GRAYISSUE

26 November 2009
Issue no. 98

Opportunity knocks offshore

During October 2009 Minister of Finance Pravin Gordhan announced an increase in the offshore investment allowance for individuals from R2 million to R4 million. Will South Africans take advantage of this opportunity?

Following on from the trend that started in 1998, emerging markets, including South Africa, have continued to outperform global markets. Over the last 12 months the rand has strengthened significantly against most developed market currencies. Returns from offshore investments are driven by returns in the foreign market, and movements in the rand. We believe return prospects on selected foreign investments are more attractive than the return prospects of South African shares in general. On top of this, we believe there is a high probability that the rand will be weaker in future, which should benefit South African investors in rand terms.

How to invest offshore

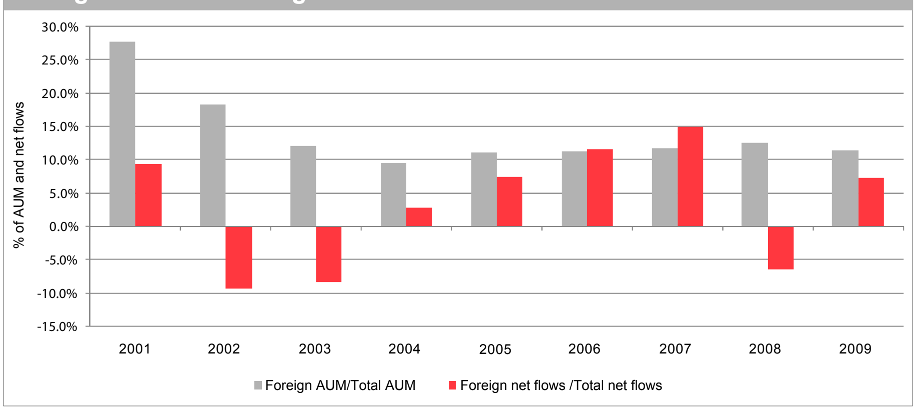
There are different routes you can take to invest offshore. You can access Foreign Collective Investment Schemes (FCIS) by using your individual foreign exchange capacity. Alternatively, you can access locally domiciled foreign funds by using the foreign exchange capacity of unit trust management companies (see information box below). These funds are also referred to as 'asset swap' funds.

How much should you invest offshore? This is a difficult question that may have different answers for different people. The 'correct' amount to invest offshore will also change as investment opportunities around the world change. The data below suggests South Africans have consistently been reducing their exposure to offshore assets, during a time when they have become arguably more attractive than South African assets.

A lesson from history

We examined how local investors have responded to relaxing of exchange controls in the past by measuring the assets under management (AUM) of foreign investments available in South Africa as a percentage of the total savings pool. We defined foreign investments as the sum of locally registered unit trusts investing offshore, and FCIS that are registered for marketing in South Africa. We measured the savings pool as all assets invested in South African unit trusts, and FCIS.

Foreign investments neglected



The graph shows the size of foreign AUM expressed as a percentage of the total savings pool (as defined above), in grey. Foreign funds have become a smaller proportion of the total pool over the last eight years, declining from 28% in 2001 to 12% at 30 September 2009. This trend can be explained in part by relative performance. In rand terms the South African market has outperformed world markets over the last 10 years, and one would expect funds invested locally to have grown faster than funds invested offshore.

The size of flows into the offshore funds has however been disproportionately small (as illustrated by the red bars on the graph above). The foreign sector only grew market share by flows in 2006 and 2007. In all other years foreign net flows were a smaller proportion than assets, compared to the total savings pool. South Africans have by and large benefited from this trend as local funds have continued to outperform foreign funds in rand terms. However, given the reasons discussed above, we believe this may not be the case moving forward.

Considerations when deciding how to invest offshore

Investing in rand-denominated offshore funds	Investing in foreign collective investment schemes
Currency considerations	
You invest in ZAR without using your foreign investment allowance. Investments are made offshore by the asset manager.	You invest in foreign currency (e.g. USD, EUR, GBP or JPY) using your R4 million foreign investment allowance.
Administration	
Since your investment is not subject to any foreign exchange control limits you don't have the administrative burden of applying for foreign exchange approval.	You need to obtain Exchange Control approval from the South African Reserve Bank to transfer money offshore. To apply for exchange control approval you must obtain a tax clearance certificate from the South African Revenue Services (SARS) and supply it to your authorised foreign exchange dealer.
Ongoing tax reconciliation is relatively simple.	Ongoing tax reporting is more complex.
Accessibility	
Both investment and withdrawal turn-around times take a maximum of 48 hours.	The investment and redemption processes can take a few extra days depending on the dealing days of the relevant manager. You should take this into account when submitting instructions.
Cost	
Costs vary between different unit trust management companies. They can include administrative fees, performance-based fees and financial adviser fees. Always educate yourself on a product's fees before you commit to investing.	

Commentary by Chris du Toit, Analyst, Allan Gray Limited
Allan Gray Limited is an authorised Financial Services Provider.