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Imara Funds Quarterly Report

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Performance Review:

African markets have had a tough time since the Global Financial Crisis and the period since 2011 has been particularly tough as a strong dollar took its toll on emerging, frontier and commodity markets. As we have written in the last two quarterlies, we believe that this difficult period is drawing to a close in part because we believe that the US dollar has peaked but also due to the necessary economic reforms that have to a great extent been forced upon various African Governments by the tight liquidity conditions that a rising dollar has brought about. The Global environment has provided a fairly benign backdrop for frontier and African markets this past quarter as well as six months with investors becoming more immune to political surprises that impacted markets in 2016. In addition rising interest rates and an end to QE are now being discussed more commonly outside of the USA where interest rates have been rising quite sharply since mid-2016. Bond yields have risen on the back of these discussions within Central Banks although their rise, which has been on a similar scale to the "Taper Tantrum" of 2013 (UST 10 year bond yields rose by 85% then vs 71% now), has not led to an equity sell-off this time round.

The net result is that Africa ex South Africa has had a very strong quarter with a 17.0% gain in US dollar terms (MSCI data but using the official Nigerian currency rates – see over) and a 16.4% gain since the end of 2016. As such Africa is slowly catching up with the MSCI Emerging Markets index which gained 18.4% over the six months and rose 6.3% over the quarter. Developed markets by contrast were rather more subdued gaining 4.0% since March. Drilling down into Africa, Zimbabwe saw the largest gain with a 41% move over the three months. The MSCI Nigeria index gained 33.6% but by an estimated 16% if the new foreign investors' exchange rate is used (NAFEX rate – see over). Egypt, Kenya, Mauritius and Zambia all rose by between 14-18% using MSCI data.

Looking ahead, it has been encouraging to see volumes in markets rising once again signaling that investors are looking more positively toward Africa, a view that we share.

Portfolio Review:

The portfolios of our various Africa funds are largely driven by our investment approach. We aim to buy good companies with high returns on invested capital and with sustainable business models at the right price wherever they might be listed in Africa. In this way we are index agnostic. The liquidity terms of the Funds allow us to invest in such businesses that may trade less often than the blue chips in the more liquid markets that make up much of the various African indices. As a result, the Funds have exposure to a number of the smaller markets and companies in Africa that more benchmark orientated portfolios might miss or ignore altogether. We choose to hold a focused portfolio of businesses that currently number less than thirty. Our aim is not just to pick the winners, but to avoid the losers as best as possible. This approach has allowed the portfolio to sustain less volatility than the indices and outperform them over the medium to longer term.

Since our focus is primarily on investing in strong business models rather than speculating on market sentiment or economic outcomes, neither of which we have any expertise in, our portfolio turnover is low....often less than ten percent. We have added no new core holdings to our African portfolios over the quarter. Indeed in many instances weighting changes reflect the movement of the underlying asset values within the portfolio. Over the past quarter we have taken advantage of the strong rise in Zimbabwe to reduce exposure there although repatriating the proceeds has proved difficult to date.

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Commentary:

In November 2016, Egypt liberalized its foreign exchange market overnight and allowed the Egyptian Pound to float freely. The subsequent devaluation was rapid and substantial but it fairly soon found its level and arguably the Central bank has since been holding the currency down on the back of huge foreign exchange inflows. At the same time the Government introduced further but complimentary reform measures as it has continued to do under the guidance of the IMF. The Stock Market has been strong as a result and volumes have ballooned as compared with 2016.

The same cannot be said for Nigeria where the authorities have chosen the slow and frustrating road to reform. Cynically much has been achieved during the past six months whilst the President has been on sick leave in London, thereby allowing his Vice President a freer hand to undertake reform. In our last quarterly, Jon Chew wrote about the Central Bank's efforts to strengthen the black market exchange rate that was trading at over N500 to the US dollar by pumping in foreign exchange to cover retail demand for the likes of school fees and medical expenses. This had the effect of cutting the black market rate to N360 as compared with an official rate of N305. This past quarter we have seen a new and more radical exchange rate policy initiative through the creation of a new foreign exchange market for importers/exporters and foreign investors called the NAFEX mechanism. This new market has allowed foreign investors to offer their US dollars for sale to those looking to exit or to importers of raw materials. This new exchange rate initially traded around N380 to N400 but ended the quarter at N366 as compared to an official rate of N322. Since introducing the NAFEX window, the Central bank has enhanced the mechanism by allowing interbank trading that has improved volumes and importantly transparency in the rate. For the Stock Market it has finally enabled foreign investors wishing to buy Nigeria to do so at a market determined rate whilst allowing those who have had Naira trapped in the country to repatriate. The net result has been a sharp rise in trading volumes and the market, a similar affect to that we saw in Egypt in 2016. Unfortunately the likes of FTSE Russell, MSCI and other index providers, have not yet decided to use the new exchange rate to calculate US dollar returns which is somewhat surprising to us. For the Imara Funds investing in Nigeria, we are using the new exchange rate as it is at that rate that we can repatriate funds should we need to. We believe that the Benchmark providers will also move to the new exchange rate when they have completed their analysis. The official exchange rate frustratingly remains in place; it is the rate used to calculate the price of imported fuel that Government is reluctant to allow to float. We hope that the Vice President will soon choose to liberalise the entire foreign exchange market as Egypt has done, especially now that Nigeria is running both a current account and trade surplus.

By contrast Zimbabwe has been strong but not on large volumes. Indeed foreign investors have remained on the sidelines in part because there is a long queue for US dollars when repatriating sale and dividend proceeds, not too dissimilar from the problems investors faced in Egypt and Nigeria up until this year. Faced with low interest rates at home, domestic pension funds have been channeling more money into the Stock market where well run companies offer dividend yields that are higher than deposit rates but with the added attraction of capital upside. Unfortunately Zimbabwe has an election year in 2018 and hence we don't expect any radical reform programmes before then. Encouragingly the IMF and World Bank are standing by to assist. Results from the local companies have also been encouraging with an increasing number of businesses paying dividends and in some cases special dividends.

Elections are expected in Kenya in August of this year. Whilst Kenyatta, the incumbent, is the likely winner, this is by no means certain. Kenya has been hit by a major drought which has negatively hit the rural population with tea, coffee and horticulture all impacted. Further bank lending has slowed sharply as a result of a politically inspired interest rate cap that has led to a reluctance by the banks to lend. These factors have given rise to a slowdown in the economy. The exchange rate has been stable for over a year now and to us looks overvalued. This could be a risk post the election.

John Legat, July 2017

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