Table Talk

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Key take-aways

- Our research indicates that the optimal long-term (strategic) allocation to offshore assets of our investor portfolios is approximately 25%, given their risk and return characteristics and how they interact with local SA assets.
- This strategic allocation needs to be actively managed and adjusted in the short term to reflect ongoing changes in asset valuations (tactical asset allocation).
- Simply because offshore assets can now comprise 45% of an investor's retirement portfolio doesn't mean that the full amount should be allocated.

I heard that the government relaxed the offshore limits in Regulation 28 by allowing up to 45% of retirement portfolios to be invested offshore. Does that mean M&G Investments will be increasing the offshore exposure in its multi-asset portfolios?

Great question, and one that many investors have enquired about following the announcement. The answer is much more nuanced than you might think.

When determining the optimal offshore exposure for each of our multi-asset portfolios, it's important to understand the role that offshore assets play in South African multi-asset portfolios, which is both to enhance investment returns and to provide much-needed protection against the numerous risks inherent to emerging market economies such as our own.

At M&G Investments, offshore assets have always been core to our portfolios, serving as key contributors to improving our clients' investment outcomes. We were therefore very pleased when the announcement was made. It represents a significant increase from the previous 30% maximum and allows substantial additional freedom in constructing investment portfolios.

Risk and return: Determining optimal offshore allocations

One of the key roles we perform is to determine the optimal mix of offshore and local assets for each of our portfolios, given that particular portfolio's investment objectives. By assessing the risk and return characteristics across local and offshore assets, and the interplay between them, we aim to construct a portfolio comprising the optimal mix of assets that will enable us to consistently deliver on each portfolio's investment objectives.

Given that offshore asset values are translated into rands within rand-denominated South African portfolios, the ever-changing exchange rate of the rand can have a substantial impact on SA investors' outcomes. Therefore one must have a deep understanding of the potential extra returns and risks that they

can add to a portfolio, and then determine whether more offshore exposure (and how much to allocate to each offshore asset class) would help create an optimal portfolio.

Regarding returns, offshore assets provide local investors with access to regions, sectors and industries underrepresented on the JSE – a very valuable, broad and more diverse opportunity set from which to deliver returns. The MSCI All Country World Index (ACWI), the most common benchmark for global equities, is made up of over 8,000 stocks, giving us an exceptionally wide opportunity set to choose from in order to deliver returns for our clients.

In terms of risk, offshore assets are very useful in balancing the unique risks embedded in South African assets, especially within growth assets like equities and, to a lesser extent, property and bonds. They help lower risk by reducing portfolio concentration and exposure to the macro and geopolitical risks that South Africa is exposed to, including the impact thereof on the rand. For example, global bonds (especially US Treasuries) have historically provided good protection to balance out the risk of holding local equities.

Meanwhile, history has shown that the expected returns available from most local assets are meaningfully higher than those from their corresponding offshore equivalents, on a long-term "through-the-cycle" perspective. This is due to the inherently higher risk prevalent in the SA market compared to most developed markets, since investors demand higher returns for holding higher-risk assets like our equities and bonds.

We believe an optimal strategic offshore allocation is around 25%

Our most recent research has shown that for our balanced funds and other mandates aiming for returns of between CPI+4%-7%, the optimal neutral allocation is approximately 25% to offshore assets in total. For more conservative multi-asset portfolios, targeting returns of CPI+3%, for example, we found that the optimal neutral asset allocation is somewhat less, at about 20% in offshore assets.

While most investors focus on the total offshore allocation, the mix of offshore assets (equities, bonds, property, cash, etc.) is just as important to consider in order to achieve an optimal portfolio, especially as one increases the total offshore component of a portfolio.

Increased scope for alpha and TAA

While many investors may consider this 25% strategic asset allocation to offshore assets lower than expected, our tactical asset allocation (TAA) process is a critical contributor to overall investment outcomes. We actively adjust asset class allocations above and below their neutral allocations over the shorter-term as valuations change and investment opportunities present themselves. So, depending on the market opportunities available, the offshore allocations within our portfolios could deviate from the SAA level at any given time.

Currently, in our view South African equities and bonds are significantly cheaper than their foreign counterparts, and we're therefore tactically overweight South African equity and bonds

relative to offshore equity and bonds. The current offshore weighting in most of our funds is therefore below 25%. However, this could change very rapidly as we respond to changes in valuations.

Before the increase in the Regulation 28 limits, we weren't able to go meaningfully overweight offshore assets to generate asset allocation alpha if we found offshore valuations attractive – going underweight was really the only feasible option. However, we are now able to go much further overweight, which will greatly assist us in generating alpha. In addition, the increased limit gives us more freedom to implement currency hedges, for example, one of the important tools we use to manage a portfolio in rands.

Both of these enhancements will assist us in generating more alpha for our clients. For now, however, we have not seen a need to move more funds offshore to implement this higher limit, given that we are comfortable with our current allocations based on relative asset class valuations. ◻

Pieter joined M&G Investments in 2015 as Managing Director of M&G Investments Unit Trusts and Head of Retail Business. In 2019 he was appointed as Chief Client & Distribution Officer. With 23 years of industry experience, Pieter previously worked for one of the country's largest financial services groups in a range of senior management positions. He holds a B.Comm (Maths) degree from Stellenbosch University, and is a Fellow of the Institute of Actuaries (UK) and the Actuarial Society of South Africa. He completed the General Management Program at Harvard Business School in 2010 and during 2020 completed a course in Behavioral Finance from Duke University.