VIEWPOINT

International investing – a key part of diversification

January 2015

AUTHOR

JACO VAN TONDER
Sales Director

In summary:

- Offshore diversification offers investors an opportunity to enhance returns and reduce portfolio risk.
- The domestic equity market is concentrated, and investors should consider widening their opportunity set by investing offshore.
- Global fixed income markets offer a wider range of instruments, which provide additional sources of return.
- Exposure to offshore funds that take active currency positions can enhance returns and reduce portfolio risk.
- When allocating to offshore assets, investors need to consider their onshore investments as well, ensuring that overall portfolio returns are optimised on a risk-adjusted basis.

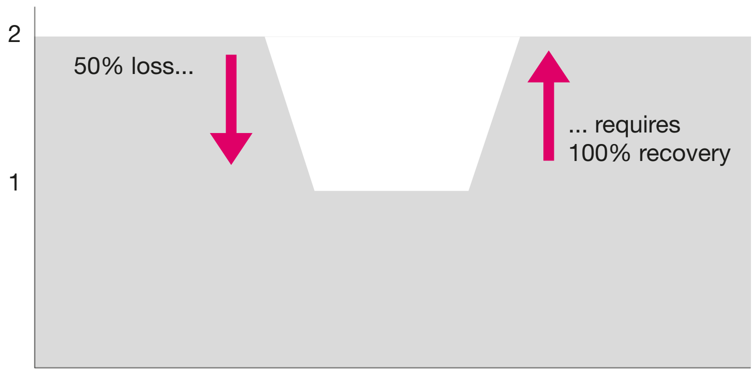
Avoiding big losses enhances long-term returns

Diversification helps to reduce portfolio risk

Investors are regularly reminded of the wisdom of having a diversified portfolio. But just how does the principle of diversification work? By combining investments that exhibit different return patterns, large fluctuations seen in individual investments can be smoothed out. This means that the overall portfolio can benefit from the different return sources in aggregate but with lower volatility of returns compared to just holding one of these investments in isolation. By being exposed to a range of assets, markets, sectors and currencies that behave in a similar way, portfolio risk increases.

In particular it is critical to manage downside risk, as Figure 1 clearly illustrates.

Figure 1: The importance of managing downside risk



Why is it so important to reduce risk? Very simply, it helps to improve outcomes. Avoiding big losses in a portfolio is a proven way of enhancing long-term investment returns. Greater risk also means greater uncertainty, for which most investors have limited appetite.

Investec
Asset Management

Many investors view the SA stock market as being fully valued

Concentrated markets pose risks

We believe widening the opportunity set is crucial when a domestic market is concentrated. The South African (SA) equity market, as represented by the FTSE/JSE All Share Index (ALSI), is a concentrated market. While the index currently consists of approximately 165 constituents, the five largest stocks by market cap have a combined weighting of 39.4%[1]. The ALSI 40, which includes the 40 largest stocks, represents the SA large cap universe and makes up 83% of the market's total market capitalisation.

In a concentrated market where performance is dominated by a few large cap shares, investment managers often end up chasing the same stocks. This serves to further push up the share prices of a few market favourites, and asset bubbles can become a real risk.

Diversification widens the opportunity set

The concentrated domestic equity market means that true opportunities for diversification are limited and investors should consider widening their opportunity set. One way to accomplish this is by investing offshore. Diversification allows investors to tap into a global universe of opportunities:

- Investors are able invest in a more diverse range of sectors, which gives them exposure to leading-edge technology and entirely new industries. Even though we have global companies listed on the ALSI, domestic investors lack exposure to technology, media, energy, automotive, drug and biotechnology sectors, among others.
- Investors are also able to gain exposure to investment markets that are in different stages of their interest rate cycle. In general, during periods of low interest rates, markets with a high equity risk premium (emerging markets) tend to outperform. Currently, the strong US dollar and the prospect of higher interest rates in the US and the UK are weighing on emerging markets, making developed markets an attractive option.
- Exposure to offshore funds that take active currency positions may also enhance returns and reduce portfolio risk. The rand is one of the most volatile currencies in the world and having exposure to other currencies helps to mitigate portfolio risk.

