to start running primarily structured application style portfolios. "We converted our business from that to active applications with the dynamic alpha model which drives all of our active products today."

"We are not big relative to the major players, but we are pleased with the size of our business and what we like most is that we can give our clients a lot of attention."

The firm has around 42 clients many with multiple applications. "We can give each one the attention they deserve," Stevens says.

"One of the key elements of our process is that we recognise that markets are dynamic and if we want to perform well we need to adapt to changes as they occur. For instance, 2015 was strong for growth and 2016 was strong for value. In our way of managing we are paying attention to that allowing those shifts to impact the way we are managing the portfolios."

The firm's global and regional mandates are entirely invested in equities of small and large cap companies.

"The idea is to help people get off the rollercoaster as many managers have a profile where they do well for a couple of years and then they go out of favour. Our goal is to provide a more stable performance profile through time because we adapt and pay attention and have a more consistent performance profile."

While 2015 saw a penchant for growth, 2016 saw a shift to value and now in 2017 it's back to growth again.

"Lately it's been alternating so we have been able to demonstrate how preferences shift and why it is important to have a process that enables you to participate," Stevens says.

He believes that ultimately the explanation for these shifts relates to the economic and political picture. "The Trump election spurred the markets as a lot of people were expecting a more favourable environment for business. Another observation is that you need to look at these relationships regionally, what happens in one region in the world could be very different in another. It's possible to have value favoured in emerging markets and growth in the developed world. You have to look at the region and build your forecast on individual securities and then aggregate global portfolios that reflect those regional views." ■

Sussex Partners comments on Brexit process

Patrick Ghali, is Managing Partner and co-founder of Sussex Partners, a firm that advises institutional investors and whose clients on a combined basis manage in excess of USD3 trillion in assets.

Sussex Partners is based in the UK and has a separate business in Switzerland, which the firm a useful perspective on the Brexit process.

Ghali says: "If there is a hard Brexit, the UK will definitely lose financial business. If fund managers lose their European passporting rights, they will have no choice but to figure out another location in Europe."

Business does not like uncertainty, Ghali says. "No one knows how Brexit will happen, so as an asset owner or business you are not going to put your resources into the UK at the moment until there is clarity. There will be no more hires in the UK until we know what is going on."

And things are not much clearer in Switzerland. The independent European authority ESMA made a recommendation that Switzerland would get the European passport, but it has not been implemented, which means that Swiss asset managers have to use European management companies based in Luxembourg or Ireland.

The Swiss financial industry made a significant commitment to changing its regulations to bring them into line with Europe and some firms have set up structures and partnerships in Switzerland, in expectation of passporting commencing.

However, it hasn't and Ghali points out that Europe now has to deal with Brexit and can't be seen to be giving the Swiss preferential treatment.

Ghali reports that the Swiss financial industry has changed since the global financial crisis in 2008. "You see an evolution going on in the whole sector," he says. "The sector is becoming more professional and institutional and the FINMA rules have made it hard to run a small investment business. You need a certain amount of scale which means added cost. Small private banks and wealth management firms have disappeared because they don't have the necessary minimum asset size – it's becoming more institutional."


Patrick Ghali

In terms of types of investments that are proving of interest at the moment, Ghali finds that a lot of pension funds are trying to figure out how to cover their liabilities. Alternative credit is proving a hit, and real estate bridge lending, or asset based lending strategies, are popular.

Systematic is also back on the agenda. "People like this because it takes away some of the emotional, discretionary element and a lot of the funds are cheaper because they are rules based and formulaic so can be less costly to implement."

Ghali also reports a big dichotomy between those who want to pay minimum fees and are looking for passive investment, and those who are looking at active, saying now is the time as volatility is low across the board.

"Alternatives are coming back again," he says. "The alternative industry has evolved. Funds of funds are still something that people invest in but the funds of funds that gather assets are very specific, not generalist, investing in a strategy or geography where picking one manager may not be good for risk or where you don't have an expertise. Investors are more focused on a theme and clear value proposition not index type of returns."

In terms of fees, Ghali comments that if you have something with limited capacity, people will still pay for it. "Fees are down for commoditised products, but if you can deliver something very specific that has capacity limits, people will still pay and you can still get a premium for that."

The scale of many funds of funds is such that they can negotiate fee breaks on the underlying funds. "You pay very little for their operational due diligence, portfolio management and so on," he says. ■



Sloane Robinson's emerging market voyage uncovers opportunity

Ed Butchart is chief investment officer at USD1.4 billion fund management firm Sloane Robinson. The firm has just hit the four and a half year anniversary of the launch of its revamped emerging market equity strategy, offered as a UCITS or a Cayman registered fund.

Butchart joined Sloane Robinson in 2011, becoming CIO in 2012, and oversees the investment team and co-manages the firm's emerging market equity portfolios with C J Morrell, interviewed in **AlphaQ** last August.

Butchart was originally an academic who came into investment in the mid-1990s, and has always focused on the emerging markets.

Sloane Robinson has some USD700 million invested in emerging market equities, about half of its total assets, through dedicated emerging market portfolios and allocations to the region from more international mandates.

"We have historically run closer to USD2-3 billion dollars in emerging markets," Butchart explains. "We are now building towards that again in the revamped strategy, aided by an annualised return since inception in January 2013 of 7.4 per cent versus the MSCI Emerging Market index at 1.8 per cent through to the end of June 2017."

"The story is that the emerging markets were in retreat for the first three years of this period, but we managed to generate positive returns in each year, hopefully proving we could run emerging markets' money effectively."

Sloane Robinson is very positive about the outlook for emerging markets. "Essentially, because there remains a long term growth story," Butchart says. "Although structural headwinds got in the way, they have been largely resolved. Currencies were overvalued

and a number of countries were running current account deficits and struggling for competitiveness. Today, emerging market currencies are far better valued."

Another factor Butchart cites as holding up emerging markets' growth was the sustained pressure on return on equity. "Companies had been over investing," he says. "It's a natural cycle of hubris to humiliation, it's human nature."

Emerging markets withstood the global financial crisis quite well and companies got over optimistic, Butchart says. "Yet China was about to slow and companies didn't see it coming. World trade would also grow much more slowly than had occurred before the 2008 credit crunch."

