INVESTING OFFSHORE VERSUS INVESTING IN OFFSHORE ASSETS

Investing in international markets is an important diversification building block to investors' portfolios, but there are different options investors can choose.

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Weak economic conditions and political instability has almost become the new normal in South Africa. Luckily, 2017 ended on a very positive note with the orderly election of Cyril Ramaphosa as the new ANC president and the Rand responded well to this news strengthening almost 10% in December. But many investors are still sceptical. Can Ramaphosa really turn this ship around? Or, will the February budget still be weak leaving Moody's – the last rating agency that has us at investment grade – to downgrade South Africa's debt to junk status?

Since we can't predict exactly what the future holds, investing in international markets remains an important diversification building block to investors' portfolios.

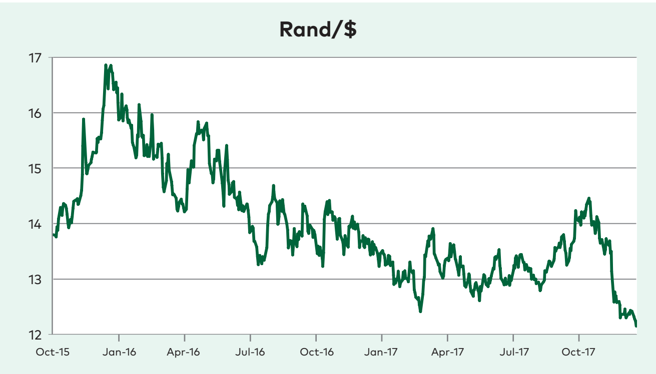
The good news is that you as an investor are spoilt for choice in your search for investments uncorrelated to the local economy, since the South African Gross Domestic Product (GDP) represents only 0.5% of the world economy. This is an exciting prospect, but it is crucial that you add or increase offshore exposure in line with your long-term investment objectives and clearly understand the ins and outs of the offshore investing.

INVESTING OFFSHORE - "LITERALLY"

The purest form of investing offshore is physically moving your money out of South Africa by converting Rand to a foreign currency and then investing the foreign currency. This can be as simple as holding cash in an offshore bank account or investing in funds domiciled outside of SA.

There are fund managers based all over the world, including in South Africa, that manage a wide range of offshore-focused, foreign currency denominated funds with varying degrees of growth assets (equity and property) and income assets (cash and bonds) for you to choose from.

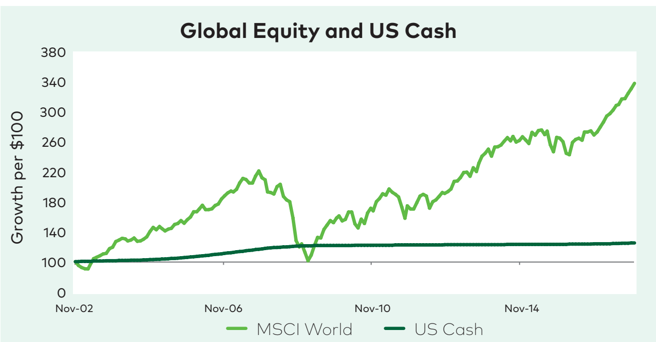
However, the absolutely critical consideration of investing offshore is the exchange rate. Using the Rand/$ as an illustration below, exchange rates can be incredibly volatile in the short term. You need to guard against taking your money out of the country at say R16.1 (the level it was at January 2016), converting it back into Rand a year later at R13.5 and in the process losing 15% of your initial investment to currency movement.

