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A fully integrated process is key to achieving optimal outcomes in multi-asset funds

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Very few South African asset managers have integrated processes across all the relevant asset classes. While most multi-asset (balanced and stable fund) portfolio managers are closely involved with the South African equity component of their funds, many outsource management of offshore equity, property and/or fixed income components to other teams or companies. Without an integrated process, however, multi-asset portfolios are sub-optimal.

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Outsourcing components of a multi-asset portfolio can be detrimental to client outcomes

Most local asset managers manage the SA equity portion against a benchmark (generally the FTSE/JSE Capped SWIX All Share Index (Capped SWIX)) and assess the teams running the outsourced assets against relevant benchmarks (for example, the MSCI World Index for global equity, SA Listed Property Index for local property and the All Bond Index for local bonds).

This process can lead to sub-optimal outcomes for clients for several reasons:

- The increased offshore allowance under Regulation 28 (up to 45% can now be invested offshore) exacerbates the potential for conflicts of interest for asset managers without an integrated process. Increasing allocations to outsourced asset classes (like global equity) involves paying more fees to third parties, reducing the asset manager's profitability. Even where the allocation is to an internal team, inter-team transfer pricing can also create conflicts of interest.
- A Capped SWIX benchmark for local equities forces managers to invest in larger SA-listed companies, many of whom generate most of their earnings outside of South Africa. Examples include Naspers, Anglo American, Prosus, Richemont, British American Tobacco and Sasol, all of whom are in the Capped SWIX top 10. The forced allocation of capital to these shares, when there are nearly 3 000 shares in the MSCI All Countries World Index (including similar but potentially significantly more attractive companies), makes no sense from an overall portfolio perspective. It also drives under-investment in smaller SA-focused companies.

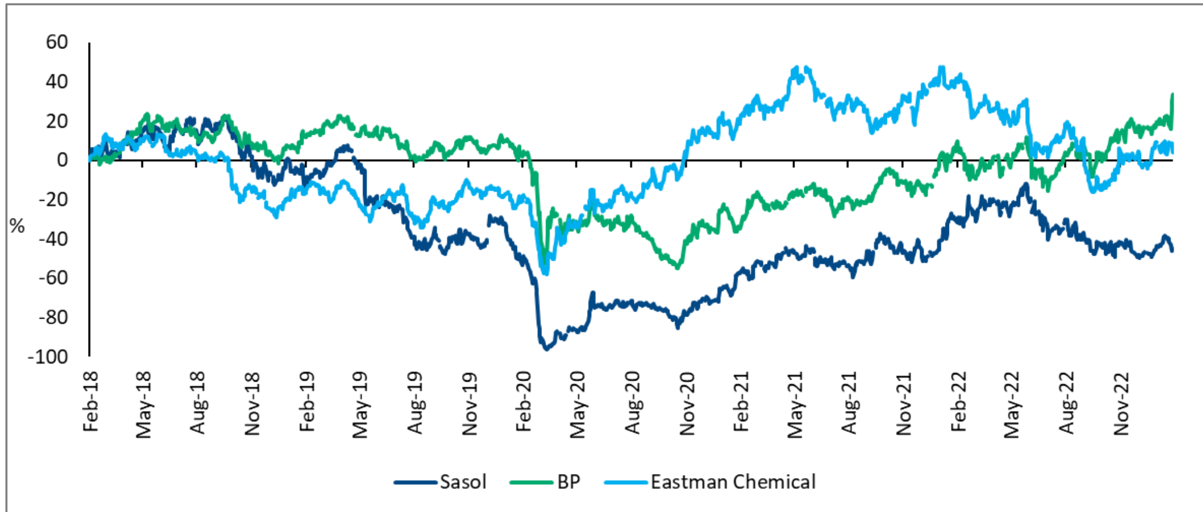
If one started with a blank piece of paper, equity within a South African multi-asset fund should consist of the most attractive global equities (regardless of whether they are listed in SA or not) and SA-listed shares where local asset managers have both the context and substantial experience in analysing the companies.