Beyond that, Butchart says that traded goods face headwinds as the push towards free trade has faded and the overall pace of global demand growth has not been that strong.

"Although we think companies have a much more balanced outlook today having been blindsided in 2011.

"We have seen a supply side adjustment in a number of sectors, such as commodities, alongside subdued Capex paving the way for an improvement in return on equity for the emerging market asset class in aggregate.

"You can now start to get more excited by the structural growth opportunities which were spoilt for four or five years."

"What excites us is a number of themes," Butchart says. "But the most obvious is essentially the sustained potential for increased consumer spending on goods and services that have a high level of penetration in the developed world, but are still in their infancy in developing markets."

Sloane Robinson casts its net wide in practical terms across the emerging markets, investing its concentrated portfolio of typically 30-35 stocks across the region. With China and India being more meaningful exposures today.

"When we talk about consumption opportunities, people think about classic consumer staples as in 'what would Warren Buffett buy if he were investing in emerging markets?'"

Butchart feels that consumer staple stocks tend to be very expensive in emerging markets and prefers to focus on the consumer services space.

"We have found opportunities in other areas," he says. "In China, we favour life insurance. The idea is that having bought a new house and car and then fitted out the house with all electrical appliances, the Chinese middle class has shifted to other areas of consumption – including financial services. There is an absence of a social safety net across Asia, and especially in China, which creates a focus upon the need for protection in old age and retirement."



Ed Butchart, CIO of Sloane Robinson

There is, Butchart says, strong growth in Chinese insurance companies but you have to be able to invest in companies that price risk properly. Chinese life insurer AIA, the former Asian business of the AIG group, achieves this. "It's almost a century old and is a well-run and trusted brand that knows how to price risk effectively."

Healthcare offers a similar story, Butchart says. "Most pharmaceutical companies are copy cats genericising existing drugs, but some are trying to be more innovative by investing high levels of R&D in innovative product pipelines."

Within this group lies Jiangsu Hengrui Medicine, a Chinese A Share, which should also benefit from inclusion in the next upgrade to the MSCI Emerging Markets' index. Sloane Robinson's emerging market equity strategy contains a number of A shares within its portfolios.

In India, a more recognisable name Butchart favours is HDFC, a bank and housing loan company. "It has grown very rapidly, not only because India is growing rapidly but because the dominant state sector has a lot of problems in terms of quality and lack of capital."

A less recognisable name held is Vakrangee, a firm that is setting up small outlets in the more rural areas of India which amongst other services facilitates people opening bank accounts for the first time.

"It is also layering on all sorts of extra services from being able to register births to receiving government benefits and paying tax bills. It is also going to act as last mile delivery for Amazon. If you don't have a computer then you can go to a Vakrangee outlet to order and pick your parcel up from there."

With its past history of running a billion dollar portfolio, Sloane Robinson is running the emerging market strategy as if it were already there in terms of size.

The expectation is that the UCITS version will appeal to European investors while the offshore vehicle is more attractive to American investors. ■

Regtech start-up offers blockchain solution to compliance pain

Shane Brett is CEO of GECKO Governance, a new Regtech firm that offers a blockchain based solution to compliance issues for fund managers and other firms within the financial sector. Brett's background is as a consultant to the fund's sector. "One of the key challenges I came across as a consultant was that it was not easy to use many of the existing compliance packages," Brett says.

"I struggled to find something that was easy to use, dynamic and could cope with the different work flows required from 40 Act funds in the US or AIFMD in Europe."

The result was GECKO, which uses blockchain to manage compliance through Hyperledger's Fabric technology (backed by IBM, Federal Reserve and the Bank of England).

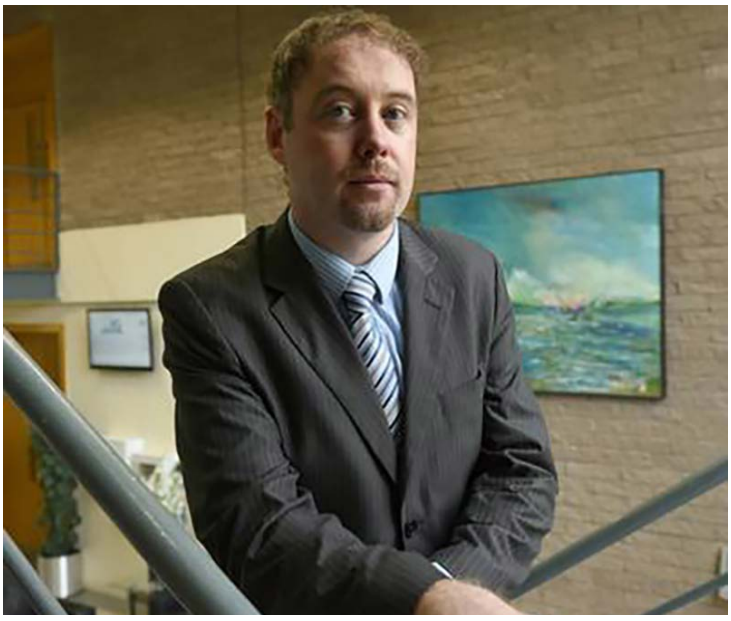
"I wanted a way to have a live dashboard to monitor your compliance or risk monitoring, then drill into underlying details of specific tasks you want to complete," Brett says. "It's a dynamic workflow solution for managing funds and each fund has its own module so we will track all the data for the fund."

The GECKO system is integrated with Microsoft Office 365, which means that all the usual Microsoft applications such as the Outlook calendar, Word and Excel also work with it. The calendar allows people to see what has been done, what is being done and what is falling behind.

Brett found that the existing systems tended to take a bottom up approach to each new piece of legislation. "We start with a top down view and then let you drill down," he says.

Recently, his firm has raised seed funding from Cosimo Ventures in Boston and now has seven clients including a number from tier one bank and fund management firms. Staff include six people in Ireland, four in Park Avenue in New York and one in Sydney. September will see the firm opening in London.

"The blockchain technology is specifically based around two pieces of functionality – the milestones and the audit trail," Brett says. "What blockchain does is enable all of the different tasks to pull in external parties to those tasks. So, if you are launching and you need to send reports to regulators, banks, auditors and so on, all can be set up as a private node of your private blockchain so they can all be allocated back and forward, with a live clear view of what is happening that is never backdated, so from a regulatory perspective and from a fraud perspective it's very transparent."



