Investment Newsletter, February 2020

London Eye, View from the Thames River, London, UK - 22nd December 2019 (Courtesy S. Dry)

Dear Investor,

As 2020 gets underway, it is a good time to look at how we preserve and grow our clients' personal wealth. It is a perennial question but one that requires assessing economic trends, demographics, and geopolitics. As someone said, whose name we can't remember, "it is kind of like walking a dog on a long leash".

One logical starting place to look, however, are growth forecasts and the assumptions that support these estimates. The usual barometer of economic growth is Gross Domestic Product (GDP) - that imprecise gauge of all goods and services produced within a nation's border in a year.

We say imprecise, because it is imprecise. For example, when economists were inventing the GDP concept back in the 1930s, there was disagreement over whether to include government spending in GDP. Since government spending is other people's taxes or even worse, taxes not as yet collected, isn't this double counting? No matter, it was decided to include it anyway. So, setting aside this and a host of other problems with GDP, it is a starting point. [For an entertaining read on the origins of GDP, read mauldineconomics.com/frontlinethoughts]

In any event, economic expansion is not what it was in the years preceding the Great Recession of 2008 where 4% plus in developed economies was the norm. These days 1 - 3% is the "new normal" in developed economies. These are some World Bank's GDP actuals and estimates going into 2020:

	Global	US	Euro Area	India	China
2018	3.0%	2.9%	1.9%	6.8%	6.6%
2019	2.4%	2.3%	1.1%	5.0%	6.1%
2020	2.5%	1.8%	1.0%	5.8%	5.9%

Christ Church, Oxford, England, UK - 25th December 2019 (Courtesy S.Dry)

Into the Future … 2020

Economic Trends

One of the economic trends that investment firms in 2020 are focused on is 'climate change investing'. Often called ESG (Environmental, Social and Governance) Investing, it includes investing in renewable energy, clean water, electric car companies and so on. Franklin Templeton has a new Climate Change Fund which is up 21% over the past 12 months. Its biggest position is in a company called Abelmare Corporation which is a leader in lithium production which is used in batteries for electric cars, solar panels, mobile phones and other battery uses. There are numerous Exchange Traded Funds (ETFs) focused on climate change sectors like Invesco's Solar ETF (ticker symbol "TAN") up 52% in 2019. Green bonds are another way to invest in climate change companies, although in debt not equity. These green bonds offer a way to invest in projects seeking to reduce the biocarbon footprint of buildings, transportation, agriculture and other areas of human activity.

Another potentially profitable trend in 2020 is the ever expanding internet retailing.

Disruptive industry giants like eBay and Amazon are replacing bricks and mortar shopping malls and the traditional high street shops. Over 9,300 US retail outlets of various companies like Sears and Payless Shoes, closed in 2019. Even industries like the pet industry are being transformed by companies like Chewy, up 40% in 2019 (ticker "CHEY") which sells discounted pet products online.

Demographic Change

Changing demographics will also be important in 2020. We read recently that 10,000 people in the US turn 65 years old every day. These Baby Boomers were all born between 1946 and 1964 and represent some 25% of the overall US population. More broadly, the UN says that in 30 years, 17% of the individuals on this earth will be 65 or older compared to 9% today. Nursing and health care are obvious growth industries as well as companies purporting to increase longevity. One Exchange Traded Fund capitalizing on this is the Global Longevity Thematic fund "LNGR" up 20% during the last 6 months.

Geopolitics

But perhaps the most important consideration in 2020 will be geopolitics. Central banks keep printing money thereby debasing currencies. Governments continue deficit spending thereby threatening a debt crisis. All European Union members, for example, signed a treaty on joining the EU promising that their annual national budgets would not have a deficit (that is, unfunded by taxes) of more than 3% of their GDP and public debt would never exceed 60% of GDP. Today, France, Spain and Belgium all have public debts at or exceeding 100% of their GDP. Greece's debt is 181% of GDP. The debt crisis is a time bomb. We just don't know when the it will go off. For our purposes, we will put it aside as a longer term problem, but it must be dealt with at some point in each nation's future. For now, let's focus on shorter term 2020 geopolitics.

