

Re-evaluating offshore investments

by Pieter Koekemoer

Opportunities beyond developed equity markets.

Since 1995 South African investors have been legally able to invest a portion of their assets offshore. Over time, offshore investment restrictions have been relaxed, most recently in this year's national budget. Retirement funds will soon be allowed to invest 20% of assets offshore, up from the current 15%. Most local unit trusts with flexible mandates, such as the Coronation Market Plus Fund, can already invest up to 20% of their assets outside South Africa. And at an individual level, registered tax payers have been granted a once-off allowance of R2 million, plus an annual combined travel, investment and maintenance allowance of R500 000. In addition, individuals can access rand-denominated foreign unit trusts, or investment policies linked to foreign funds, as another means of obtaining greater offshore exposure.

The change in foreign investment restrictions, a dramatic weakening in the rand (to levels last seen in 2002) and the extreme turmoil in global markets pose a challenging set of variables for consideration by asset allocators, investment advisors and individuals. But before deciding on the quantum of assets to take offshore, and where it should be invested, one should first consider whether it makes fundamental sense to invest offshore.

Popular arguments include:

- the proven portfolio diversification benefits of introducing assets that are expected to not fully correlate to existing assets in the portfolio;
- reducing country risk;
- hedging future foreign currency payments, and
- gaining exposure to investment opportunities that are not available in the domestic market.

Probably the most pronounced of these arguments is protecting the future purchasing power of your capital by owning assets in the countries that will produce your future imports.

The majority of South African investors have historically used their foreign investment allowances to buy developed market equities, most notably in the US, the UK, Europe and Japan. To date, the benefit of following this 'conventional' strategy has not been to enhance returns.

Investing in developed market equities at the beginning of any calendar year between 1996 and 2006 would have resulted in lower returns than if you had invested in South African equities over the same period (measured in US dollars). Depending on the start point, the local share market outperformed developed market shares by between 2% and 21% per annum. This world-beating performance by local shares reflects a re-rating of SA Inc. as a result of our reintegration into the global economy, the adoption of prudent fiscal policies by Government and superior earnings growth underpinned by the country's best economic growth performance in decades.

This historical outcome will not necessarily repeat itself in the future and does not singularly provide a strong enough argument to avoid including foreign assets in your investment portfolio. It does however seriously question the conventional wisdom of using offshore allocations to solely buy developed market equities and bonds. Evaluating other asset classes in developed markets, such as real estate and hedge funds, as well as additional markets beyond the traditional, seems warranted.

While discussing the relative merits of the various alternatives to developed market equities is beyond the scope of this article, it is worthwhile to dispel the myth that South African investors should avoid investing in emerging markets simply because we live in one.

Global emerging market equities presented one of the few investment options that outperformed South African equities over the last five years. Economies across Asia, Latin America, Eastern Europe and the Middle East have consistently achieved high growth rates over the last decade. This has been achieved on the back of increasing integration into the global economy through export-led growth, the continued deepening of domestic consumer markets, massive infrastructure expenditure programmes and a major boom in commodity prices.

Typically South African investors are underexposed to emerging market equities. Many investors believe that limited offshore capacity should be used to buy less correlated, and potentially less risky, assets such as developed market equities and hedge funds. After five years of emerging market outperformance, some investors may also be concerned about current emerging market valuation levels.

We believe that the recent increase in foreign investment allowances offer long-term investors the opportunity to consider adding emerging market exposure to their portfolios.

Increase in diversification benefits

Intuitively it makes sense to expect better longer-term diversification benefits when you broaden the investment universe. There are more than 5 000 shares listed in emerging markets, which are quite often exposed to very different valuation drivers than those of domestic or developed market shares. Adding concentrated and actively managed exposure to businesses as diverse as Russia's Gazprom, the largest owner of gas reserves in the world, and Cemex, the largest building materials company in Mexico, should over time provide diversification benefits.

There is also quantitative support for the diversification benefits of adding emerging market exposure to a portfolio of South African assets.

Over the past 20 years, the MSCI emerging market index had a positive correlation of 0.55 to the local all share index, compared to developed market equities with a positive correlation of 0.37 to local shares. Although this is a fairly high correlation co-efficient, adding emerging market assets would have provided some diversification benefit over the period. One way to measure this is through the Portfolio Diversification Index (PDI). The PDI measures the number of unique sources of investment risk in a portfolio (the higher the PDI, the more diversified the portfolio). Over the past 20 years, a portfolio made up of domestic bonds, domestic equity and cash had a PDI of 2.53. If developed market equities and bonds had been added this would have increased to 3.47, and through the inclusion of emerging market equities would have further increased to 3.61.

