September 2023

Ninety One

—
Investing for a world of change

Navigating offshore investments beyond emotional impulses

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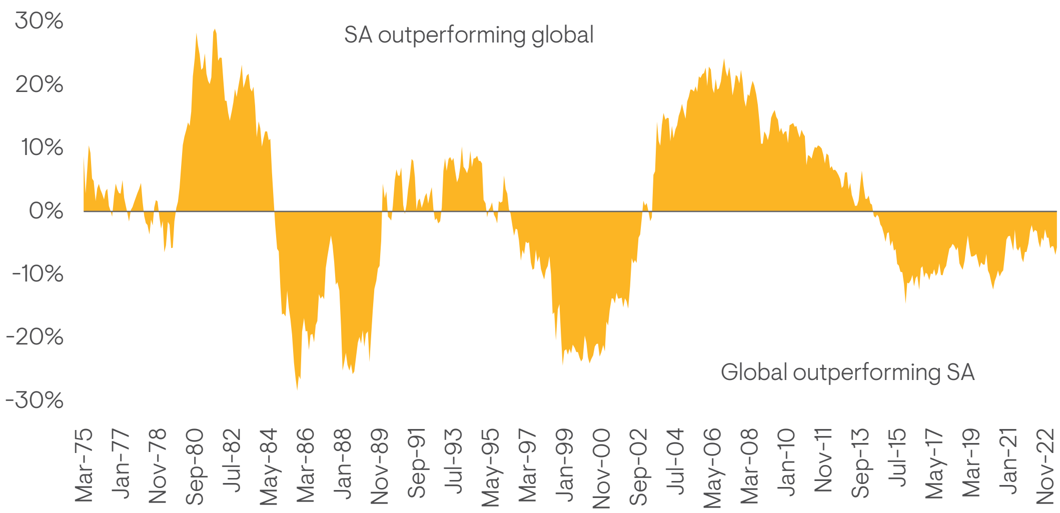
History doesn't always repeat itself, and in the world of investments, past performance isn't necessarily a guide to the future, and the same is true when it comes to the offshore and local debate.

Often, our motivations tend to be swayed by emotional impulses, characterised by sentiments like "Get me out of SA!... the lights are out." It's vital to look beyond these emotionally charged factors and explore the more profound and rational reasons why offshore investments have gained favour among investors, as we outline below:

- Offshore assets have recently outperformed local ones (graph 1), and many investors suffer from recency bias, extrapolating their recent experience and assuming this trend will continue.
- Additionally, in February 2022, the National Treasury announced the further relaxation of exchange controls, allowing investors to take 45% of their pension fund assets offshore, a significant increase from the previous limit of 30%. This change prompted many asset managers and investors to increase their offshore holdings.
- Many South Africans are also concerned about the country's negative sentiment, political uncertainty, and management (including rising debt levels), leading them to diversify their risk.

Figure 1: SA Equities out/underperform Global Equities, rolling five-year annualised



Source: Morningstar to 31 August 2023.

When thinking about investing offshore, there are three key questions to consider:

1 Why go offshore?

Increased return: South Africa's economy represents less than 1% of the global economy and offers limited investment opportunities. For instance, we have one pharmaceutical company and a few technology firms, while cyclical companies dominate, especially in the resource sector. This concentration in riskier assets prompts many to seek offshore opportunities.

Reduced risk: South Africa is an emerging market and a higher-risk country to invest in. While it seems counterintuitive that, given the risk of multiple currencies and assets, investors can reduce risk by investing offshore. This results from the returns from local and offshore assets not being perfectly correlated.

Improved diversification: The volatile nature of the rand makes exposure to international assets a hedge against its weakening global purchasing power. Over the last 15 years, the rand has lost around 6.2% per annum against the US dollar, exceeding the annual inflation level of 4.8%*. By investing offshore, SA investors are protected from inflation stemming from local currency weakness, as their rand returns from international assets will benefit from rand depreciation.

*as of August 2023

2 When do I go offshore?

Timing the currency market can be a formidable challenge, but historical data reveals that the rand has depreciated by an average of 6.4% per annum over rolling five-year periods. It's a common observation that investors often hesitate to venture offshore when the rand appears weak. However, it's crucial to remember that offshore investments are inherently long-term endeavours. Our analysis at Ninety One, using data from the Investment Platform, underscores this point by revealing that the typical investment horizon for offshore investments spans more than 20 years. Looking back to 1974, we find that the rand has never appreciated over 20 years.

