FUTURE FOCUS

OCTOBER 2022

EXPLORE

INN8 INVEST

WELCOME TO FUTURE FOCUS,

SPRING EDITION

Insights on building wealth for your clients.

In this edition, we discuss some of the challenges that the DFM industry is facing and what needs to be done to raise the bar for the industry. We discuss diversification and share the outcome of our transformation survey. Lastly, now with investors taking more assets offshore it is important to remember that there is a difference between how your income is taxed locally and how it is taxed offshore.

Navigation

We hope you find relevant insights in the Spring Edition of the INN8 Invest Future Focus.

INN8 INVEST

TALKING POINT

How do we take **the DFM industry to the next level?**

*HOVER TO SEE MORE INFORMATION

Leigh Köhler

Head: INN8 Invest

Key Points:

- Scale in the industry is likely to be key in years to come, on what is generally quite a thin margins business.
- Full transparency remains an issue and it is crucial for the industry to come together to resolve this issue to level the playing field.
- DFM investment skills are now being questioned, with a trend towards lower cost solutions. If the game is to be raised, due diligence on DFMs is essential to ensure client outcomes are not compromised.

Introduction

The Discretionary Fund Management (DFM) industry in South Africa currently finds itself at an interesting juncture. It is now approximately 10-15 years old and the latest DFM survey conducted by the Collaborative Exchange puts total assets managed by DFMs between approximately R400-R450 billion. This is significant growth from 2014 when DFM assets were estimated to be around R40 billion. This raises the question as to

> “***what lies ahead*** *for the DFM market and how the industry can take itself to the next level?*”

Consolidation of DFMs must be on the cards, bizarrely we still grapple with transparency issues and lastly, the impact of cost pressures may be at the detriment of investors going forward. I briefly discuss each of these points.

Inevitable consolidation

Building a successful DFM is not easy. Investment performance, total asset size and distribution footprint are crucial factors in building a sustainable investment business. I am not sure that all DFMs are at the required level when it comes to any of these factors. While there is definitely space for boutique DFMs with differentiated value propositions, some LISPs are reporting up to 60 DFMs running money on their platforms. With approximately 70%-80% of the total DFM assets being concentrated within the largest 5 or 6 DFMs, it will be very difficult for smaller DFMs to sustain themselves indefinitely on what is generally quite thin margins. This is worrisome in that more competition can only be healthy for the industry and keep the big players on their toes.

Consolidation can happen in many shapes and forms, from strategic partnerships to full corporate deals. But no matter how consolidation takes place, it seems highly likely that over the next 5-10 years, there will be fewer names in the industry. With large institutional players moving into the market, DFM value propositions will come under tremendous pressure, particularly around the ability to access more competitive fee rates with asset managers.

Transparency is key to raising the game

Surely an adviser should be able to make an informed choice when partnering with a DFM? Unfortunately, despite the maturity of the DFM industry, major transparency issues remain. It seems difficult to believe.

Investment performance – ‘show us the numbers’

The drive for transparency in the investment performance of DFMs is crucial to the integrity of the industry – because not all DFMs have an actual, established track record of managing money. Some DFMs have pushed back and even questioned the motivations for pushing the performance transparency agenda. I have heard some interesting comments from my peers, the best being, “it’s an agenda pushed by asset managers”. The real question is, why the push back? Fortunately, our business has been managing client money for more than two decades with a published track record in our unit trust funds that is freely available for all to see. Most DFMs have only managed

TALKING POINT

How do we take **the DFM industry to the next level?** (cont.)

model portfolios on LISPs and verifying the history of these track records can prove difficult, although not impossible. I would therefore implore that the DFM industry come together to resolve this. Surely increased transparency can only lead to better client outcomes?

Becoming more institutionalised requires opening up

When you scratch the surface, it is not surprising to find that not all DFMs have the same investment and operational capabilities – this can and probably will result in performance differences over time. Investment pedigree and team size will eventually become more important as DFM selection criteria for advisers – there are many DFMs with only one or two individuals responsible for managing solutions. With more than 1 500 local funds and tens of thousands of global funds, performing fund research and portfolio construction at an acceptable standard is very difficult.

