

# Offshore shares the place to be – fund managers

There are risks to the global economy, but many of these risks have already been discounted in the prices of offshore shares. This makes global equities compelling investments for South Africans, who face the prospect of inflation, rand depreciation and unexciting returns at home. **Laura du Preez** finds out what leading funds managers think.

Fund managers are still backing global equities to deliver the best returns in the quarter ahead, despite an increase in risks over the past quarter.

Louis Stassen, a senior portfolio manager at Coronation, says Coronation believes that if you need to diversify offshore, now is a good time. The returns you will earn from offshore investments will be better than those you can earn locally and the rand is likely to depreciate and boost your returns.

Coronation's worldwide asset allocation flexible fund, the Coronation Optimal Growth Fund, currently has a 90-percent exposure to offshore assets and an all time-low 10-percent exposure to South African securities.

Worldwide flexible funds have no restrictions on the markets in which the manager can invest, allowing it complete freedom to alter the fund's exposure to global and local markets in line with its views.

The top-performing fund in the worldwide flexible sub-category over five years to the end of March – the Flagship IP Worldwide Flexible Fund of Funds – also has 90 percent of its assets in offshore markets.

Winston Floquet, the manager of Flagship, says a 90-percent exposure to offshore assets is extremely high but Flagship believes the rand is overvalued and must weaken at some stage. Most of the fund's global assets are in equities, he says.

Stassen says global equity markets have remained resilient in the face of a number of events with potentially negative consequences for shares. This is because corporate profits continued to surprise on the upside as a result of company cost-cutting and cut-backs on capital and discretionary spending, such as marketing, he says.

Allan Gray's funds are also still heavily invested in offshore markets. Currently, the manager's domestic asset allocation prudential variable equity fund, the Balanced Fund, has the maximum exposure of

25 percent of the fund to offshore assets.

Chris du Toit, an actuary at Allan Gray, says the manager still sees better value in offshore equity markets than in the local one.

Du Toit says the strength of the rand to other major currencies means it is a good time to buy into offshore markets. He says if the rand does weaken as expected, offshore assets will offer you some protection against the effects of inflation that typically accompany a weaker rand.

Although the valuations (prices relative to earnings) of local shares based on next year's expected earnings are not extremely high, Du Toit says Allan Gray's estimate of normal earnings make valuations look much higher.

Allan Gray does not believe the outlook for profits is as rosy as expected and, as a result, local equities' returns over the next four to five years could be lower than those of offshore markets.

Allan Gray's local portfolios are in more globally diversified and defensive stocks, such as SAB Miller, Sasol and Remgro, he says.

## RISKS REMAIN

While asset managers prefer offshore equities, they acknowledge there are risks to investing in foreign markets. The risks have in some cases heightened over the past quarter.

Jeremy Gardiner, a director of Investec Asset Management, says although the world is fixing, it is not fixed. He says global growth is improving, unemployment is falling and stock markets are firm.

"The problem is that it remains unclear at this stage how much of that is due to quantitative easing (printing money) and unsustainably low interest rates," he says.

Gardiner says a lot of consumers, companies and countries remain "geared to the gills and are struggling to keep their noses above water". Ideally, the world needs two

years of solid stable growth, with no surprises, to allow growth to get going again and everybody to reduce their debt to more reasonable levels.

The overall impact on global markets of the Japanese earthquake, tsunami and nuclear disaster appears limited, Gardiner says. He says you can expect roughly 0.5 percent to be shaved off Japanese gross domestic product growth as a result.

Although the turmoil in the Middle East and North Africa region caused the oil price to spike, the impact otherwise is also somewhat limited, Gardiner says.

The threat of a shutdown in Libyan oil supplies is reasonably limited, he says, but if Libyan disruptions extend to Saudi Arabia, the impact on oil prices and thus global markets would be immense. A higher oil price would stoke inflation and, with it, interest rates.

Portugal's needs as a result of its government debt crisis will be relatively small, Gardiner says, but Spain will require a lot more euros to plug the leak. Spain is still claiming that it won't need a bailout.

