

Time for a strategy rethink

Greater opportunity set and growth potential in foreign markets are outweighing the risks

● The appetite for offshore investments is muted right now, with many local investors adopting a wait-and-see approach to global markets given the uncertainty that's been driven primarily by the Russia-Ukraine war, rising inflation, interest rate hikes and supply chain issues.

While this may have been the correct approach to take earlier in the year, all indications are that local investors looking at offshore markets should be acting now, says Wayne Sorour, head of sales and distribution at Old Mutual International.

"In the first six months of the year, investors were right to wait for markets to correct, but knowing exactly where the bottom is, is impossible," says Sorour.

"The markets have, to a certain extent, shown signs of bouncing back, with the S&P 500 up about 10% recently, so investors need to consider

dipping their toes back into offshore markets."

They should not wait for the rand to strengthen as a cheap market seldom correlates to a cheap currency. "When the rand strengthens, global markets typically correct at the same time," says Sorour.

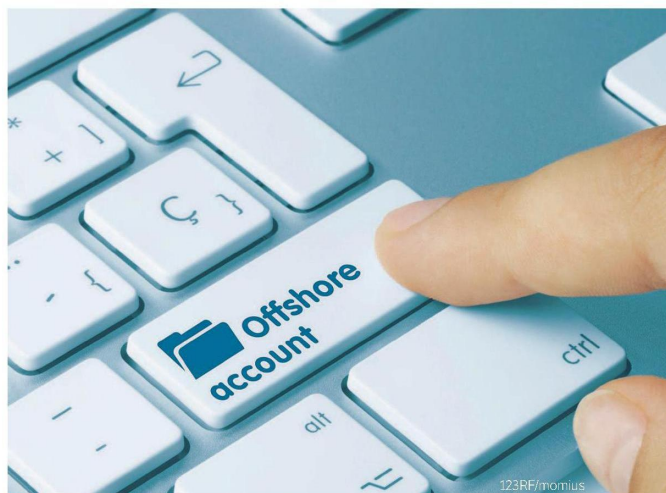
Direct investments vs feeder funds

There are a multitude of reasons for investing offshore, diversification being the most compelling one. "Typically, investors send their discretionary income offshore, allowing their local investments to meet their local needs to avoid the risk of currency volatility when bringing money back to SA," says Sorour.

He advises a direct investment rather than a rand-denominated asset swap or feeder fund if the investor needs to have money available in a specific jurisdiction, such as for overseas tuition for children or travelling abroad.

"Direct investments offer more flexibility. However, if it's only a small amount being invested offshore, it makes more sense to invest via a rand-denominated unit trust fund as it removes the hassle factor. Bear in mind, however, that if investing via a feeder fund or an asset swap, your money will be paid out in SA in rand."

There are advantages and disadvantages to using feeder funds, says Paul Marais, MD of NFB Asset Management. An advantage is that the offshore investment capacity of the business running the feeder fund is used rather than that of the investor, and that the institution handles all the offshore capacity administration issues, including obtaining tax



What it means: Now's a good time to dip your toes back into offshore markets

clearance.

A disadvantage is that the institution will charge investors for the privilege and when the investment is ultimately liquidated, the investor receives the proceeds in rand.

Amendments to regulation 28 of the Pension Funds Act, which increased the offshore allocation to 45% up from 30% (in respect of retirement funds), is evidence of the liberalisation of the SA investment environment, rather than the feared tightening, says Andrew Brotchie, MD of Glacier International, a specialist business providing SA investors with direct international investment opportunities.

He says the amendment aligns the Pension Funds Act with the relative freedom provided to individuals to invest offshore.

"Interestingly, there haven't

been strong calls from asset managers for more than a 45% offshore asset allocation at this stage, suggesting that this allocation provides significant portfolio diversification potential in their view."

The amended offshore allocation for pension funds will potentially affect feeder funds, he predicts.

"The expectation is that businesses would rather have more flexibility in their pension funds and forgo their feeder funds. The market has changed significantly since feeder funds were first introduced. Consider, for example, that it's now much easier to get money out of SA, which means that the structural case for feeder funds is less urgent," says Brotchie.

The case for offshore

Most experts suggest that at least some of an investment portfolio should be offshore given that SA represents less than 1% of global GDP, providing a small investment opportunity set and with relatively



Matt Slow Photography

Wayne Sorour: Direct investments offer more flexibility than feeder funds

poor growth fundamentals compared with many other markets.