The most attractive global equities?

Analysis by Avior indicates that only 42.7% of the Capped SWIX's revenues are generated in South Africa (for the FTSE/ JSE All Share index it is significantly lower). The top 10 shares by index weight account for 43% of the Capped SWIX, but on average they generate only 27.4% of their revenue locally. If you remove the largest local banks (Firstrand, Standard Bank and ABSA), the remaining seven shares, on average, generate less than 9% of their revenue in SA. These shares, many of which are dual-listed, should ideally compete against their global peers for inclusion in any client's balanced portfolio, but are frequently default inclusions due to their prevalence in index benchmarks. This can have a substantial impact on returns generated for clients, as is evidenced by the case studies below.

Global equity case study #1: Sasol vs BP and Eastman Chemical

Figure 1: Cumulative total return in USD: Sasol, BP and Eastman Chemical

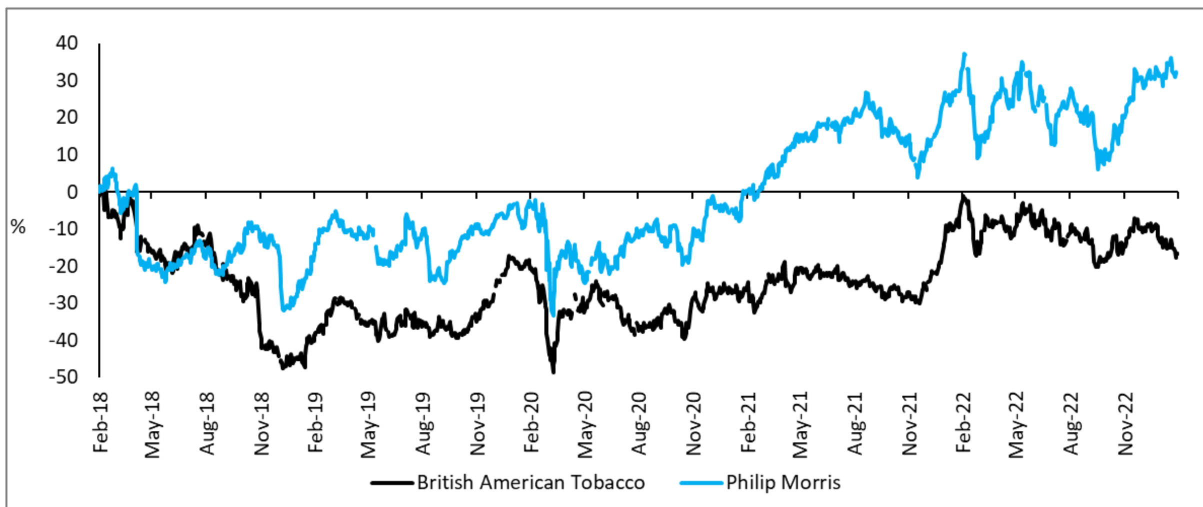


Source: Bloomberg

As Sasol is both an oil and chemicals company, we compared it to BP, a global oil major and Eastman Chemical, a large chemical company. (Neither have been stand-out performers in their respective sectors, and their inclusion is purely for illustrative purposes). Over the last five years, several management missteps have contributed to Sasol losing 45% in USD vs BP's total return of +34% and Eastman Chemical's gain of 4%. a 50:50 combination of BP and Eastman Chemical outperformed Sasol by 64% over this period.

Global equity case study #2: British American Tobacco vs Philip Morris International

Figure 2: Cumulative total return in USD: British American Tobacco and Phillip Morris



Source: Bloomberg

Despite historically being a strong performer in tough market environments due to its resilient sales base, British American Tobacco has delivered -17% in US dollar over the last five years. Its largest competitor, Phillip Morris International, has been rewarded for its globally well-diversified business, market-leading position in reduced-risk

products (including heat-not-burn products like IQOS) and a proven ability to generate substantial free cash flow with a gain of 32% over the last five years, resulting in an outperformance of BTI of nearly 50%.