Fortunately at INN8 Invest DFM, we have an investment team of 20 plus in JHB, CT, Jersey and London, along with global fund research partnerships.

Participating in performance surveys can only assist the adviser

There are still DFMs that are reluctant to participate in performance surveys. This is particularly important since the number of DFM choices for advisers has exploded over the past 3-5 years as mentioned above. Just as when selecting a fund manager, DFMs should be put under the same scrutiny of due diligence, including both qualitative aspects such as investment philosophy, process and team, as well as quantitative research of which understanding performance is crucial.

We have a curious scenario in SA where the same DFMs that conduct due diligence on asset managers and expect transparent performance from them, are not willing to be transparent themselves.

Wrong approach for the wrong reasons

This brings me to the last point and perhaps most controversial, the impact of low DFM margins and fee pressures on portfolio construction approaches. We are seeing more DFMs moving towards a specialist building-block approach – using asset class building blocks such as local and global equity funds, local and global bond funds, local and global property funds etc – for portfolio construction. This need not be of concern since many multi-managers or DFM teams should be able to use this approach – and most experienced outfits do, both locally and globally. But in order to use this approach, the DFM investment team should have the skill and expertise to not only develop long term strategic asset allocations (SAAs) but also shorter-term tactical asset allocation views – and then have the ability to execute on these views.

The trend that we see developing is that many DFMs without the necessary asset allocation capabilities are turning to building block solutions, not because they think they have the required asset allocation skill and experience to do so, but rather because these building blocks are a lot cheaper to manage than multi asset (balanced) funds. Remember that with balanced funds, all the investment decisions are outsourced to the underlying funds/managers. The overall cost pressure means that they have to find ways to build client portfolios at lower costs in order to justify the DFM charge. There is a cost difference between an asset manager's multi asset fund and building block funds – with the latter being cheaper – as a result of the cost of the manager's asset allocation capability. The client will generally pay a bit more for the asset manager's asset allocation views in a multi asset fund. But as a result of the total cost pressure, DFMs have started moving away from a balanced approach to that of a building block/specialist approach. Essentially moving away from a blend of asset manager asset allocation views, to just one – that of the DFM.

There are generally two scenarios that can play out when a DFM uses building blocks. The building block approach can follow an active or a passive approach. Actively, the client still gets the underlying manager's active view/picks with each asset class, whereas with the passive approach, the client is 100% exposed to market beta/risk, despite lower fees. In both cases the client only gets one tactical asset allocation view from the DFM, who may not be skilled or experienced enough to execute on this approach. The reality is that cost pressures may lead to situations where the client is bearing the risk of lower quality portfolios.

TALKING POINT

How do we take **the DFM industry to the next level?** (cont.)

In conclusion

The role of a DFM is very important for any financial adviser. We have seen tremendous growth of DFMs and for good reason.

Surprisingly though, investment experience is something that is often overlooked by advisers when deciding on a DFM partner, especially experience in portfolio management. Its sometimes feels like anyone with a FAIS CAT II licence can now call themselves a DFM. To take the industry to the next level, we need full transparency for DFMs. Allow adviser due diligence and have the necessary investment capability to build robust investment solutions for clients, whether via building blocks, multi-asset or a hybrid approach.

Leigh Kohler
Head: INN8 Invest

Understanding what diversification is... and what it is not

Joao Frasco

Chief Investment Officer: INN8 Invest

Key Points:

- Diversification remains the one 'free-lunch' in investments, as it is unrewarded, and investors can use it to reduce idiosyncratic risks.
- It applies at many different levels of unrewarded risk, ranging from individual securities, through asset classes, to the manager level.
- It should be measured over multiple periods and over the time horizon of the investor, not over a single period or short-term time horizons.
- It should not be confused with hedging, which should involve assets that behave in exactly the opposite way to each other.