The local market provides only limited opportunities: the number of local listed equities have declined significantly in the past two decades, down by about half on the JSE right now, with many industries not adequately represented compared with the global market. Factor in structural, economic and political issues and it's no wonder investors are looking offshore to diversify risk.

"Our clients are having conversations with us about SA's political climate, with requests for safe havens offshore. Ultimately, investors are looking to invest in growth stories," says Brotchie.

"Last year, investors found growth locally but, to some extent, that was an anomaly as previous years have provided restricted growth. Investors want to put their money to work and if there is little growth to be found locally, they will look offshore."

From abundance to scarcity

But it has been far from plain sailing in global markets this year. "It's been a tough year so far for investors, with broad-based declines across assets," says Clyde Rossouw, co-head of quality at Ninety One.

"The equity sell-off has been pretty indiscriminate, with few places for investors to hide as liquidity is withdrawn from the world's financial system."

Some sectors, such as commodities, have benefited amid the shift from abundance to scarcity due to tighter financial conditions and supply chain disruptions. But the shift has weighed more heavily on others.

"Profitless technology companies have been particularly hard hit by the higher cost of capital," says Rossouw.

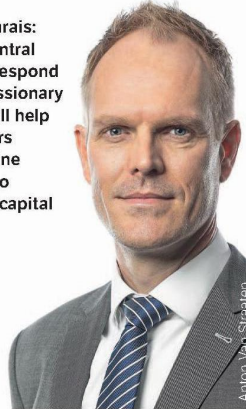
"These companies attracted a lot of free money based on the promise of returns some time in the distant future, but had little to show in terms of cash flow. Those businesses are now clearly out of favour, with

their share prices plunging as borrowing costs rise and the prospect of a recession looms."

Investors looking to invest offshore should be targeting companies that have earnings and cash flow resilience and avoid poor-quality cyclical businesses with the most earnings risks, such as those in the energy, steel and shopping spaces, advises Rossouw.

As commodity prices

Paul Marais:
How central banks respond to recessionary risks will help investors determine where to deploy capital



weaken and industrial activity ebbs, he predicts the market will rotate back to higher-quality companies.

"In a global market where liquidity is scarce, it's crucial to consider businesses' ability to generate cash flows and profits and whether companies need access to capital, which is becoming more expensive. Free cash flow yield is an important indicator of how financially stable a company is."

Where to invest

How central banks respond to recessionary risks will help investors determine where to deploy capital, suggests Marais.

"The US Federal Reserve, for example, appears willing to risk a recession to contain inflation. Interest rates there appear set to continue rising and will in all likelihood remain elevated until inflation returns to their target of 2% per annum. For investors looking for a First-World currency with higher interest rates, diversific-

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ation into the US therefore appears to be a reasonable investment strategy.”

The tax implications

Any offshore investment portfolio needs to factor in tax considerations, advises Sorour. Many countries, including the



Andrew Brotchie:
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US and the UK, require that nonresidents pay inheritance tax on assets, including property and direct shares.

“The US, for example, imposes a 40% inheritance tax on nonresidents for investments valued at over \$60,000, which is why it’s important to structure offshore investments in a vehicle that does not result in higher tax or inheritance tax,” he says.

“We’re big proponents of wrappers, an investment vehicle that legally entrusts the investment manager to handle all the tax affairs of the investments, given that they are easy to administer, don’t require probate or an offshore will, and aren’t subject to offshore tax.”

The impact of greylisting

The global anti-money laundering body, Financial Action

Task Force (FATF), has highlighted deficiencies in SA’s financial controls and said the country will be placed on a greylist unless sufficient initiatives are introduced to curb money laundering, corruption and terrorist financing.

In October 2021, the FATF gave SA 18 months to introduce the necessary measures allowing it to prevent financial crimes. The country needs to have demonstrated progress in addressing the deficiencies by October 2022.

However, it was only in late August 2022 that the National Treasury announced a raft of amendments to existing laws to address illicit financial activity and submitted the amendments to parliament.

The Treasury has conceded that it won’t be easy to avoid greylisting.



Clyde Rossouw: The equity sell-off has been pretty indiscriminate

“Should SA be greylisted it won’t stop South Africans from investing offshore, though there will be more due diligence required before any investment can be made, as well as increased complexity,” says Brotchie.

“The most significant impact of a greylisting will be to negatively affect sentiment, which is likely to result in more investors wanting to take their money offshore.”

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