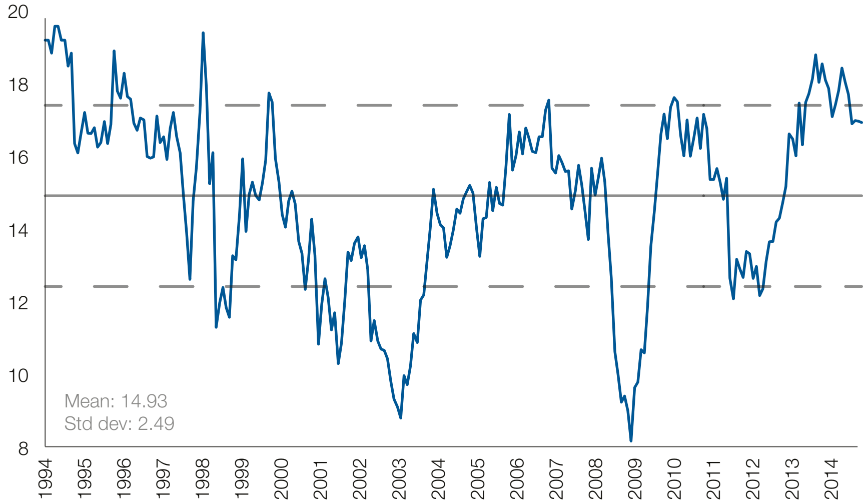
Valuations matter

While managing volatility is important, the valuation of offshore assets should also be a key consideration. Investment opportunities within the wider, global universe should be assessed by taking into account their potential to both enhance portfolio returns and reduce portfolio risk. Looking at the price earnings ratio for the South African stock market, many investors currently regard it as being fully valued (Figure 2). While some offshore equity markets have run hard, the large universe of shares means there remain many opportunities for astute managers to uncover. Steady, if unspectacular, global growth coupled with subdued inflation should keep global interest rates low and be generally supportive of corporate earnings. In turn, this should be positive for global equity markets.

[1]Source: Bloomberg, as at 12 December 2014.

Figure 2: SA equities (ALSI) – trailing price earnings ratio

Twenty years to 31 December 2014 (16.9x)



Source: I-Net Bridge

For SA investors rand volatility remains a concern

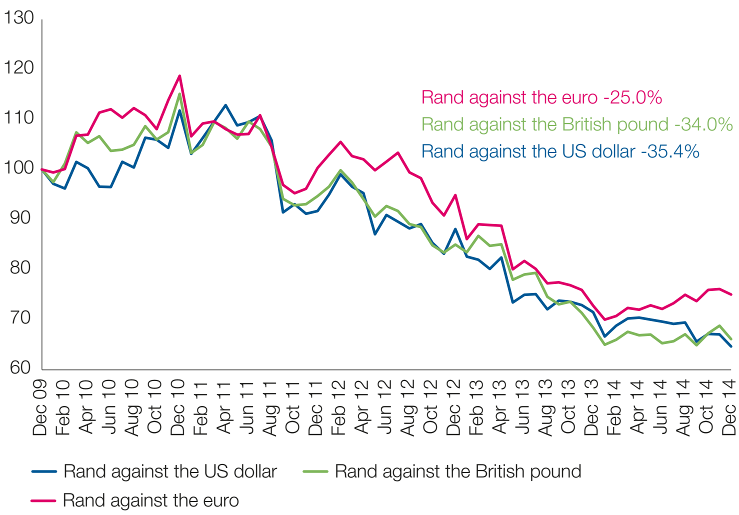
What about the rand?

For South African investors who invest offshore the volatility of the rand against developed market currencies remains a major concern. In this regard, the rand has appeared particularly vulnerable over the past three years. A number of factors such as the South African sovereign credit downgrade, the strong dollar, lower commodity prices, the local electricity crisis and the woes of our parastatals (Eskom, SAA and the Post Office) all weighed heavily on the rand in 2014. More recently emerging market jitters, caused by the impact of the oil price collapse on oil-producing emerging market countries, have also put pressure on the rand.

Figure 3 clearly highlights the extent of the rand's deprecation against the major global currencies over the past five years.