Introduction

Diversification is easily one of the most discussed topics in investments, but it is also one of the most misunderstood. If you think this statement is hyperbolic, consider two misconceptions that are often attributed to the failure of diversification.

1. The first, is when two asset prices move in the same direction over a given period.
2. The second is simply, when two asset prices move in the same direction, irrespective of the period.

Although this may sound like exactly the same thing, they are in fact two distinct elements of diversification that are often misunderstood. Reread any article that discusses the failures of diversification, and you may find one or both elements being misunderstood. Let us explore them in greater detail to understand where the failure occurs.

Understanding diversification

The most important thing to understand about diversification is that it is a continuum and not a binary phenomenon. What do I mean by this? Like most things in investments, you should think about them as continuums between two extremes and avoid the convenience of thinking about them in binary terms. At the one extreme, you have two assets that are perfectly correlated, either positively – they move together, up and down – or negatively, where they move in opposite directions. At the other extreme, they have zero correlation, or move completely independently of each other. This is where the first misunderstanding creeps in. Most people struggle with the simple concept of two assets behaving independently, because they see them move in the same direction and assume that they must be correlated.

> "BUT *what are the options for the behaviour of two uncorrelated assets?*"

If one moves up, what can the other do? If it moves up or down and you assume that it is then either positively or negatively correlated, what then does uncorrelated represent? There is no other option i.e., unless assets do not trade, they will invariably move up or down. The definition of uncorrelated is in fact that they will sometimes move up together and sometimes they will move down together, and these outcomes are effectively equally likely.

Yet people will observe two assets that have moved in the same direction, usually down, over the same period of time and assume that diversification has failed, when the truth could be the opposite i.e. the assets have behaved exactly as predicted – independently, even though they just so happen to have moved in the same direction.

> "AND *here is the catch.*"

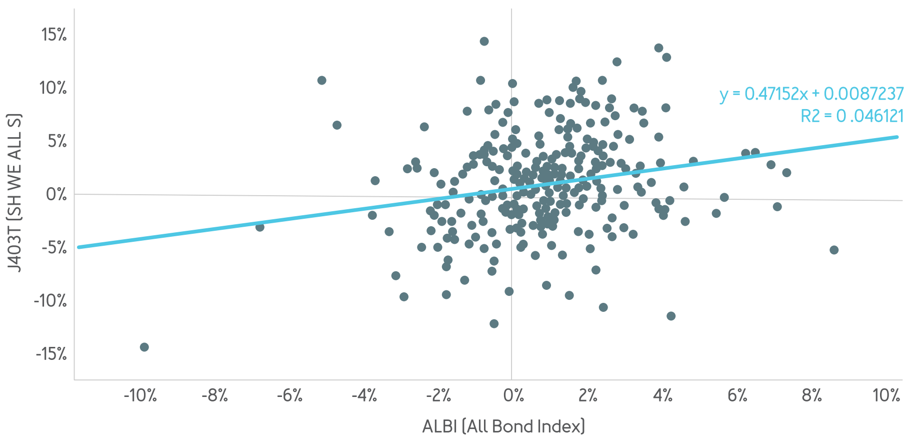
*HOVER TO SEE MORE INFORMATION

Understanding what diversification is... and what it is not (cont.)

Correlation must be measured over many observations. Technically it is undefined over one observation, say a single day or month, and always plus or minus one (perfectly correlated) over two observations, which makes it meaningless. If you have therefore understood two assets as being uncorrelated, say over time, and then you look at the failure of this diversification over a single observation, you have failed to understand how diversification works.

Let us consider an example to solidify our understanding. The chart below shows the monthly returns of equities relative to bonds over a period of more than 20 years. While the correlation of 0.215 is statistically significantly different to zero, it is not very high, and bonds are generally a great diversifying asset for equities. In March 2020, however, most commentators spoke about the failure of bonds to provide diversification as they fell almost 10% when equities fell about 14%. Unfortunately, looking at a single observation is not meaningful, and you could draw the wrong conclusions about diversification virtues of bonds. For example, in the next worst single month for equities, bonds delivered close to 0% and in the third worst month for equites, bonds delivered more than 4%. This is exactly the behaviour that you would expect from a diversifying asset.

