Consider your portfolio holistically when investing offshore

While most investors understand the compelling reasons for investing offshore, which include diversification benefits, reduced emerging market and currency risk, and maintenance of ‘hard’ currency spending power, they tend to lose sight of the fact that offshore is only one component of their overall portfolio. Therefore, their offshore investments must be considered holistically, together with their local investments.

The currency effect

Studies have shown that when considering the historical returns of foreign investments, the impact of the exchange rate is uncertain and volatile, and that when measured over shorter time horizons, the exchange rate can have a significant impact on the investment return and, as we will illustrate, the risk in rands. By simply looking at offshore investments in a dollar context the overall picture – and accordingly the appropriate portfolio construction strategy – is skewed from a South African investor’s perspective.

Figure 1, a simple risk return scatterplot, illustrates this point. If you compare the dollar returns and standard deviation over ten years of a money market portfolio versus a bond, multi-asset and equity portfolio, the chart demonstrates the expected traditional banana curve (efficient frontier).
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The money market portfolio is in the lower left corner (lowest return at lowest risk or volatility) and the equity portfolio is in the top right corner (highest return but with the concomitant highest volatility).

Figure 1: US dollar returns and standard deviation over ten years

Next, compare these same four portfolios in rands rather than dollars. As illustrated in Figure 2, the traditional efficient frontier is thrown off with an unexpected clustering. What the chart shows is that over ten years the bond and money market portfolios deliver the lowest returns as you would expect but, counter-intuitively, they do so at higher volatility than the multi-asset and equity portfolios!

Figure 2: Rand returns and standard deviation over ten years

This illustrates that the simple conversion from rands to dollars can add in the region of 16% volatility to your portfolio. So, when it comes to offshore investment, as important as the offshore asset class decision, is the risk in taking your money offshore (i.e. the currency decision). And the evidence further suggests that your risk reduces when you’re invested in an equity or multi-asset fund offshore, as your portfolio would benefit from the diversification effect.

Investors unfortunately have this notion that they should park their money offshore in something they perceive to be low risk, like a dollar-denominated money market fund. However, historically this has proven to be both riskier and less rewarding.

Your risk reduces when you’re invested in an equity or multi-asset fund offshore.
The performance of the rand is a key consideration

The rationale is actually very simple; offshore equities and the rand tend to move in opposite directions. In ‘good’ times, offshore equity markets are likely to perform well, offshore bonds are the losers and the rand tends to strengthen (resulting in a currency loss on the offshore portfolio). The opposite also holds: in ‘tough’ times, offshore equities perform poorly, offshore bonds gain and the rand tends to weaken (resulting in a currency gain on the offshore portfolio). In summary, rand depreciation adds to the offshore investment’s return calculated in rands, and rand appreciation detracts from the overall return.

Offshore equities and the rand tend to move in opposite directions.

Figure 3 shows that since 1994, over rolling five-year periods, the rand has experienced periods of both depreciation (85% of the time) and appreciation (only 15% of the time) against the US dollar. On average, however, the rand has depreciated by approximately 6% per annum over rolling five-year periods.

Figure 3: Rolling five-year performance of the rand (May 1994 – March 2019)

Source: Morningstar and Ninety One calculations.
In conclusion

We believe that when investing in international assets, investors need to take a longer-term view and look past the shorter-term movements of the currency. Furthermore, South Africans investing offshore should look to global equities or high-equity global multi-asset solutions with long-term track records that have proven their mettle through investment cycles, such as the Global Franchise Fund and the Global Strategic Managed Fund respectively.

And to make a discretionary offshore investment even more tax efficient, consider investing in an offshore unit trust fund via the Global Life Portfolio sinking fund, available on the Ninety One Investment Platform.

The Ninety One Global Life Portfolio offers investors subject to high tax rates a significant reduction in the rates of tax applicable to their investment. In addition, Ninety One Assurance Limited takes care of all the tax administration by calculating and paying any tax due. This is possible because a sinking fund is taxed in terms of the five funds approach, which means the policyholder fund is the taxpayer and not the end investor. The result being that all tax is deducted within the sinking fund policy and the following rates apply:

1. 30% on income (if any) rather than the investor’s marginal tax rate which may be a maximum of 45%
2. 12% on capital gains (40% inclusion rate x 30% income tax rate), rather than a maximum effective rate of 18% (inclusion rate of 40% taxed at the investor’s marginal tax rate which may be as much as 45%)

The proceeds, when received, are tax free in terms of current revenue practice. And importantly, in the event of the death of the policyholder, no capital gains tax is payable when the policy is transferred into the name of the beneficiary.

As always, we recommend that investors seek independent financial advice when choosing the most appropriate funds and investment vehicles for their needs.

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1. Applicable to the 2019/2020 tax year. Taxed in the individual policyholder fund.
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