

Consider this

Table Talk: Should SA investors allocate more offshore?

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Q: With everything going on in South Africa, I'm concerned about my retirement savings which is heavily invested in local assets. Should I be diversifying more offshore?

A: This is a complex question, with the answer depending on a variety of factors. There is really no single optimal offshore allocation that can be applied universally. An optimal allocation should be specific to an investor's individual circumstances, and there are some key considerations that will influence this decision.

It's true that investor sentiment towards South Africa has grown more cautious over the past year due to intensified load-shedding, lacklustre growth prospects, and the FATF grey-listing, to name a few developments.

In the current conditions, diversification in portfolios is especially valuable, and attractive opportunities are presenting in the widely diverging real yields and valuations we are seeing between countries, sectors, companies, issuers and instruments – there are many opportunities, but investors need to be selective in their choices.

Review your overall offshore allocation before adding more

Before deciding to increase your offshore allocation, review your portfolio holistically to get a sense of the total offshore exposure. Underlying funds in your portfolio are likely to be already invested in offshore assets so that collectively, your exposure may already be aligned to your objectives, time horizon and risk profile. Keep in mind that some 75% of the corporate earnings on the JSE are sourced from outside South Africa, so an existing local investment could hold substantial offshore exposure. Locally listed global companies can be a valuable source of diversification.

Take advantage of diversification benefits

Investing offshore provides local investors with access to regions, sectors and industries underrepresented on the JSE. This allows access to a broader and more diverse opportunity set from which to deliver returns.

Offshore assets are critical in balancing the risks specifically embedded in South African assets, especially within growth assets like equities and, to a lesser extent, property and bonds. They help lower risk by reducing portfolio concentration and the macro and geopolitical risks that emerging economies, like South Africa, are exposed to. As an example, a relatively weaker performance from SA assets and the rand so far in 2023 has resulted in offshore investments offering South African investors excellent diversification benefits.

Align your offshore allocation to risk-return objectives

As with any asset allocation decision, it's important to consider the optimal allocation most likely to help you achieve your investment objective within the time horizon.

When looking at the various local and global asset classes, you should consider the correlation between them, as shown Graph 1. The lower the correlation, the higher the benefit of diversification. As an example, global cash and bonds are negatively correlated to SA nominal bonds and would be good diversifiers for each other as they will most likely move in opposite directions in the market cycle. As a result, diversifying globally reduces overall portfolio risk.