J403T (SH WE ALL S) vs ALBI from October 1998 to August 2022
Monthly return linear regression (r=0.215)



Let us now consider the other misunderstanding. You do not need uncorrelated assets to benefit from diversification. Two assets could be positively correlated – like with equities and bonds above – and still provide diversification benefits, simply because the magnitude of their moves is not identical. This is the case with many shares for example, and represents the benefit of diversifying what is commonly referred to as idiosyncratic risk. Idiosyncratic risk is the risk that is particular to a specific share – as opposed to risk that affects the entire market. It is different to systematic risk, which affects all investments within a given asset class.

Investors can therefore mitigate idiosyncratic risks by diversifying their investment portfolios, as these are, by definition, company specific.

Consider another example of investing in the shares of two banks. While there are many factors that will drive the share prices of all banks, there are also many that will affect banks differently, because they could only apply to individual banks. An example of this would be strategy.

If the shares of one bank drop by say 20%, and the shares of another drop by say 10%, that is diversification. Yes, you have lost money on both, but not the same amount. And if you held the same rand value in each, you would only have lost 15% on average, and in aggregate. You see, if you only held the bank whose shares dropped 20%, your loss would have been 20%, so the diversification worked. If you think that diversification is one asset going up to offset the loss of the other going down, you are confusing diversification with hedging. While both help to reduce overall risk, they are two very different things. Hedging is the act of removing risk – and unfortunately return as they are two sides of the same coin – whereas diversification is reducing risk by taking on additional risk in a different asset that is not perfectly correlated.

INVESTMENT CENTRE

Understanding what diversification is... and what it is not (cont.)

Diversifying the many layers of idiosyncratic risk

So if you now understand what diversification is and how it works, you may recognise that its benefits can be derived by considering diversification at all levels i.e. every little bit of diversification counts. While most managers will espouse the benefits of diversification at the asset class and security level, few will consider the additional diversification benefits to be gained by considering diversification at higher levels, such as at the manager level.

You need to understand that manager risk is not rewarded and you would be well advised to diversify this by investing with multiple managers, whether you do this yourself with the help of an adviser, or through a multi-manager fund – but do not confuse this with a fund of funds as the two are not synonymous.

Conclusion

Do not misunderstand diversification to be hedging and be careful about understanding the benefits of diversification over a single period or over the short term. Diversification should be measured over the same period as your investment horizon and not over a short or single period, unless this happens to be your investment horizon, in which case you should not be invested in risky assets to start.

Also understand the many levels at which you can derive diversification benefits. While this may start at a security level, it should not end there. At the extreme you should diversify single manager risk, especially where managers are taking high conviction positions, because there is a chance that they could be wrong.

Joao Frasco
Chief Investment Officer: INN8 Invest

*HOVER TO SEE MORE INFORMATION

MANAGER INSIGHTS

Transformation...progress has been made but investment teams are still lacking

The results/outcome of a survey conducted on transformation within local investment teams

Puleng Kgosimore

Portfolio Research Analyst: INN8 Invest

Key Points:

- 73% of our survey respondents (47) are level 1 and level 2 BBBEE contributors.
- Only 26.5% of contributors to investment decision-making are female, with better representation in senior non-investment roles.
- Our perception is that race diversity has improved with 51% of investment decision makers being people of colour. But there is still a large gap in the context of South Africa's demographics.

We treasure what we measure and in that context the Broad-based Black Economic Empowerment (BBBEE) targets became a focal point of asset managers, with 73% of asset managers being BBBEE level 1 or level 2 contributors. 17% of managers are non-compliant – most of these managers are those that we would refer to as boutiques managers.

Asset manager BBBEE ratings

Level 1: 45%
Level 2: 28%
Level 3: 2%
Level 4: 4%
Level 6: 2%
Level8: 2%
Non-compliant: 17%

Transformation at different levels – but there are gaps

Although transformation is there to pave way for inclusive growth and participation by all, it is more so for those who were previously disadvantaged. There are several positive stories of women or people of colour being appointed to senior roles such as the CEO or Head of Investments.