We did further analysis, using data since January 2000 for investments in global equities. The average return over a rolling one-year period was 11.6% in rand terms. When we dissect this return, we find that 69% is attributed to the underlying assets, with only 31% stemming from currency depreciation.

Understanding the rand's behaviour is essential. It functions as a risk-on/risk-off currency, exhibiting cyclical patterns. In simplistic terms, investors shift their exposure from developed markets (DMs) to emerging markets (EMs) during a risk-on environment. This dynamic can depress DM asset prices while boosting EM asset prices and currencies like the rand. Conversely, in a risk-off environment, the trend reverses as investors reallocate to DM assets, causing the rand to weaken, thus acting as a 'shock absorber' for offshore investments.

While the rand's fluctuations may offer potential entry points for offshore investments, offshore asset valuations, and momentum can offset these gains and vice versa. Therefore, adopting a longer-term perspective and overlooking short-term currency movements is advisable when delving into offshore investments.

3 How do I go offshore?

Embarking on an offshore investment can be complicated, especially when faced with over 800 approved offshore funds in South Africa and alternative investments like share portfolios and structured products. Here, we offer a set of considerations to assist you in fine-tuning your investment universe. While the list provided serves as a starting point to stimulate your thinking, it's important to acknowledge that your circumstances and investment objectives might require additional criteria tailored to your specific investment strategy and advice practice.

> Adopting a longer-term perspective and overlooking short-term currency movements is advisable when delving into offshore investments.

A. Should I construct my portfolio using multi-asset funds or building block funds?

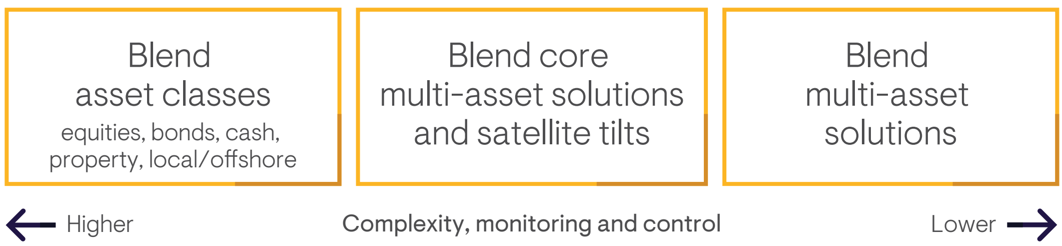
Investors must decide whether to build their portfolio using multi-asset funds or opt for a more granular approach with building block funds. The choice hinges on the complexity, monitoring, and control the investor or advisor prefers.

— Opting for multi-asset funds means that the combined insights of selected underlying managers determine the asset allocation. On the other hand, the building block approach, which involves investors choosing individual equity, bonds, and cash funds, offers a higher level of complexity and control. However, it requires more frequent decision-making as asset allocation directly results from investors' choices.

— A middle-ground option entails utilising a multi-asset approach for 60-80% of the portfolio as the core allocation and adding regional, thematic, tilts, and sector allocations.

Ultimately, the choice is up to the investor, but one needs to be aware of the advantages and disadvantages of each approach.

Figure 2



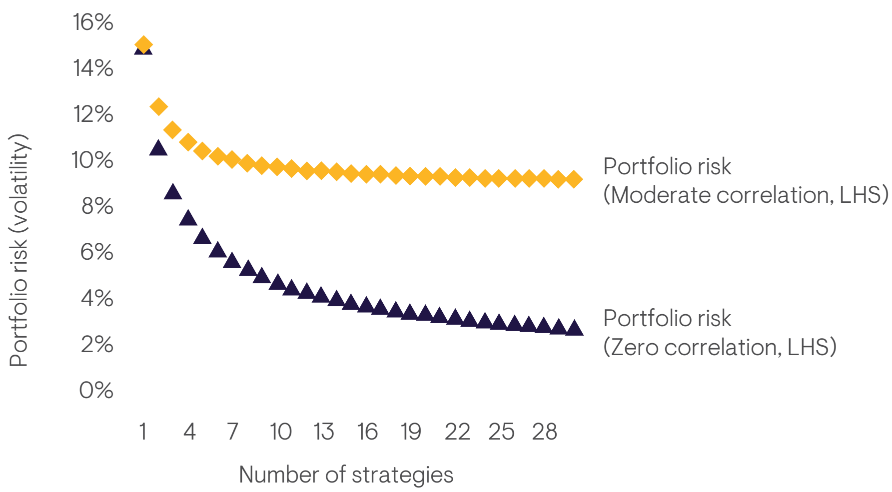
Source: Ninety One.