What is perhaps the most striking consequence of the Great Recession of 2008 is the continuing negative or near negative interest rates in developed economies. Interest rates have not returned to their historical levels over the past decade as happened in previous recessions. Germany's 10year bond currently pays a negative 0.61%. Yes, German investors are paying the government to hold their money meaning these investors believe it is a reasonable investment option - basically "protecting" their money.

Now, some of these central bank engineered trends have not been all bad for investors. While keeping interest rates low and printing money debases currencies and accumulates debt long term, the short term effect is that it has pumped up stock prices in developed economies. With fixed income securities paying next to nothing, stock dividend yields are

now often higher than bond coupon payments. Consequently, there has been a net capital flow into equities. This combined with the fact that low interest rates reduce interest costs for companies and boost profits has also pushed up stock prices.

So, while bond returns in developed countries are not attractive, stock markets returns are. The US Dow Jones Industrial Average is 220% higher today than in 2007 before the Great Recession. India's Sensex is up 100% over the same period and the UK's FTSE 100 is up 22%. Kenya's NSE 20 Share index, on the other hand, is down 55% over the same period which leads us to our next topic.

US Dow Jones Industrial Average – 10 year Graph

Lion's Bluff, Lumo Conservancy, Taita, Kenya - 15th June 2019 (Courtesy S. Dry)

Home Bias - Obstacle to Wealth Creation

Equity Investments

Home bias means investing the majority of one's investment portfolio in one's own country to the exclusion of other countries. It is a bias that affects many investors whether Kenyan, British, American or whatever nationality. These investors feel better investing their money in their own country because it's what is most familiar to them. Understandable, but not smart. It simply does not make sense to ignore opportunities in other parts of the world in the 21st century. Using Kenya as an example, it must be conceded that Kenya is a tiny country on the economic scale. Kenya currently has 63 stocks listed on the Nairobi Stock Exchange out of a universe of 630,000 listed stocks worldwide. That is 0.01% of worldwide stocks. Kenya's market capitalization (meaning the value of all listed stocks) is $25.4 Billion versus a worldwide market cap of $67 Trillion. Why would anyone limit their equity investment portfolio to 1/10th of 1% of shares available to them?

Second, considering the changes in economic trends, in particular- technology - how else is one going to participate in the profits of companies like Tesla, Amazon, Uber, Airbnb without investing abroad. Consider this; the Franklin Templeton Technology Fund is up

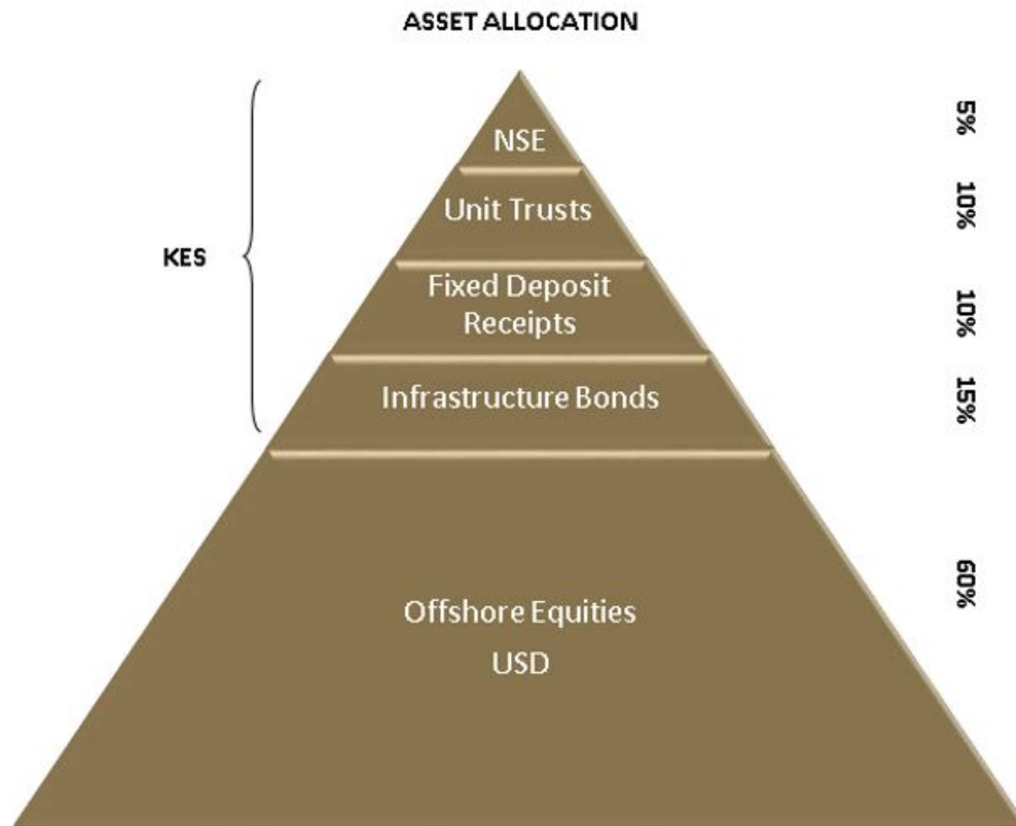
38% in the past 12 months, 96% over the past 3 years, 125% over 5 years and 307% over the past 10 years. This is wealth creation and it is the kind of equity that should have a place in every investor's portfolio today, regardless of nationality.

