

Why invest offshore?

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PAUL HUTCHINSON
Sales Manager



We are a small economy with a relatively illiquid and volatile stock market

Investors are regularly reminded of the wisdom of investing offshore and not adopting an investment strategy that focuses only on South African assets. There are a number of compelling reasons for investing offshore. Briefly, these include:

- **Diversification benefits** – investing in international assets allows for greater diversification, which is a key investment principle for reducing risk. In addition, investing in international markets provides access to countries, currencies, asset classes and industries that are not available locally.
- **Reduced emerging market risk** – South Africa remains an emerging market, albeit with pockets of first world industries (e.g. banking and mining) and infrastructure (e.g. roads, ports and railways). By world standards though, we are a small economy with a relatively illiquid and volatile stock market.

Interestingly, while the FTSE/JSE All Share Index makes up less than 1% of the world's market capitalisation, South Africa's gross domestic product (GDP) comprises only approximately 0.6% of the world's GDP. Why is the size of market capitalisation compared to GDP so high in South Africa? The reason is that our country was amongst the earliest adopters of a market exchange aimed at raising external capital to finance business activity, which happened to be mining at the time. (The JSE was founded by Benjamin Woollan in November 1887 to provide a market place for the shares of South Africa's many mining and financial companies that resulted from the discovery of the Witwatersrand goldfields in 1886.) It was not until more recently that financial markets geared towards raising external capital became a feature in many other emerging markets, including Russia and China.

Why is this relevant? Index trackers and many global portfolio managers base their allocation to a particular emerging market on relative market capitalisation, not GDP. It is likely that other emerging markets will, over time, see a proportional increase in their market capitalisation in line with their relative GDP, thereby reducing South Africa's relative market capitalisation. Ultimately, this change will likely mean less capital flows to South Africa, which will put pressure on the rand.

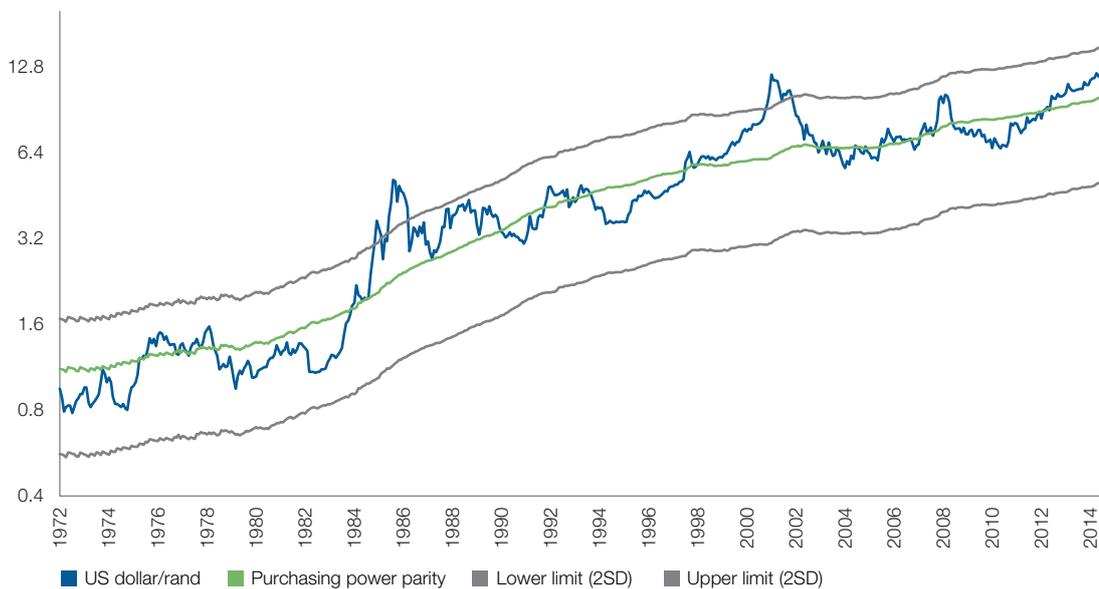
- **Reduced currency risk** – all things being equal, economic theory states that one can expect a currency to depreciate in line with the differential between that country's inflation rate and those of its major trading partners. With inflation hovering close to the upper end of the South African Reserve Bank's 3 – 6% target, South Africa's inflation rate exceeds, by some margin, the inflation rates of its major trading partners. Therefore, over time, we can expect the rand to depreciate against these currencies.