"I have spent most of the last few months in the US and Australia and the consistent feedback is that compliance is a nightmare and it is getting worse."

Shane Brett, GECKO Governance

The technology also means that everything in the chain is time stamped so there is a searchable and downloadable audit trail, which the SEC accepts as immutable. Under the hood is what Brett calls a 'live cockpit' of operations visible at all times in all time zones and colour coded for progress. It's aimed at funds of all types, but can also be used for managing clients or projects as it is very flexible.

It needs to be. Brett says: "I have spent most of the last few months in the US and Australia and the consistent feedback is that compliance is a nightmare and it is getting worse." ■



Rapid growth predicted for South African economy

Capricorn Fund Managers is an emerging markets specialist with assets of USD500 million that combines its South African heritage with global reach. Founded in 2003 by Damon Hoff, the firm initially focused on South African equities, before launching a global emerging markets strategy based in London in 2008.

From the beginning, the firm has had a consistent investment approach, based on the belief that there were major transformative themes at play in emerging markets which were driving economic growth, and that a traditional bottom-up stock-picking approach could identify stocks with significant upside.

The firm also had a strong sense of what it calls the 'Capricorn way', which involves thorough analysis of each company's drivers and future earnings prospects. Capricorn has an exhaustive process with each company and likes to meet management face-to-face. If the team believes that a company has a sustainable competitive advantage in its industry, and can therefore accelerate its earnings growth, a position will be built in the portfolio. The team focuses on medium and large cap emerging market growth companies trading on recognised exchanges. Conversely, the team will look for the opposite of this methodology to source short positions.



Stephan Engelbrecht

Capricorn fund manager Stephan Engelbrecht explains that in 2008 the business took a strategic decision to take a global emerging markets perspective, using the same methodology that had been pioneered in South Africa. "We felt that having watched South Africa emerge as it moved to a democracy, we could bring that knowledge to an emerging markets portfolio."

London was chosen as the natural base to launch this investment strategy. In what would subsequently be recognised as the teeth of the financial crisis, the firm opened an office there in July 2008.

The Capricorn Global Emerging Markets fund has USD150 million split between a Cayman-domiciled fund and a UCITS structure on the Lyxor platform and is aimed at family offices and institutions.

"We focus on long-term quality growth companies who will accelerate their earnings aggressively over the medium to long term," Engelbrecht says. "And we are able to invest globally, from India to Russia, Poland, Turkey, Brazil, Mexico and South Africa."

The South African team, comprising five investment professionals, focuses on domestic companies and opportunities while the five investment managers in London take a global perspective. Being in London means they can meet, in person, management teams from around the world when they visit. "We get to see most management teams and a close relationship is critically important to us," Engelbrecht says.

"Over the long term our investment performance is driven by thematic longer term holdings and your performance over the long term gets driven by your top 10 holdings over that period and so it is critical you get those right but be cognisant that the market can be irrational.

"You can't just hold high quality growth companies and expect returns. You have to keep your finger on the pulse and be willing to eke out returns. We are extremely active traders and will take a high conviction decision to invest and then trade around those positions."

Engelbrecht feels that South Africa is facing a compelling scenario at the moment. The ruling ANC party will vote for a new president in December and if the reform minded Cyril Ramaphosa is elected, Engelbrecht believes that by the second half of 2017, the South African economy will be an economy on steroids.

"The growth numbers we saw in the early 2000s will return as we have so much latent demand. Companies have been sceptical about investing in the economy, but once they get their confidence back, the market will be surprised by the significant upside." ■



Northleaf maintains mid-market focus

Northleaf Capital is one of the world's leading independent private equity, infrastructure and private credit managers, writes James Williams.

The firm has strong Canadian roots and currently manages more than USD9 billion in assets on behalf of its institutional clients. From a global investment strategy perspective, Northleaf focuses most of its private equity investments in the mid-market space.

"We like investing in funds which target the mid-market segment because of the number of growth opportunities in that sector, where GPs concentrate on operational growth and build ups. Also, we like established mid-market companies, because of predictability of positive cash flows," explains Daniel Dupont, Managing Director of Northleaf's London office.

The mid-market has presented a lot of good investment opportunities for Northleaf over the years, allowing its funds to generate well above the public market index returns over the years in North American and European markets.

Although many people believe private equity is driven by microeconomics, Dupont thinks the sheer scale of the political and economic uncertainties that we face worldwide, but particularly in Europe, puts additional pressure on managers to operate in this volatile environment. Dupont admits that while it is quite a heated market, this can also bring interesting opportunities in certain markets.

"Therefore, we focus on managers who concentrate on creating operational value within their portfolios and look for ways to navigate in this environment, especially in the UK.



"We focus on managers who concentrate on creating operational value within their portfolios and look for ways to navigate in this environment, especially in the UK."

Daniel Dupont, Northleaf Capital

"Some European managers have gradually refrained from making investments in the UK as they wait for the Brexit trade negotiations to be completed. However, in recent times US fund managers and companies looking at the UK have benefited from the favourable exchange rate as they look to acquire UK companies. It is a heated, uncertain environment that creates opportunities, but one must remain cool headed and prudent to provide investors with good returns on their capital. Preservation of capital, especially in secondaries, is very important," says Dupont.

Northleaf has always been disciplined in its due diligence process when investing in European PE funds. Much time is spent mapping out the market and meeting with GPs far in advance of their fund-raising phase, in order to become a preferred long-term partner. "We have to choose managers that we believe can generate attractive investment returns and fit within our strategy targeting primaries, secondaries and co-investments," says Dupont.

Brexit is an obvious macroeconomic risk that any global fund manager must take account of. The UK only grew 0.3 per cent last quarter, much lower than in 2016, prompting some to speculate that the Brexit effect is starting to be felt. Indeed, based on discussions with managers who invest at the lower end of the mid-market, Dupont says the fund-raising market appears more difficult for some of them.

Aside from private equity, good returns have been generated in Europe in VC over the recent years. However, Northleaf's VC programme focuses on the North American market because of the historical relationships it has built over time with high quality groups from its offices in Toronto, Canada and Menlo Park in California. This accounts for approximately 20 per cent of the portfolio in its current fund, Fund VI, which is now at the end of its investment period.