Debt Investments

On the other hand, debt investments in less developed countries like Kenya pay higher interest rates than developed countries. They do so, for a number of reasons but it is primarily related to the perceived strength and stability of a country and its currency vis-à-vis other countries. Even though Kenya's sovereign debt rating is B2 ("speculative"), living in Kenya as we do, our daily expenses are shilling denominated. As such, we're happy to receive high shilling current income from debt investments. On a day to day basis every currency is in competition with every other currency for your money and higher interest rates are a way to attract and retain capital in the local currency, even when your rating is a B2. So, as an investment manager it makes good sense to split a client's portfolio to achieve high interest yields in Kenya, for current income, and high equity returns off shore for estate building. Savvy Investors have learned to ignore home bias.

The Ideal Portfolio

While every portfolio must reflect an investor's age, risk profile, objectives and so on, a properly structured portfolio in Kenya today might look something like the following, to capture high current returns while building wealth:



Note that 60% of the portfolio is invested outside Kenya. This is where portfolio wealth is being created. This is estate money.

The 15% allocation to Infrastructure Bonds is for wealth preservation and current income. They pay 10% – 11% tax free which is a fairly good return (although inflation in Kenya is running at slightly more than 5% per annum). While these bonds are somewhat illiquid in that we must find a buyer if the client wants to exit; their return is attractive as there is no tax imposed on the interest.

Commercial bank Fixed Deposit Receipts are for current income. They are currently paying 8% – 11% depending on the commercial bank. There is a 15% withholding tax, which is a final tax levied on the interest paid to individuals. These time deposits are generally safe and can usually be broken without penalty if purchased through Dry Associates. These investments must be rolled over periodically but are appropriate as back up for personal emergencies and have a place in every portfolio.

A final 10% or so of one's portfolio is in unit trusts, and in particular, money market unit trusts being the most sensible. These funds are also safe because the funds are invested in many different entities but mostly commercial banks. The Dry Associates Kenya shilling money market fund currently pays 9% but varies slightly day to day. There is a 15% withholding tax which is a final tax on interest withdrawals for individuals. For clients who

