THE CASE FOR EMERGING MARKET INVESTMENTS FOR SOUTH AFRICANS

One of the most common counter-arguments we get from South African investors, when we recommend investing in emerging markets, is that allocating to this investment opportunity is a duplication of their existing onshore portfolio and this exposure will thus reduce any diversification benefits. Let's unpack this.

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It is true that South Africa, as an emerging market itself, possesses typical key emerging market characteristics, such as: the potential of high economic growth due to its young working population; an expanding middle class; social stability, as well as open capital markets with improving transparency and finally; a stable financial and legal system. There are also common risks that have historically been associated with emerging markets such as the political and policy uncertainties.

It is clear though that these risks are not isolated to emerging markets given the major geopolitical events that have recently originated from the developed world. Examples of this would be the tariff wars between US and China, the UK's exit negotiations from the EU, the worst political demonstrations in France in decades and Angela Merkel's end of term as German Chancellor.

SAME SAME, BUT DIFFERENT

So let's agree that South Africa is, and behaves as, an emerging market. However, to explore the benefits of expanding global investments, a South African investor should not view emerging markets as a single broad asset class. Rather, when a South African investor living in one of the emerging markets considers investing further in emerging markets, they should consider these important factors:

The emerging market landscape has evolved

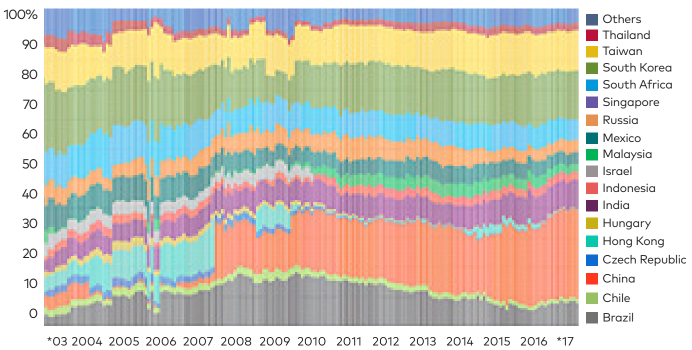
- Over the years, the emerging market landscape has become bigger and more dynamic thanks to improved accessibility and increased integration of the financial markets. Today the "MSCI Emerging Markets Index consists of 24 countries representing just over 10% of world market capitalisation, compared to just 10 countries representing less than 1% of world market capitalisation in 1988 when the index was launched"[1].

- This evolution has significantly widened the emerging market investment universe for a South African investor; which reduces the risk of country, sector or stock concentration of the portfolio. As recently as November 2018, we saw the shares on the JSE drop, partly due to a rebalancing exercise conducted by MSCI. This resulted in outflows from the domestic equity market as South Africa's weighting in the MSCI Emerging Market index decreased to below 7%.

- This shrinking of South Africa's percentage in the emerging market universe means South African investors should reassess their emerging market allocation, in pursuit of a well-diversified global portfolio.

The graph below shows the current makeup of the emerging markets index, and how it has changed over time.

Exhibit 2 The Ebb and Flow of Emerging Markets



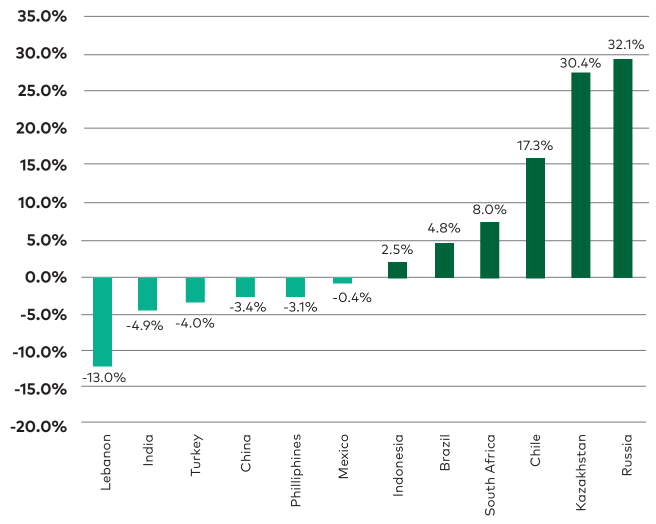
Source: Direct. Country-level composition of the iShares MSCI Emerging Markets ETF from inception to Sep 2017

The commodities effect is not the same for all emerging markets

- A strong dollar and low commodity prices are known to be negative factors for emerging markets' asset prices and currencies, although some emerging markets (i.e. those that are net importers) can benefit from a weak commodity environment, which improves their balance of payments and inflates corporate profits. An example would be the likes of China and India, who benefit from a falling price of oil, relative to South Africa whose economy is negatively affected.

[1] Source: MSCI website: https://www.msci.com/emerging-markets

Net Importers and Net Exporters of Oil, Petroleum & Fuels, % of GDP



Source: PIMCO, Nedgroup Investments as at November 2016

The domestic demand versus external demand of these heterogeneous regions

- Globalisation and the convergence of markets means companies have become more international and accessing direct domestic economic growth can be a challenge. South Africa is no exception. Our equity stock market actually derives more than 60% of its revenue offshore - so South African stocks do not always achieve the desired level of domestic emerging market growth opportunities.

- Adding emerging market investments which do not rely on external demand gives an opportunity to capture revenues of domestically focussed companies. There is also the opportunity of taking advantage of the economic growth of other emerging markets; especially during those times when the growth outlooks diverge from South Africa (as we have seen in the past few years).

- The following table shows how South Africa is becoming less positively correlated with the different individual emerging market countries over time, particularly in relation to countries whose currencies are not commodity-linked or whose economies are commodity-consuming, such as India and China. This is further reason to diversify away from South African stocks and developed markets.

Correlation Matrix
(Excess Returns vs. MSCI World in Rands)

SA Relative to:	5 years to Nov 2008	5 years to Nov 2008	5 years to Nov 2008	Correlation over time
Brazil	0.64	0.49	0.60	↔
Russia	0.51	0.52	0.31	↓
India	0.32	0.42	0.27	↓
China		0.12	0.02	↓
Ermerging Markets	0.75	0.67	0.70	↔
All Country World	0.71	0.68	0.70	↔
S&P 500	-0.72	-0.39	-0.45	↑
Japan	0.22	-0.09	0.00	↑

Source: Morningstar Direct, Nedgroup Investments as at November 2018

CONCLUSION

Emerging markets remain a compelling investment opportunity in the coming years; and the prolonged market sell-off experienced over the years has opened attractive entry points to exploit this opportunity.

Earnings growth in emerging markets has accelerated sharply and the forecasted growth is expected to remain in double digits. There are also critical themes and upcoming events in the major emerging market economies that are possible catalysts in term of unlocking value.

It's clear that a sufficiently diversified investment strategy should reflect a balance across emerging market countries, provided that the underlying valuations make investment sense. An active stock-picker can help navigate the regions to find selective opportunities with significant upside potential. ■