Albright Capital

THE POWER OF COMPOUNDING

Investors are correct to demand excess returns and/or positive diversification benefits from emerging market (EM) private markets.

However, our sense is that limited partners and fund managers alike focus excessively on the pursuit of excess returns and insufficiently on the pursuit of diversification benefits, which we primarily define as low correlation to developed markets.

Moreover, limited attention is paid to the interplay between these two variables: investors should seek a larger premium for performance that is highly correlated to major indices and a smaller premium (if any) for performance that has low correlation to major indices.

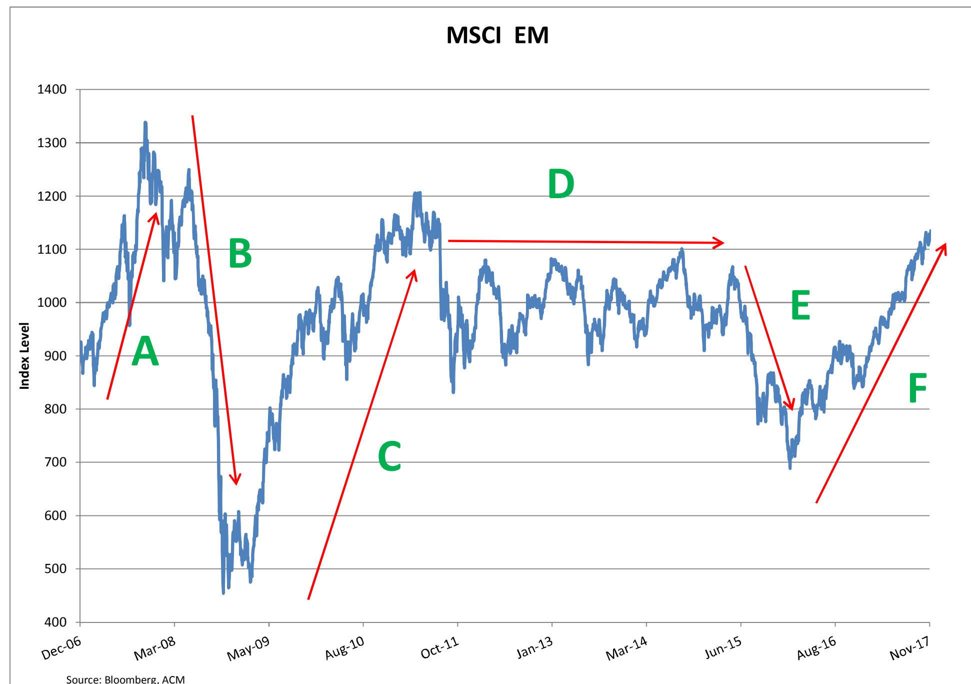
Excess returns from EM private markets are often implicitly or explicitly sought through macro based global (MSCI EM) or local (country selection) market timing, rather than through the micro based selective acquisition of a portfolio of high-quality assets at attractive prices. The latter strategy can be intentionally designed to compound consistent uncorrelated results (i.e., generate alpha).

Compounding Produces Superior Risk Adjusted Returns

We thought it would be interesting to look back in time to January 1, 2007 and investigate what might have been possible from a market-timing standpoint since then.

The chart below shows the MSCI EM with the major moves highlighted (A-F). Further below, we show how three fictional long only investors—The Guru, The Hugger, and The Chump—might have fared.

These results are then compared with The Bargain Hunter, who prefers the selective pursuit of high quality assets at attractive prices over market timing. His goal is to generate a consistent mid-teen net return with an intermediate term horizon across all market environments.



The Guru: This investor managed to catch 100% of the major up periods and avoid 100% of the major down periods. However improbable this accomplishment, he earns an impressive 19% annualized gross return. Some may be justifiably surprised that the returns from such clairvoyance are not higher. In fact, extensive periods in cash when the market is flat or declining limit the aggregate upside.

The Hugger: This investor was fully invested throughout the period and replicated (hugged) the MSCI index, either by buying the index itself or being over diversified in their EM PE program. He earned a gross annualized 1.9% return (with a whopping 23% annualized volatility).[1]

The Chump: This poor soul somehow mistimed the market completely and was fully invested during all major down moves and fully disinvested during all major up moves. He earned a gross annualized *loss* of 10.5%. If the annualized loss may look somewhat smaller than expected for such extreme misfortune, it may be helpful to consider that the losses are on a declining capital base. In fact, he manages to disastrously lose 70% of his original capital.

