Gaining a global advantage locally

By Vuyo Mkhathazo, Portfolio Manager, STANLIB Multi-Manager

Economic exposure should be used to determine the extent of offshore exposure already captured by locally listed companies.

South African exchange control – a brief history

The beginning of exchange control dates back to 1939 when South Africa introduced restrictions on the outflow of funds to non-sterling countries. From 1961 to 1993, exchange control was extended, mostly in reaction to worsening internal political and increasing external pressures.

South Africa embarked on a gradual phasing-out of these exchange controls, starting in 1993. For example:

- Non-residents were free to bring funds into South Africa and repatriate investments without restriction; and
- Resident companies were gradually allowed to make direct foreign investments within certain limits.

These limits have increased over the years and are as follows:

- **Individuals** - R1 million per year discretionary allowance for residents over 18 years, and R10 million investment allowance per calendar year
- **Pension funds** - 25% offshore investment allowance, per Regulation 28 of the Pension Funds Act, with an additional 5% allowance for investment in African countries. The 25% limit is set by the Financial Services Board, but the maximum limit is subject to exchange controls set by the South African Reserve Bank.

Avoiding the "home bias"

Behavioural finance studies suggest that investors generally have a negative bias against foreign securities. This results in a preference for familiar domestic securities - a "home bias." However, less familiar foreign securities may provide better diversification benefits in a portfolio.

"Home bias" has disadvantages and limits diversification because of the following factors:

- South Africa represents less than 0.5% of the world economy. An investment in local securities only, means investors miss out on the returns of significant industries and economies
- There is no diversification of economic risks (eg recession or low economic growth rates)
- Investors miss out on the global opportunity set because South Africa is about 1% of global equity markets

Whether consideration is given to domestic only or both offshore and domestic investments, investors need to evaluate both the direct and indirect global exposure in their portfolios.

In this article the concept of domestic companies that are invested or that have operations offshore is explored. These are typically known as rand-hedges. An investment in a rand-hedge may offer protection against local currency deprecation, but not all rand-hedges will counteract the depreciation of the rand.

Rand-hedges and global diversification

Global diversification – home away from home

The basis for defining a foreign company mainly focuses on the location of the company's head office as opposed to where its operations or main earnings drivers are located.

To determine (in substance) whether a company should be classified as domestic or offshore, the guidelines below from the **International Accounting Standard (IAS) 21 - Accounting for Changes in Foreign Currencies** (published IFRS Foundation) may be useful. These guidelines help establish the de facto currency of the company.

In terms of IAS 21, a functional currency of a company is the currency of the primary economic environment it operates in. The primary economic environment is where it mainly sells its goods/services and incurs most of its costs, for example, where a company imports all of its inventory and such costs form the majority of its costs.

It is, therefore, possible that a South African company may have US dollar, Japanese yen, British pound, etc earnings .

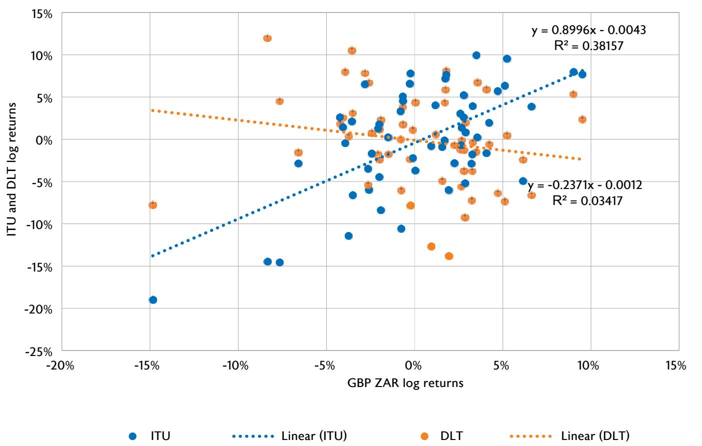
For example, BidCorp Ltd is viewed as a South African company because it is headquartered in South Africa. But investors should look into the location of its operations. This is the crucial point made by IAS 21. BidCorp's valuation needs to incorporate that almost 40% of its revenue originates in the United Kingdom, another 25% in Europe and 22.5% in Australasia. Only 10% of its operations or sales originate in South Africa.

MSCI[1] broadly defines economic exposure as the sensitivity of a company's performance to the range of regional and local economies in which it operates. Both the IFRS[2] and MSCI guidelines indicate that we have to look beyond the location of registered head office or primary securities exchange listing when assessing a company.

Investors need to consider the drivers of these companies' revenues.

