

Guide to offshore investment as SA slouches towards debt trap

● *But while tactical trading of currency movements may work for some, it's a high-risk strategy*

Andrew Duvenage

NEither the proposed economic recovery plan nor the medium-term budget policy statement did much to instil confidence that SA is on a path to economic recovery.

That certainly appears to be the sentiment of the ratings agencies, which responded by pushing SA's sovereign credit rating deeper into junk territory.

Fitch cut the country's foreign and local currency rating to BB-, three levels below investment grade with a negative outlook, while Moody's Investors Service took its rating to Ba2, two levels below investment grade. SA now faces higher borrowing costs, making recovery even more challenging.

The downgrades mean ratings agencies are not convinced that recovery plans proposed by the government will reverse SA's economic slide. SA's economic and fiscal picture is in a diabolical state.

Tax revenue has plunged due to the economic shock of Covid lockdown combined with longer-term economic mismanagement, stagnation and even regression.

As expenditure rises, SA's budget deficit is rising, to 15.7% of GDP or R76.lbn, with gross debt at 81.8% of GDP and rising to 95.3% in 2025. The cost of servicing this debt is the fastest-growing item of spending.

SA now runs the risk of falling into a debt trap that will ultimately lead to bankruptcy and a painful visit to the IMF or another funding institution. Recent rand levels are more a function of dollar weakness – and some “risk on” market dynamics that has provided support for emerging markets – than rand strength.

While this has provided some welcome respite, the fundamental and structural issues

the country faces remain in place. The reality is that there is still significant downside risk to the local currency.

These heightened risks mean diversification, including offshore investments, are not only sensible but essential.

When an economy is under pressure it's unlikely that on aggregate the participants in that economy will flourish. The recovery of stocks on the JSE, for example – excluding rand hedge stocks – is not broad-based. Worsening this situation is the continued shrinking and concentration in the JSE, which reduces the opportunity set available to investors. So it's vital to have exposure to foreign markets that offer investors access to a broader, more diversified opportunity set.

Diversifying investments offshore can be achieved in a variety of ways. The preferable option is direct offshore exposure through the investor's individual discretionary allowance or through tax clearance as it externalises funds from the country and allows direct exposure to investments.

Where this is not possible – such as a trust, for instance – an asset swap can be used to get access to offshore investments. A key consideration here is that although exposure is offshore, proceeds will always need to be realised locally.

It's also possible to use local funds that have exposure to offshore investments. This can be achieved through multi-asset class funds such as balanced funds, which typically hold 30%

KEY TO SUCCESSFUL OFFSHORE INVESTING IS TO REGARD IT AS A LONG-TERM, STRATEGIC INVESTMENT DECISION



Offshore wins: While the rand may have been looking relatively healthy recently, the currency in reality carries much downside risk and investing offshore is a wise move. /panuwat/123RF

offshore, or through feeder funds, which are local funds fully exposed to offshore investments. Bear in mind that even though the exposure is to offshore investments, the proceeds are realised in SA.

Capital gains are calculated on rand growth so, in essence, there is capital gains tax on currency depreciation, which is not particularly tax efficient.

Choosing the right investment is critical. The mix between equity, property, bonds, cash or structured investments will be driven by investors' risk appetite. In the current low and even zero interest rate environment investment alternatives are a tricky decision as asset classes like cash and even high quality bonds offer little or no return.

The risk is therefore that investors and global capital will gravitate towards equity, with dividend yields regarded as a replacement for interest. While this may support and drive equity prices up, it's important to understand the risks investors are exposed to.

Investors who have tradi-

tionally held a significant weighting to defensive assets like cash or high-quality bonds may now feel the near zero returns are less attractive and therefore increase their equity exposure.

This can result in a misalignment of risk profile. Be cognisant of the risks associated with a portfolio structure and have longer time horizons to deal with potential volatility.

One area that can make sense in this environment is products with market exposure but with some form of capital guarantee. Guarantees don't imply zero risk as issues like credit risk, tax and liquidity all need to be factored in.

The reality is that offshore investments are inherently more

THE REALITY IS THAT OFFSHORE INVESTMENTS ARE INHERENTLY MORE VOLATILE FOR LOCAL INVESTORS

volatile for local investors as they have two dynamics in play: currency risk and underlying investment risk.

While evidence points to long-term rand depreciation, it's entirely possible that the rand can counterintuitively strengthen, which negatively affects the rand value of the investment.

A number of basic principles apply when it comes to offshore investing. These include ensuring that investments are diversified, understanding the credit risk, being patient when entering markets, and – given the volatility of the rand – following a strategy of regularly exiting the rand may make sense as it could mitigate the risk of externalising at unfavourable rates (a cost averaging approach).

However, while tactical trading of currency movements may well produce results for some, it's a high-risk strategy. Ultimately, the key to successful offshore investing is to regard it as a long-term, strategic investment decision.

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