The private equity funds that Northleaf raises fall into two categories. Firstly, the global funds are comprised of primaries, secondaries and co-investment opportunities, all within a single vehicle. Secondly, pure-play secondary funds.

"The first type of fund is a great way, in my opinion, to benefit from the opportunities at a certain time, depending on the market cycle. Having up to 30 per cent secondaries and 20 per cent in co-investments within a fund helps to mitigate the J-curve effect," comments Dupont.

When constructing a portfolio, Northleaf avoids investing with a GP for one fund only. Its aims are much more strategic, building long-term partnerships with managers that help create the right conditions to do co-investments, or buy secondary holdings from LPs at certain points in a fund's lifecycle.

Dupont confirms that fund raising has commenced in North America only, for Northleaf's next fund, NPE VII, and that fund raising has also commenced for a dedicated secondaries fund, Northleaf Secondary Partners II.

"There is strong appetite from our existing investors, as well as new investors who want to allocate to a secondaries fund with a global approach to the mid-market. We are usually involved in transactions smaller than USD100 million. There is often less competition at that level and is in line with mid-market opportunities," says Dupont.

In line with its predecessors, NPE VII has a global mandate. Due to the style of its investment programme and the make-up of its investors, roughly 60 per cent of each fund

focuses on North America, with approximately 30 per cent focused on Europe and the remainder in Asia.

To further accentuate and strengthen its GP relationships, Northleaf has also established a private debt platform.

"We are trying to provide a full partnership package. With European GPs, they like the North American angle. Many of them also want to build closer ties with Canadian investors. Canada has a relatively good press these days," says Dupont.

It is about building partnerships that benefit Northleaf and its investors in Europe, and the European GPs benefiting from its network in North America.

"We noticed not only with GPs we invest with, but GPs we know on the market, that when we introduce our private debt team they are very interested because they know our reputation. We're not alone, there are many private managers that have created such operations over the last five years as banks have deleveraged in the market. In the mid-market space, there are lots of opportunities for private debt," adds Dupont.

As mentioned earlier, the screening process for GPs begins way in advance of any fund raising. This is to plant the seeds of the relationship and get to know one another, to ensure the right chemistry, and investment objectives, can be achieved.

In the past, says Dupont, some GPs interested in building relationships have provided Northleaf with secondary opportunities that come to their knowledge. Having a better understanding of a manager's investment strategy and operations is part of the relationship building process, even before Northleaf invests with the manager.

"Private equity remains a local business and a people business. You want to work with people you like, you trust, and who you believe can make decent returns for your investors. It has to fit with our overall mid-market strategy. We like the buyout sector in Europe and we try to find the champions in each region, either locally or at the pan-European level.

"We look at the ancillary benefit from a primary commitment as well; will there be secondary or co-investing opportunities, for example? These can help with the overall return of our fund and make the relationship with each GP more valuable," outlines Dupont.



Aside from the personal chemistry, it is ultimately about the GPs track record, strategy, management style and alignment of interest with investors and within the team. Have they made successful investments in low markets and high markets? It's always comforting to know that managers have gone through market cycles and still generated good returns, says Dupont.

"The operational value created by the GP is very important. It's the same on the secondaries side. When looking for opportunities, we obviously want to pay the best price for our investors, but it really comes down to the quality and the growth of the underlying companies. More than 80 per cent of the value creation in our portfolio is generated by the growth in the portfolio, as opposed to the price discount," confirms Dupont.

With respect to PE secondaries, it has become a much more mature marketplace compared to 15-20 years ago, when there was still a stigma attached to LPs selling their positions in funds. GPs did not want it to be public knowledge.

Over time, however, GPs have learned that they could be involved in the process to build long term with investment partners, sometimes building a restricted list of potential investors.

He observes that there are a lot of deal types ranging from single LP positions/ portfolio positions to GP restructurings and preferred return solutions (where someone provides top-up capital against a preferred return on the portfolio).

The secondary market is very active at the moment. Greenhill's report estimated that around USD22 billion of PE secondary transactions were closed in the first half of 2017, which is much higher than last year. But some sellers remain patient.

"Interestingly, we've seen several transactions where even if one meets the seller's price, some decide to wait another quarter to see if additional upside in the valuation could be achieved. That could be a tricky guess, in the present environment. But overall, one could say there is a buoyant secondaries market in Europe, which should remain that way for a certain number of months," comments Dupont.

He concludes by noting that, while high valuations remain a concern, and despite GP quality, "one has to make sure not to get caught in a valuation bubble." ■



China opens up to new investment

Beverly Chandler investigates the likely impact of new steps to open up bonds and equities in China.

Recent news on both equities and bonds in China has placed the country squarely in the centre of the emerging market investment arena for institutional investors.

Early June saw MSCI unveil plans to slowly add China A shares to its emerging markets index. The index firm plans to add 222 China A Large Cap stocks – including Bank of China and Tsingtao Brewery – on a gradual basis, beginning in 2018.

However, reactions were mixed as the market had largely discounted this widely broadcast development in valuations and ongoing concerns about the transparency of the Chinese business sector.

David Walter, director, PAAMCO, says: "The process of getting China A Shares into the MSCI was longer drawn out than people expected, and even when that was announced, it was kind of an opening of the door rather than the Full Monty and you will see the same with the bond market."

Timothy Atwill, Head of Investment Strategy at Parametric – which invests entirely in emerging market equities – agrees, saying: "There will be minimal impact at first, given the relatively small size of the allocation to A-shares in the index. For active managers, they can ignore without suffering tracking error consequences, while passive investors will have a very small allocation which will likely have a small diversification benefit from the inclusion of A-shares."

Diversification could be improved because there is a wider scope of industries represented on the mainland exchanges, potentially enabling a broader representation of the Chinese economy for both active and passive investors.



"There still exists material currency repatriation risk with respect to the Chinese yuan, and market access and investor protections are extremely primitive when compared to other emerging markets."

Timothy Atwill, Parametric

"As the allocation grows, this will have a more meaningful impact for both types of investors, as the decision will be more consequential. On the positive side, there is evidence that A-share managers are able to uncover more alpha in the mainland markets," Atwill says. "However, many theorise this is due to the high amount of retail investors on these markets, which means the introduction of institutional investors may remove this alpha generation."

