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Integrated decisions that impact investment returns

Authors: Brian Thomas and Omri Thomas, Portfolio Managers of Amplify mandates

Introduction

With developed market equities overvalued, emerging markets offer relative value, especially South Africa. With this relative value and the attractiveness of the real yield from South African 10-year bonds, South African fund managers are considering the array of opportunities presented by additional offshore allocations facilitated by recent exchange control adjustments.

However, they are also aware of the need to factor in any unexpected consequences of this relaxation that may impact their investment strategies.

Asset managers, previously restricted to no more than 30% of their portfolio offshore and a further 10% in Africa, can now invest 45% of their funds in total outside of South Africa's borders. This creates opportunities and widens the investment universe, says Omri Thomas.

"The ability to invest just under half of funds offshore opens up the international market and gives asset managers in South Africa additional scope," says Brian Thomas. "The big issue we are grappling with as the fund management industry is what to do with the extra allocation."

Decisions, decisions, decisions…

Decisions in this regard have been rendered less pressing by the strong performance and returns of local investments, and this is evidenced by the lack of aggressive movement to increase offshore allocations since the amendment was published in February's Budget. "South Africa for the minute, looks like a more attractive destination for investment than the rest of the globe. We have a neatly hedged JSE at the moment, with some great performance that's come through in this time of turmoil since the crisis in Ukraine, by a number of diverse stocks, whether they are diversified miners, or the likes of Sasol, that have continued to offer great returns to investors," he says.

"No one has taken the bull by the horns and shifted yet – although that doesn't mean that won't happen as other markets devalue and so become more attractively valued."

"Increased offshore allocations will have consequences for businesses that dance to the heartbeat of what's going on in South Africa – and the music to that heartbeat is the capital that asset managers like us put in to generate returns," he says. "There will be some diversion of capital, and we think capital will flow to the choice that exists outside the country, which could have consequences for the capital-raising ability of South African companies. Also, when buying assets abroad, as you have to sell rand and buy dollars, there could be rand effects over time."

Another consequence is that the potential for the spectrum of returns to widen is going to be increasingly immense. For example, if you are going to the 45% maximum in your fund and there is rand volatility, this could result in a large dispersion of returns within the various ASISA fund categories.

In both the multi-asset flexible and high equity ASISA fund categories, asset allocation is a big element of return. Omri Thomas says that in South African equity portfolios, there is some element of natural correlation between managers. "Everyone has a few Naspers, or FirstRand", he says, "but now the differentiation between equity selection and sector exposure will further amplify volatility and variance between fund returns."

It will also be of some interest to see if some local managers get replaced on the offshore equity component when it comprises an increasingly large percentage of a portfolio. "There is some misperception that you can't pick global stocks while sitting in Cape Town, but we have proven that you can. It all depends on the investment philosophy and process," says Omri Thomas.

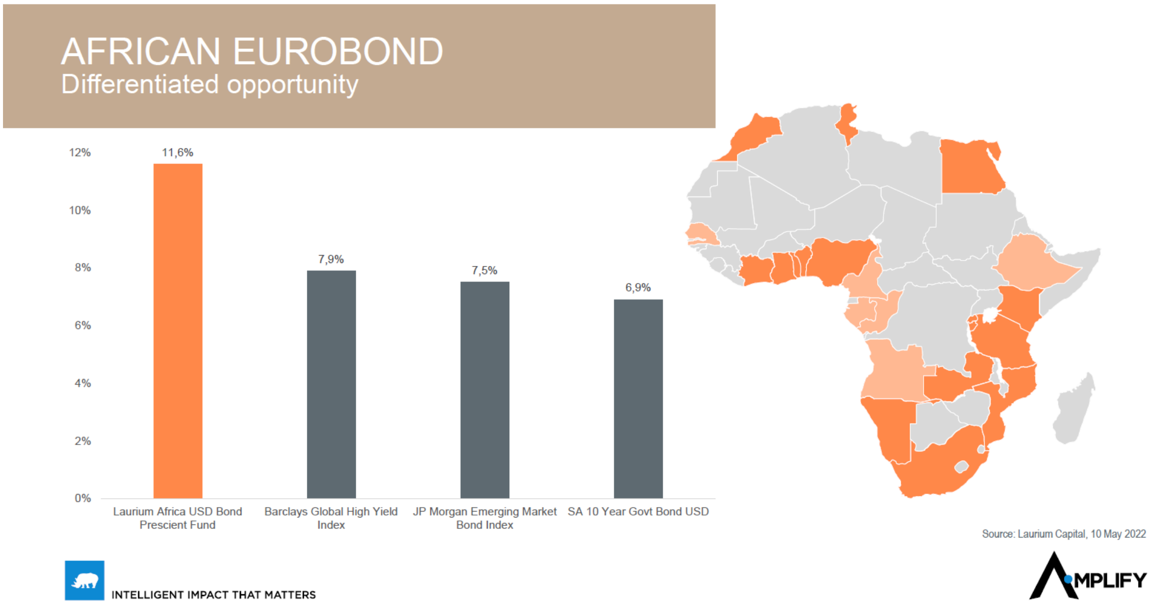
From a multi-asset perspective, it depends very much on the way asset allocators work – if they are using a building block approach – a South African manager for South African equities and offshore manager for offshore investments – or an integrated global and local team, says Brian Thomas.

