Our 10th Birthday!

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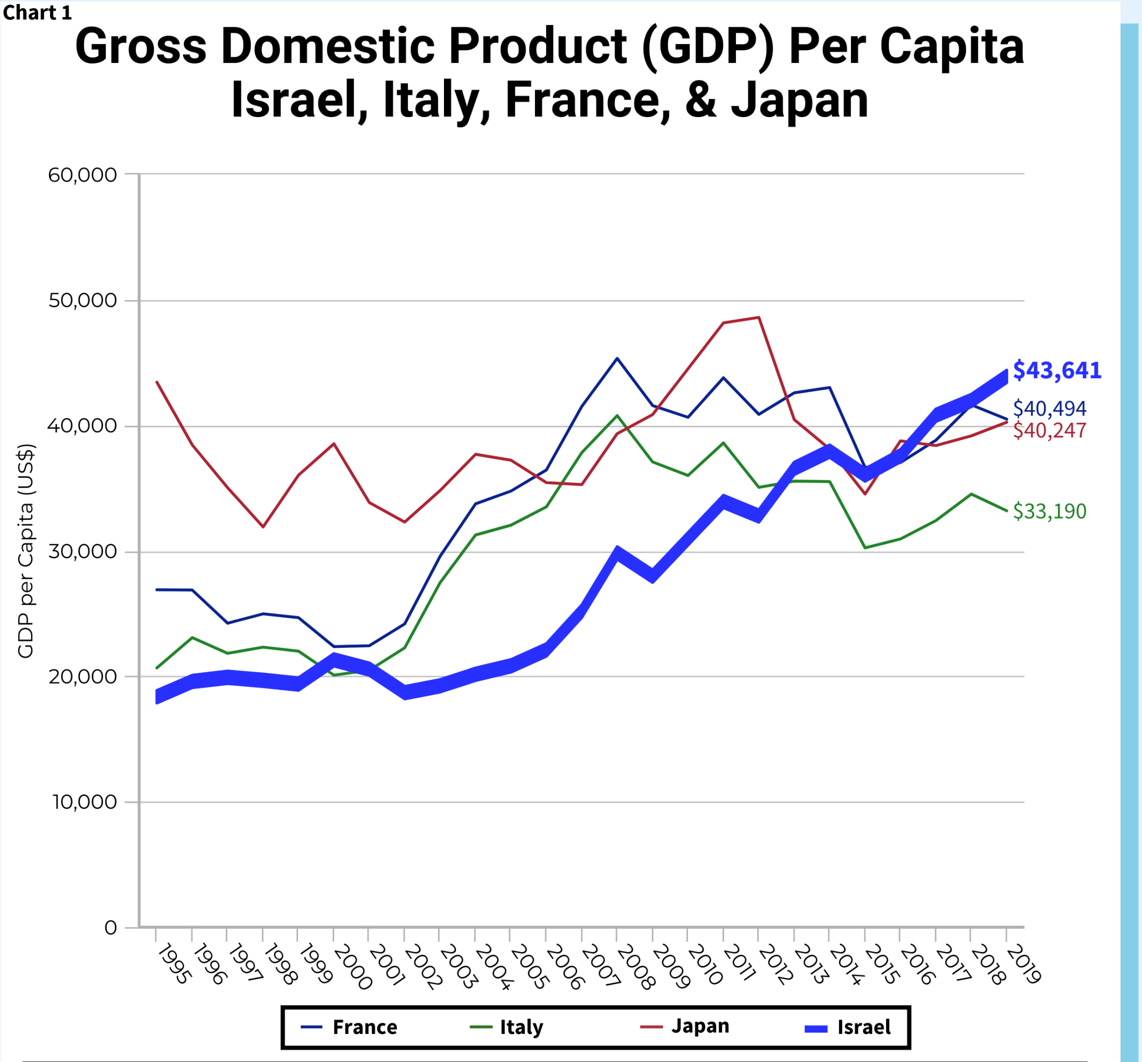
We started Israel Investment Advisors, LLC (IIA), and launched the Israel Investment Fund, L.P. on August 1, 2010. Our investment thesis that Israel's economic rise would continue proved correct. Since then, ongoing fundamental economic reforms vindicated our optimism, laying the foundation for further growth in the decades to come.

Israeli GDP per capita now exceeds Japan, Italy, and France, in part because these countries did not adopt obvious but politically unpopular reform policies (see Chart 1). Unlike Israel, these countries do not face security challenges that make economic reform unavoidable.