Let's look at an example of two JSE (Johannesburg Stock Exchange) listed property companies in South Africa. One is Intu (ITU), which owns properties in Europe and the other is Delta (DLT) which only has properties in South Africa. These companies' share price performance provides a reasonable contrast of the behaviour of rand-hedge shares versus "SA Inc" shares as the exchange rate fluctuates.

ITU and DLT vs GBP ZAR log returns

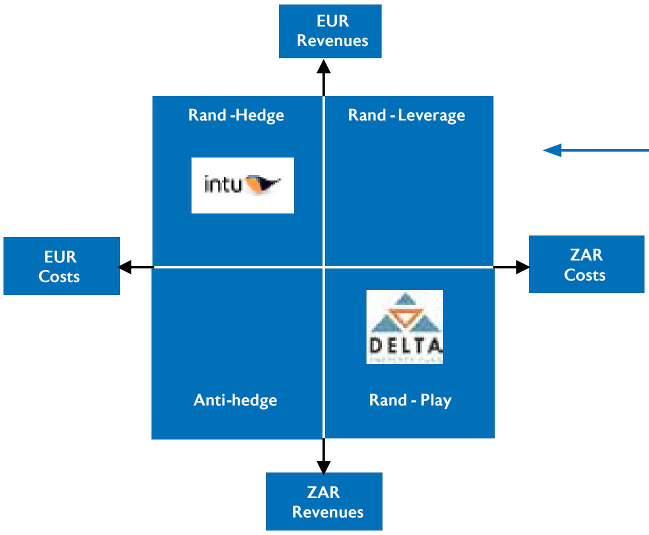


Source: STANLIB Multi-Manager

The graph above shows that Intu's monthly returns (since December 2012) tend to have a positive linear relationship with the rand / pound exchange rate, providing a cushion for rand depreciation. However, Delta's returns generally move in the opposite direction to rand exchange movements and do not provide protection when the rand declines. This is because Delta's revenues and costs are rand denominated, whereas Intu's are foreign currency denominated. We have used the pound as our foreign currency for the purpose of our analysis above, but this general tendency of rand-hedge shares can be observed for other hard currencies.

1 MSCI Inc., is an American provider of equity, fixed income, hedge fund stock market indexes, and equity portfolio analysis tools..
2 International Financial Reporting Standards formulated by the International Accounting Standards Board of the IFRS Foundation.

The diagram below illustrates the generalised classification of share price behaviour based on the company's functional currency (using the euro in this case).



Rand-hedge shares – Companies with mostly euro revenues and euro costs

Rand leverage shares – Companies with predominantly euro revenues and SA rand costs

Rand play shares – Companies that almost entirely generate SA rand revenues and incur SA rand costs

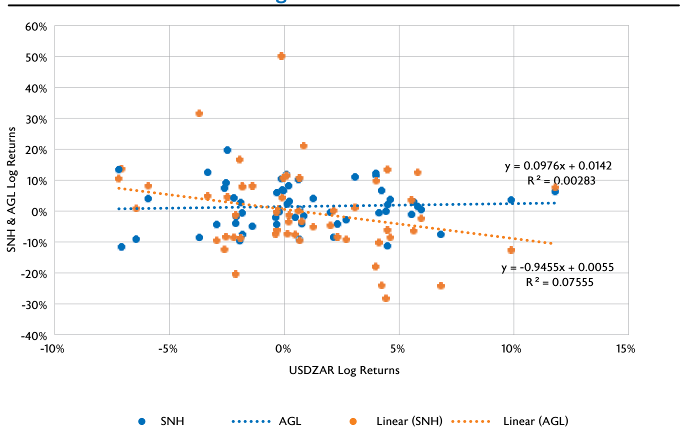
Anti-hedge shares – Companies that generate SA rand revenues and incur euro costs

Therefore, for local investors invested locally, offshore equity exposure, if looked at from the point of view of direct holdings, may be understated. This potentially results in an unintentional overweight to offshore drivers, based on the effective offshore exposure (direct and indirect).

A comparison of resource and industrial shares

The above relationship may, however, not always result in share price performance as expected, and it is important to understand this. To illustrate this point, an analysis was conducted using Steinhoff (SNH) and Anglo American (AGL), an industrial and resource company respectively shown in graph below .