Figure 3: SA rand against the pound, euro and US dollar

Five years to 31 December 2014



Source: I-Net Bridge

Research shows that an SA portfolio benefits from an offshore exposure of 20-40% of total assets

Some investors may wonder about the wisdom of investing offshore at the moment, given the weak rand. In our view, attempting to predict major short-term movements in the rand is not the premise upon which investors should base their offshore investment decisions. Investors who try to time their entry into an offshore investment based on the perceived value of the rand are taking dangerous risks.

Exchange rates represent not just relative long-term macroeconomic fundamentals, but also market sentiment. It is this market sentiment that is responsible for the volatility in our exchange rate. What we do know is that, over the medium to long term, relative pricing power and the economic growth prospects of a country are useful in predicting the long-term direction of its currency. And on both these counts, South Africa can expect to face a steadily declining currency. On a relative pricing power basis, the rand is currently priced not too far from fair value against the US dollar. So while short-term market fluctuations in the currency are to be expected, they should not deter investors from making offshore investments at the current level of the rand.

Tailoring an offshore portfolio to meet personal needs

Offshore assets form an essential component of a well-balanced investment portfolio. When allocating to offshore assets, investors need to consider their domestic investments as well to ensure that overall portfolio returns are enhanced on a risk-adjusted basis.

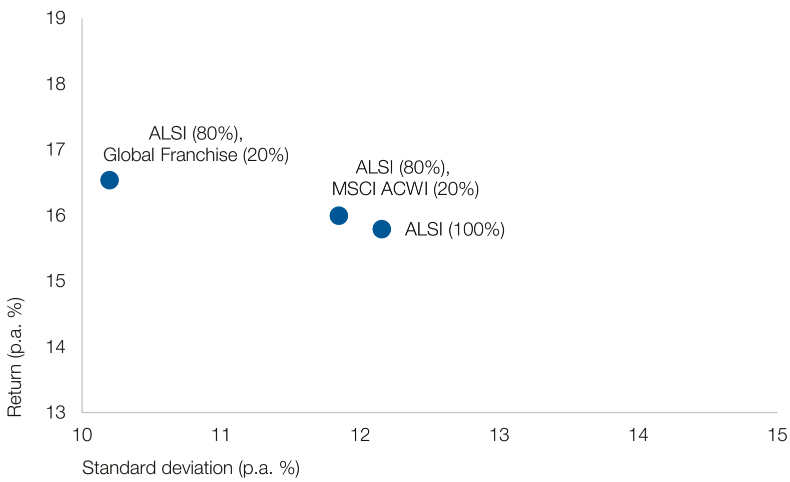
There is no magic optimal offshore weighting that can be applied to all investors. It depends on an individual's personal circumstances. But research over the past 15 years have shown that a South African investment portfolio benefits significantly over time from a meaningful offshore exposure of between 20% and 40% of the total portfolio.

To illustrate this, Figure 4 shows the risk return characteristics of a number of different investment portfolios over the five years to 31 December 2014:

- The ALSI (total returns – no direct offshore investment exposure)
- An exposure of 80% to the ALSI (total returns) combined with a 20% exposure to the MSCI All Country World Index (MSCI ACWI) – total returns
- An exposure of 80% to the ALSI (total returns)combined with a 20% allocation to the Investec Global Franchise Fund

Figure 4: Offshore diversification helps to improve risk return characteristics

Five years to 31 December 2014



Source: Morningstar. Data to 31 December 2014. Returns are calculated on a bid to bid basis of the A Acc class reinvested in USD, converted to ZAR (gross of fees). Fund inception date: 4 July 2009.

It is clear from Figure 4 that, over the past five years, the addition of offshore assets to a South African equity portfolio resulted in not only increasing the investment return from the portfolio, but also dramatically reducing the volatility of the portfolio (as measured by the standard deviation of returns). This same effect can be observed over longer investment periods.

Conclusion

In this article we highlighted many of the shortcomings of an investment strategy focused only on the South African equity market. The benefits of a meaningful allocation to offshore assets are significant, providing access to new investment opportunities that increase investment returns and significantly reduce portfolio volatility.

CONTACT INFORMATION

36 Hans Strijdom Avenue
Foreshore, Cape Town 8001
Telephone: +27 (0)21 416 2000
Facsimile: +27 (0)21 416 2001
www.investecassetmanagement.com

20441 - 01/15