Gardiner says another risk is inflation. Expect interest rates to rise, the extent of which will depend on food and fuel prices, he says.

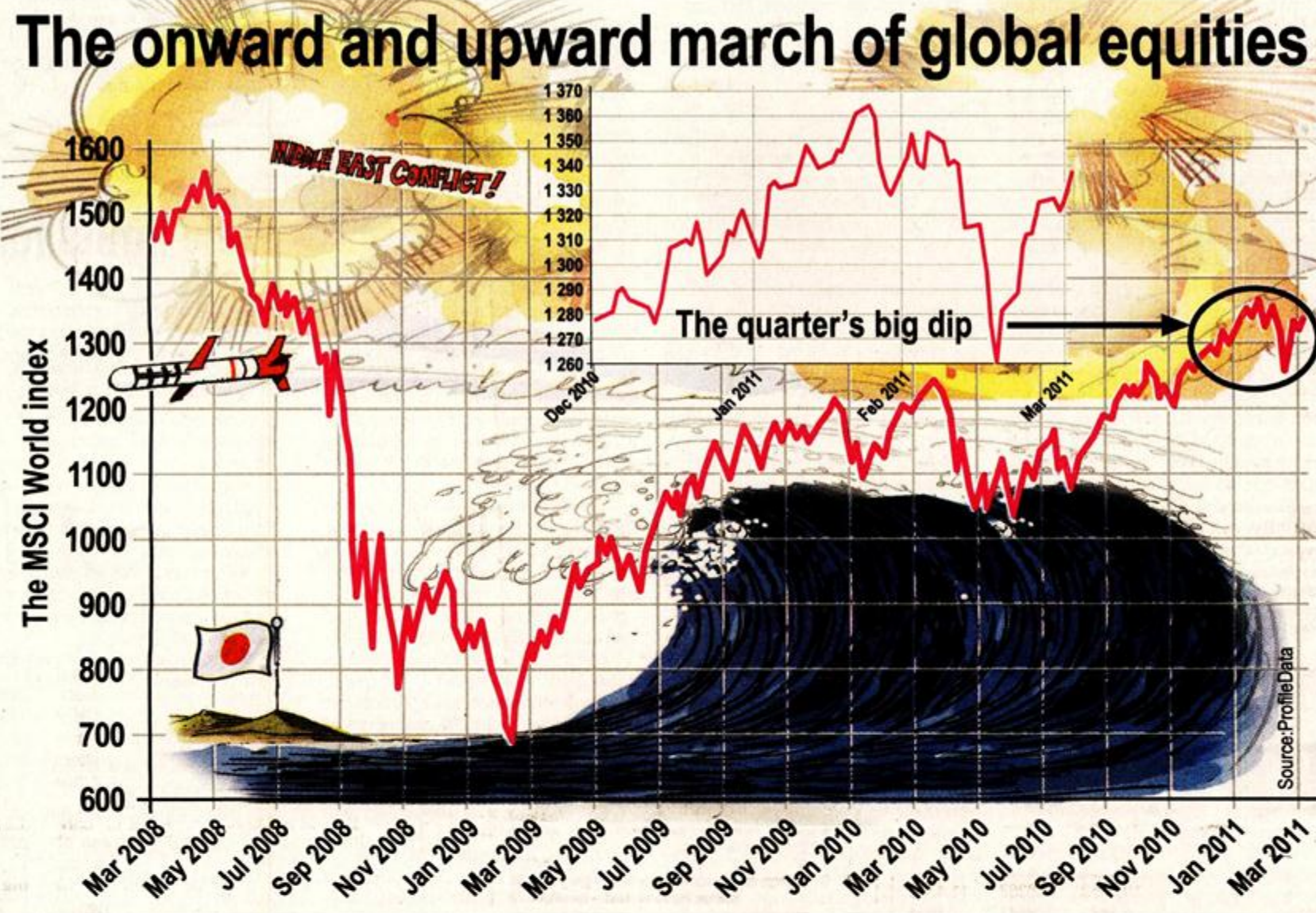
In South Africa, you need to watch the rand in addition to food and fuel, he says. If the rand weakens substantially, inflation will rise.

