Global investing strategies – currency matching and rand cost averaging

By Joao Frasco, Chief Investment Officer, STANLIB Multi-Manager

Investing globally provides you with investment return opportunities while reducing risk.

Although the democratisation of investing in general, and global investing specifically, has made it cheap and easy to get exposure to global capital markets, many complications and questions remain for investors and their advisers. In this article I discuss the most important issues, provide clarity and share insights that may make some of the decisions a little easier.

Why invest offshore?

Let's begin with the most basic question, why should we invest offshore at all? After all, the South African stock market provides extensive exposure to offshore opportunities, which you can read about in Vuyo's article that deals with how much offshore exposure companies listed on the local JSE (Johannesburg Stock Exchange) provide. This is an important consideration that will become increasingly important if we continue relaxing exchange controls and globalisation continues, although this isn't guaranteed given the political movements and trends of the last couple of years. Gaining offshore exposure through the JSE may not be enough. Let's explore why.

One of the fundamental principles of investing is diversification. You can read more about this in our first Mindset of 2016. The local stock market provides South Africans with many wonderful companies to choose from when investing. These companies may be exposed to many different markets and opportunities, but the rest of the world is a much, much bigger opportunity. At roughly 57 million people, South Africa represents less than 1% of the world's population. In GDP (gross domestic product) terms, the percentage is even lower at around 0.5%.

Diversification doesn't only apply at company level, but at higher levels including industries and sectors. Think about artificial intelligence, which we discussed in the last quarterly Mindset, that is taking the world by storm in terms of investment and impact on business. We also get to diversify across other sources of idiosyncratic risk, including political (this is a big one); geographies (think climate, natural disasters, as well as natural resources); and cultures (yes, many nations differ in many different dimensions that affect work and consumption habits for example).

I don't specifically mention currencies, because exchange rates reflect all other factors in aggregate, and otherwise don't represent a separate risk factor to invest in, although as an investor you could easily choose to reflect your investment views via specific currencies.

Diversification, like investing, has two facets, risk and return. These are not separable concepts in efficient portfolio management unless you choose to invest inefficiently by not diversifying and hence, take more risk than necessary. Diversifying by investing globally provides you with more investment return opportunities while reducing risk. Don't believe the rhetoric that too much diversification is a bad thing.

So why not invest 100% globally?

I mentioned our population and GDP being less than 1% of the world's, and this applies to our capital markets as well. Although very well developed, they are similarly a drop in the ocean when considering the global context.

Why then don't we invest more than 99% of our wealth offshore, in accordance with efficient portfolio theory? There are a couple of important reasons and many more less important ones.

The first reason is merely a restriction by the South African Reserve Bank. South Africa has progressed from a closed to fairly open economy since achieving democracy. In this process, we relaxed exchange controls allowing for greater freedom of capital flows, although not complete freedom. Pension funds can now invest up to 25% outside of South Africa, and up to an additional 5% in Africa. The limits or restrictions for individuals have also evolved, and most individuals can get significant offshore exposure if they so wish, although it may take the very wealthy longer to do so.

Currency mismatch

The second reason is much more important, and often poorly understood. Many investors, perhaps too many, tend to focus on the asset side of the equation when considering investing, paying little to no attention to their liabilities. What liabilities they ask, I thought we were talking about investing? The recent goals-based or outcomes-based investing movement has begun shifting the focus to the liability side of the equation (read our second quarter 2017 Mindset on goals-based investing for more information). By focusing on the reasons for investing, we can bring the liabilities to the forefront, giving them at least equal prominence to the assets or investments.

Why do the liabilities matter when considering how to invest? Liabilities represent the goals or outcomes being sought and they matter if you care about improving your chances of meeting these objectives. If you don't care about the result, it doesn't really matter how you invest as all outcomes will be equally good. But if you care about achieving a specific outcome, or at least about improving the chances that this will happen, understanding the impact of different investment strategies is important.

Generally, you should think about matching assets and liabilities along many dimensions.

So let's think about two examples to clarify this. The first is investing for retirement in a foreign country. If you choose to invest 100% in South Africa, you would be exposed to the exchange rate at retirement when you take your savings offshore. Clearly you have no idea what the exchange rate will be in the future, when you plan to retire. If instead you left your wealth invested locally after retirement, and drew an income from this on a regular basis, you would still be dependent on the exchange rate at each point in the future that you make a withdrawal. In neither of these cases would your investment bear any resemblance to inflation in the country and currency you are planning to retire in.

It is therefore important to match your investment and your goal by currency.

If you retire in continental Europe, investing in the euro may provide you with a good hedge for European inflation over the long-term. If you invested in rand instead, you would be at the mercy of the rand / euro exchange rate which has, in the past, depreciated by more than 40% over the span of six months. Imagine the span of six months having the impact of 40% on your retirement income for the rest of your life. For longer periods, the impact can be much greater - and has been.

Now let's think about retiring in South Africa, probably more likely for most of us. Does this mean that we should invest 100% locally, and what are the implications of the foreign exposure we may get from locally listed companies, and the 25% we may have invested offshore?

The important point is that your assets and liabilities should be matched by currency, as a first step. Not doing so introduces currency mismatch risk. Matching assets and liabilities doesn't necessarily imply that assets should be invested locally, but rather that the currency mismatch may need to be hedged. Hedging currency could be complex and expensive, but in theory would provide you with the opportunity to diversify your investment, and hedge out the currency exposure from foreign investments. If cost and complexity was not an issue, is this something you would want to do, and if so, would you want to hedge out the currency completely? Is there any reason to leave some of the exposure unhedged?

