Investing offshore

March 2011

Since late 2008 Coronation has consistently advocated the view that most long-term investors will benefit from increased offshore allocations. A cynic might well observe that this opinion is hardly original at present, as it is shared by a number of investment companies in South Africa. However there is little evidence to suggest that this is a consensual view when one analyses the inflows to international funds.

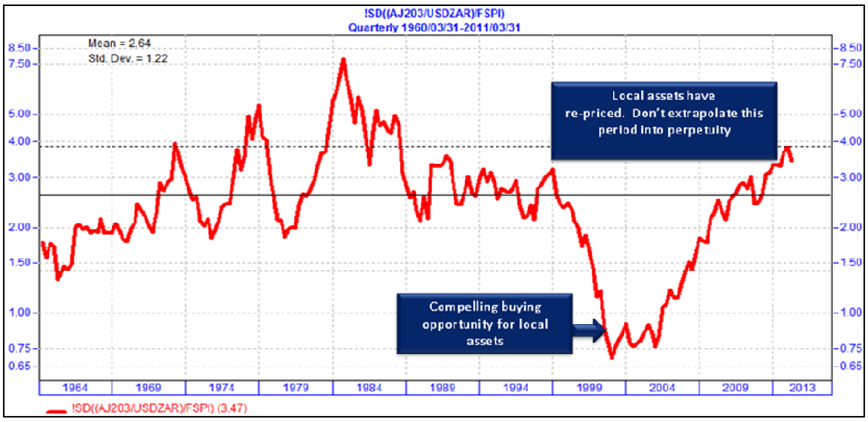
We believe that high quality international equities offer attractive value over the medium to longer term, both on an absolute basis – when viewed in the context of their poor returns over the past 10 years, and on a relative basis – when compared to the buoyant returns enjoyed by investors in the local market.

Below we briefly answer four key questions that we believe investors will face over the next three years.

1. Will local equities continue to outperform international equities?

While almost every asset manager in the country agrees that investors should be increasing their international equity weightings, the graph below (Fig 1) helps explain why retail flows into offshore funds still reflect skepticism and resistance amongst investors. South African equities have performed incredibly well over the past decade, leaving investors in domestic equities four times better off than their international counterparts.

Figure 1: FTSE/JSE All Share Index relative to the S&P 500 Index (in US dollars)



Source: I-Net Bridge

However, Figure 1 also illustrates what an anomaly the past ten years has been and that South African equities have largely moved back in line with their long-term trend. Of concern to us is that investors are almost 'too' comfortable being invested locally and are effectively dismissing the merits of investing offshore.

In summary, our view is not predicated on a weaker rand and nor are we advocating placing all your money offshore. What we are saying is that South African equities are trading on an earnings multiple roughly equal to that of an international portfolio of high-quality stocks. We therefore believe that now is a good time to increase the offshore component of your portfolio by increasing exposure to these high-quality stocks.

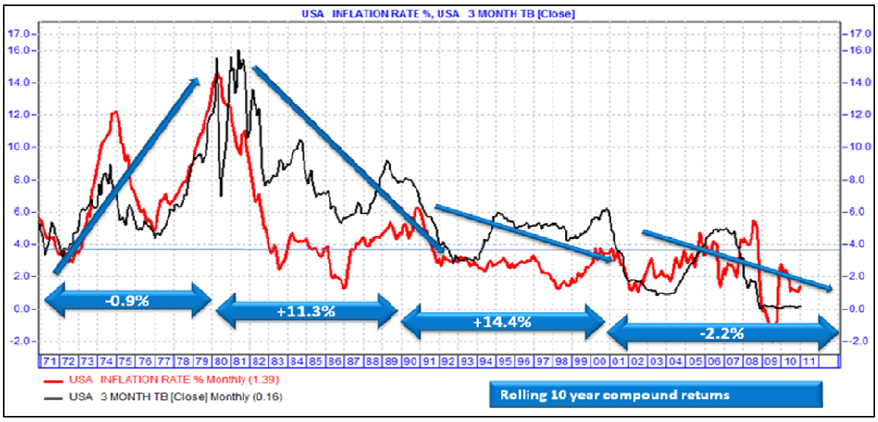
2. What does rising inflation mean for equity valuations?