"Having an intelligent integrated approach and global reach enables entities like ours to make cross sectoral choices. Funds that have plug-and-play solutions for offshore building blocks – where they rely on an outside manager – may be disadvantaged as it is difficult to have interplay in your funds. An integrated approach is advantageous to the portfolio performance going forward."

Integrated managers are more likely to provide better returns as offshore opportunities continue to open up. "Many big investment houses outsource the offshore component, which may even sit in a different country. In a non-boutique house, the team responsible for global assets don't necessarily take consideration of assets in the South African fund. At boutique managers, we don't work in silos, so we can ensure the portfolio is optimally positioned. This plays to our advantage."

Brian Thomas points out that the Amplify SCI* Balanced Fund has for some time been pretty much fully invested in offshore equities and fixed income, and added onto that some exposure to individual African equities, which it was allowed to do within the 10% allocation. More recently, African Eurobonds (African sovereign USD debt) were added, through Laurium's Africa Bond Fund "to bring our effective dollar exposure higher, because we are able to use our extra ability in Africa and expertise in equities and fixed income. The Fund invests in dollar-based assets currently yielding 8% in dollars and are sovereign backed with low default rates".

Figure 1: Opportunity in Africa



"We believe we have a competitive competency in investing in Africa," he says, adding that boutique managers with skills in investment in Africa and globally have the ability to use these skills to generate meaningful returns and reduce risk by diversifying into asset classes that have low correlation, especially those in South Africa.

Over time, results have proven that high investment returns can be achieved from anywhere in the world and that performance depends more on one's investment philosophy, process and the type of companies that you invest in, says Omri Thomas.

Bringing it home

With boutique managers, "we are all sitting around the same table and are able to look each other in the eye every morning and talk about what's going on. In this way you ensure your portfolios are properly integrated and pro-actively managed".

The Amplify SCI* Flexible Equity Fund, managed by Omri Thomas, seeks maximum capital growth with two thirds of the upside and a third of the downside of the local equity market. It is not constrained by Regulation 28 and utilises special instruments to achieve an asymmetric return profile.

Brain Thomas manages the Amplify SCI* Balanced Fund that has a strategy to deliver long-term capital growth through strong upside capture of the market. It is constrained by Regulation 28 (maximum 75% equity exposure) and he runs the portfolio as aggressively as possible to ensure maximum savings growth which is ideal for long-term investors, especially in pre-retirement savings. It utilises additional asset classes (such as Africa equities and bonds, in which it has specific expertise) to diversify and achieve as much upside capture as possible.

Local equities and bonds are currently providing fund managers with the ability to generate superior investment returns and remain the preferred investment destination. With the relaxation of exchange controls, agile boutique managers are in a relatively better position than large managers to manage the diversion of capital, widening returns, rand volatility and other unintended consequences of increased offshore allocations.

Agile boutique investment managers continue to demonstrate their ability to make integrated decisions and quickly adapt to changing market conditions to provide meaningful investment growth.

Glacier Research would like to thank Brian Thomas & Omri Thomas for their contribution to this week's *Funds on Friday*

Brian Thomas

Portfolio Manager, Laurium Capital

Prior to joining Laurium Capital in September 2017 as a retail analyst and co-portfolio manager of the Amplify SCI* Balanced Fund, Brian was the lead international client services fund manager at Coronation Asset Management. Brian spent five years as the managing director of the Central European, Middle East and Africa (CEMEA) equity sales desk for Deutsche Bank in London, a position he took after eight years in equity sales at Deutsche Securities in Johannesburg.

Omri Thomas

Portfolio Manager, ABAX Investments

Omri Thomas manages the Amplify SCI* Flexible Equity Fund and has 20 years of investment experience. He joined Abax in 2007 as an investment manager.

Prior to joining Abax, Omri was the chief investment officer at Sanlam Investment Management, where he worked from 2003 to 2007. From 1998 to 2003, Omri was an investment analyst at Old Mutual Investment Group.