	Investment Period							
	A	**B**	**C**	**D**	**E**	**F**	**Cumulative Return**	**Average Annualized Return**
The Guru	Long	Cash	Long	Cash	Cash	Long	562%	19.0%
The Hugger	Long	Long	Long	Long	Long	Long	23%	1.90%
The Chump	Cash	Long	Cash	Cash	Long	Cash	-70%	-10%

[1] Returns for MSCI EM are annualized compounded price returns and The Bargain Hunter by IRR, as per market standards for public and private investments respectively. The returns highlighted here are for illustrative purposes only. Investors should do their own analysis of comparative returns before making any given investment.

The Bargain Hunter: By comparison, a value-based private investment program should have the potential to generate a consistent mid-teen net return (15% used for this exercise). The businesses built, and the idiosyncratic opportunities sourced, continue to compound attractive returns even when the MSCI EM is flat or declining. The Bargain Hunter underperforms the Guru, but not by as much as some might think. Moreover, most investors would acknowledge the superiority of these returns on a risk-adjusted basis since today's Guru is often tomorrow's Chump.

				Correlation to		
	Net IRR	Net MOIC	Avg. Life	MSCI EM	S&P	EMBIG
The Bargain Hunter	13 - 17%	1.8 - 2.5x	<7 yrs	< 0.25	< 0.25	< 0.25

Generating Consistent Results from EM Private Markets

Just as there seems to be undue faith in the EM growth story, there seems to be a false narrative that investing in EM private markets inherently delivers positive diversification benefits. Positive diversification benefits are not automatically produced because one is investing a long way from home.

Diversification benefits (low correlation) are produced when a value-oriented manager purposefully seeks investments that are either (i) naturally idiosyncratic, (ii) intentionally structured to generate an asymmetric return profile[2] , or (iii) inherently uncorrelated[3]. Opportunities like this are more prevalent in EM than DM, given their relative inefficiency, especially in the midst of capital flight after market declines.

Most professional investors conceptually understand the value of diversification benefits, but seem to lose track of this important objective when actually allocating capital to EM private markets. Additionally, even if they do seek low correlation, they may accept notional assertions of diversification benefits that ultimately prove illusive, rather than demanding quantitative evidence of low correlation from a given investment strategy historically.

The Bargain Hunter Avoids Selecting Deals with Macro Drivers

Emerging markets are endlessly fascinating, featuring a growing consumer class, rapid economic growth, economic and currency shocks, entrepreneurial energy, political turmoil and regime change, ethnic and civil strife, compelling developmental and other human achievements, and (our favorite) fantastic local cuisine.

[2] Defined as the high probability of a return of capital when things go poorly, while maintaining "equity" upside when things go well.

[3] For example, consistent returns from the provision of essential public services (which are often aligned with the objectives of host governments).

Smart people have an understandable tendency to develop strong opinions about these (and other) macro phenomena and their future trajectory (thus the temptation to market time). The Bargain Hunter understands that such opinions should never be misconstrued as effective primary drivers for a given EM private investment thesis.

To be clear, for risk management purposes, every potential investment must be sequentially viewed through a variety of macro prisms. They just shouldn't be the central thesis and distract from the primary mission of discovering (i) exceptional management teams singularly focused on addressing major market inefficiencies; and/or, (ii) high-quality assets temporarily stressed or orphaned by dynamics essentially outside of their control.

The Bargain Hunter's Portfolio Construction

Rather than continually seeking outsized returns (>3X net MOIC) with frequent losses (somewhat similar to the return dispersion of a venture capital portfolio), The Bargain Hunter prefers steady returns across market cycles and a portfolio consisting of a lot of attractive returns (>2X net MOIC) with limited losses.

When each deal inherently delivers or is structured to deliver excess returns and low correlation, the whole portfolio naturally follows suit. It should be noted that the inefficiency of EMs (capital shortage) is often so great that downside protections can be negotiated without any sacrifice of upside. Avoiding losses also allows for more realistic assessments of potential exits for winners and thereby accelerates return of capital, thereby materially shortening the average life of the portfolio.

Such a portfolio effectively de-risks the emerging market asset class, with a high probability of comfortably exceeding an investor's official hurdle return, and outperforming developed markets, in the intermediate term.

The Bargain Hunter Requires a Flexible Mandate

In EM private markets, a flexible mandate, by geography, sector, and place in the capital structure, is essential for alpha generation. It enables a contrarian instinct and targeted sourcing from temporarily out of favor sectors and jurisdictions.

Effective bargain hunting from out of favor jurisdictions still relies primarily on micro factors, especially a strong management team, as the central investment thesis. While it is tempting to base investment decisions on macro factors after a sharp market sell off, care should be taken to avoid the "value trap" or attempting to "catch a falling knife."