INVEST FOR GOOD

A Healthier World and a Wealthier You

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BLOOMSBURY BUSINESS
LONDON • NEW YORK • OXFORD • NEW DELHI • SYDNEY

BLOOMSBURY BUSINESS
Bloomsbury Publishing Plc
50 Bedford Square, London, WC1B 3DP, UK
1385 Broadway, New York, NY 10018, USA

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First published in Great Britain 2019

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Cover design: Eleanor Rose
Cover image © Getty Images

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A catalogue record for this book is available from the British Library.

A catalog record for this book is available from the Library of Congress.

ISBN: HB: 978-1-4729-6265-2
ePDF: 978-1-4729-6267-6
eBook: 978-1-4729-6266-9

Typeset by RefineCatch Limited, Bungay, Suffolk
Printed and bound in Great Britain

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Governance

With substantial hydroelectric power, and among the largest oil and gas reserves in Europe, Romania is the most energy self-sufficient European Union (EU) member state. A few years ago, an Austrian oil and gas company, in which we had invested, began negotiating to buy a Romanian oil-refining business. Due diligence had revealed a mixed picture. The company seemed to be potentially very profitable, but there were some puzzling anomalies in the numbers, particularly in the relationship between fluid input and output volumes.

The opacity of the numbers created risks, but we were used to that. The business model appeared sound and growth prospects were thought to be good enough to offset the risk. The Austrian company decided to take the plunge and acquired a controlling interest in the Romanian refiner.

However, it took some precautions. Suspecting that skulduggery of some kind would turn out to be the cause of the anomalous numbers, the Austrian company hired an East German anti-corruption agent, a former spy for East Germany's secret police, the Stasi. He found hundreds of pipes leading from the plant's output pipelines into the forest on the other side of the refinery's boundary fence. Through

these parasitical pipelines, refined product was being stolen for subsequent sale on the black market.

It would have been difficult and very expensive to send plant and people into the forest to rip them all up, so the problem was solved by the simple expedient of closing the pipeline temporarily and pumping concrete slurry down the illegal spur lines.

Later, the anti-corruption investigator discovered toxic waste from the refinery had been illegally buried on a nearby strip of land. The new Austrian parent company announced the discovery to the local press and immediately embarked on a $100 million remediation of the contaminated area.

The acquisition of a local business by a foreign company, and subsequent revelations of corruption and illegal disposal of toxic waste in open countryside, would usually generate storms of protest and hostile press coverage about predatory invaders. In this case, the conventional storyline was turned on its head. The foreign acquirer had stamped out corruption, and had discovered and cleaned up contaminated land. The positive press coverage that followed was given added retro glamour by the role played by a former communist spy from East Germany.

In Chapter 4, there is also the example of a company we recently invested in, the Romanian state-controlled utility, Hidroelectrica, which, unaccountably for a hydroelectric generating company with negligible marginal costs, had been losing money.

Our purpose in telling these stories is not to suggest that Romania is a conspicuously corrupt country (it is not, see below), but to show how corrupt practices and delinquent or non-existent corporate governance offer opportunities for investors. If you are able and

willing to engage with local managers and officials, and have a good understanding of the strengths and weaknesses of local institutions, you can make money by investing in a company plagued by corrupt practices and returning it to the straight and narrow.

Mapping corruption

Corruption is a venal form of national and company governance that impoverishes society. It is more common in some countries and some companies than in others, but that is not because the people of some countries are more corrupt than those of others. It is because, in countries where institutions such as property rights and the rule of law are weak or non-existent, corruption becomes rampant at the top and, consequently, a way of life in many other businesses. As the Sudanese-born philanthropist, Mo Ibrahim, put it when talking about his Ibrahim Prize for Achievement in African Leadership: 'It is the head of the fish that goes rotten first, so what's needed is to shed a light on the performance of the leadership' (3.1).

In Transparency International's Corruption Perceptions Index (CPI) in 2017, Romania ranked 59 out of a total of 180 countries. Table 3.1 lists the top (least corrupt) and bottom (most corrupt) countries in the years 2013–17, according to their CPI scores, and includes, in the two right-hand columns, the IMF's estimates of gross domestic product (GDP) per capita of population in 2017, at Purchasing Power Parity, and each country's GDP/capita ranking.

Correlation does not necessarily mean causation, but the clear link in these figures between high levels of corruption and low levels of