However, there is not nearly enough of these appointments or specifically, appointments within investment teams, to have moved the dial materially. The target should be an asset management industry where senior management and investment teams closely resemble the demographics of South Africa.

Large gender and race gaps exist in investment decision making

From the analysis of the 47 respondents to our survey, we found a few statistics of concern that point to asset management continuing to be dominated by men.

ONLY 26.5% of women contribute to investment decision-making.

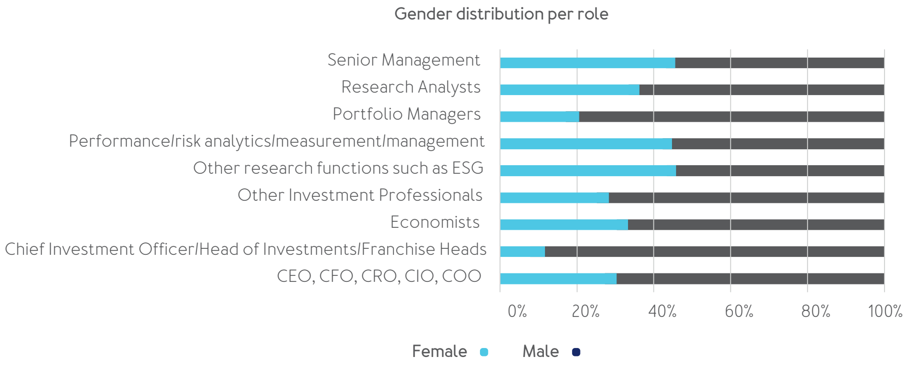
THERE ARE SIX smaller asset managers that do not have a single woman in their businesses.

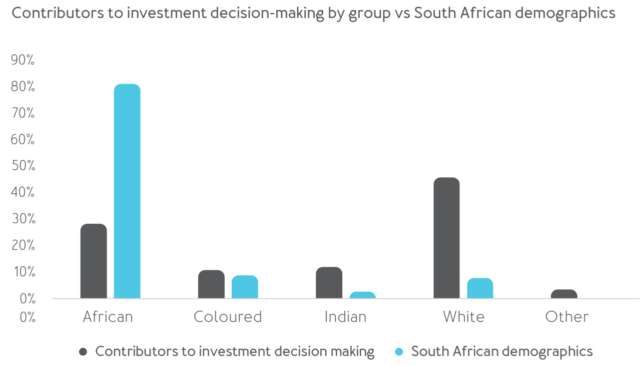
APPROXIMATELY 80% of portfolio managers are men.

ONLY 12% of CIOs are women.

MANAGER INSIGHTS

Transformation...progress has been made but investment teams are still lacking (cont.)





When assessing race demographics at a high level, it might appear that transformation has improved with 51% of contributors to investment decision-making being people of colour. However, the gap from an African perspective is stark, with only 28% contributing to investment decision making.

From our discussions, some managers cited time as a limiting factor to implementing transformation objectives in their businesses. This is due to issues such as a high staff retention or low team turnover. Scarcity of senior talent, especially of women has also been cited as reasons for not achieving gender parity or transformation in investment teams.

Other (AM) largely represents the foreign nationals in the investment teams.

It is disappointing to see that some of the larger asset managers continue to struggle with diversity in their investment teams, with white professionals largely making the investment decisions. These are the institutions that should be championing this level of transformation given their access to resources. The smaller managers that managed to achieve this balance were those that focused on being transformed businesses from the onset, but still with diversity in their teams. By contrast there are four smaller asset managers that do not have neither people of colour or women in their businesses.

How are managers dealing with the challenges?

There are managers who have business initiatives/plans to address transformation as an issue and others that have none. However, we realised that there seem to be a move towards improving internal hiring policies by focusing on EE candidates as first choice of employment. Commendable are those managers who have internship and graduate programs that focus on growing their own timber. This focuses on candidates of colour to address the race and gender challenges in our industry.