Floquet says the global economic outlook remains fraught with risk. He cites housing, unemployment and fiscal stress in the United States.

He says the imminent end of Federal Bank stimulus measures in the US is causing concern, as this will mean interest rates must rise, which will threaten the already weak housing market.

Emerging economies face tighter monetary policies, Floquet says, and the European government debt crisis shows little sign of easing, with the prospect of higher Eurozone interest rates in the near term intensifying pressures.

"These are concerns which can't



Local inflation is likely to go much higher than its current level, and this makes local asset classes expensive, Marriott Asset Management says.

Marriott believes an average annual rate of seven percent is a reasonable expectation for inflation and current yields indicate returns from local listed property and equities will not meet inflation and compensate you for the additional risk of investing in these asset classes, Duggan Matthews, a portfolio manager at Marriott, says.

He says currently you would do better to invest in developed markets. The yields of South African bonds, property and equities are well below their historical averages. At current prices, you would pay too much for the income streams you can expect from local bonds, property or equities.

Matthews says the minimum return you should accept from an investment is inflation plus three percent, because

be dismissed lightly but appear to be reasonably well discounted by the market," Floquet says.

Stassen agrees that the supply of oil, and hence the oil price, will sort itself out and that the economic impact of the disaster in Japan will not be as severe as the market has discounted.

He sees the biggest threat as the sustainability of corporate earnings. Stassen says companies have cut their costs severely and their operating margins are high. They may struggle to hold onto these

## DANGER OF INFLATION

government-backed inflation-linked bonds guarantee an after-inflation return of three percent.

Listed property has historically returned inflation plus seven percent, while equities have historically returned inflation plus eight percent.

If inflation reaches seven percent, you should get a return of 14 percent from property. But current yields are 8.7 percent, and Marriott expects income growth of three percent from listed property. Together these make a return that falls short of 14 percent.

With inflation at seven percent, local equities should give you a total return of 15 percent. He says the income growth of local equities is 10 percent and the current average dividend yield is 2.6 percent, so

combined they are below 15 percent.

In contrast, Matthews says, mega-cap stocks in the first world have dividend yields that are unusually high at present and are well above bond yields. Equity valuations (price to earnings levels) on these shares offer you a significant opportunity to generate more-than-acceptable inflation-beating returns over the next five years, Matthews says.

Mega-cap stocks are also known as global brands and include shares such as Unilever and Johnson & Johnson. They offer a hedge against rand depreciation, which should follow an increase in domestic inflation.

Marriott believes South Africa's inflation rate will rise because of structural inefficiencies in the economy

of the past quarter, saying they have resulted in some government spending, which will stimulate equities.

The Bank of Japan has committed Y34 trillion to ensure liquidity for banking operations and Y5 trillion to underpin investor confidence by buying exchange traded funds and real estate investment trusts, Monson says.

The Japanese government has also committed to a public spending programme aimed at rebuilding infrastructure in the area destroyed by the earthquake and tsunami.

– high labour costs without matching increases in productivity and increases in electricity and other administered costs – and rapidly rising prices of commodities such as food, oil, cotton and metals.

South Africa's substantial currency appreciation served to dampen the impact of surging dollar-denominated commodity prices, Matthews says. However, the rand is overvalued on a purchasing parity power measure and therefore is likely to weaken.

A weaker rand will affect inflation because about 23 percent of the local inflation basket is a measurement of food and fuel prices, which are directly affected by the currency movements.

Louis Stassen, a portfolio manager at Coronation, says Coronation believes there is a 50-percent chance that inflation will breach six percent, the upper limit of the inflation targeting band, in the next year.

Monson says the political turmoil in the Middle East and North Africa resulted in governments there committing themselves to spending in order to ease hardships. He cites examples in Saudi Arabia, the United Arab Emirates, Bahrain and Oman.

This supports growth and will stimulate global earnings, he says.

Monson likes developed market equities because their valuations are good, company balance sheets are strong, and there is dividend growth and earnings momentum.