History tells us that a sharp increase in money supply feeds inflation over time. We also know that, given the anaemic nature of the current economic recovery, central banks in the developed world will not take their feet off the accelerator pedal by hiking interest rates until there is clear evidence of sustained and strong economic growth. While we don't expect any major increases in global inflation within the next year or two, it may well kick up quite sharply in the next five years. This leaves investors with the question: Where do I put my money in a rising inflation environment?

Again, history suggests that commodities and cash offer the best short-term protection once developed world inflation approaches a level of 4%. While it may be worthwhile to increase your commodity weightings, it would be unwise to have your entire portfolio in commodities (and we believe a lot of the upside is already reflected in the price). This time we also don't believe that cash will be your next best option as the fragility of the developed economies will prevent interest rates from going up sharply in the short term.

We also know that equity markets respond much better to stable or declining inflation, and do not like rising inflation or threatening deflation, as is clear from the good returns achieved in the 80s and 90s, compared to the poor outcomes in the 70s and 'naughties' as illustrated in Figure 2 (in blue) which compares inflation, interest rates and market returns in the US over the past four decades. However, as long as the current low interest rate environment endures, we believe well-run companies should remain in a position to steadily increase their profits and offer investors the best protection against inflation.

Figure 2: What rising inflation will do to equity market ratings?



Source: I-Net Bridge

In addition, while international equity markets have disappointed over the past decade, over the longer term (see Table 1 below) they still outperform other asset classes. The point at which investors should start lowering their equity weightings is when the authorities respond to rising inflation with sharp interest rate hikes; this is unlikely to happen in the foreseeable future (1 - 2 years).

Table 1: US real investment returns (p.a.)

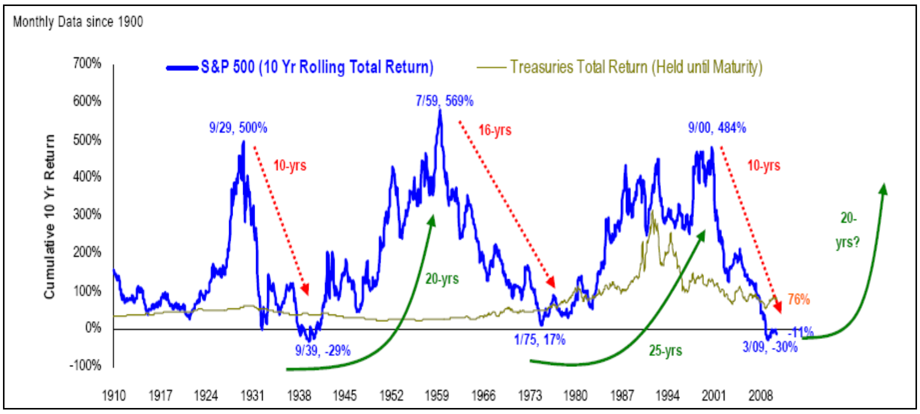
	2009	10 years	20 years	50 years	84 years
Equities	28.7%	(2.2%)	5.8%	5.5%	6.6%
Government bonds	(15.5%)	5.0%	5.3%	2.9%	2.3%
Cash	(2.6%)	0.2%	1.0%	1.2%	0.6%

Source: CRSP, Barclays Capital

3. Are international bonds a better bet than equities?

In Figure 3 we look at 10-year rolling return on the S&P 500 (blue line) compared to that of US Treasuries (green line) over the past 100 years. Bonds have only managed to outperform equities on three occasions, after each of which equities returned to their longer-term trend, i.e. much higher than bonds. This time we don't believe it would be any different and have every reason to believe that in the next 10 to 20 years you will earn better returns from equities than from bonds.

