Global investing – an extensive menu to order from

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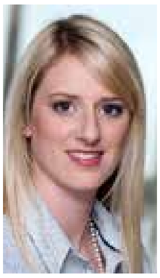


Once an investor has decided to invest globally, there are still numerous decisions to make.

Investors can choose to invest in the traditional asset classes and alternatives (you can read about this in Naweed's article). Focusing on equity alone in the traditional space, you can invest in a global portfolio, which invests in stocks from all over the world. Alternatively, you can specify the geography you want exposure to for example a Japanese equity fund or exchange traded fund.

In addition, you can specify a style you would like exposure to, for example small cap or growth.

Finally, you have the option to invest directly yourself where you buy the stocks or buy a fund – be it actively managed, a passive tracker or somewhere in between (alternative beta).

Importantly, these decisions do not need to be made in this order – you may choose to invest with a specific active manager or multi-manager who can guide you on how to structure your mandate.

Investing globally brings diversification benefits (read our 2016 first quarter Mindset publication for more information). In addition, there are enhanced return opportunities globally that we cannot access via the South African markets. Biotechnology firms developing antibiotics or genetically modified food are not available on the JSE (Johannesburg Stock Exchange). Tesla, founded by Pretoria born entrepreneur Elon Musk, gives investors exposure to electric cars, energy storage and solar panels – also not available in the South African listed market. These, and many others, are distinct opportunities for investors where there is no locally listed alternate or proxy. In addition, global investing gives investors the ability to access strong growth areas such as India.

The question is, should your global exposure be managed in the context of your other assets (a completion portfolio), or should it stand on its own?

South African asset managers manage their global assets in fully discretionary global mandates, where they are responsible for all the investment decisions (asset allocation and security selection) using both methodologies. There are managers who select global equity stocks given their local exposure, while other managers attach the global exposure that they can manage as a stand-alone solution, or use an independent global manager, or passively managed funds.

Investing in a standalone product managed by global managers may bring investors more opportunities.

One would expect global managers to spend 100% of their investment research time focused on global investing. Considering South African managers have local-biased mandates, they tend to spend a lot more time researching domestic stocks. We think the time spent "on the ground", researching companies as well as the environment in which they operate is integral to good investment management. Considering bottom up fundamental managers spend a lot of their research getting close to companies' management, investment teams located in the global financial centres such as London or New York have so much more on their doorstep. Being in close proximity to the companies they value is advantageous. Global managers with a worldwide footprint can further leverage this advantage.

In addition, smaller investors aren't always afforded the same degree of access as large investors to corporates and management. Consider a large South African asset manager with US dollar 50 billion (bn) in assets under management, of which only a portion is invested globally (less than US dollar 10bn). This results in South Africa's largest asset managers being considered small in the global arena. Facebook executives are unlikely to agree to a one-on-one meeting with an asset manager who may invest less than one million dollars in their stock in total. Large asset managers typically have better corporate access, which can translate into more in-depth analysis, understanding and potentially better investments. On the contrary, smaller managers have a wider investment universe given liquidity constraints that can impact larger managers.

The question also arises whether the universe of stocks a manager chooses to research may be unduly reduced or influenced as a result of the investment opportunities we have available on the JSE. Considering we have a world class brewer listed on the JSE (Anheuser-Busch InBev, the company that bought SAB), are brewers possibly down weighted or completely excluded in the global portfolio for South African investors? Similarly given the high weighting of Naspers in FTSE/JSE Equity Indices, are other internet and media stocks also excluded? Is the portfolio allocation to China reduced?

We are of the view that these kinds of reductions may result in a suboptimal portfolio, all else being equal, resulting from a reduced investment pool with less return and diversification opportunities.

There may be times where a higher allocation to these industries or sectors could be appropriate. By not excluding them from the universe, the manager will have the opportunity to add alpha and reduce tracking error, thereby producing better risk adjusted returns.