Table 3.1 *The good, the bad and the ugly*

CPI Rank	Country	2017	2016	2015	2014	2013	GDP/ capita (Int$K)*	Rank (IMF)
1	New Zealand	89	90	91	91	91	38.5	31
2	Denmark	88	90	91	92	91	49.6	20
3=	Finland	85	89	90	89	89	44.0	25
3=	Norway	85	85	88	86	86	70.6	6
3=	Switzerland	85	86	86	86	85	61.4	9
6=	Singapore	84	84	85	84	86	90.5	3
6=	Sweden	84	88	89	87	89	51.3	16
8=	Canada	82	82	83	81	81	48.1	22
8=	Luxembourg	82	81	85	82	80	109.2	2
8=	Netherlands	82	83	84	83	83	53.6	13
8=	UK	82	81	81	78	76	43.6	26
12	Germany	81	81	81	79	78	50.2	17
. . .								
169	Venezuela	18	17	17	19	20	12.4	96
171=	Equatorial Guinea	17	N/A	N/A	N/A	N/A	34.9	37
171=	Guinea-Bissau	17	16	17	19	19	1.8	173
171=	North Korea	17	12	8	8	8	N/A	N/A
171=	Libya	17	14	16	18	15	9.8	108
175=	Sudan	16	14	12	11	11	4.6	138
175=	Yemen	16	14	18	19	18	2.3	161
177	Afghanistan	15	15	11	12	8	1.9	170
178	Syria	14	13	18	20	17	N/A	N/A

179	South Sudan	12	11	15	15	14	1.5	176
180	Somalia	9	10	8	8	8	N/A	N/A
Rankings of other selected countries								
13	Australia	77	79	79	80	81	49.9	18
16	USA	75	74	76	74	73	59.5	11
20	Japan	73	72	75	76	74	42.7	28
23	France	70	69	70	69	71	43.6	27
29	Portugal	63	62	64	63	62	30.3	43
32	Israel	62	64	61	60	61	36.3	35
34	Botswana	61	60	63	63	64	18.1	71
42	Spain	57	58	58	60	59	38.2	32
46	Georgia	56	57	52	52	49	10.6	105
51	South Korea	54	53	54	55	55	39.4	30
54	Italy	50	47	44	43	43	38.0	33
57	Saudi Arabia	46	46	52	49	46	55.3	12
59=	Greece	48	44	46	43	40	27.8	49
59=	Romania	48	48	46	45	43	24.0	59
66	Hungary	45	48	51	54	54	28.9	45
68	Belarus	44	40	32	31	29	18.6	70
71	South Africa	43	45	44	44	42	13.4	89
77	China	41	40	37	36	40	16.6	79
81=	India	40	40	38	38	36	7.2	122
81=	Turkey	40	41	42	45	50	26.5	53
85	Argentina	39	36	32	34	34	20.7	63

(*Continued*)

Table 3.1 *Continued*

CPI Rank	Country	2017	2016	2015	2014	2013	GDP/ capita (Int$K)*	Rank (IMF)
96=	Brazil	37	40	38	43	42	15.5	81
96=	Indonesia	37	37	36	34	32	12.4	97
111	Philippines	34	35	35	38	36	8.2	118
117=	Egypt	32	34	36	37	32	13.0	92
117=	Pakistan	32	32	30	29	28	5.4	135
130=	Iran	30	29	27	27	25	20.0	64
130=	Ukraine	30	29	27	26	25	8.7	114
135=	Mexico	29	30	31	35	34	19.5	65
135=	Russia	29	29	29	27	28	27.9	48
143	Kenya	28	26	25	25	27	3.5	149
148	Nigeria	27	28	26	27	25	5.9	129

Note: * Geary–Khamis or International dollars (000s)
Sources: Transparency International and International Monetary Fund.

GDP per head strongly suggests that corruption is a very bad form of governance that impoverishes societies. It substitutes inefficient systems of patronage for free markets, leads to a suboptimal allocation of resources and consequently to low returns on investment and equity. And, worst of all, corruption suppresses the entrepreneurial energy that drives economic growth, by denying the rights of local entrepreneurs to the wealth they create. If people believe businesses they build will be stolen by corrupt officials or by predatory conglomerates, they will not seek out entrepreneurial opportunities.

This link between corruption and poverty is probably stronger than the figures suggest, for two reasons: first, because a number of highly corrupt countries, including Russia and Venezuela, are rich in natural resources such as oil and gas, which inflates GDP; second, because the distribution of GDP is invariably very unequal in corrupt societies.

As José Ugaz, Chair of Transparency International, puts it on the Transparency International website: 'In too many countries, people are deprived of their most basic needs and go to bed hungry every night, because of corruption, while the powerful and corrupt enjoy lavish lifestyles with impunity.'

A high degree of inequality in a country will deter a foreign investor because inequality leads to social and political unrest. The country becomes vulnerable to coups and populist leaders who call on the people to rise up against and throw out their corrupt or incompetent governments. There may be calls for nationalisation of foreign-owned businesses without compensation, increases in tax rates, the introduction of crippling regulatory regimes, etc. The message for investors is to stay well clear of countries where wealth is distributed very unequally.

Inequality is usually measured by the Gini coefficient, which ranges from 0 (perfect equality) to 1 (one person owns all the wealth). The US Central Intelligence Agency (CIA) is interested in Gini coefficients because high Ginis are good predictors of civil unrest.

The riskiness of countries with high levels of corruption and economic inequality means corrupt regimes are inherently fragile. Their inability to attract foreign direct investment restrains the levels of economic activity well below these countries' potentials and puts their governments under pressure to reform themselves.

