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Three global investing challenges facing SA managers

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Global investing provides many benefits to the South African investor –; increased diversification; better access to global themes and sectors that are underrepresented in the South African market; and protection against a depreciating currency, to name a few.

However, it's not without its risks and these must be considered alongside the advantages. We highlight three key challenges that South African asset managers face when investing globally and describe how we overcome these hurdles at Sentio.

Spoiled for choice?

Opening up the investment universe outside of our borders results in a vast opportunity set that can be difficult to navigate. Take, for example, the MSCI World Index. This highly diversified, market cap-weighted index consists of more than 1,600 stocks. Performing sufficiently thorough and in-depth fundamental analysis on this number of stocks is often an inefficient exercise for many investors who simply don't have the resources to commit to such an undertaking. The MSCI World Index is also only one such index; there is a plethora of other indices that comprise similarly large numbers of constituents.

We believe the best way to handle such volumes of data is through the use of machine learning techniques that enable us to manage the dimensions of a complex investment universe in an efficient and manageable way.

There are several approaches that can be implemented which can accurately identify the features that result in outperformance, thus making fundamental analysis more efficient.

Currency volatility

Being a South African investor deploying capital offshore introduces two layers of currency risk in our portfolios, one at the portfolio level and one at the investee company's operational level.

At the portfolio level, the decision to use the entire 30% offshore limit is very much determined by the level and volatility of the rand. This decision becomes even more complicated given a significant portion of JSE-listed companies are already rand hedges in themselves. Our approach has been to limit the overall sensitivity of the portfolio to movements in any one factor, particularly the rand. We stress-test the portfolio to currency moves (e.g. euro, US dollar and Japanese yen), to minimise underperformance to acceptable limits.

The second layer of currency volatility is at the investee company's operational level as currency movements will impact the investee company's earnings. In many instances we encounter currency volatility at the company level when we are investing in, say, export-orientated companies. Japanese stocks, for example, are often significantly impacted by yen strength, experiencing depressed share prices when the yen is strong. Typically, the yen is a "safe haven" asset and tends to strengthen in times of global stress which is negative for an exporting company's earnings. This necessitates that when investing in Japanese stocks, consideration needs to be given to the global risk environment. This implies that when deploying cash into Japanese companies, one must ensure that they invest when the global risk regime is also in line with the company's operations. Regime analysis is an example of a machine learning technique that we use in our integrated equity investment process where fundamental analysis is implemented in concert with machine learning techniques.

High transaction costs

Higher transaction costs are unavoidable when it comes to global investing. These costs emanate from the higher implementation costs associated with trading various currencies and the nuances of differing geographies.

Typically, trading currencies can cost up to 8bps per trade. The cost to trade the equity itself is a further 10bps in the currency of that particular bourse. So, when purchasing a US dollar-denominated equity, the brokerage fee of 10bps is on the dollar value of that particular counter, which when converted to rand is about 18 times higher in a rand-denominated portfolio. These costs unfortunately can only be controlled by keeping trading to a minimum and ensuring that, when a decision is made to make a purchase, there is sufficient return to compensate for the elevated brokerage cost.

It has also been the case recently, that we have had to purchase promissory notes (mandate allowing) as opposed to the direct equity holding as a result of regulatory requirements in certain markets. Promissory notes tend to attract a higher brokerage fee as opposed to buying the underlying equity.

Overcoming the three key challenges to global investing

Global investing has many advantages, but the risks and challenges cannot be overlooked. Of particular importance, in our view, are issues of dimensionality, currency volatility and high transaction costs. Insofar as we are able to, we mitigate the effects of these factors through our distinctive investment process which integrates bottom-up fundamental analysis with quantitative risk management. In this way we are able to ensure that our clients are being adequately rewarded to endure the risks and challenges presented by offshore investing.

Glacier Research would like to thank Olwethu Notshe for his contribution to this week's Funds on Friday.

Olwethu Notshe, Portfolio Manager at Sentio

Olwethu is a CFA charterholder, he joined Sentio in 2011 as a portfolio manager. Prior to his current role, his experience in financial markets was gained at Coronation Fund Managers and Jacques Malan Consultants and Actuaries. Olwethu is an aviation enthusiast and licenced to fly a Sling II and Cessna 172 aircraft. He is also fluent in Mandarin and most of the official South African languages.