By Joe Kalema

PRIVATE EQUITY: AN UNTAPPED ASSET CLASS FOR PENSION FUNDS

Stephen Mukwasi, an engineer, joined a large national company where all its employees were mandated to contribute to its retirement benefits scheme. He worked diligently for 20 years contributing to the scheme annually (ultimately contributing a total of UGX 120m). To his dismay, upon retirement, he received a package of UGX 150m – a figure less than the value of money he contributed to the scheme, given the effects of inflation. Why was the outcome so poor for Stephen, and by extension, other members of company retirement benefit schemes? How can we, as Ugandans, achieve a fairer outcome and guarantee our future through our investments and our retirement benefit schemes' investments today?

Firstly, let's examine what Stephen's retirement benefits scheme did. The company's scheme, though investing for its employers' long-term benefits, predominantly invested in short-term government securities and fixed deposit accounts, while also sporadically foraying into the Ugandan stock market. This earned the scheme a compounded annualized growth rate (CAGR) of no more than 3%, an under-performance of inflation over the same period. Basically, the fund LOST Stephen's money and DESTROYED value. Compared to regional, continental and global pension funds and retirement schemes, Stephen's, and most of Uganda's retirement benefits schemes, are doing their beneficiaries a dis-service. What could this fund have done, to do right for Stephen and its other beneficiaries?

So, what is the task, or more pertinently the fiduciary duty, of a retirement benefit scheme? The practice of spreading money among different investments to reduce risk is known as diversification. By picking the right group of investments, you may be able to limit your losses and reduce the fluctuations of investment returns without sacrificing too much potential gain.

As an example, a portfolio of only treasury bonds and cash is more risky than one where additional more risky assets are added (such as real estate and private equity) – this is because even though the assets themselves are riskier, the likelihood of all asset classes faltering at once – and thus of the portfolio potentially losing money – becomes negligible.

It is always important to keep an eye on and learn from what global pension plans are doing, since they employ some of the best global minds in finance and their strategies are typically deeply rooted in theory and best practices, developed over 50+ years of experience.

Let's take a look at the asset allocations of one of the most successful investment funds of our time – the Yale Endowment Fund. The Yale fund has boasted an annualized return of 17.2% during the last 10 years, outperforming the U.S.'s stock exchange by about 10% over the same period. With returns like that I think it is wise to see how they did it. It came down to their asset allocation. The asset allocation used by the fund was simple, yet very effective.

For a typical retirement benefits or endowment fund, no more than 30% is kept in fixed income (yet in Uganda, many are at 80%+!). Conventional finance wisdom and teaching, which tallies with the average split over more than 10,000 global funds of this nature, is that about 30% is allocated to fixed income, about 40% is allocated to equity, and about 30% is allocated to alternative investments (private equity, real estate, forestry, hedge funds, etc.).

With regards to the aforementioned asset classes, many of these are familiar to the retirement benefit schemes and fund managers in Uganda, save alternative investments. Alternative investments are a great complimentary asset for a retirement benefit scheme portfolio of investments for a number of reasons, one of which is their long-term match-up with the long-term nature of the retirement benefit schemes' capital, and the ability to therefore achieve exceptional returns through the power of compounding. Alternative investments are defined as investment products other than the traditional investments of stocks, bonds, cash and these include but not limited to, private equity, real estate, venture capital, hedge funds and derivatives.

A particularly interesting alternative investment that is developing a strong foothold in East Africa in general- and in which I have specific expertise- is private equity. Private equity is an investment asset class in which private capital is invested

into a privately held business in exchange for ownership in the said business. Private equity investors then translate this capital and their strategic and operational experience into rapid growth and profitability enhancement for the business in which the investment was made having added value, they exit their percentage ownership in the business at this new value, which is significantly higher than the value when the initial investment was made thus making money for their investors (pension funds, insurance funds, high net-worth individuals).

Private equity returns in Africa have been consistent and above average. Long-term saving vehicles, such as pension funds, are uniquely positioned to manage the long investment term of private equity to capture the significant performance premium and diversification benefits. In addition, private equity has lesser correlation with the aforestated asset classes, compounds its annual gains and is more resistant to the volatility of the stock market and short-term macro effects relative to short-term investments. Private Equity returns have been consistent and above average. The 2011 Monitor Group's report shows that all fund managers expected returns of over 20% in Sub-Saharan African markets outside South Africa with established players like Actis, Helios, ECP all reporting in excess of this. Established players have consistently outperformed the local public markets and other emerging regions. For example, Kingdom Zephyr's first private equity fund averaged an annualized compounding rate of 92% – unseen in other investment markets. Coming closer to home, according to Actuarial Services (ActServ) East Africa's investment survey, looking at Kenya alone, private equity has earned a one year annual return of 37%-39% for pension funds, again performing well over the NSE.

So, as the Uganda Retirement Benefits Regulatory Authority Act and the imminent Liberalisation Act come into effect, it is imperative that even voluntary retirement benefits funds and pension funds look to more appropriately allocate their portfolio funds, and that, in the process, they look more carefully at private equity as an investment asset class. Ignorance is not a sufficient excuse for the violation of one's fiduciary duties. With the urging of their beneficiaries, retirement benefits schemes must push themselves to do the best for those who, like Stephen Mukwasi, have entrusted them with their future.

About the Author
Joe Kalema is an investment professional at Damascus Capital. Damascus Capital is an East African private equity investment firm which invests in and consequently focuses on building capacity and fuelling growth in local small and medium enterprises.

A combine harvester at the Northern Uganda Agricultural Centre (NUAC). NUAC is one of the projects that accessed financing from Principal Capital Partners (PCP) a private equity fund manager.