Looking forward, Atwill believes that the time frame for China having its impact on EM equities will depend on the pace of growth of the index's allocation to A-shares.

"Currently, they are using a 5 per cent inclusion factor to temper the impact of the initial allocation to A-shares. This equates to 0.75 per cent of the index's value. At 100 per cent inclusion, this becomes something like 17-20 per cent.

"At such an allocation, all institutional investors will have to have the capability to trade in the mainland exchanges, and, arguably, all active managers will need to be able to apply their alpha-seeking activities to mainland-listed companies. The pace is dependent upon market reform within China, so could take as little as five years, or as much as 10."

Atwill says that as a firm they have deep concerns about some aspects of the mainland China markets.

"There still exists material currency repatriation risk with respect to the Chinese yuan, and market access and investor protections are extremely primitive when compared to other emerging markets. Currently, 5-6 per cent of the market cap of the A-share market is halted – it cannot be bought or sold. This far exceeds the amount halted in any other country, and represents a large risk for investors expecting the ability to buy or sell at a given price on any given day," Atwill says.

Atwill also notes that China has developed its markets extremely rapidly to allow foreign investors access.

"Many of these developments were done in pursuit of entry into the MSCI index," he says. "Now that they have achieved this status, it is hard to predict how much impetus they will have to continue. While this initial allocation appears appropriate, as it increases, investors would be well-served to make sure that they are in agreement with the assessment of the index providers. In our opinion, one needs to approach with caution a major allocation to a market which has historically shown little interest in the rights of foreign investors."

Turning to bonds, May saw the China authorities announcing the launch of a Bond Connect programme to allow investors operating in Hong Kong to trade Chinese bonds, called a 'northbound' flow, with a 'southbound' flow of Chinese investment into Hong Kong to be considered later.

In a report, UBS Asset Management projected that China's bond market would double in size from the current USD9 trillion over the next five years, overtaking Japan's to become the world's second largest behind the United States.

Commenting on the launch of Bond Connect, Mo Ji, Chief Economist Asia ex Japan at Amundi, says: "This is another step in the normalisation of Chinese capital markets which is a trend that no one should underestimate.

Chinese stock markets account for 10 per cent of global market cap, and Chinese



"Greater transparency around the Chinese bond market should lead to increased investor awareness and confidence."

David Walter, PAAMCO

bond markets rank third in the world. We will see their integration into global markets go progressively deeper.

"Governance and transparency will continue to improve in the process. Investors who ignore this strategic development will be at a significant disadvantage. We will increasingly see Central Banks buying Chinese government bonds."

However, again there are voices expressing caution. PAAMCO's Walter says: "In the short term, it won't have much effect, the access is to the mainland bond market and we can only see the weakness of credit discovery on onshore markets and the cost of hedging back into offshore so there is no real value in the market at the moment."

Trading platform Tradeweb is already at the forefront of electronic trading in China. The firm writes that it is the first electronic trading link in the Bond Connect initiative, enabling international investors to trade Chinese debt instruments more easily and efficiently, while allowing for greater pre-trade transparency.

Li Renn Tsai, managing director and head of Asia at Tradeweb, says: "Over the last two years, Tradeweb played a critical role in the creation, development and design of Bond Connect, helping to further open China's domestic bond market. We will continue to invest in our China business and enhance our Bond Connect product to add more value to our clients."

Tradeweb explains that Bond Connect is a scheme providing electronic trading only access to the China bond market. "Over time we expect this to accelerate the adoption of electronic trading in their fixed income markets a result of increased behavioural familiarity from the trading community. Traditionally, operational efficiency and access to a more complete network of market participants have been catalysts in this growth, though we've seen the rise of regulation become a new factor in electronifying markets.

"Greater transparency around the Chinese bond market should lead to increased investor awareness and confidence. The establishment of Bond Connect will open up the Chinese bond market to foreign investment. This will give international investors the ability to diversify their assets into the world's third largest bond market, but it will also provide Chinese issuers with new sources of international capital.

Walter says: "From the credit point of view foreign rating agencies will be able to look at onshore bonds which will be interesting as one of the big criticisms is that credit discovery has been very poor with bonds from the same company rated investment grade onshore and high yield offshore." ■



Li Renn Tsai



Investcorp to build UK property portfolio

James Williams writes that Investcorp is rolling out a UK industrial and logistics programme to target income-generating industrial assets across the country.

It is the first time Investcorp has zoned in on European real estate. The UK industrial strategy, which will be part of a wider European investment strategy, aims to build a diversified portfolio of single-let assets with individual lot sizes of GBP10 million to GBP20 million. Once completed, the portfolio of eight to 10 assets will have an aggregate value in excess of GBP100 million.

"We have a very successful US real estate business and for a variety of different reasons there was never a focus on European real estate. There was a review of various business lines a couple of years ago and the decision was taken to build upon the success of the US real estate business and try to build a real estate platform here in Europe. I was hired 18 months ago to oversee the development of this platform," explains Neil Hasson, Managing Director in Investcorp's Real Estate Investment division in Europe.

The first two real estate assets are two modern warehouse units in Doncaster, a key distribution hub in the UK.

Additionally, Investcorp has acquired a light manufacturing facility on the Sutton Fields Estate, the largest industrial estate within Hull. The properties comprise a total of 504,000

square feet and are both let to two different tenants on long leases. Investcorp acquired the assets for a total consideration of approximately GBP35 million, in partnership with UK-based asset manager, Brydell Partners.

"Both the Doncaster and Hull assets fit well within our UK industrial and logistics programme. The assets are well located and we believe they are positioned to benefit from the growth in e-commerce and consumer spending habits," says Hasson.

Investcorp has approximately USD5 billion in gross AUM and operates a diversified investment approach, investing across a broad range of sectors including office, industrial, multifamily, retail, and hotel. To give some context on the scale of its US business, over the past two years it has acquired US commercial real estate assets totalling approximately USD2.5 billion in gross asset value, including over four million square feet of office assets from sellers such as Tishman Speyer, Prudential, Blackstone, Baupost, AEW, and Fortress.

The Investcorp model, which has worked well in the US real estate space and global private equity space, utilises its strong balance sheet to acquire assets directly.