Figure 1 illustrates the overall deteriorating performance of the rand against the US dollar since 1972. The graph also uses the theory of purchasing power parity (PPP) to illustrate the relative cheapness or expensiveness of the rand against the dollar over time. (PPP is a theory which states that exchange rates between currencies are in equilibrium when their purchasing power is the same in each of the two countries.) When the blue line in Figure 1 is below the green line it suggests that the rand is cheap and vice versa. The two grey lines represent two standard deviations (SD) – cheap or expensive. This simply means that we expect the rand to trade within these bands about 95% of the time.

Currently, therefore, PPP is suggesting that the rand is on the cheap side. However, it is important to consider South Africa’s worsening terms of trade, general risk aversion and continued US dollar strength on the back of expected rising US interest rates. All these factors are potentially negative for the rand.

Figure 1: US dollar/rand purchasing power parity



Source: I-Net Bridge and Investec Asset Management, as at 30 June 2015.

- **Maintenance of ‘hard’ currency spending power** – it is important for South Africans who travel abroad or who purchase imported items (or any product or service priced in an international currency) to ensure that they maintain (and grow) their spending power in real terms.

A long-term view is required to fully benefit from offshore assets’ return potential

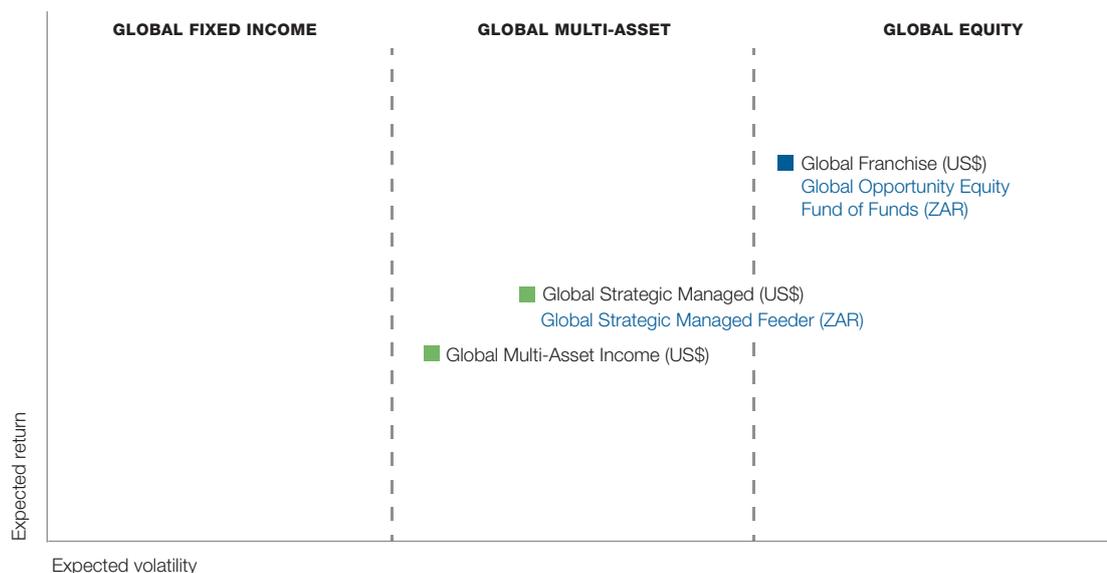
While the case for investing offshore is compelling, it is important to consider where the return from an international investment could come from: the exchange rate and/or the underlying foreign investment. The impact of exchange rate risk on a foreign investment should also be an important consideration. Many South Africans got burnt when they invested offshore in 2001 and 2002 when the rand traded at around R12 to the US dollar. As a result, South African investors now tend to have an underweight exposure to foreign investments.

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 in rands. Research indicates that it is only over longer time horizons that the underlying investment contributes more to the return than the exchange rate. Therefore, we are of the opinion that when investing offshore, investors need to take a long-term view to fully benefit from the return potential of the international assets in which they are invested.

A global specialist asset manager

Investec Asset Management is well placed to assist South African investors looking to diversify offshore. With an impressive global investment team of 168 investment professionals (of which more than a hundred are based in the UK and Asia Pacific), Investec Asset Management now manages assets for six of the ten largest sovereign wealth funds. And while Investec Asset Management has built an impressive track record in managing global asset class and regional/sector funds, we have created a simplified core range of investment solutions (conservative, balanced and aggressive) for South African investors seeking to diversify offshore.

Figure 2: Investec Asset Management's core international fund range



CONTACT INFORMATION

36 Hans Strijdom Avenue
Foreshore, Cape Town 8001
Telephone: +27 (0)21 416 2000
Client service support: 0860 500 100
Email: comcentre@investecmail.com

www.investecassetmanagement.com



Follow us on Twitter
@investecam_sa

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