Graph 1: Global diversification reduces overall portfolio risk

Take advantage of low and anti-correlations between asset classes

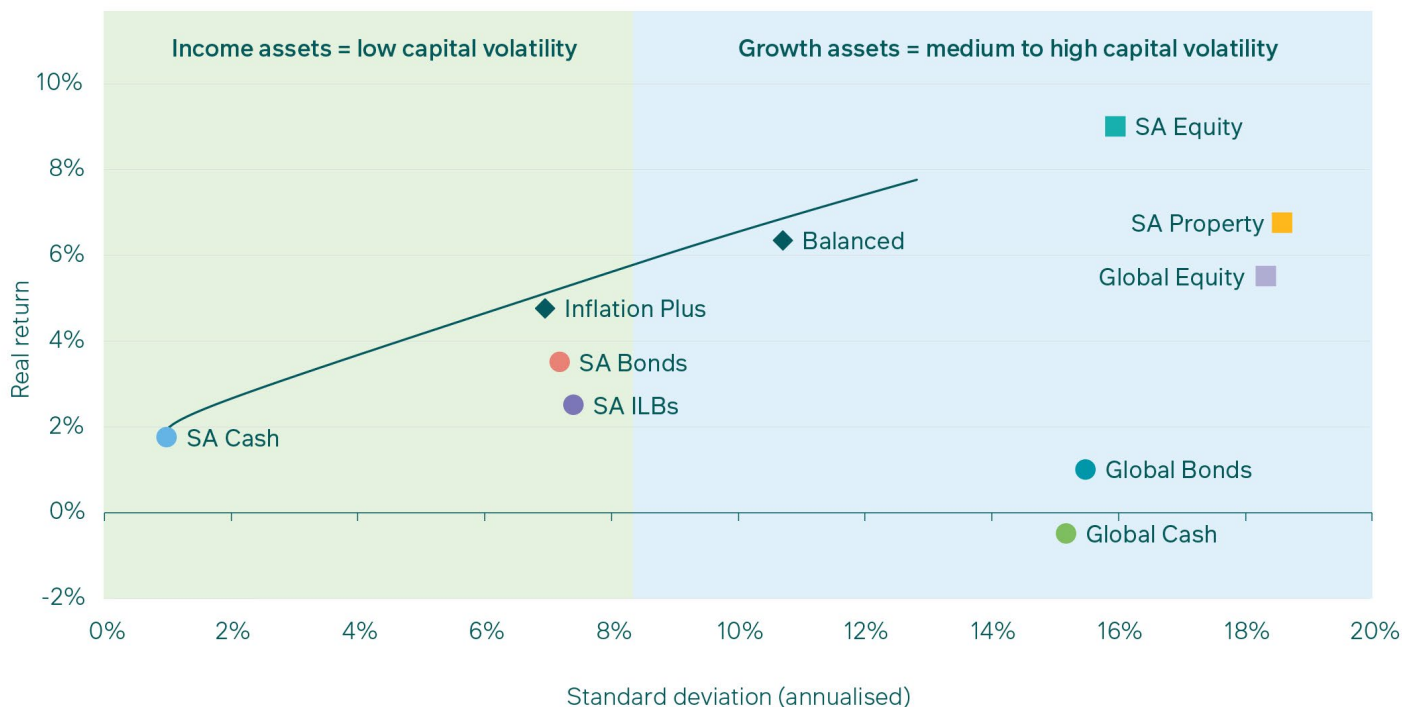
	SA Cash	SA ILBs	SA Nominal Bonds	SA Property	SA Equity	Global Cash	Global Bonds	Global Equity
SA Cash	1.00	0.03	0.11	0.02	-0.16	-0.05	-0.02	-0.25
SA ILBs	0.03	1.00	0.44	0.35	0.26	-0.20	-0.16	-0.03
SA Nominal Bonds	0.11	0.44	1.00	0.54	0.24	-0.50	-0.40	-0.26
SA Property	0.02	0.35	0.54	1.00	0.50	-0.36	-0.31	0.03
SA Equity	-0.16	0.26	0.24	0.50	1.00	-0.16	-0.19	0.46
Global Cash	-0.05	-0.20	-0.50	-0.36	-0.16	1.00	0.95	0.59
Global Bonds	-0.02	-0.16	-0.40	-0.31	-0.19	0.95	1.00	0.53
Global Equity	-0.25	-0.03	-0.26	0.03	0.46	0.59	0.53	1.00

Source: M&G Investments

From Graph 2, it's evident how divergent the various single local and offshore asset classes are with respect to the efficient frontier (or optimal risk/return combination, where the highest return is possible for the given risk, and represented by the diagonal line). The best approach is to blend asset classes to deliver optimal risk-return for a portfolio, as evidenced by the relative closeness of the M&G Balanced and Inflation Plus Funds to the efficient frontier.