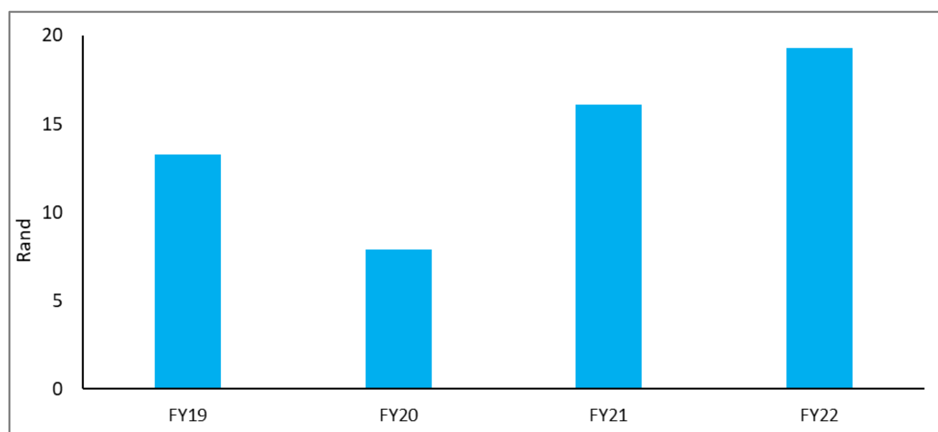
SA-listed global shares will not always be the poorer investments compared to globally listed alternatives (and the above are purely examples to illustrate the potential impact). However, any limitation on investment freedom is likely to drive poorer performance over the longer term. Use of a Capped SWIX or similar benchmark within a fund that can also invest directly offshore forces that fund to hold potentially less attractive SA-listed global shares, to the detriment of the investor.

Seeking out truly attractive SA-focused shares

While we acknowledge the significant headwinds and challenges South Africa is currently facing, one should not conflate poor economic prospects with poor investment opportunities. A number of SA-focused companies have managed to grow earnings strongly over the last few years despite the economic challenges. Not only have these companies proven their resilience and ability to grow in a tough environment, but the outlook for their future earnings growth is attractive. Despite this, they are priced as though they will never grow earnings. Most of these attractive opportunities lie outside the top index constituents, making their meaningful inclusion in the typical balanced fund unlikely.

Local equity case study #1: Hudaco

Figure 3: Hudaco earnings per share (EPS)

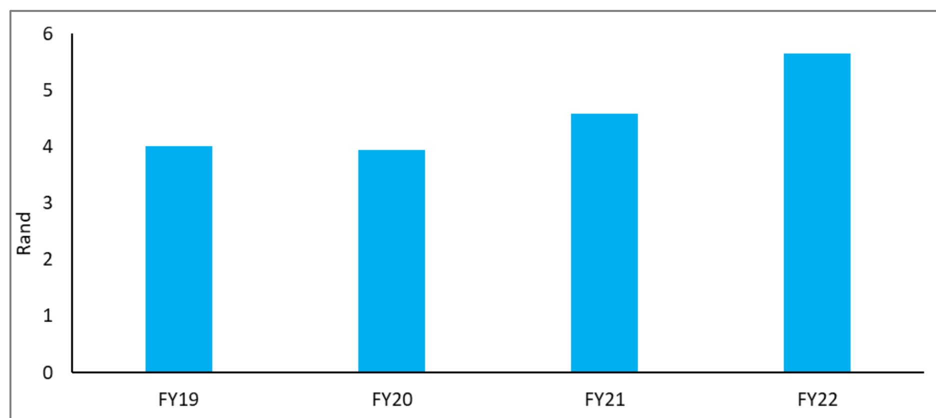


*Source: Bloomberg (*adjusted earnings per share)*

Over 90% of Hudaco's R8.2bn sales from distribution and manufacturing is generated in South Africa (with 58% from consumer-related businesses and 42% from engineering consumables businesses). Despite this, Hudaco has been able to grow EPS by 45% over the three years since 2019. Despite a strong share price performance since the announcement of its FY22 results (which finally took the share price above levels seen in early 2019), Hudaco is still trading on a 5.6% dividend yield, and is priced at 8.6X earnings, indicating substantial market skepticism about its ability to continue to grow, despite the proven track record.

