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On the contrary – Investing Offshore

Despite the strong Rand, and the opportunity that this presents, few investors are diversifying their portfolios offshore. Pension funds generally are not increasing their foreign exposure, nor are individuals taking up the offshore capacity available in locally registered unit trusts. Yet when the Rand was at its weakest in 2001/2002, South African investors poured funds into offshore assets despite the fact that the currency factor aside, they were expensive in foreign currency terms.

When diversifying offshore, investors should take into account **both** the underlying value of the foreign assets they are buying as well as the level of the exchange rate. It never makes sense to sell a cheap local asset measured in dollars to buy an expensive offshore dollar asset. Yet this is precisely what investors did in 2001 and 2002.

Now the reverse is occurring. Bullish about South Africa, investors are keeping their money onshore, despite the fact that local markets have become more expensive. Between 2001 and 2003 South African equities offered substantial discounts relative to offshore equities when measured in dollars, but were eschewed by many investors in favour of their more expensive offshore counterparts or locally listed 'rand hedges'. With the subsequent appreciation of the Rand and concurrent losses in offshore markets, many investors sustained substantial losses.

In Allan Gray's view, the current strength of the Rand is not sustainable. We think the Rand should be priced at around R7 or R8 to the US dollar. As a result, a conservatively selected portfolio of offshore assets is now less expensive than local markets. This points to an opportunity to diversify into selected investments offshore.

However, investors should be aware of the dangers of simply buying an index such as the MSCI World Index. The MSCI comprises more of those shares that have recently appreciated, from the regions that have recently appreciated and less of those shares and regions which have gone down in price. For example, US counters currently comprise approximately 51% of the MSCI World Index, after a 20-year bull market. Japanese stocks, on the other hand, account for only 9% of the index after a 15-year bear market. In 1989 when Japanese stocks were at their most expensive relative to US Stocks, Japan comprised fully 44% of the MSCI and the US only 29%.

Driven by fear, investors typically buy assets when they are expensive and sell them when they are cheap, thereby eroding the value of their investment portfolios over the long-term. In buying the Index, you'd be buying more of something that has already appreciated, and less of something that has fallen in price but which, therefore, holds the potential of stronger returns.

The portfolio of the Orbis Global Equity Fund, which is registered for marketing and distribution to South African investors, is currently weighted in favour of Japan at approximately 27% (9% in the MSCI) versus the USA at approximately 26% (51% in the MSCI). Orbis has been able to find value well supported by tangible assets in Japan whereas these are much harder to find in the US. Thus, the risk of capital loss is lower in Japan than the US. Whilst a higher weighting of US stocks in the Orbis portfolios would reduce relative risk, in absolute terms US equities in general are currently priced such that they need substantial earnings growth over the longer term to justify their valuation. In addition to Japan, Orbis is attracted by valuations in Korea. Shares from emerging markets currently account for 18% of the Orbis Global Equity Fund portfolio as opposed to the 7% they comprise of the MSCI World Index.

In conclusion, South African investors learnt to their peril the extent to which currency moves can substantially detract from foreign asset returns in 2002, 2003 and 2004. The danger now is that investors might miss out on the attractive returns available from selected foreign assets, which are cheaper in dollar terms than they were in 2001/2002 and substantially cheaper when the strong Rand is taken into account.

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