MANAGER INSIGHTS

SA equity manager responses to the higher offshore limit

March 2024

Cleo Molepo

Research Analyst: INN8 Invest

Key Points:

- Data shows that SA equity managers have not rushed to increase their offshore exposure.
- Our survey revealed a diverse response – from strategic views to mandate restrictions.
- Business models are expected to evolve to boost the depth and breadth of offshore markets.

Background

In February 2022, South Africa's financial landscape underwent a significant shift as the investment allowance for local retirement funds was increased from a 30% allocation to global assets and 10% to African assets, to a 45% allocation offshore. The Africa specific limit was removed. Despite this regulatory change, data reveals that most funds have yet to fully exploit the increased limit. This raises questions about the industry's response and the implications for investors.

Morningstar data from December 2023 indicated that the average offshore allocation among SA Equity General peer category funds stood at a mere 10%, with many of the funds focused exclusively on domestic markets. Even those with notable offshore exposures fell short of the new 45% limit, prompting further investigation into how fund managers are adapting.

Survey process...and results

We conducted a formal survey among South African equity managers, which revealed diverse responses from the 29 participants to the regulatory adjustments. The survey focused on three relevant topics:

- Factors influencing the managers' offshore positioning (if applicable) and the reasoning behind the size of shifts.
- How managers would change their strategies if ASISA created local only categories.
- Managers' strategies on covering the vast number of offshore counters.

This article first appeared in Q1 2024 edition of Liberty DFM Future Focus, published in April 2024

Portfolio strategy

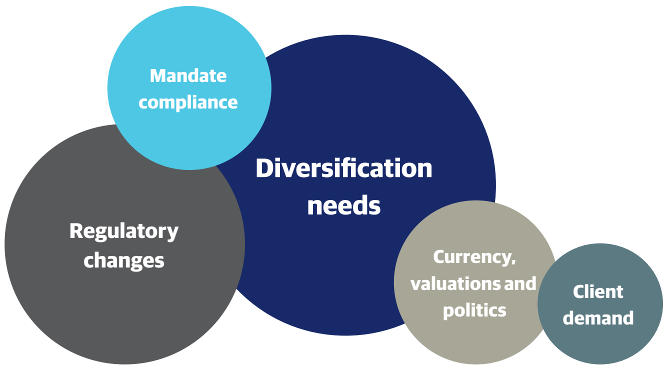
Almost half (46%) of participants opted to maintain their existing strategies, while 30% increased offshore allocations, approaching the new limit. The remaining 24% made minor adjustments within a 2-5% range.

While it may come as a surprise that so many equity managers did not increase their offshore allocation, it is important to understand the rationale behind this. Most of the equity managers have mandates that allow them to only invest in the local equity market. The reason they would be limited to the domestic market only is because most of these local-only mandates are used as part of asset class building blocks within specialist multi-asset fund of funds and/or model portfolios.

Mandate influences on portfolio strategy has limited an increase in offshore exposure, on average.

Motivations are wide-ranging for those managers that increased their offshore exposure. Global diversification emerged as a main theme, driven by the pursuit of attractive opportunities and risk diversification outside of South Africa. The ability to invest in sectors, industries, and companies that are not available locally – such as major technology firms and luxury brands – appealed to many. Others cited the potential for enhanced risk-adjusted returns and alignment with global market trends.

Greater offshore investment allows for additional diversification.



The survey feedback also revealed that local and global economic conditions, valuations, currency, and political scenarios influenced offshore allocation decisions. Some managers saw the regulatory relaxation as an opportunity to align their portfolios more closely with their strategic view of global markets, while others used the opportunity to respond to investor preferences for global exposure.