The addition of emerging market equities would historically have improved the probability of producing higher returns, albeit at the cost of increasing the overall risk in the portfolio.

Changes to the world economic order

At the turn of the millennium, emerging markets represented less than 15% of global economic output, compared to around 30% today. This rapid expansion is the result of much faster economic growth in the emerging world. This will continue through 2008 and beyond, with emerging markets expected to deliver more than 70% of the growth in the global economy this year. While it is likely that emerging market growth will slow down in line with that of developed markets, it is expected to remain at significantly higher levels. Consensus forecasts for growth in emerging markets are around 6%, compared to around 1% for the US and Europe.

Rapid growth can continue for at least another decade, as the emerging world represents 85% of world population - nearly three times its share of current economic output. We expect that 50% of global economic activity, and hence share market value, will be in the emerging world in 15 to 20 years time.

The relationship between share market value and size of the economy provides another means of illustrating this point. The combined market capitalisation of emerging Asia (including China, India, South Korea, Indonesia, Thailand, the Philippines and Malaysia) equals one sixth of the value of the combined GDP of these countries, while the market capitalisation of the US is more than double the value of its GDP.

The current crunch in global credit markets, specifically in the US, exhibits characteristics historically associated with 'emerging markets crises'. Few market commentators would, as recently as a year ago, have associated a sudden reduction in liquidity, a lack of confidence in the banking system and the need to raise fresh emergency capital from foreigners, with the biggest economy in the world. These events are turning long-held assumptions about the relative riskiness of developed and emerging market assets on its head.

Access to the fastest growing economies

The level of market penetration in different countries further illustrates the growth opportunities in emerging markets. China has 228 million internet users, compared to 217 million in the US. While this represents only 17% of Chinese, it constitutes 80% of Americans. Less than 3% of adults in Russia and Indonesia own a credit card, compared to an average of four cards per American, and nearly two per British adult.

Ongoing urbanisation will continue to support growth across the communications, banking and most other industries for many years to come. It will help to keep economic growth high, labour costs low and productivity gains high for the foreseeable future. In 1975, three emerging market cities made the list of the 10 biggest cities in the world (with the remaining seven in the developed world). The United Nations expects that the order will be reversed completely by 2015, with New York and Tokyo the sole remaining developed country cities amongst the world's largest.

The opportunity presented by rapid urbanisation can only be exploited for a limited time. Its impact will gradually diminish as the pace starts to slow, particularly in Asia (potentially towards the end of the next decade).

Reasonable valuations are still available

Despite a sustained period of outperformance and concerns about valuation levels in specific markets, such as China and India, emerging market equities as a whole are not in bubble territory. The above-trend annualised return of 28% over the past five-year period reflects the recovery post the emerging market crisis of the late 1990s; contrasting with the 10% return per annum achieved in the past decade, which highlights the low starting point for many of these shares. The chart below, comparing current emerging market valuation levels to the previous excesses in the market value of Japanese and technology shares, confirms this.

In fact, there are numerous examples of undervalued shares across the various markets:

Sberbank, completely dominating retail banking in Russia with 20 000 branches, is well positioned to benefit from the increasing use of banking services by under-banked consumers. We believe that this potential is not reflected in a price to book multiple of less than two, a forward PE of 11 and a return on equity of 25%.

Latin America's largest bottler and distributor of soft drinks, Femsa, is responsible for 10% of Coca-Cola's global volumes and currently trades at a forward free cash flow multiple of 13. This company is expected to continue to produce above-trend growth, building on its track-record of generating 34% annualised growth in free cash flow over the last 10 years.

It is also possible to find attractively valued shares in Asia. Telekomunik Indonesia is the telecommunications market leader in this country with 220 million people and mobile phone penetration of less than 40% (compared to 80% in South Africa). With an operating margin and return on equity north of 40%, this company trades at an undemanding forward free cash flow multiple of 12.

While a significant body of evidence exists to support the ongoing investment case for emerging market equities, some caution is required. Considered stock selection remains key as valuation levels for certain individual countries and shares appear to be overstretched. Correlations between all categories of equities have also increased fairly significantly over the shorter term, potentially reducing some of the near-term diversification benefits, and uncertainty regarding the direction of investor cash flows further increases the shorter-term risks.

The combination of supportive demographic and economic trends, the resulting higher expected growth rates supporting a relatively more resilient earnings outlook and reasonable valuations for selected shares make it possible for emerging markets to produce reasonable longer-term returns. Allocating a portion of your foreign investment allowance to emerging market assets is warranted, specifically for investors with long time horizons.

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