Graph 2: Portfolio Construction

Blending asset classes to deliver optimal risk-return solutions



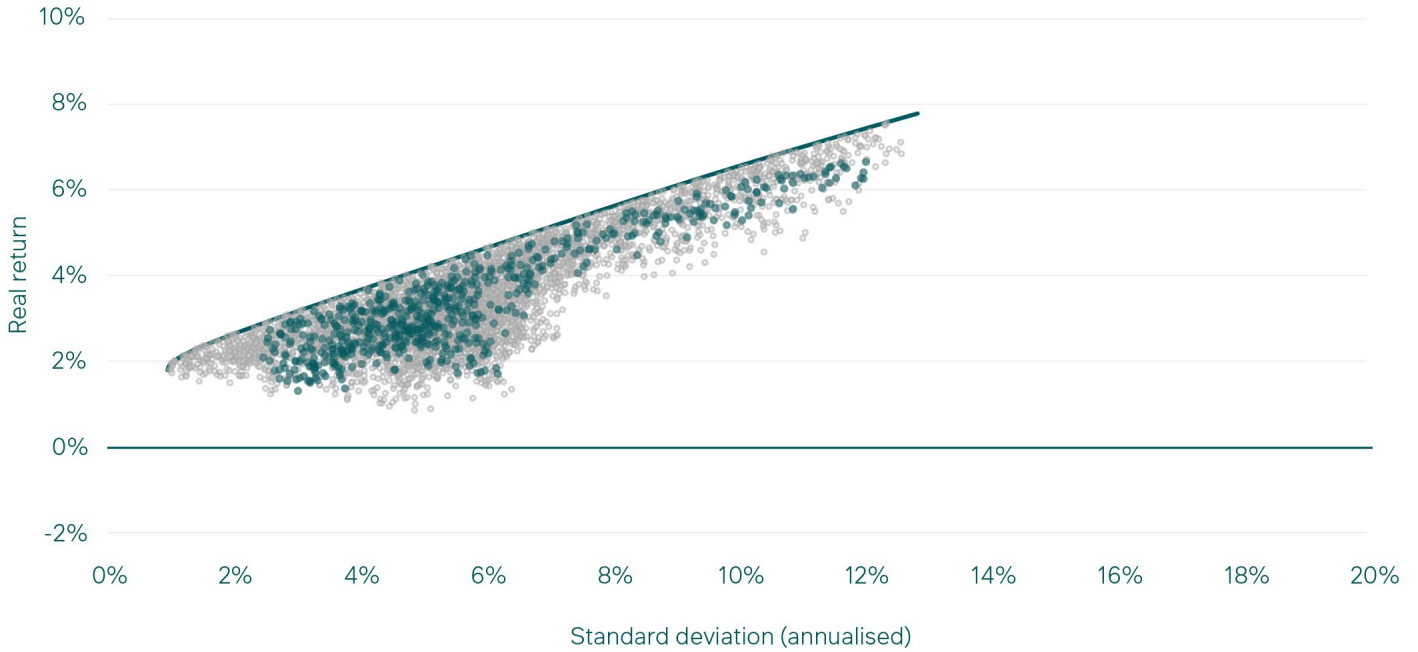
Source: M&G Investments

Our research examining different offshore asset allocations in a portfolio has shown that for our balanced funds and other mandates aiming for returns of between CPI+4%-7%, the optimal “neutral” long-term allocation is between 25% to 30%. For more conservative multi-asset portfolios targeting returns of CPI+3%, we found that the optimal neutral long-term asset allocation is somewhat less, between 20% to 25%. With weights considerably above or below this range, a fund’s risk-return profile becomes less optimal.

This is shown in Graph 3, where each dot illustrates the different combinations of risk/return outcomes that can be achieved over a range of portfolios with different offshore weights. Here, the closer the portfolio weight is to the 45% limit dictated by Regulation 28 for retirement portfolios, the further it moves away from the efficient frontier. Key here is that additional foreign currency risk is introduced to a portfolio by increasing its offshore exposure, to a point where eventually the additional return potential added is offset by the risk.

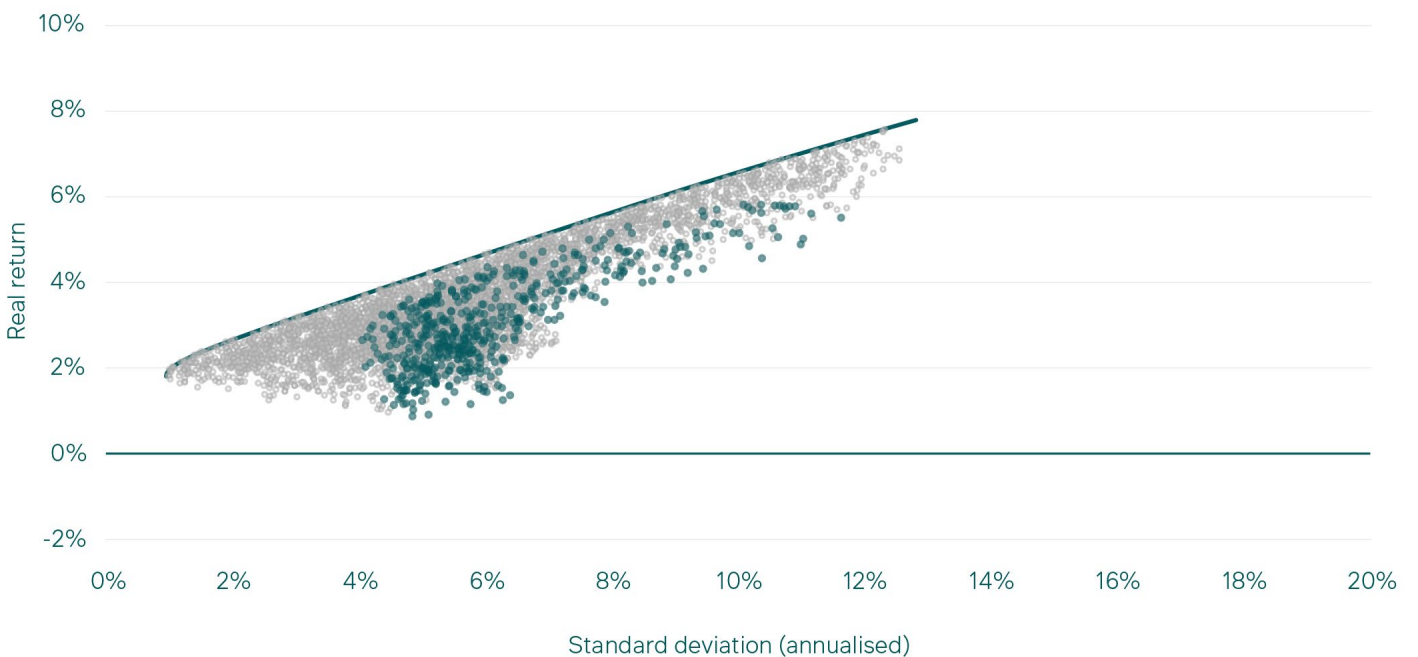
Graph 3: Portfolios with foreign weights of 25-30%

