

Moving on from ten forgettable years

Too many South African investors are still spooked by the first ten years worth of paltry returns delivered by offshore markets in the first decade of this century. Depending on when you converted from rands to a major offshore currency – you would have seen zero, less than zero, or far lower growth than the local market delivered. And that could well be in fund currency.

Ten years for many investors is perceived to be enough time to deliver some good growth – and to see the effects low return markets and volatile currency movements have on an investment portfolio has left even the hardiest investor unsettled.

Following the financial crisis and recession investors have been looking for opportunities to grow their wealth – and in the last nine months even contrarian fund managers are punting developed offshore markets as the place to look for good returns.

The latest ASISA inflows however show that foreign funds remain low on the shopping list and investors have fresh in their minds the returns from the local market. Developed market economies are also in some serious debt and show far lower growth than many of their emerging counterparts. So is there merit in the argument that offshore looks like a better investment opportunity or will the JSE continue to deliver stellar returns?

Neville Chester, portfolio manager at senior Coronation Fund Managers dealt with the investor aversion to offshore at the recent Conversations with Coronation held around the country. Chester said we need to look at why South Africa has delivered such good returns to assess whether they will continue going forward. He gave several reasons why the returns

in SA have been so good:

1. Infrastructure free ride – in the 1970s and 1980s South Africa built a lot of infrastructure for growth that never happened. When growth finally arrived in the late 90s and 2000s we had spare capacity that we could use – already paid for.

That spare capacity has filled up (electricity and roads for example) and to build new infrastructure for further growth will come at a cost.

We have to spend on infrastructure to grow and we have to pay for that spend – so costs will go up and profits may not be as spectacular.

2. 'Unbelievable' commodity boom – and every investor on the JSE has benefited from this. Growth is never just confined to one particular sector – many others benefit and one example of this would be banks- when your business grows your bank also sees the benefits.

3. The technology dividend has also benefited SA – and think here of giants MTN and Vodacom. Ten years ago what were these? Today they are enormous companies with big budgets and wide reach. While growth is planned for both it may not be as fast and furious as the first ten years of their existence.

4. Tax rate reduction – and this was also across the board.

Taxes came down leaving more funds available for spending and that boosts the economy. Given current debt levels it is unlikely that tax rates will reduce much further and the major benefits of the tax reductions have happened.

5. Low interest rates and lower inflation - if your mortgage bond is tied with interest rates as most are you will notice a massive decline in these rates. SA Reserve Bank Governor Gill Marcus has publicly said that while

global growth is so tenuous there may be a chance of another rate cut – this will again be only a minor benefit.

Furthermore to grow South Africa needs jobs and any further rate cuts would signal a very depressed economy that would be unlikely to create jobs. So again another boom factor for the decade whose benefits are largely already passed on.

6. Credit – there has been a huge amount of credit pumped into the economy, Chester commented. And just think here of the property market. Household debt to GDP in SA has gone from 52% to 82% in the last ten years. Could this go much higher?

7. Structural decline in the risk discount rate – SA is seen as a stable, well regulated and 'decent' growth area – it has made us far more attractive to foreign investors.

Much of the benefits of this have been seen – and we are also now competing

with a very significant number of other emerging economies.

8. Real job creation – aside from the last two years where an unaffordable million jobs were lost – South Africa managed to create jobs in the previous eight years.

All these factors contributed to the impressive real returns in the local market as profits rose.

One of the big questions is the commodity supercycle – where will this go and when and how will it end?

Chester said that while commodity prices are above normal and close to peak share prices are not and there may be some opportunities here.

Chester observed these last ten years have been something of an anomaly – with above average returns and the next ten years could be very different. South Africa faces far greater competition and on many measures of ease of doing business and global competitiveness we

have been slipping down the rankings.

Inflation and interest rates are at or near a bottom, credit growth is slow at best, and taxes may well have to rise.

And if you haven't yet noticed the electricity hikes and new toll tariffs- next year will see even greater price increases.

Another massive headwind we face, said Chester, is around red tape and increasing labour inflexibility.

South Africa is not creating jobs and is "slowly putting itself out of work."

He pointed out that in the last ten years only two have seen wage inflation below official inflation. "If you are not able to keep unit labour costs under control they will come back and bite you."

