PRUDENTIAL
INVESTMENT MANAGERS

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What about the quality of your offshore exposure?

While most South African investors these days tend to focus on the question of whether they have adequate exposure to offshore assets in terms of quantity, less is heard about the quality of those offshore holdings. Quality can be defined in terms of attaining excellent risk diversification, as well as accessing the best possible investment opportunities. Both of these are key ingredients for building an appropriate investment portfolio.

From a statistical perspective, adding global investments to a portfolio has been widely shown to meaningfully reduce that portfolio's risk characteristics without detracting from returns, helping to create an "optimal" portfolio when considering risk-versus-return.

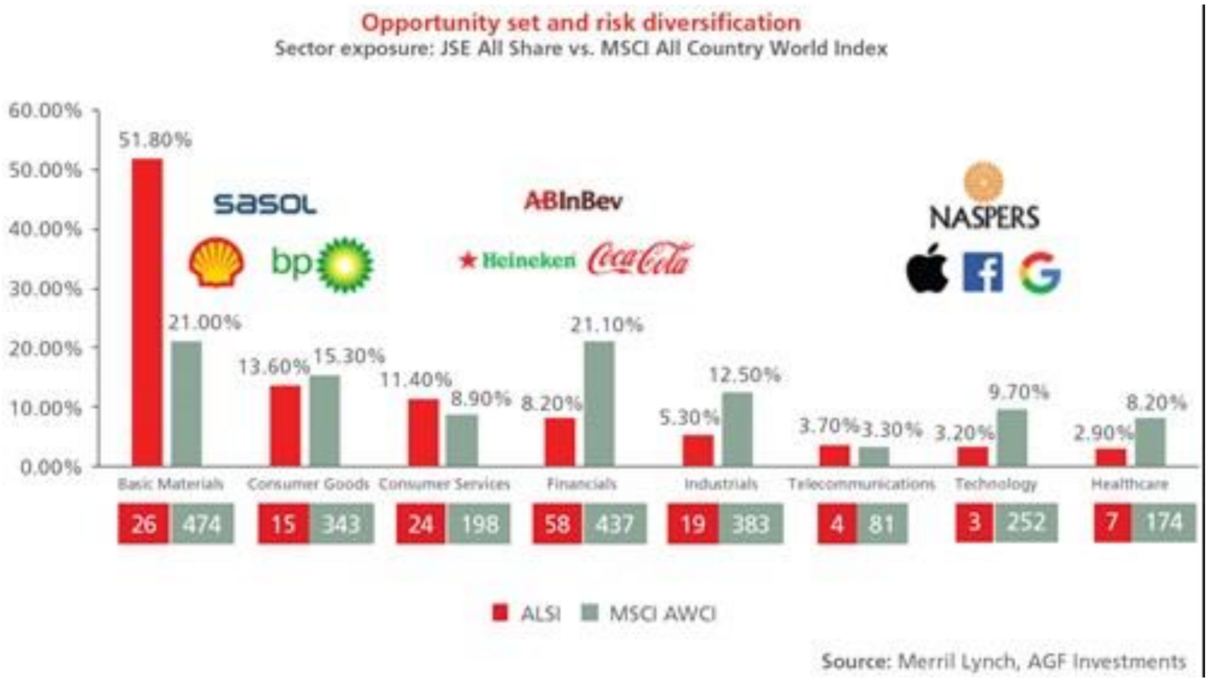
Given this fact, it is somewhat surprising to note that, according to a 2016 IMF survey, most equity investors around the world are very overweight their own home market. Those in many emerging markets like Turkey, Mexico, India and Russia have nearly 100% of their equity portfolios invested at home, while US and Japanese investors have about 75% in domestic equity. In only a handful of smaller and more open markets have investors kept less than 50%

at home, like Singapore, Austria, the Netherlands and Portugal. In South Africa, the equivalent figure is approximately 80%.

Excessive domestic exposure can certainly pose problems for investors. This is because even large and well-diversified equity markets can experience long periods of poor performance. This is evidenced by the US between 2000 and 2013, 13 years during which the S&P 500 Index was basically flat. In Japan, returns from the Nikkei 225 Index were close to zero for 31 years between 1986 and 2017. And our own equity market has effectively traded sideways for well over three years now. Extended periods of low returns can have serious consequences for individuals' longer-term retirement savings, especially for those nearing retirement or having just retired.

When examining the companies listed on the FTSE/JSE All Share Index (ALSI), we can observe far less diversification and a narrow set of opportunities compared to global equity markets (represented by the MSCI All Country World Index (ACWI)). Regarding geographic diversification, ALSI investors are very underexposed to both the Americas (comprising an estimated 6% of earnings versus 42% in the ACWI) and Asia-Pacific (20% versus 33%) - yet these regions encompass the world's biggest capital markets and some of the world's largest and fastest-growing companies. And the ALSI's higher exposure to South Africa and to African equity markets makes investor portfolios more susceptible to emerging market volatility.

Comparing sector exposure, South African investors certainly lack choice, as shown in the accompanying graph. For example, in the rapidly expanding technology sector, the ALSI has three relatively small companies (Altron, EOH and Advtech, comprising 3.2% of the Index – Naspers is listed in Consumer Services), while the ACWI offers 252 tech companies boasting global giants like Alibaba, Apple, Facebook, Microsoft, etc.. and comprising 9.7% of the Index. In the energy sector, the ALSI has Sasol (the only option), but the ACWI can offer the likes of Shell, Chevron and Repsol, renewable energy companies, etc. And let's not forget popular consumer brands that aren't listed locally such as Coca Cola (one of Warren Buffett's long-term favourites) Heineken and Nestlé.



By contrast, ALSI investors are overexposed to the volatile Basic Materials sector, which makes up nearly 52% of the Index. This compares with the sector's 21% weight in the ACWI. And although the ALSI does offer a broad selection of mining and commodity companies, it's important to note that over the past 10 years to the end of 2017, the FTSE/JSE Africa Basic Materials Index has returned 0% (a zero total return). When you contrast this with the 18.1% return recorded by the MSCI World Information Technology Index in rand in over the same period, it's easy to see that the ALSI does not offer the highest-quality opportunities for South African investors.

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