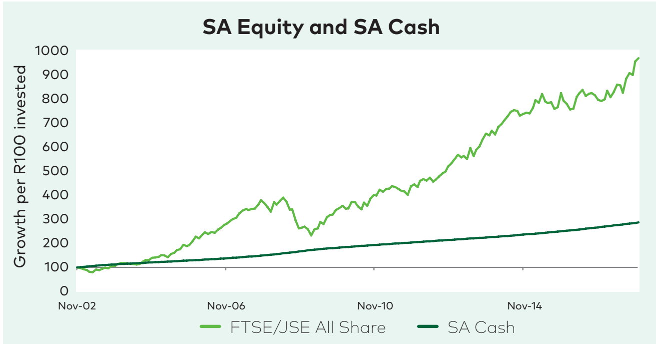


Source: IRESS

Once you have converted your Rands to a foreign currency, the basic investment principles remain unchanged. Finding the balance between time, risk (both your tolerance and appetite) and return remains vital to successful investing. In order to increase your expected growth rate, you need to be prepared to sit through some short term capital volatility and loss and stay invested for longer in order to achieve your expected growth rate. If you can't afford, or bear, to lose any capital in the short-term, you will have to lower your growth expectations.

US dollar cash, just like SA cash, is the stable, but low growth option suitable for US dollar capital protection needs. The offshore equity markets (as illustrated by the MSCI World index below), just like the local market (as illustrated by the All Share index below), offer significantly higher growth over the long-term, but at much higher short-term volatility.





As a South African tax payer you can, however, only move up to R1 million out of South Africa per tax year without applying for a tax clearance certificate. You do have the option to move up to R10 million out of our borders, but you will have to apply for tax clearance from South African Revenue Services (SARS) for anything above your first R1 million per tax year.

Even though this money has left the country, as a South African tax payer you are still liable for tax on income and dividends earned, as well as capital gains realised – just according to a slightly different tax treatment, which we will discuss later.

KEEPING IT LOCAL

What many investors don't realise is that it is possible to gain exposure to the likes of the booming US equity market, without your money physically leaving the country.

For example, numerous companies listed on the Johannesburg Stock Exchange (JSE) have very little exposure to our economy since they earn the bulk - or even all - of their revenue outside of South Africa. These companies are commonly referred to as 'rand hedges' and regarded as SA investments, despite the drivers of their performance being globalised. Some of the larger, well-known names are Naspers and Woolworths that fall in the 40% - 60% offshore revenue bucket and British American Tobacco at close to 100% offshore revenue.

The South African, Rand-denominated unit trust industry offers a few offshore exposure options for you to choose from, without needing to worry about breaching a maximum rand value per tax year or getting tax clearance.

- Exposure to local 'Rand hedges' within the local equity and property building blocks
- Various single and multi-asset class funds that can invest directly in offshore equity, property and fixed income markets within the rand-denominated fund
- Global feeder funds that hold a single position in an underlying fund that is domiciled outside of South Africa, foreign currency denominated and completely offshore focused.

As mentioned above, if you invest directly offshore you will be using your foreign allowance afforded to a natural person of R1m. However if you invest into a rand denominated offshore unit trust that holds foreign assets, you will be using the foreign allowance of the MANCO itself.

Just like offshore investing, it is important to consider the impact of the exchange rate on these investments, especially when investing in a global feeder fund. If the underlying fund is USD-denominated the USDZAR exchange rate is added to the feeder fund price every day.

The ASISA fund classification system according to which South African unit trusts are grouped determines how much direct offshore exposure (excluding rand hedges) funds within each category is allowed to hold.

- 'South Africa' fund classes must have a minimum of 70% invested in South Africa and a maximum 25% offshore and maximum 5% in Africa
- 'Global' fund classes must have a minimum of 80% invested offshore and a maximum of 20% in South Africa (with less than 80% in any specific country/region)
- 'Regional' fund classes are concentrated to a specific country or region with at least 80% invested in any one specific country or region, with South African exposure limited to 20%
- 'Worldwide' fund classes, on the other hand, have no restrictions on South Africa vs offshore allocation and the regional allocation is completely up to the fund manager's discretion

Once you have chosen the level of direct offshore exposure that is suitable for you, each category offers various types of funds managed by various different fund managers to choose from. It includes the full 'risk-return-time horizon' spectrum that can be summarised into four broad categories, depending on the level of growth and income asset each fund mandate allows:

Money Market and Income	Time horison:	Less than 1 year
	Return expectation	CPI + 0% - 1%
	Cash-like exposure	100%
	Growth assets	0%
Low Risk	Time horison	Min 1 - 3 years
	Return expectation	CPI + 2% - 4%
	Growth assets	10% to 40%
Medium Risk	Time horison	Min 3 - 5 years
	Return expectation	CPI + 4% to 6%
	Growth assets	40% to 75%
High Risk	Time horison	Min 5 to 7 years
	Return expectation	CPI + 6% to 7%
	Growth assets	75% to 100%

Another important consideration is whether or not your investment is for retirement savings or discretionary savings. Offshore exposure within retirement savings must be Regulation 28 compliant and are, amongst a few other investment restrictions, limited to 25% direct investment in offshore markets and an additional 5% in African markets.

UNDERSTANDING THE TAX IMPLICATIONS WHEN YOU INVEST OFFSHORE

Interest earned on offshore and local investments is taxable at your marginal income tax rate and offshore and local dividends are taxed at 20%.

Capital gains tax, on the other hand, is the tricky one as the exchange rate plays a different role in the calculation when you invest offshore vs. gaining offshore exposure through local investment vehicles. When you disinvest, the difference between the proceeds and base cost* will be subject to capital gains tax (CGT).

- When you invest offshore the taxable capital gain is effected by the growth earned on your foreign currency investment and the exchange rate on the day you realise the gain.
- When you obtain offshore exposure through a local investment vehicle, your taxable capital gain is effected by the growth earned on your rand denominated investment – which includes the exchange rate at the start and end of your investment period.

Let's look at an example of how currency movement can affect your capital gains tax liability

Sam decides to invest R1.6m and can invest either directly into a US dollar denominated foreign fund or a rand denominated feeder fund. At the time of investing the Rand was trading at R16 to the dollar. This means that Sam invested $100k directly into a foreign fund.

Rand amount invested	Exchange rate	Equivalent $ amount
R 1 600 000	R16/$	$ 100 000

A year later the US dollar fund has returned 20% and Sam decides to fully disinvest his current market value of $120k (assume no other purchases or withdrawals made prior to sale of units). At the time of disinvestment, the Rand was trading at R14 to the dollar.

$ Market value one year later	Exchange rate	Equivalent R amount
$ 120 000	R14/$	R 1 680 000

* Nedgroup Investments uses the weighted average base cost (WAC) method in determining the base cost.

If Sam invested offshore, the $20k capital gain will be converted at the current exchange rate of R14 which translates into a taxable capital gain of R280k. If Sam invested in a rand denominated feeder fund, the strength of the currency would've largely offset the growth of the US dollar fund and one year later sits at a capital gain of only R80k. I.e. in periods of Rand strength, it is more tax efficient to realise capital gains from a rand denominated investment vehicle than an offshore investment.

Let's redo this example assuming that the Rand weakened to R20/$ over one year.

- The $20k capital gain in the US dollar fund translates to a R400k capital taxable gain
- The equivalent rand amount in the rand denominated feeder fund is R2.4mil ($120k * 20) and translates to an R800k taxable gain.

So when the Rand weakens, it is more tax efficient to realise capital gains from a foreign currency denominated, offshore investment vehicle.

STICK TO THE BASICS

While there is definitely a good case for diversifying offshore, it is important to stick to the basic principles of investing and remember to keep a long-term view and investment time horizon. Listed (and discussed in more detail by Trevor Garvin in a previous newsletter**) are a few suggestions to think about to ensure that you have "ticked the boxes" before making any final investment decisions

- Choose investments that are appropriate to your risk profile
- Choose a credible investment partner
- Diversification is crucial
- Avoid making emotional decisions
- Remember that valuation drives long-term return
- Don't base your decision on currency alone
- Seek advice. ■

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** http://www.nedgroupinvestments.co.za/Insights/InsightDetailsPage/Investing-offshore-have-you-ticked-the-boxes