These headwinds lead to the conclusion that in SA the picture for equity returns does not look as good as it did ten years ago. The problem however, is that offshore too looks pretty

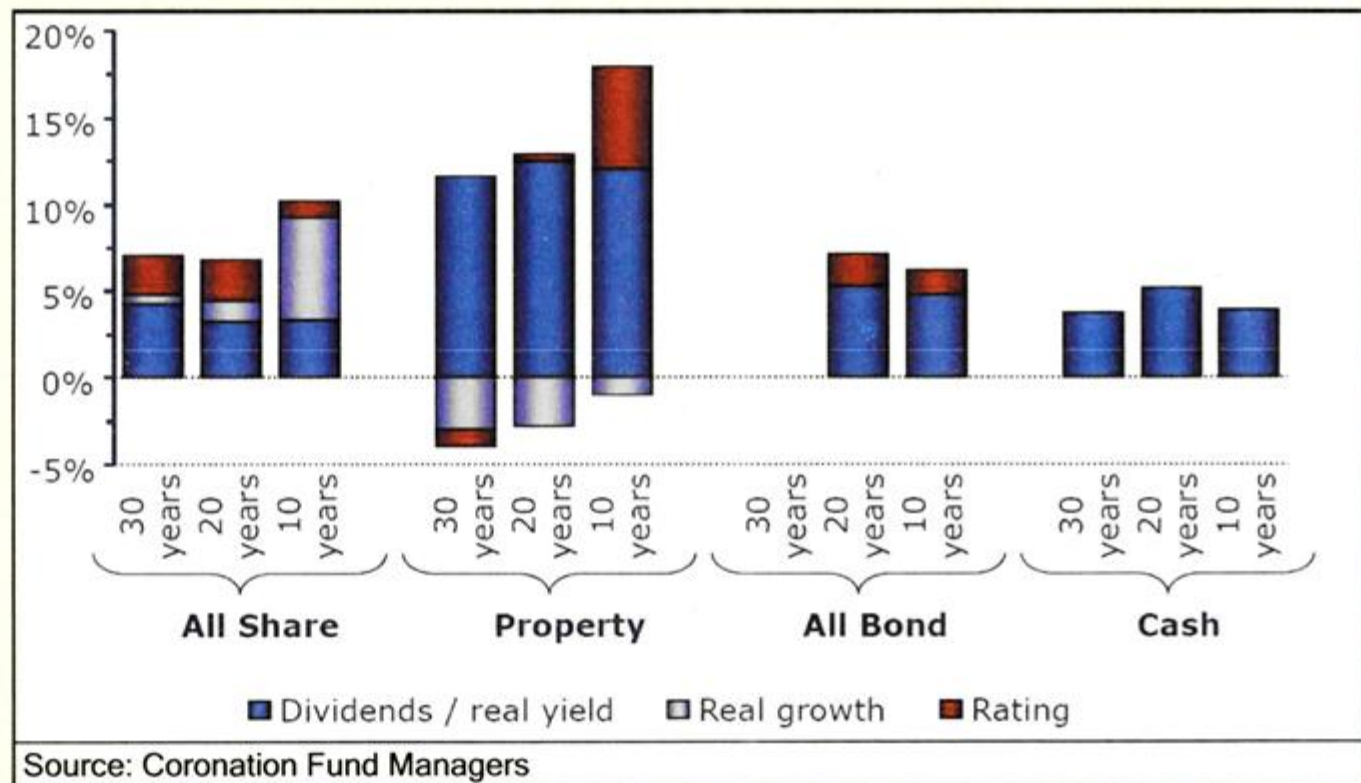
dismal. But offshore is not just a single entity with one investment return profile – there are far more companies and regions to access when going offshore.

As there are pockets of excellence in the local market – some still at a reasonable price ; because of size there are even more of these opportunities offshore.

It remains an investor prerogative to view the world of economics and investing as a skeptic. But it would do us well to remember that markets can show decades of anomaly – followed by much lower growth and a return to average returns.

South Africa may well have experienced its boom years of investment growth – and it now remains the decision of the investor to resort to diversification that will lead to a more balanced investment profile.

And this has to include an allocation to offshore investments.



Historical real returns