"We develop a portfolio of similar-type assets and then we place the equity from those deals with our clients. They access these deals once we have acquired a portfolio of assets, and we have enough size and diversification to offer them. That's the simple way of describing the business model," confirms Hasson.

This is broadly similar to co-investing, but as Hasson is quick to point out, what it is absolutely not, is a syndication model. "That implies you tie up deals and then run around to try and find the money, which is the opposite of what we do. Maybe a better term to co-investing is club deals; we are building portfolios alongside our clients."

Hasson says that what works well for its investor base are assets that produce relatively predictable cash flows over the entire investment period, with the opportunity to generate some capital growth through either the appreciation of the asset(s) or by adding some value along the way:

"We refer to that as Core Plus investing, and that's what our European investment strategy will focus on. Our view is that that style of investing probably lends itself best to investing in Europe. We will look at assets that are defensive, assets where there is limited new supply coming to market, and assets where there is good demand from occupiers. That has directed us towards the industrial and logistics space in the UK. We have developed a good relationship with an operating partner and we see good deal flow in that sub-set of UK real estate."



"What these industrial assets give us is a runway to be able to deal with this period of uncertainty. If we get through the next 24 months, we've still got enough lease term for our tenants to adjust to whatever the new business climate is."

Neil Hasson, Investcorp

A second area Investcorp would consider, as part of its European investment programme, is suburban office space. Hasson confirms that they would like to make acquisitions on the residential side, "but the pricing of European for-rent residential relative to what my colleagues in the US see for similar risk, is much more expensive at the moment".

The fact that the US team has a 25-year

track record means that Hasson and his European team have substantial experience to draw upon and guide them in their deal selection. "They have great relationships with our stable of investors and there's a lot of confidence within the organisation, simply because of the length of time they've been investing in these deals," says Hasson.

"However, real estate investing is very much a local business. My US colleagues realised they couldn't do this without being here on the ground in the UK."

If a prospective deal has too much of a value-add component to it, the European platform would debate with their US counterparts whether it has the right risk/return profile or whether it's the right sort of investment for its investors, many of whom are looking for good cash flow from the get-go.

"Our US real estate arm has seen some great success investing in the industrials and logistics space and we look forward to leveraging and replicating that experience and success in Europe as we approach our medium-term target of USD25 billion AUM and are actively working on a strategy to increase that to USD100 billion," commented Mohammed Al Ardhi, Executive Chairman of Investcorp, at the time of the European acquisitions announcement last month.

The most important criteria for both of the UK industrial assets is that they are mission critical assets for the tenants' respective businesses.

In the one asset, the tenant makes and distributes food products. In the second asset, the tenant stores glass bottles and containers. "When you walk through the warehouse, you see just how important the distribution facility is to the tenant. They would find it very difficult if they didn't have access to this real estate. We take a lot of comfort from that. It is reflected in the rent they pay and the length of the lease they have signed, which is very helpful in terms of predicting future cash flows," states Hasson.

He says that one of the core tenets of the investment strategy is that by building a portfolio of individual assets, it will reduce the idiosyncratic risks associated with individual assets.

"If we build a portfolio of eight to 10 assets and something goes wrong with one of those assets, it is likely to be asset-specific rather than market-specific. That is really



what's driving the strategy, and I think the characteristics of the first two assets are exactly what we're looking for in the overall portfolio.

"Both these assets are in good markets, both are functioning real estate. In the event that a tenant was to leave, we think we've got something that would be picked up by another tenant in the marketplace. Both assets are of the right quality, the right layout, and have the right characteristics for distribution and logistics."

One might consider investing in the UK to be a risky business right now, given the uncertainty that lies ahead while the UK government tries to negotiate its divorce with the European Union.

Hasson confirms that following the Brexit decision last year, there was pause for thought before rolling out the industrial programme. "At the time, we were mostly focused on office space in the city of London and our view today is that there is still an element of uncertainty. It's impossible to predict what will happen in London over the next 24 months.

"What these industrial assets give us is a runway to be able to deal with this period of uncertainty. If we get through the next 24 months, we've still got enough lease term for our tenants to adjust to whatever the new business climate is," confirms Hasson.

In both instances, distribution is local. These are businesses that are, by-and-large, UK-centric. The glass bottles are used for domestic consumption. Inputs are sterling-based, and therefore input costs are not affected by a weaker currency as nothing is being imported.

The second asset is also purely for domestic consumption.

"Some of the inputs are imported but we felt comfortable in both instances, when acquiring these assets, that the tenants would be able to deal with any of the Brexit shocks," he adds.

As expected, a weaker sterling is attracting foreign capital to pick up UK assets at discount, but Hasson notes that sellers always look in the rear-view mirror. They want pricing based on the market pre-Brexit and won't take a discount.

"There is still pretty good demand at the property level in the UK property market but more of a widening of the bid:ask spread between buyers and sellers," concludes Hasson. ■



Responsible investing meets activist shopping

James Williams investigates various approaches to impact investing.

Speaking at the Cayman Alternative Investment Summit (CAIS) this February, Tania Carnegie, Leader of the Impact Ventures practice at KPMG, said: "Impact investing is investing in innovation that will help drive success for both society and the economy over the long-term. Many institutional investors are already investing in impactful opportunities in emerging markets, real estate, and infrastructure so it's complementary to their current approach to asset selection."

Abigail Noble is the CEO of the ImPact, a non-profit organisation whose mission is to help families to make more impact investments, more effectively. In her view, family offices are engaging in impact investing because the next generation is interested in social impact and sustainability.

"It is a way for the next generation to take a leadership role within the family," said Noble. Also, it's a way to engage in new markets; private equity funds that focus on affordable housing, green energy companies, agricultural technologies that have a positive impact on the environment, etc. She said that while we are still at the early stages of measuring impact investing: "It will continue to evolve as the horsepower of analytics and greater collaboration improve."

With that in mind, one might expect the number of hedge fund signatories to the UN Principals of Responsible Investment (PRI) to be on the rise, keen to demonstrate to investors that they are embracing ESG factors into their investment strategies. However, this has yet to transpire.

According to Marisol Hernandez, Manager, Investment Practices, UN PRI: "We have no more than 30 or 40 managers but you don't need to be a PRI signatory to develop an RI policy. Investors come to us and ask 'Who are those managers who are signatories?' The problem we have is that the number of managers is still very small in comparison to the total industry."