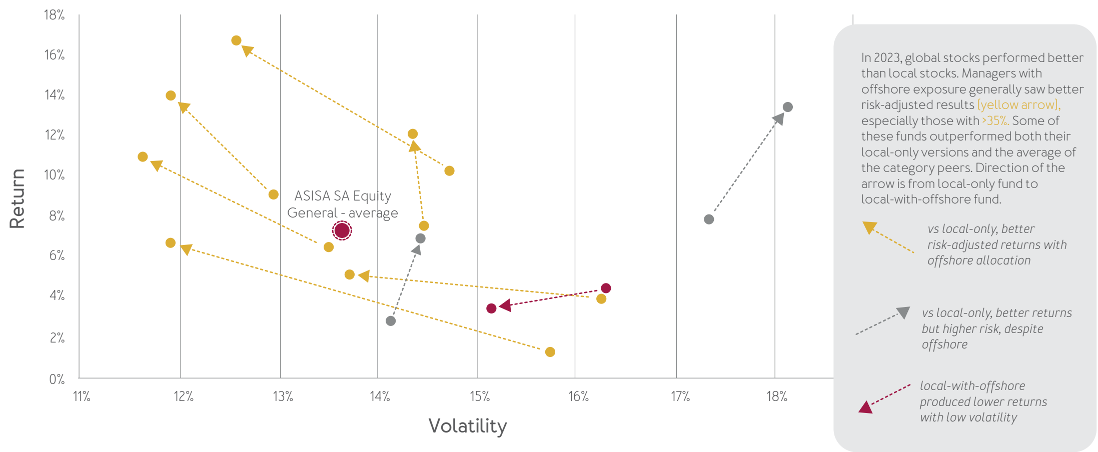
This article first appeared in Q1 2024 edition of Liberty DFM Future Focus, published in April 2024

Offshore diversification in practice

Performance metrics suggest that managers with offshore allocations have outperformed their local-only counterparts over the past two years. For instance, in 2023 the MSCI World Index notably outpaced the Capped SWIX Index by 25.1% in rand terms, underlining the benefits of offshore diversification. While the analysis presented on the chart that follows is dependent on the time frame chosen, generally we would expect diversification benefits from including offshore allocations.

In the risk and return chart below, the local-only funds of managers are linked with their funds that includes offshore. It shows the divergence in 2023 performance from the same asset manager between funds with offshore exposure and their domestically focused counterparts. This highlights how domestic-only funds have generally underperformed funds with global exposure, at higher levels of volatility or risk.

Annualised Nominal Risk-Return Scatterplot - January to December 2023



Source: MorningStar and INN8 Invest

Potential categorisation changes

The survey also explored potential categorisation changes within the industry. In a paper published for the Actuarial Society of South Africa, Joao Frasco, our Chief Investment Officer, delved into the current ASISA standard for classifying regulated Collective Investment Scheme (CIS) portfolios. His analysis examined the existing framework and suggested improvements in the categorisation to make CISs more easily comparable for advisers, clients, and investors. One of the recommendations from the paper was the splitting of certain categories into two categories, namely local-only CISs and CISs with both local and global assets.

Local-only CISs and local with global CISs are advisable.

This article first appeared in Q1 2024 edition of Liberty DFM Future Focus, published in April 2024

Some managers supported the idea of distinct categorisations for funds based on their geographic focus, anticipating clearer distinctions between local-only and global allocations.

- Approximately 40% of managers positioned themselves in the 'local only' category.
- 20% identified as 'local with offshore'.
- Others, particularly larger asset managers, planned to offer funds in both categories.

We highlight that managers are cautious on launching new funds given the saturation of funds in the South African market. Uncertainty regarding benchmark impacts and concerns about the breadth of the South African equity market also influenced viewpoints.

The approach of local managers to offshore coverage

The last section of the survey disclosed how the participants think about offshore coverage and the strategies required to become and/or remain relevant. Some equity managers integrated the offshore analysis into their existing teams. For those equity managers with a global presence the adjustment was rather easy, leveraging complementary skills across teams to cover offshore markets.

In addition, there were some equity managers that opted to outsource the offshore management, whilst some of the smaller managers relied on Exchange Traded Funds (ETFs) and passives to gain offshore exposure.

Looking forward, the ability to invest a larger percentage offshore will require a different mindset – local equity managers are now competing with established global managers that have solid performance track records in offshore markets. The general consensus among the participants is to expect changes to business models with more partnerships, leveraging both global insights and local expertise to meet the evolving needs of clients.

In conclusion

With the large increase in the offshore limit, you may have thought the local equity managers would immediately increase to their offshore allocations. However, this has not been the case, as many equity mandates only allow managers to invest in the local equity market. At the same time, the added diversification benefits resulted in managers upping their offshore exposure.

Yes, the ball game has changed. The opportunity to invest more offshore has not only 'forced' the industry to rethink how to improve the categorisation of CISs, but has also forced equity managers to consider how they remain relevant in an increasingly competitive environment.

This article first appeared in Q1 2024 edition of Liberty DFM Future Focus, published in April 2024