Local equity case study #2: Kaap Agri

Figure 4: Kaap Agri EPS



Source: Bloomberg (adjusted earnings per share)

Kaap Agri is an SA-focused company that has diversified from an agricultural business to a group with agricultural, general retail and fuel retail (including convenience stores and quick service restaurants) activities and R15.7bn in sales. Kaap Agri has grown EPS by over 40% since 2019 and looks highly likely to continue growing earnings at more than 15% p.a. for a number of years as a recent acquisition is bedded down and debt is reduced. Despite this strong track record and positive growth outlook, the share trades at 7.5X earnings.

There are many more examples of SA-focused mid-cap shares that should be able to grow earnings strongly even in a tough environment, but which are extremely cheap. In addition, if the South African environment proves less challenging than current sentiment suggests, these companies will perform incredibly well, with less resilient competitors having fallen by the wayside.

It is worth noting that many larger asset managers may struggle to make meaningful investments in smaller SA-focused shares due to liquidity constraints. This constraint, combined with economic incentives associated with not having a globally integrated process, and historical precedents in terms of how they manage the funds, means many asset managers are comfortable continuing to manage multi-asset portfolios using underlying index benchmarks (either explicitly or implicitly).

Positioning across the balanced fund category

31 December 2022	Average fund*	PSG Balanced
Equity and property physical exposure	65.6%	75.9%
Offshore equity	25.9%	28.9%
Local equity	39.1%	41.8%
- SA inc (look-through based on revenues)	16.7%	24.0%
- SA Inc mid cap (look-through based on revenues)	6.8%	17.3%
SA bonds	15.7%	20.5%
Offshore cash & bonds	8.5%	1.7%
SA cash	6.5%	1.9%
Other	3.7%	
Total	**100.0%**	**100.0%**

* Largest 7 balanced fund unit trusts

Source: PSGAM analysis

An analysis of the largest balanced fund unit trusts at the end of 2022 reveals that:

- Offshore equity allocations remain fairly low at 25.9%, despite the Regulation 28 offshore limit having been increased to 45%.
- A sizeable additional effective offshore exposure of 22.4% is obtained through locally listed shares that generate revenue globally.
- There is limited exposure to smaller SA Inc. shares (less than 7% of the portfolio on average) – we believe some of these shares are among the best investment opportunities globally due to the extremely poor SA sentiment and resultant low ratings.

In contrast to the typical outsourced approach, PSG Asset Management runs a globally integrated process, and this is reflected in the portfolio composition. The PSG Balanced Fund holds only two of the largest shares in the Capped SWIX (Anglo American and Standard Bank), preferring to invest directly offshore in the best global opportunities – as is evidenced by the higher direct offshore holding than average. In addition, the Fund has a sizeable exposure to smaller SA Inc. shares (including both Hudaco and Kaap Agri).

We believe a globally integrated investment process allows the fund manager to construct optimal portfolios and to assess SA-listed opportunities more objectively. PSG Asset Management has been investing globally since 2008, with a fully integrated process and portfolio managers making the instrument level investment decisions across all asset classes.

Glacier Research would like to thank John Gilchrist for his contribution to this week's *Funds on Friday*

John Gilchrist

Co-Chief Investment Officer

PSG Asset Management

John is the co-CIO and lead manager of the PSG Stable Fund and co-manager of the PSG Diversified Income Fund. He joined PSG Asset Management in 2018 and has over 20 years' investment experience. Prior to joining PSG, he was co-head of the Customised Solutions Boutique at OMIGSA, which had funds under management totalling over R135bn. At OMIGSA, he developed and managed a number of multi-asset low risk, equity and hedge fund offerings. He is a CA (SA) and has an MBA (with distinction) from Insead in France.

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