Aim wide

Investing in global mandates as opposed to regional mandates widens the opportunity set available. When investing in a regional fund, certain sector understanding or specific stock insight, for example the competitive landscape, may be overlooked if a manager only concentrates on one specific region. The value of understanding the global competitive landscape has increased as global trade increases. Even if a regional manager incorporates this information in their analysis, it is less likely they will do a full analysis on a stock they cannot invest in. This is understandable given that the majority of their time will be spent analysing stocks they can invest in, and that these holdings' returns drive the fee they earn.

An example of this is where some local managers underestimated the potential returns from SA retailers in 2010 / 2011 as the retailers appeared expensive relative to our market and their historical valuations. However, SA retailers were dramatically cheaper than other global retailers, which drove global flows into the stocks, driving up the returns. Therefore, in order to have thorough global insight, shouldn't investors rather be considering global mandates that allow the manager to allocate money to all geographies?

Global mandates are better positioned to take advantage of valuation anomalies across sectors and/or regions which is not possible in regional mandates. As an example, if a manager believes that banks have a good investment outlook, they can invest in the best bank(s) available globally. This allows them to take advantage of any possible mispricing across regions. Global mandates further increase the investment opportunity set for some managers who take an investment view on both countries and currencies. This is especially important in the fixed income universe where managers take extensive currency views.

Furthermore, investing in a specific region may not be reflective of that country's economic environment. Naspers is an obvious example, where the share price is driven mainly by their Tencent holding as opposed to the health of the South African economy (read about this in Vuyo's article.) Additionally, evidence from Credit Suisse has highlighted that domestic market factors have become less important over time. In the early 90's, local factors accounted for a third of a particular stock's return but this declined to 10% over the next 15 years. For example, companies such as Samsung listed on emerging markets' exchanges are no longer necessarily considered emerging market companies.

Therefore, investing in a solution that provides global exposure, and accessing this through wide mandates with managers who are global specialists appears to be the most suitable strategy. Even if this results in a global manager holding a South African stock that an investor already has exposure to via their local exposure, we do not view this as reduced diversification. Each manager introduces their own idiosyncratic risk driven by their philosophy, process, people and economic assumptions to name a few. Investors are not rewarded for this risk. By having multiple managers, this idiosyncratic risk is diversified away. Even if there is a stock owned by two managers at a point in time, this positioning results from two different processes, and they are as such independent bets. We would expect this to change with time where sometimes there are no common holdings.

Other emerging markets?

A popular question is, should South African investors invest in emerging markets, considering that 75% or more of your compulsory savings are invested in South Africa, an emerging market? We think you should as emerging markets can be vastly different. This is demonstrated by the BRICS nations – Brazil, Russia, India, China and South Africa. Brazil and Russia are energy exporters and will benefit from high energy prices. In contrast, India is an energy importer and will favour low energy prices. Alternatively, China has an aging population whereas South Africa and India don't. Looking at debt to GDP, there is a wide range across the BRICS, with India at almost 70% and Russia less than 20% in 2016.

Emerging markets' returns can differ extensively, just as developed markets' returns differ. Europe and America are not viewed the same just because they are both developed economies. Looking at the correlations of various developed and emerging markets , in the chart below we can see that including other emerging markets increases diversification. For example, South Africa has a lower correlation to India (65%) than it does to Europe 70%. Similarly, China is less correlated to Russia (54%) than to the USA (61%).

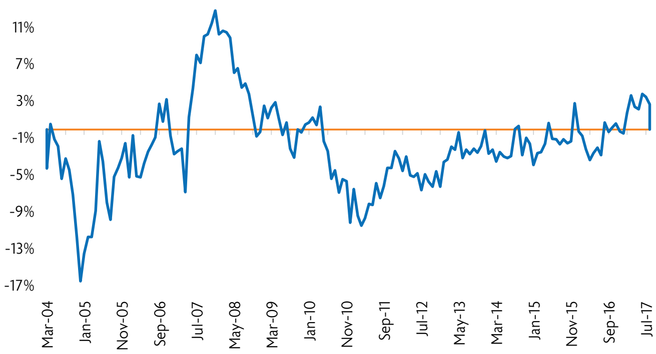
We recognise there are times when emerging markets tend to move together, and provide lower diversification benefits. Considering equity investing should span a long time horizon (more than seven years), these periods are short in context of the full time horizon.