SNH and AGL vs USD ZAR log returns

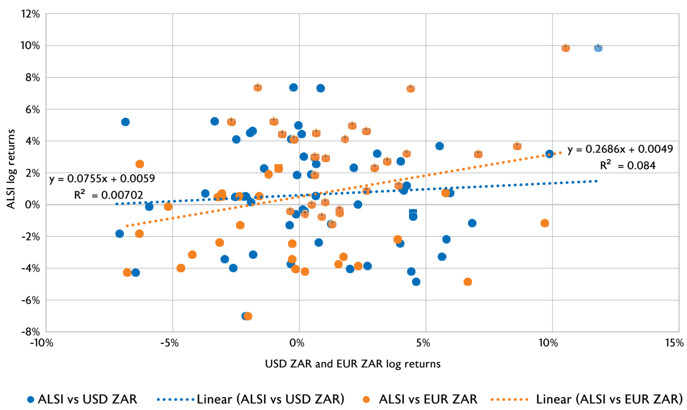


Source: STANLIB Multi-Manager

The graph shows that Steinhoff's returns (again monthly since December 2012) do not have a linear relationship with the rand / dollar exchange rate, and do not provide any hedge against rand depreciation, as might be expected. The result doesn't change if we substitute the US dollar with the euro. The negative relationship between Anglo's returns and the rand / dollar returns is perhaps very strange and highlights that other factors may be at play that potentially dwarf the currency effects, for example, the price of commodities. If you therefore include these shares in your portfolio on the basis that they will provide you with some hedge against rand depreciation, you may end up being surprised by the result.

Buy South African, get global

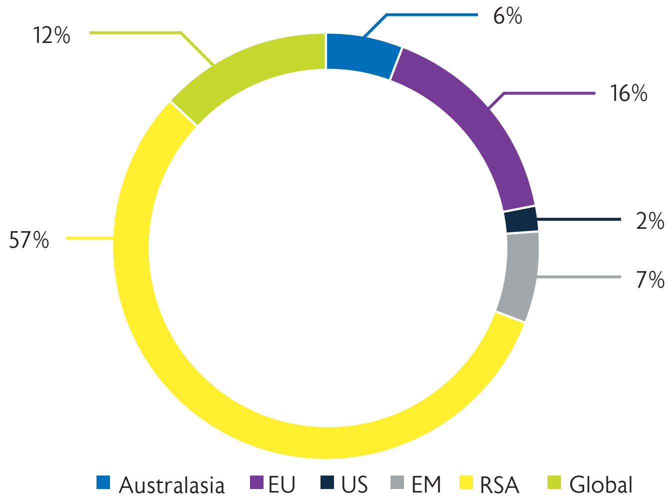
ALSI vs USD ZAR and EUR ZAR log returns



Source: STANLIB Multi-Manager

The above graph shows that, generally, the Top40 index returns tend to move in the same direction when compared to rand exchange rate movements, although the relationship with the US dollar is very weak. The Top40 Index therefore provides some protection against rand depreciation.

Regional exposure by revenue



Source: STANLIB Multi-Manager

This chart provides an indication of geographic exposure (based on revenues) of the constituent companies of the Top40 index. It reaffirms the relationship found above to the US dollar and euro, which shows a very weak relationship with the US dollar, and a stronger relationship with the euro.

Almost half of the companies in the Top40 index are rand-hedges (from a revenue perspective) with the balance being SA Inc (although this may not translate into a portfolio that behaves this way). [3]

About 60% of the earnings attributable to the index are earned offshore. The following companies were selected from the index to show more details:

- **Naspers Ltd** - a media company with roughly 54% offshore earnings, predominantly generated in the Australasia region..
- **BidCorp Ltd** - an industrial company with almost 100% offshore earnings and operations mainly in the European Union (EU) and Australasian regions.
- **British American Tobacco Plc** - 97% offshore earnings generated from the EU, United States (US) and emerging markets excluding South Africa.
- **Compagnie Fin Richemont** - a luxury goods company that derives 91% of its earnings offshore from the Australasia and EU regions, and the US.

Conclusion

The sources of company earnings have become more global in nature. This leads to important considerations for investors such as:

- How should investors adjust to increased globalisation and what opportunities does it present?
- Do investors understand their direct and indirect exposure to global markets and are they comfortable with this exposure?

We believe different lenses should be adopted for viewing what is classified as domestic versus offshore investing.

Traditionally, companies listed on the JSE are treated as domestic investments and are not counted as part of the offshore exposure. However, from a risk point of view, many of these companies are effectively offshore investments. This is based on the proportion of revenues and earnings they derive offshore.

To optimise global diversification, economic exposure should be used to determine the extent of offshore exposure already captured by locally listed companies.

3 SA Inc. (a.k.a rand-Plays) are those companies whose operations are predominantly in South Africa, thus generating SA rand earnings