B. How many funds do I need? What is the optimal number of funds to achieve diversification?

Assuming that more funds equate to a more diversified portfolio is common, but this isn't necessarily accurate. True diversification hinges on adding assets or funds with low or no correlation to existing portfolio components.

In the graphic overleaf, the blue triangles demonstrate the benefits of adding funds without correlation to the existing portfolio. The steeper line signifies reduced portfolio volatility and risk with such additions, provided they remain uncorrelated. However, finding numerous funds with zero correlation to one another is improbable. The modeled yellow line illustrates the benefits of adding assets with a moderate correlation (35%). As evident, the line flattens quickly, indicating limited diversification advantages beyond 3-5 funds.

Figure: 3

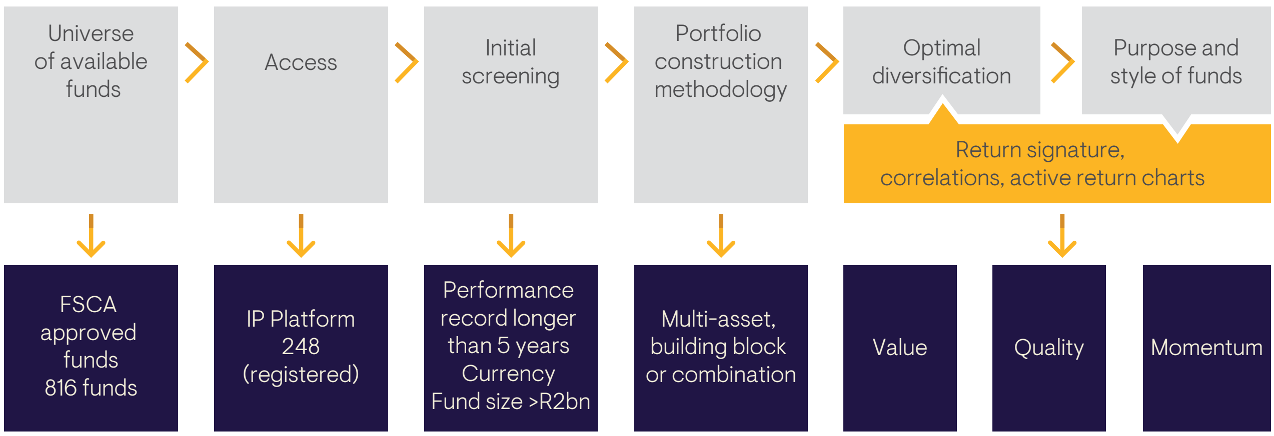


Source: Ninety One. Moderate correlation = based on a correlation assumption of 35% between assets.

C. How do I start to refine my investment choice?

With a vast selection of more than 800 funds, refining your investment universe is essential. Here are some suggested strategies to consider and processes that you can follow to refine your investment universe. This is simply an example to get you thinking, as your specific practice may require additional qualifying criteria. Ensure that your shortlisted funds contribute to portfolio diversification by examining their return signatures (styles) and correlations to create a well-rounded, risk-conscious, diversified portfolio.

Figure 4



Source: Ninety One.

Understanding the dynamics of offshore investing is essential for making informed decisions. Offshore investment has gained traction for valid reasons, driven by the recent outperformance of offshore assets, exchange control relaxations, and concerns over local sentiment and risk. Ultimately, offshore investing unlocks an array of opportunities. While the rand's movements can present entry points, it's crucial to remember that offshore asset dynamics may offset gains derived from currency fluctuations. You can make informed decisions by staying focused on your long-term goals while employing thoughtful diversification strategies.

Contact information

Please visit our website at www.ninetyone.com for more information on our range of funds and portfolio products. You'll also find application forms and other relevant documentation for offshore investing on the website.

For more information and assistance with investing, call the Advisor Service Centre Tel 0860 444 487. Alternatively, please contact your Ninety One investment consultant

0923-0178-Capability-Offshore-Viewpoints