Index	MSCI Brazil Index	MSCI China Index USD	MSCI Emerging Markets Index	MSCI Europe Index USD	MSCI India Index USD	MSCI Russia Index	MSCI South Africa Index USD	MSCI USA Index	MSCI World Index
MSCI Brazil Index	100%	64%	83%	68%	60%	64%	71%	63%	70%
MSCI China Index USD	64%	100%	82%	66%	64%	54%	67%	61%	68%
MSCI Emerging Markets Index	83%	82%	100%	83%	79%	76%	83%	78%	86%
MSCI Europe Index USD	68%	66%	83%	100%	65%	66%	70%	87%	96%
MSCI India Index USD	60%	64%	79%	65%	100%	53%	65%	60%	67%
MSCI Russia Index	64%	54%	76%	66%	53%	100%	65%	57%	66%
MSCI South Africa Index USD	71%	67%	83%	70%	65%	65%	100%	62%	71%
MSCI USA Index	63%	61%	78%	87%	60%	57%	62%	100%	97%
MSCI World Index	70%	68%	86%	96%	67%	66%	71%	97%	100%

Source: Bloomberg, monthly returns for April 2001 to August 2017

As you can see in the graph below, South Africa has underperformed the emerging market index by at worst 16% per annum (pa) over a rolling three-year basis in US dollars in 2004. And in 2007 South Africa outperformed by just less than 12% pa over a rolling three-year basis.

Rolling 3 year alpha pa of MSCI South Africa vs MSCI Emerging Markets April 2001 to August 2017 in USD



Source: Bloomberg

As such, investors should rather consider each investment on its individual merits as opposed to allowing broad labels such as "emerging markets" to imply similar return and risk outcomes.

Style investing in a global portfolio

We think investors should cast their net as wide as possible when investing globally. This enables the investment outcomes to benefit from the greatest diversification, the largest opportunity set, and as a result, the best risk adjusted returns. So what does this mean for style investing?

Active managers in South Africa are predominantly value and valuation style managers. Given the small number of stocks listed on the JSE, to segment the universe as value or growth results in an even smaller number of eligible companies for investment. In extreme circumstances this can result in nothing looking attractive, and a sub-optimal portfolio, that lacks diversity.

Globally, with over 20 000 stocks to choose from, the universe can be segmented into styles while sufficient choice remains for the manager to build a well-balanced diversified portfolio.

Screening the universe of 20 000 stocks to a reduced universe of as little as 500 stocks allows a global manager to select from a universe larger than what is listed on the JSE in total.

There is a much larger range of style managers globally where investors have access to growth, value, aggressive, defensive and thematic managers to name a few. These styles are highly competitive with many managers playing in each space. In addition, they include high quality managers who have been successful in multiple cycles. This increased choice of styles allows for a lot more options in portfolio construction in global investing.

Being able to blend multiple managers together where each manager is doing something distinctly different results in a diversified portfolio with numerous return drivers.

For example, if growth is underperforming, by having exposure to a value manager, a thematic manager and/or a momentum manager who may be outperforming, investors will not be as detrimentally affected by the growth style's underperformance compared to if they held that style only. Considering investors should aim to diversify manager idiosyncratic risk, blending managers who are vastly different will maximise this diversification benefit.

Summary

By casting the net wide for global investing, and allowing managers to go where the opportunities present themselves, investors are able to access well diversified exposure that produces better risk adjusted returns. The broad opportunity set coupled with brilliant managers doing vastly different things allows investors to access the best alpha sources available around the globe. In investing where diversification is the only free lunch, are you ordering an entrée or a main course for your global exposure?