In the decade since we launched IIA, the Middle East was constantly in turmoil. Israel endured ongoing rocket fire in the Negev from Hamas and Islamic Jihad, conducted two major military operations in the Gaza Strip, and regularly engaged with Iranian military forces and proxies. More broadly, the Arab Spring degenerated into an Arab Winter; the Islamic State rose and fell; the military regime in Egypt rose, fell, and resumed power once again; and peaceful protests in Syria devolved into murderous civil war, a global refugee crisis, and victory for the incumbent Assad regime.

Chart 1



Source: www.worldbank.org

Politicians in more economically stagnant countries like Italy or Japan seem unable to challenge vested interest groups blocking change. By contrast, Israel implements growth-oriented economic policies because stagnation is not an option. Sustained economic growth is vital to Israel's military defense. A growing economy allows Israel to raise living standards for its people while also investing in security. In turn, strong security provides necessary space for the economy to grow. Over the past 10 years, Israel paired significant military investments with substantial economic restructuring.

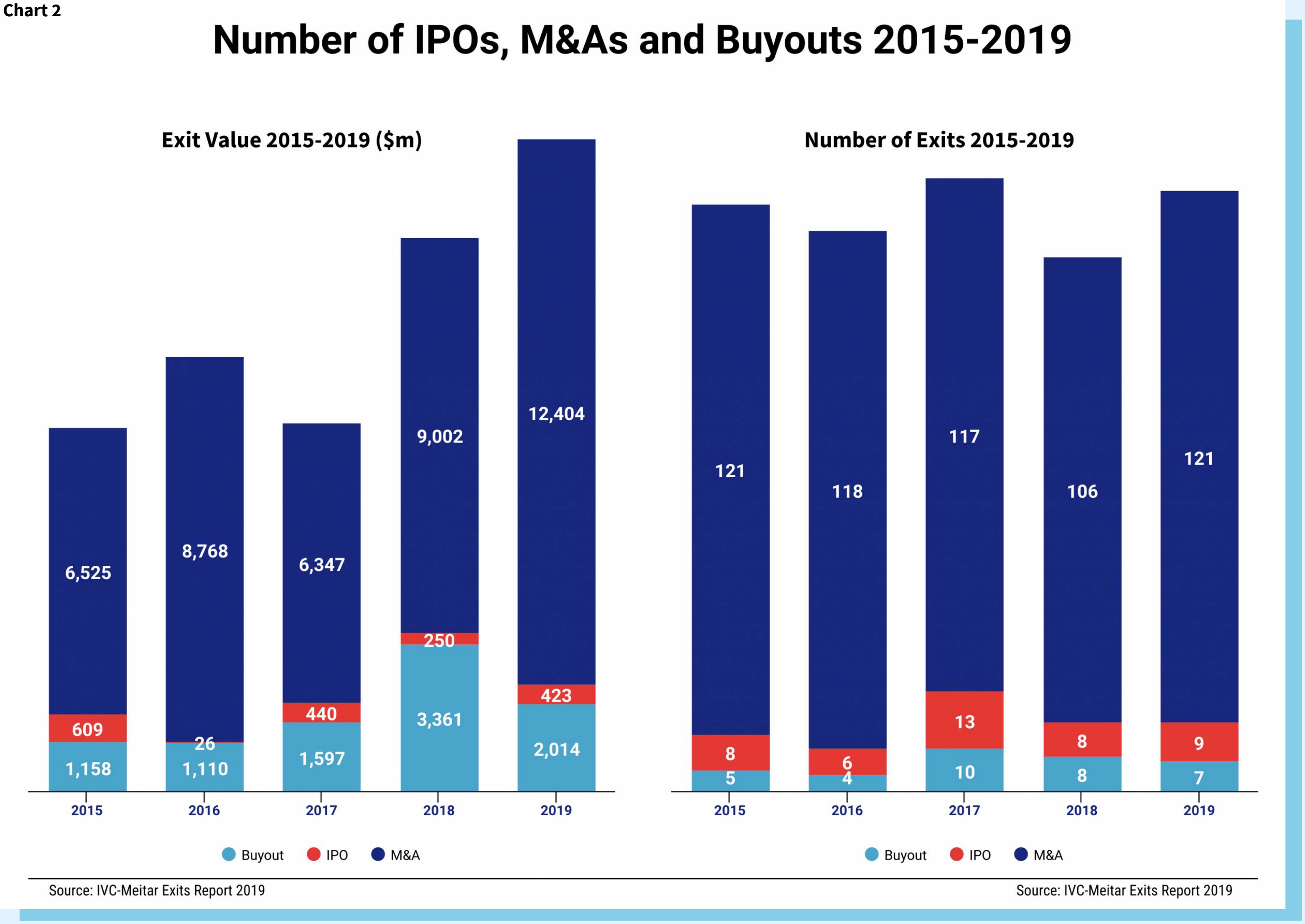
The most significant reforms were focused on the financial system. **Finance in Israel is moving away from its monopolized, bank-dominated, political, and sometimes corrupt past toward more competition and a greater reliance on capital markets.** Israel's savings rate is robust, financial assets are growing, and the government debt burden is modest. In the coming decade, we believe the burgeoning financial services industry will compete with an already vigorous technology sector for Israel's best and brightest talents.