Announcements of 'anti-corruption' policies by incumbents, or political parties aiming to replace them, are designed as much to attract more foreign investment as to appease angry electorates. Some turn out to have more substance than others, but, over time, changes in Transparency International's CPI rankings show that no country is irredeemably corrupt.

CPI scores change constantly and suggesting that perceptions of corruption are affected by particular events. The UK's 6-point rise between 2013 and 2017 may be a recovery from the effects of the LIBOR fixing scandal in the wake of the 2007–2008 financial crisis. Greece's 8-point improvement over the period may reflect a perceived tightening of the country's governance after the Greek debt crisis that began in 2009. Turkey's vertiginous 10-point fall in its perceived corruption score probably has a lot to do with the political turbulence in the country.

It is not surprising that most CPI movements are modest. Once established, corrupt national governance systems, and the corrupted cultures they breed, become normal and unremarkable. When gathering up his things at the end of a meeting with officials of a state-controlled company in Moscow, Mark found his mobile phone was missing. The security staff were dismayed. They searched high and low for the phone, but to no avail. When he returned to the same building a few years later, the security staff told him, 'We're still looking for your phone.' He thought no more about it. It was par for the course. Quite unremarkable.

Corruption, fraud and outright theft might seem endemic in some emerging markets, but they are not incorrigible. There is always pressure for reform. We hope by actively engaging on these issues we

may be contributing to improvements in corporate governance in emerging markets. Perhaps the revelations of skulduggery at the Romanian refinery described at the beginning of the chapter were partly responsible for a 5-point improvement in Romania's CPI score between 2013 and 2017.

Step by step. Too many powerful people have vested interests in the status quo for governance reform to be easy. It takes time for good governance to drive out bad governance even when it is clear that the economic benefits of the process for the population at large are likely to be enormous.

The quality of governance

Corruption, fraud, theft and other forms of criminality are not the only corporate governance failings of concern to investors. Agency costs – the costs of hiring others to run your business – include: incompetence; negligence; recklessness; conflicts of interests and conflicts of interest and duty; a lack of transparency; unfair and unequal treatment of shareholders; insufficient separation of the powers of the executive committee and the board; and insufficiently diverse boards in which so-called 'group think' is an ever-present danger.

Chuck Prince, the former CEO of Citigroup, illustrated the dangerous power of 'group think' when he explained Citi's ill-fated enthusiasm for subprime mortgages and consumer loans in July 2007 in the *Financial Times*: 'as long as the music is playing, you've got to get up and dance'. Four months later, Prince resigned after Citigroup announced a fourth-quarter loss of almost $10 billion.

After the chastening lessons learned by mature Western economies in the 2007–2008 financial crisis, everyone knows, or can find out, what 'good' corporate governance looks like. The reasons why some listed companies do not comply with corporate governance codes vary from the wish of founders to retain control, the determination of ambitious CEOs not to be hamstrung by their boards, the resistance of those with vested interests in weak controls and oversight, and government interference, to inertia, a general lack of pressure to comply and sheer laziness.

A few years ago, we flew to Ankara for a meeting with the CEO of Turkish Airlines. We were thinking of investing in the company, alongside the Turkish government, which still held a controlling interest. To be frank, we were not optimistic. Turkey was not known for its high standards of corporate governance and we knew all too well about the risks of being a minority shareholder in a company controlled by a government. But we were interested to hear how far the company would go to accommodate our governance demands.

When we asked if we could have an independent director on the board, the CEO said we would have to talk to the government. Not a good sign. It was up to the board, not the largest shareholder, to nominate a new director. But we had nothing to lose. We decided to go along with the CEO's suggestion and arranged a meeting with the Minister of Finance. We arrived at the ministry offices at the appointed time and then had to go through a seemingly interminable series of security checks. We were eventually ushered into a plush office. The minister stood up, greeted us and gestured towards two leather chairs.

After the usual pleasantries and assurances by our host that foreign investors were welcome in Turkey, we asked the minister the same

question we had asked the CEO, knowing the answer could only be a polite, but firm, 'No.' We asked, 'If we invest in Turkish Airlines, can we have an independent director on the board?'

'Why only one?' was the astonishing reply. 'Why not two?'

The lesson here is: 'Don't jump to conclusions about corporate governance.' The Turkish government was more pragmatic and market-orientated than it appeared. There was a willingness to modernise the Turkish Airlines board by appointing independent directors. It had not happened because no one had been pushing for reform. This demonstrates the value of shareholder engagement and advocacy at a time when the general trend is towards passive investment.

It also illustrates the influence that foreign investors as a group have on governments of countries such as Turkey that need large inflows of foreign capital to finance large trade deficits. At the time of writing, Turkey's structural current account deficit is running at close to 6 per cent of GDP.

Governance and gender

Last, but not least, good governance includes paying attention to the issue of diversity, particularly the representation of women in business, government and all institutions. Like many other areas of human endeavour, the moral questions really point to the most beneficial outcomes for mankind. Fully including women means adding enormous intellectual, creative and productive assets to all manner of enterprise.