Small managers stated that it is also difficult to retain this talent given their demand in the market, and that large managers have a bigger budget to compete for this talent. This supports our thinking that, given their resources, larger managers should have transformed teams.

MANAGER INSIGHTS

Transformation...progress has been made but investment teams are still lacking (cont.)

Conclusion

Transformation has come a long way, with previously disadvantaged people given opportunities to own equity stakes or participate in asset management businesses. However, transformation is not only about the level of black ownership or management control in the business. It is also about the individuals within the organisation representing diversity of race and gender.

SOME OF THE REASONS
cited for not achieving diversity include:

- a shortage of - senior female professionals
- low team turnover - implying a lack of opportunities to hire new individuals
- lower budgets - to compete for talent.

Although there are managers who have their own programmes to grow the pool of talent in the industry, there seems to be slow growth of the pool of females and individuals of colour in the roles that matter. If this challenge is not addressed now and sufficient programmes are not put in place, this imbalance will perpetuate for a long time.

Puleng Kgosimore
Portfolio Research Analyst: INN8 Invest

PRACTICE NOTES

The tax treatment of investment income – **local vs foreign**

*HOVER TO SEE MORE INFORMATION

Investment income = interest and dividends

South African residents are subject to tax on their worldwide income. There is a difference in the way South African residents are taxed when investing locally or when investing abroad.

We provide a brief explanation of the tax treatment of local and foreign investment income/distributions for a tax resident individual in South Africa.

Summary table

Income	Interest	Dividends
Local	• Exemptions apply with the excess taxed at the marginal tax rate	• 20% dividends tax • Exempt from normal income tax
Foreign (rand-denominated CIS)	• Fully taxed at marginal rate *Foreign interest withholding tax may apply	• No South African dividends tax • Maximum effective income tax rate of 20% in SA *Foreign dividend withholding tax may apply
Foreign (investment allowance – non CIS)	• Fully taxed at marginal rate *Foreign interest withholding tax may apply	• No South African dividends tax • Maximum effective income tax rate of 20% in SA *Foreign dividend withholding tax may apply
Foreign (investment allowance CIS)	• No dividends tax • Full (dividend) income distribution taxable at a maximum effective income tax rate of 20% in SA *Foreign dividend withholding tax may apply	

**The foreign withholding tax suffered may be claimed as a tax credit against the South African tax payable - limited to the amount of South African tax payable.*

The tax treatment of investment income – **local vs foreign** (cont.)

Introduction

Each tax year, investors are issued with an IT3(b) certificate for local investment income and/or a statement for foreign investment income. This certificate/statement states the total interest and dividends earned locally and offshore during the course of the tax year. These amounts should then be included on tax returns submitted by the investor to SARS. Investors are entitled to claim a tax credit for any withholding tax paid in respect of a foreign dividend/interest that is included in gross income up to the amount of South African tax payable.

Interest

Local interest

Local interest is currently taxed subject to the following exemptions:

65- Under 65 years of age: **R23 800**

65+ 65 years of age and older: **R34 500**

The excess is taxed at the investor's marginal tax rate, which varies between 18% and 45%.

Foreign interest

Foreign interest earned is fully taxable.

Dividends

Local dividends

A dividends tax of 20% is required to be withheld in respect of dividends received from South African resident companies and cash dividends from dual-listed companies. South African residents will receive the dividend less dividends tax of 20%. As the dividend was subject to dividends tax, it will be exempt from normal income tax. Dividends tax is categorised as a withholding tax because the tax is withheld from the dividend (income) distribution and paid directly to SARS by the company paying the dividend and/or the withholding agent, such as STANLIB.

Dual-listed companies

Dividends declared by foreign companies listed on the JSE are subject to dividends tax in SA. Foreign withholding tax may also apply to the dividend declarations. Richemont, British American Tobacco and Anheuser-Busch would be examples of such companies.