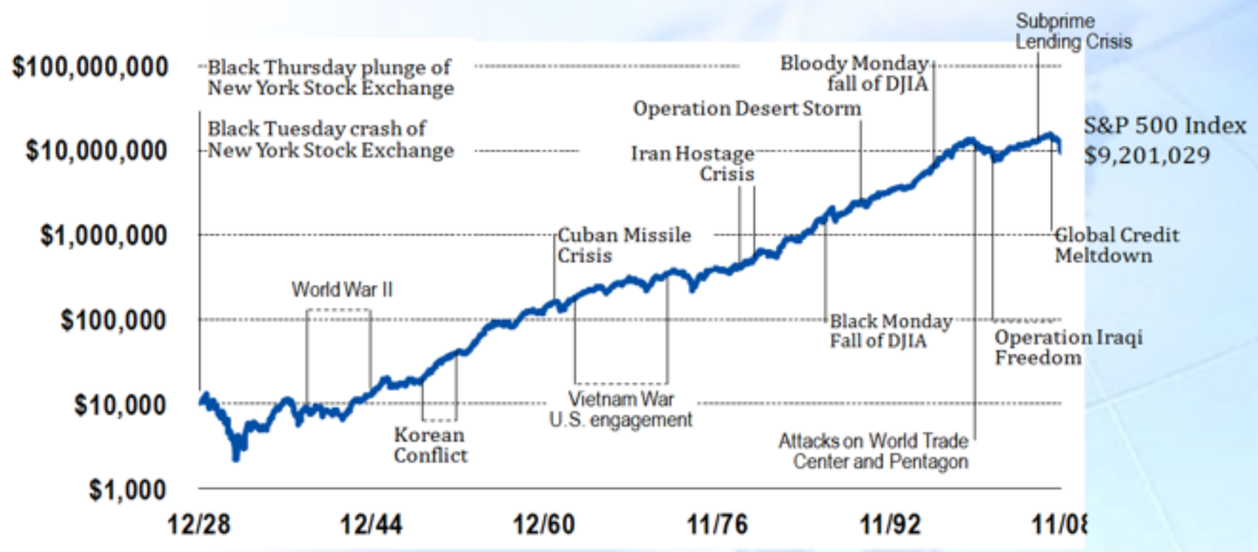
want current income, these unit trusts can pay out interest monthly or quarterly. For clients wishing to create wealth, the interest can be retained in the account and interest is compounded (an extremely powerful tool) daily until is it ultimately withdrawn. Payout is within 3 days of request.

And finally, a 5% allocation for special local opportunities such as securities on the Nairobi Stock Exchange, would round out a portfolio. Our current NSE picks include Safaricom and bank stocks.

Banbury's Fine Lady, Banbury, Oxfordshire, UK - 24th December 2019 (Courtesy S. Dry)

Coronavirus

We've been asked how the coronavirus may affect portfolios. Our answer is simple – stay the course. These sorts of human tragedies, as bad as they are, must be kept in perspective. They are being dealt with at the national and global level by medical institutions and professionals and history has shown that these sorts of epidemics will be brought under control. Consider this diagram depicting major events and their very limited effect on the US stock market.



Paintball, DAL Teambuilding, The Forest, Kereita, Kenya - 15th November 2019 (Courtesy S. Dry)

Kenyan Economy

The World Bank has the Kenyan economy growing at 5.9% in 2020. This is similar to the 5.7% expansion in 2019. While these rates of economic expansion seem upbeat, the average Kenyan probably would not agree. As Patrick Njoroge, the Central Bank Governor pointed out recently "You can't eat GDP".

One of the ironies of GDP as mentioned earlier is that the index includes government spending. Well, government spending is made up of your taxes, or what is the same, Treasury bills and bonds that must eventually be repaid by your taxes. So, while the government is spending trillions on infrastructure, pushing up GDP, it is not putting more income into the hands or wallets of citizens. Tax relief is what Kenyans and Kenyan businesses would like to see.

Then, there is the abysmal performance of the local securities market. The reasons can be debated but there is no doubt that the interest rate capping legislation was dead wrong from an economic viewpoint. It cut off credit to the private sector for three years. It also cut off bank credit to individuals driving them into the arms of loan sharks.

In our estimation both the private sector and government must share blame for the less than robust economy on the ground. Much of this has to do with debt management. Both government and local businesses are acting irresponsibly by taking on too much debt. Government debt has exploded to the point the government is behind on paying current obligations and now has pushed overall public debt to 62% of GDP which is beginning to undermine the credit worthiness of the nation.

Large Kenyan businesses also seem to have an addiction to debt. Many are carrying short term debt that cannot be repaid when misfortune strikes. And misfortune is a constant occurrence in Kenya, particularly when the government does not consult business before it acts. Aside from interest rate capping, the abrupt closure of the plastic bag industry, the knocking down of buildings willy-nilly within Nairobi, the forced haulage of cargo on the Standard Gauge Railway - are all events that need not have occurred. In the private sector, businesses must do a better job anticipating misfortune – particularly government edicts.

Yours sincerely,

Dry Associates Investment Bank
21st February 2020

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