Increasing foreign exposure shifts the outcome further from efficient frontier



Portfolios with foreign weights of 40-45%

Increasing foreign exposure shifts the outcome further from efficient frontier



Source: M&G Investments, IRESS, Bloomberg

Invest with current valuations in mind

From a portfolio construction perspective, it's important to start with the long-term neutral optimal offshore allocation, which for the M&G Balanced Fund would be between 25% to 30%, for example. This allocation then needs to be analysed and adjusted to take into account current absolute and relative asset class valuations, to arrive at an appropriate shorter-term offshore weight for the portfolio. This weight will shift over time as we respond tactically to changes in asset class valuations as markets move, taking advantage of short-term market mis-pricing opportunities that may arise.

Currently, in our portfolio positioning our offshore allocation remains well below the full allowance of 45% and is a function of the attractive valuations of South African assets. In our current view, South African equities and bonds are significantly cheaper than their foreign counterparts, and we're therefore tactically overweight South African equity and bonds relative to offshore equity and bonds. The current offshore weighting in many of our client funds is just over 30%.

Within global portfolios, we are relatively defensive in our asset allocation positioning and selective in our stock-picking. We are positioned neutrally in our asset allocation to equities in multi-asset portfolios, while across global bonds we are neutral duration relative to the Bloomberg Global Aggregate Index, but are underweight in asset allocation terms. This also leaves us overweight global cash, providing a tactical opportunity to take advantage of cheap valuations when they present themselves.

We're currently balancing somewhat divergent considerations on the global front: on the one hand, there are concerns that the era of low and stable inflation, which allowed for low and stable short interest rates, may be coming to end, and if 2022 is anything to go by, may be quite traumatic for both bonds and equities. On the other hand, given the rout in asset prices through 2022, a lot of value has been restored in both bonds and equities, creating attractive tactical opportunities. These two offsetting considerations thus leave us broadly neutral at asset class levels. Additionally, among other factors, consumers are holding considerable debt, which could weigh more heavily than expected on household spending, company earnings and growth.

Finally, but also worthy of consideration, is the exchange rate of the rand. Our local currency has depreciated sharply so far in 2023, and many consider it to be undervalued. This supports a tactical preference for South African assets over global assets and avoiding buying relatively expensive assets at an expensive exchange rate.

Many considerations before going offshore

Offshore diversification offers considerable benefits, but the extent to which you can capture those benefits also depends on how and when you diversify. It's not simply about taking extra cash offshore right away. It's about carefully considering all the alternatives: your underlying local investments, relative asset class valuations (both local and global) and the rand exchange rate. If you're looking for opportunities to diversify offshore, our comprehensive range of global funds covers most investment needs and is backed by the skills and expertise of our global investment team. So before making any changes to the offshore weightings in your portfolio, speak to your financial adviser about diversifying offshore within the context of your holistic portfolio.

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