Figure 3: 10-year rolling return of US bonds versus US equities

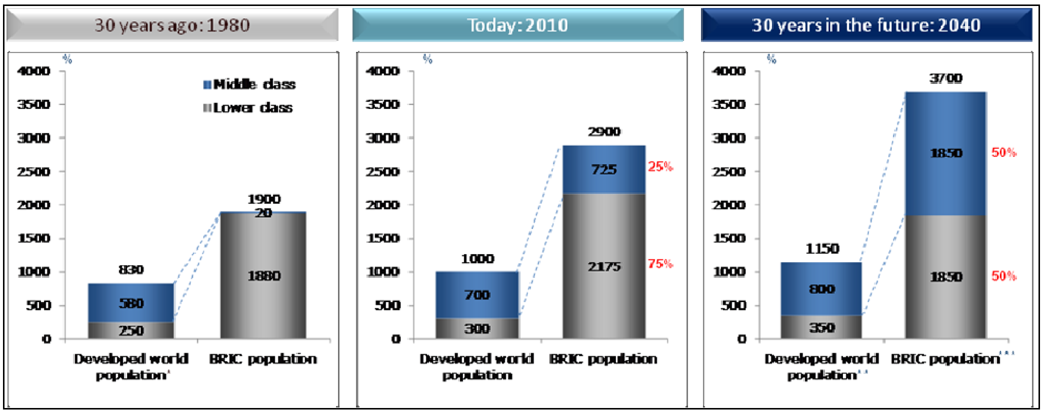


Source: JP Morgan and Shiller

4. Do I invest in Emerging Markets or Developed Markets?

There is no doubt that it is intuitively very appealing to invest in emerging markets as the demographics are overwhelmingly in their favour. Figure 4 shows the estimate of middle class populations - which typically determines the economic success of a country - in the developed world versus that of emerging markets. Thirty years ago the developed world had a middle class population nearly 600 million, and the emerging markets close to none. Thirty years later (i.e. today) the developed world middle class has increased marginally to about 700 million, which is now smaller than the middle class of the big four emerging markets. Of interest is that in 30 years' time, estimates for the developed world remain largely static, while the emerging market middle class will increase by a further 2.5 times to 1.85 billion.

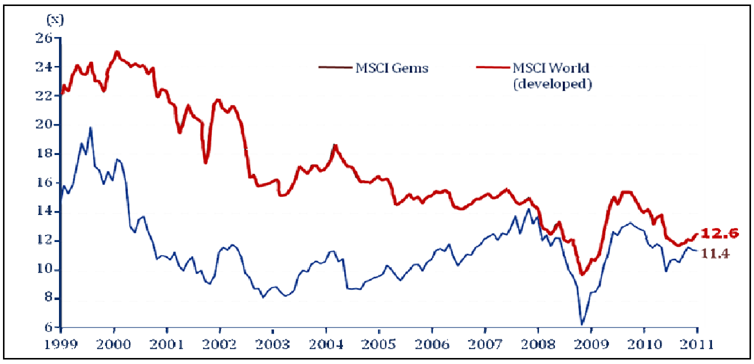
Figure 4: The evolution of the middle class



Source: IMF, Lansdowne Partners analysis

As investors we do however also have to take a view on the valuations of emerging market companies. While in principle it may be tempting to invest all your capital in emerging markets, based on current valuations, the answer would be 'No'. Figure 5 shows the major differential that existed between the forward PE multiple on developed world equities and emerging market equities. Ten years ago the developed world was on a very high rating, while emerging market ratings were much lower due to one or two market bubbles bursting in Asia. Since then, the two have converged. However, given the risks associated with emerging markets – North Africa and Egypt being recent cases in point – one should expect some discount between the two broad markets as is clear in Figure 5.

Figure 5: Forward PE multiple of the MSCI Emerging Markets Index versus MSCI World Index



Source: Citigroup

Given this convergence in ratings, we prefer to invest in high-quality, branded companies (e.g. Unilever, Nestle or Heineken) that generate a large part of their earnings from emerging markets on multiples of 12.5 times, rather than buying, say an Indian company that trades on a multiple of 25 times.