In the first step towards bringing greater clarity and uniformity, on how to think about this issue, UN

PRI engaged with AIMA and the Hedge Fund Standards Board to develop a DDQ to help managers respond to investors in a consistent way. The questionnaire, known as the HF RI DDQ, is available on AIMA's website and will be part of the wider Fund Managers' DDQ this autumn.

"The idea was not to repeat the same questions on governance already covered by AIMA. We came out with four questions that focus on responsible investments for investors. Governance is a key starting point, in our view, when thinking about developing an RI policy," says Hernandez.

Hernandez notes that one of the first questions that managers often raise with respect to responsible investment is, 'Where do we start with this?'

The first step, she says, is to develop an RI policy, which then prompts the next question: 'If I develop a policy, would I need to change my investment strategy?'

The answer is 'No', with Hernandez asserting that it has no bearing on the strategy whatsoever.

"The way I understand it is that allocators who like your strategy will look at your RI policy concurrently with – not instead of – their more traditional due diligence," says Marianne Scordel, Founder of Bougeville Consulting, a consulting firm for hedge funds now based in New York. "Your investment strategy, and your returns that go with it, is the reason why they've decided to look at you in the first place, so changing that would completely defeat the purpose," adds Scordel, who attended the PRI event in New York last month.

Nearly all ESG investment programmes emphasise the long side: managers typically employ quantitative measures such as CO_2 emissions per USD of sales, environmental fines, and indices of board diversity, to identify companies that have a positive impact on society,

Apache Capital takes a more aggressive approach. Philippe Burke, CIO of the New York-based hedge fund, manages a long/short strategy called Disrupt! that targets commodities and companies with a negative impact on the environment, and shorts them, selecting his entry points using machine-learning algorithms. Disrupt!'s ESG mission is to have a positive impact on the environment by reducing economic incentives to damage nature.



Marisol Hernandez, Manager, Investment Practices, UN PRI

As Burke sees it, companies don't degrade the environment because they like pollution or are inherently bad agents, they pollute because they are handsomely rewarded by the market for doing so, and if we can introduce a market mechanism to correct this market failure, there may be materially less of it.

"We care about S and G, but we are much more driven by E, says Burke. "Our primary interest is to get polluters to change their behaviour. Our message to management is 'You have two choices: if you don't change your behaviour, we will short your stock and get as many people as possible to divest or short with us, or we can come together and work out ways to make positive change'," explains Burke.

Burke, incidentally, has every intention of becoming a UN PRI signatory. Building investment strategies and allocation ideas around responsible investment, or ESG, is becoming a key consideration for a wide range of institutional investors.

Dipender Saluja is Partner and Managing Director at Capricorn Investment Group, which manages USD5 billion in assets for the Jeff Skoll Foundation. He sees energy, agriculture, healthcare and space as key sustainable investment opportunities, with technology the common theme in each.

"In the next 50 years, we are going to grow more food than we have in the last 10,000 years.

As the world's population grows from seven billion to 10 billion people, and markets like China, India and Africa catch up with the rest of the world, we see huge opportunities in investing in those themes, with a positive impact. In India and China, the energy consumption, per capita, is 1/20th that of the West. Some two billion people have no access to reliable energy, food or transport and we think the opportunity to bring technology to these themes will create huge returns," said Saluja at the CAIS event in February.

Although Apache Capital also takes long positions within its portfolio, the impact part of its investment strategy is manifest through its short book. Burke explains that financial markets are beginning to reflect environmental and social objectives today in three ways:

First, is the necessity to disclose material ESG risks to shareholders: if a company's supply chain is materially exposed to global warming risks such as water scarcity, that

exposure must be disclosed to investors in the same way other traditional financial exposures are reported under standard accounting rules. The SASB – Sustainable Accounting Standards Board – is doing remarkable work in championing this effort.

"The second financial argument for including ESG factors in one's investment decision is based on research showing that firms that demonstrate superior risk management discipline, including rigorous supply-chain risk management and environmental stewardship, tend to outpace their competitors on a variety of performance metrics, including exposure to regulatory fines, employee retention, and long term stock returns.

Apache's ESG mission is to help bend the pollution curve with a simple, market-based mechanism, that encourages firms to internalise their pollution externalities. Apache's hope is that with sufficient scale and partnerships with like-minded investors, the capital markets can become a significant positive force for environmental change, even in the face of government inaction.

"Our shareholders are very clear with us says Burke: 'their mandates dictate that they earn an attractive return on invested capital. The primary mandate of a pension fund for, say, retired teachers, is to earn an attractive return for its teacher-stakeholders. If that can be achieved with a positive ESG impact, great, but the financial objective must be met. Fortunately, these two objectives are not inconsistent with each other. For instance, a polluter with a poor financial profile may be an attractive shorting candidate irrespective of its environmental footprint. In addition, a long/short fund with an ESG mission is likely to deliver a return profile that is uncorrelated with those of traditional long/short funds."

Apache's approach seems to be working: their impact strategy has been running for about two years, and has generated double-digit annual returns.

Burke has a number of unconventional activist plans for the coming years. One is to build a mobile application that will allow people to scan bar codes on products they plan to purchase and obtain an estimate of their personal environmental cost associated with the product they are considering buying.

"Even if we only convince 2 or 3 per cent of consumers to become 'activist shoppers', that could have a material impact on the top line of polluting companies. Another is to encourage environmental activism with a curated, content-rich social network that "environmental evangelists" and "citizen scientists" can use to share information, brainstorm on grass root activist strategies, and collaborate on projects including tracking pollution, habitat protection, and divestment.



Delegates at the CAIS summit in February

This grass roots approach to encourage environmental activism is just the latest example of where investment management is tapping in to the needs of investors for more socially responsible investing. Whether activist shopping takes off remains to be seen, but with the power of the platform generation, anything is possible.

With investors becoming ever more discerning over which managers to allocate to, having access to clean data that provides evidence of those running ESG policies could, according to Hernandez, become an important factor in how managers differentiate themselves from their peers.