Example 1

Richemont, a company listed on the SIX Swiss Exchange and the JSE, pays a dividend of R100 to a South African shareholder named Natina. The R100 is subject to Swiss dividends tax at a rate of 35%. This rate is reduced to 15% in terms of the Double Taxation Agreement concluded between SA and Switzerland, whereby 35% is withheld and 20% can be claimed back. Richemont generally provide investors with assistance in this regard. Therefore, Natina only receives R65.

In SA, Natina's dividend attracts dividends tax at a rate of 20% on the R100. However, as she already suffered an effective 15% Swiss dividend withholding tax, only an additional 5% SA dividends tax will be withheld.

Dividend withholding tax in Switzerland: **R35 (35%)**

Withholding tax claim: **R20 (20%)**

Effective Swiss withholding tax: **R15 (15%)**

South African withholding tax: **R5 (5%)**

In total Natina will receive a cash dividend of R80 (R65 after Swiss withholding tax + claim of R20 for overpayment of Swiss withholding tax - R5 paid to SARS).

The dual-listed dividend is thus generally subject to tax at the highest effective tax rate between the relevant treaty countries, since a tax credit can be claimed (i.e. no double tax applies). It should be noted that, contrary to Switzerland, many countries only withhold at the reduced treaty rate, subject to receiving the relevant dividend declaration forms from shareholders.

PRACTICE NOTES

*HOVER TO SEE MORE INFORMATION

The tax treatment of investment income – **local vs foreign** (cont.)

Foreign dividends

There are two ways in which South Africans can invest offshore:

1. Via a rand-denominated investment such as a collective investment scheme (CIS); or
2. Directly in foreign currency making use of the foreign investment allowance, to invest in a foreign-denominated CIS and/or buying shares in a foreign company by way of an offshore stockbroker account.

In both cases, the investments are in foreign companies that are not listed on the JSE – not dual-listed – and therefore, local dividends tax does not apply. **Foreign dividends are, however, subject to normal income tax** in the hands of the South African resident taxpayer, subject to certain exemptions or partial exemptions.

In order to align the effective tax rate applicable on local and foreign dividends, 56% (25/45) of the foreign dividends arising from a portfolio of shares accruing to a natural person, are treated as exempt. At the highest marginal rate of 45%, this will result in a maximum effective tax rate of 20%; and proportionally less at lower tax rates as illustrated in the table that follows.

Marginal tax rate	Dividend paid	Taxable portion	Effective tax rate	Income tax
45%	R200	44%	20% (44% x 45%)	R40
30%	R200	44%	13% (44% x 30%)	R26

A foreign withholding tax may also apply in respect of foreign dividends, which, if applicable, is withheld by the relevant foreign tax authority. Where applicable, a tax credit may be claimed in respect of the foreign tax suffered, limited to the amount of tax payable in SA, even though such dividend may only be taxed at an effective rate of 20%. For example, if a person received only one foreign dividend and no other foreign income during the tax year; and the foreign dividend withholding tax was 12% on the dividend payment, the South African tax on the dividend will be 8% (20% less 12% credit).

Example 2

Natina opened an account with an offshore stockbroker and bought Apple shares with her foreign investment allowance. Apple pays a dividend of R100 to Natina. Firstly, withholding tax of 15% is paid to the US tax authority – the rate is reduced from 30% to 15% in terms of the US/South Africa Double Taxation Agreement. Natina therefore receives R85 in her pocket. Apple is not listed on the JSE and Natina does not hold at least 10% of Apple's shares. Natina pays tax at 45%.

In this scenario, the income tax implications are as follows:

Foreign dividend:	*R100*
Foreign withholding tax:	*R15*
Foreign dividend subject to SA income tax:	*R100*
Minus: exemption (25/45):	*-R56*
Income tax payable:	*R44 x 45% = R20*

*Total tax payable by Natina on the Apple dividend: R20 (R15 US withholding tax and *R5 normal tax in SA).*

**R20 income tax less R15 rebate/tax credit for foreign withholding tax suffered.*

Albert Louw CFP®
Practice Manager: INN8 Invest

INN8.CO.ZA