Inflation hedging

At a superficial level, you may think that matching the currency of assets and liabilities is enough to improve the chances of getting a good outcome. If, however, you think about the underlying components that make up local inflation, you will realise that in most instances local inflation is sensitive to the rate of exchange of the rand against a basket of currencies.

A simple example illustrates this. You may think that a few items in your basket (the goods and services you consume on a daily, weekly and monthly basis) should not be sensitive to the exchange rate - perhaps they are all locally produced. If the rand depreciates significantly, you think you are insulated from this because the goods and services are not exposed to this depreciation. The price of petrol will, however, go up as oil is priced in dollars, which in turn will push up transportation costs, and the price of producing goods such as the cost of fuel for tractors used in farming. The price of services may increase – for example your hairdresser spends more on petrol getting to work and pushes up the price of haircuts. Inflation will therefore tend upwards reflecting the upward pressure on prices, and your rand savings will be able to purchase a little less than they did before. Obviously any goods in your basket that are imported will suffer a similar fate, except in this case the upward pressure on prices will be more direct, and probably happen quicker.

If we were a self-sufficient and closed economy, we might be insulated from exchange rate movements outside of inflation and interest rate differentials, but this is not the case. We are a fairly open and globally integrated economy, with many dependencies on foreign trade, and because of this we are at the mercy of our exchange rate with our trading partners.

How much is enough?

This implies that having some unhedged offshore asset exposure may not be a bad thing. To be clear, matching is still important and actually represents what is going on at a more granular level in this case. So if we look into our basket of goods and services we could match currency to each of the goods and services we consume. Investing offshore and leaving some of this exposure unhedged just represents an approximation of how much of our basket depends on the exchange rate.

Deciding how much to invest offshore unhedged, means we need to know the composition of the ultimate goal we are saving for, and then match the investments' currencies to the goal's. I have unfortunately needed to simplify the discussion here to a single dimension of the goal (the currency), but in practise you want to consider many other dimensions of the liability such as the time horizon, the nature (nominal or real), and the certainty of the payments required (for which liquidity may be important).

In the case of a simple goal, for example Harvard university fees, it may be straightforward to invest in US dollar assets. For other goals the solution may be more complex illustrated by answering the question "what will my retirement basket look like many years into the future?" It is therefore important to think about your goals carefully to understand the underlying drivers and to then ensure some level of matching.

Rand cost averaging

The other important consideration when investing globally that we alluded to when we spoke about a sudden depreciation of the rand, is the timing of taking money offshore and bringing it back. While the ideal strategy would combine taking money offshore before the rand depreciates and bringing it back before it appreciates, no one would be able to get this timing right with any decent level of consistency. There is, however, a fundamental principle in investing that will help you out, referred to as "Rand cost averaging".

To be fair, there is no magic going on here, except some complex mathematical magic!

Let's illustrate this point. My usual examples for discussing the concepts of averaging are gambling (which ties in nicely to Monte Carlo simulations) and insurance. In both cases the service provider (the casino and the insurance company) is expected to make a profit, which is another way of saying that the expected outcome is positive in their favour. For the individual, the casino provides an opportunity for winnings, and the insurer provides protection against losses (negative winnings). In the face of uncertainty of the outcome and positive expected winnings (for the house) the optimum strategy, which is the strategy that maximises the probability of achieving the required outcome, is to take many small and independent bets (risks). This is a fact that is easy to show mathematically, it is not an assumption (it is however still probabilistic).

In investing, a significant risk is the volatility of prices of assets or exchange rates (generically referred to as market risk). Price volatility does not imply that prices are not "fair" or that markets are inefficient (although price volatility is often misunderstood to imply market inefficiency, whereas it could actually reflect very efficient markets – quickly incorporating new information as it becomes available). If you invest or disinvest a single lump sum at the worst possible time / price, this will turn out to be a "bad" outcome. If you instead spread investments and disinvestments over time, you will reduce the chance of getting this "bad" outcome. To be clear, you will similarly reduce the chance of getting a "good" outcome, but given that losses are much more painful than gains are pleasurable, this is an optimal strategy.

So when should you move money offshore?

What follows from the discussion above, is that you should move money offshore regularly and consistently, as you invest in the market. Equally, you should disinvest and bring it back onshore regularly as required for consumption. This will minimise the impact of currency depreciation or appreciation, especially significant moves. The exception to this is where you have the potential to significantly reduce risk by taking immediate action. Let's look at one more example to clarify this point.

If you reach retirement and wish to purchase a life annuity from an insurer, and at the current values being quoted you will achieve a level of income that you are happy with, you may want to pull the trigger and do all of this at once. The risk is that we want to hold out for a better outcome and end up with a worse off outcome. Again, given the gain versus pain argument, not pulling the trigger is a sub-optimal solution.

Conclusion

The benefits of global investing have long been touted in the investment literature. Diversification and opportunities for returns are just two of these great benefits, but there are many more. Unfortunately, there are also risks that should be well understood, and currency mismatch could be a significant one. Investing offshore consistently, will reduce the risk of reacting after the "horse has bolted" (rushing to move large amounts after the rand has depreciated, and then bringing the investments back after the rand appreciates), resulting in potentially massive losses to wealth.

South African investors have access to great local and offshore assets through great local and offshore asset managers. With great financial advisers, we can ensure that we are invested appropriately given our very unique and specific goals and objectives, improving the chances of achieving great outcomes.

In their articles, Renate and Naweed will discuss what this looks like from a global and alternatives perspective respectively.