Israel's Capital Markets Revolution

Between 2010 and 2019, Israeli technology start-up companies raised $39 billion, predominantly in the information technology and life sciences sectors. In 2019, there were 20 Israeli start-ups that each received more than $100 million in a single funding round. According to the IVC Research Center, which studies venture capital in Israel, Israel now boasts 39 high-tech "unicorns," start-up companies with equity valuations of at least $1 billion .

Start-up funding came from a variety of sources, including venture capital funds (VC), technology companies, and institutional investors. Venture capital funds were the largest funding source, supplying $28 billion over the past decade. Despite phenomenal growth of the Israeli VC industry, more than 80% of investment capital came from abroad. Venture capital in Israel is well-organized, globally attractive, and growing rapidly.

Chart 2



During the same period, Israeli companies raised just $22 billion offering stock on the Tel-Aviv Stock Exchange (TASE). Israel is a unique market in which young companies raise much riskier venture capital in larger volume than lower-risk public equity. By comparison, U.S. technology start-ups raised $647 billion between 2010 and 2019 while more mature companies raised $2.2 trillion from new stock sales.

While technology start-ups punch well above their weight in Israel, they hit significant barriers as they grow. Technology pundits in Israel often lament the "early exit" problem. They usually blame founders, investors, or managers for selling out to larger companies too soon, but they often miss the true culprit: a small, illiquid, and therefore inadequate stock market (see Chart 2). Despite its high growth rate over many years the technology sector employs only about 9% of the Israeli work force and accounts for a similar percentage of Gross Domestic Product (GDP).

The future of Israel as a "Scale-Up Nation" in complement with its strengths as the "Start-Up Nation" resides with the potential for more robust capital markets. Global investors have reason to be optimistic in this regard. Yet they seem unaware of the capital markets revolution underway in Israel, perhaps because it emanates from news they do not follow regarding domestic reforms. So far, corporate bond trading benefited the most, but the stock market is also poised for an upsurge in the coming decade.

IPO Nation?

Starting in 2013, the Israeli government forced oligarchic tycoons to divest their monopoly control over Israel's banks, insurance companies, and pension funds. Regulators injected competition into the securities industry, corporate lending, credit cards, mortgages, and other financial products. During the 2010s, as financial sector competition intensified, Israeli companies raised $132 billion selling corporate bonds, triple the amount of all start-up fundraising during the same period.

Thanks to low interest rates, corporate bond activity surged first, and that was likely just the first wave of Israel's capital markets revolution. Pension reforms in the early 2000's pushed personal savings rates higher, and private capital is accumulating in Israel at an accelerating pace. In 2005, the Israeli government forced monopolistic banks to divest pension management, boosting the insurance and asset management industries. The same law opened the securities industry to a wider variety of competitors. The Concentration Law of 2013 broke up large business pyramids controlled by financial institutions. **In 2018, the Tel-Aviv Stock Exchange (TASE) converted into a for-profit company and listed its shares for trading in 2019 (on the TASE).**

Corporate bond activity will likely remain strong as long as interest rates remain low. Recent reforms and accumulating domestic capital should boost equity markets as well. The Israeli financial system is on a long-term path of convergence with the dynamic competition and innovation on display in the technology sector. The nascent but growing competitive strength of Israel's banks, insurance companies, pension funds, asset managers, private equity funds, hedge funds, investment banks, and securities firms will benefit all sectors of the Israeli economy. Moreover, this trend could also ameliorate Israel's premature exit problem as technology start-ups seek higher valuations and access to expanding financial resources with more domestic Initial Public Offerings (IPOs).

The Role of Foreign Capital

Again, many global investors may not be aware of these developments. That lack of awareness goes back at least a decade, to the moment when Israel "emerged" from the indices of emerging-economy nations, where it was a big fish in a small pond. Its promotion to the developed-economy indices, where it now comprises a tiny percentage of invested assets compared to other countries, led many investors to overlook Israel. Indeed, this moment in 2010 was one of the catalysts for us to establish Israel Investment Advisors, to seize the opportunities we believed others were missing.

We are proud of our success at IIA over the past 10 years, but we are still just getting started. Much potential for growth remains as economic reform continues and the financial services industry opens up. Israel still lives in a difficult neighborhood, forcing it to implement policies other countries have been reluctant to enact. Yet these steps laid the foundation for Israel's enhanced prosperity over the past decade and for decades to come.

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