My dad's conundrum

"The rand has strengthened quite a bit. Is it a good time to take some money offshore?"

This was a question from dad a few weeks ago over Father's Day lunch as we basked in the post-election euphoria. It's a very sensible question to ask, but a tricky one to answer, and something that we have had to grapple with in managing our funds too.

by Catherine Blersch

Our funds have gradually increased **offshore exposures** over recent years

Under restrictions set by the South African Reserve Bank, retirement funds in South Africa were historically only allowed to invest up to 30% offshore. In February 2022, this limit was increased to 45%. We viewed this as a great development for investors for a few reasons. Firstly, it widens the investment universe. There are about 400 companies listed on the Johannesburg Stock Exchange (JSE). By contrast, there are over 58 000 listed companies in the world, with over 5 000 on the American exchanges (Nasdaq and the New York Stock Exchange) alone. The investment universe is massive, so to be restricted to putting three quarters of your money in the small JSE pool was very limiting. Secondly, while there are excellent companies on the JSE, there are certain industries that can't be accessed. One example is semiconductors, which present a unique opportunity to invest in companies with strong competitive advantages – in some cases near monopolies – on the very strong growth vector of digitisation. The larger offshore limit allows us to give such opportunities the weighting they deserve. Lastly, having broader exposure to different economies provides some diversification. We have been cautiously optimistic about South Africa, and remain so. But it is still prudent to not be too heavily exposed to the whims of one government. It's for all these reasons that we have gradually increased the offshore weighting in the funds over recent years to over 40%.

A **strengthening rand** is a real risk

This brings us to my dad's conundrum. Every time we buy a share in a foreign company, we sell rands to buy forex at the prevailing rate and our investors end up with an asset denominated in a foreign currency. When the rand weakens, those assets are worth more (assuming a static stock market) when translated back to rands. A weakening rand has been the general direction of travel over recent years, so not only have you benefited from offshore stocks doing well but also the gains from having non-rand assets. Your hard-earned savings are worth more – excellent, that's our goal! However, if the rand strengthens, this reverses and the gains from making good stock picks can easily be undone when translated back to rands. If you are a South African investor who plans to retire here, what matters most at the end of the day is that you have more rands. A strengthening rand is a real risk. **So how does one manage this risk?**

One option is to try to **time the market**

This is what my dad was trying to do – taking money offshore when the rand is weak and bringing it back when the rand is strong. To do this, we need to figure out what the rand is worth. The most common framework used is a purchasing power parity (PPP) model. Put very simply, this model determines the exchange rate at which a basket of goods would cost the same in two countries. Market research and trading company Avior publishes very useful work on this, using a data set that spans from 1980. Their work shows that despite some recent strength, the rand is still trading at the 95th percentile against the dollar. This means it has only been this cheap for 5% of the time in the past 45 years. Their PPP model suggests a fair value for the rand at R11.65 vs the US Dollar and R14.28 vs the Euro. This means that it is in the realm of possibility for the rand to strengthen by 30%. We have done some of our own work on this, and determined that the starting point for your analysis makes a big difference. However, our conclusions have been largely the same: the rand is very cheap. If you have been on an overseas holiday recently and forked out R200 for a beer, you know this to be true!

These numbers are helpful, but the real trick is knowing what to do with this information. We don't profess to have any skill in timing the market and the PPP models show that the rand has been undervalued for the past 15 years. When you face the kinds of structural challenges that South Africa has experienced, models start to break down as a tool for prediction. Over this period, it would have been foolish to keep waiting for a better time to take money offshore, especially if it meant missing out on opportunities to invest in wonderful companies.

The other option is **insurance**

So, what do you do when you want to own a great asset, but also to limit your chance of a costly loss if factors outside of your control move against you? You take out insurance. This is the approach we have chosen to take in our funds. It might be overly optimistic to think the rand will strengthen to R11 to the dollar, but it could easily go to R14 as it did in 2021. With 45% of a portfolio offshore, a 25% strengthening of the rand would mean an 11% drop in the value of your investments. This is not a risk we want to take with your money.

The cheapest form of insurance is called a 'zero cost collar', which effectively pegs the rand in a certain range. For the benefit of protection against rand strengthening, you give up the upside of the rand weakening. The problem here is that even with the current optimism about the country, many things could happen that cause the rand to blow out – think Nenegate or a global pandemic. We wouldn't want you to lose out on the benefit of owning non-rand assets in such a scenario. We have, therefore, chosen instead to use a one-way approach: buying put options at various levels below the current exchange rates covering most of your offshore exposure. These options limit your downside risk in the event of a strengthening rand, (in essence, paying you when the exchange rate moves beyond the strike price), but leave you fully exposed to the benefits of the rand weakening. Just like insurance, to have this asymmetrical protection we pay a small premium. We believe the expense is worth it to maximise the odds of a good long-term outcome for you as South African investors.

We have been using this strategy for over a year and will continue to do so for as long as we deem prudent. Buying insurance means we don't have to ask ourselves my dad's question every time we buy an offshore asset. Instead, **we can focus our energy on finding the best possible places to invest your money.**

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