"If investors are selecting managers based on ESG criteria, there is still a lack of good data available today. The advantage we have, however, is that because little has been done, we can develop the baseline for engagement. We are engaging with database providers to help with this. For example, the HF RI DDQ is available on eVestment's platform and we are in discussions with other database providers. For investors looking for these types of funds, they will become more visible," concludes Hernandez. ■

Angelo, Gordon makes key hires

James Williams talks to Angelo, Gordon & Co, the USD28 billion alternative investment firm focused on credit and real estate investing, which has made key hires to support its ongoing business growth efforts.

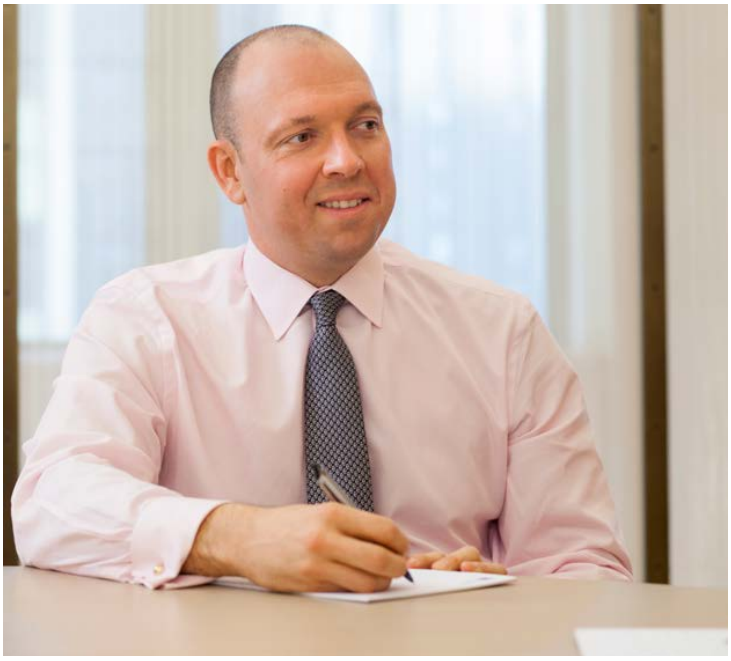
As Gareth Henry, Global Head of Investor Relations, tells AlphaQ: "Client service is critical to the success of a global real estate investment manager. We believe investors are best served when skilled investment management is supported and enhanced by excellent client service."

The two hires, Terri Herubin and Matthew Brody, will focus on client service and real estate marketing, respectively. Terri Herubin is former Managing Director and Portfolio Manager at Barings Real Estate. Her role will be to oversee client service for the firm's real estate portfolios and to serve as the real estate product specialist for the firm. Matthew Brody is former Principal at Walton Street Capital and will be responsible for new business development for the firm's real estate activities. Both are based in New York.

In talking about the importance Angelo, Gordon places on client relationship, at a time when digital platforms are changing the way that fund managers interact with their end clients, Henry emphasises that understanding clients' needs is vital to the firm's success as a business.

"We are committed to continuously improving not only the breadth and flexibility of investment options and advice we bring to our clients, but also the quality of service we provide. Terri and Matt are a big part of how we continue to evolve our Real Estate marketing and client services function in line with these commitments," he says.

While at Barings Real Estate, Herubin led the firm's open-end, core real estate fund. Previously, she served as Principal and Portfolio Manager for The Townsend Group, where she led the underwriting of US commingled fund mandates. Prior to Townsend, Herubin was a



"We are committed to continuously improving not only the breadth and flexibility of investment options and advice we bring to our clients, but also the quality of service we provide."

Gareth Henry, Angelo, Gordon & Co

Co-Portfolio Manager for the New York State Teachers' Retirement System's equity real estate portfolio.

"Terri is a respected leader in the real estate pension fund community with more than two decades of real estate experience serving in both client-facing and portfolio management roles," says Henry. "Her unique skillset spanning real estate product development,



fund management and client service will be especially valuable in meeting the changing and increasingly complex reporting and communication needs of clients. She will provide a knowledgeable and experienced interface between our portfolio management team and our clients.

"Terri will work closely with Matt and the broader business development team to serve the interests of investors looking for real estate investment opportunities. The quality of client communications and access to information is vital to a successful client relationship so the partnership between client services and marketing is a vitally important one."

Brody's deep product knowledge and relationships will help to deepen the quality of Angelo, Gordon's marketing efforts. He spent 11 years at Walton Street Capital, where he was responsible for business development and client services activities, as well as portfolio management for a variety of real estate products. Earlier in his career he served as an Assurance and Advisory Business Services Associate in the Real Estate Group at Ernst & Young.

Both Herubin and Brody will join Aliana Spungen who has been successful in building the firm's real estate marketing and client services capability since 1999.

"Terri's unique skillset, which spans real estate product development, fund management and client service, coupled with Matt's experience with the real estate investment community, will bolster our capabilities as we further strengthen relationships and expand the solutions we provide for our clients," commented Spungen at the time of the announcement.

Herubin will fill a newly created position of product specialist for real estate, as well as head of client service for real estate. "The role and the experience she brings to it will continue to improve the quality of service we provide to our clients, and provide enhanced support for our portfolio management and marketing teams," confirms Henry.

At a time when institutions increasingly look to do co-investing with private equity and real estate managers, building closer alignments will be a key facet of the ongoing fund raising process. Those who understand what LPs want from a product perspective, what their risk appetite is, etc, are going to be well placed.

"Angelo, Gordon's success over the last 28 years has been built on the depth of its talent across every part of the business and the level of teamwork that exists across the firm. Bringing on Terri and Matt expands our reach and deepens our existing teams as our real estate platform continues to grow. They deepen the bench of talent supporting our real estate clients," says Henry.

Asked about the co-investing trend, he adds: We are continually evaluating how best to respond to changing investor demands. To date, we have worked with certain clients interested in establishing co-investment platforms, and continue to work with individual partners on solutions outside of our platform."

Commenting on her appointment, Herubin says: "Angelo, Gordon has long been recognised for its unwavering commitment to putting its clients first. I am thrilled to work alongside this talented team to meet the evolving needs of the firm's real estate clients."

Angelo, Gordon's reputation in the real estate industry is built on its successful value-added approach across a broad range of real estate investment strategies, said Brody. "I look forward to working closely with the team to further engage the investment community and share our fund offerings with our investment partners." ■