What to know to invest offshore with confidence

As we move towards the end of the first quarter of 2021, it seems timeous to review the state of the local investing landscape and the extent to which markets have reciprocated the hope with which many market participants would have started the new year. After an incredibly eventful 2020, the global investing environment has become a precarious one. In the aftermath of the pandemic, economies around the world are in a fragile state, with recent delays in vaccine distribution prolonging the agony of many businesses with ties to the traditional economic system. With this in mind, Dean de Nysschen, Senior Research and Investment Analyst at Glacier, discusses some important considerations when investing offshore.

Home and away

Considering that the effects of COVID-19 have in many ways been exacerbated in developing economies with stronger dependencies on debt funding and consumer expenditure, it may come as a surprise that the local market has returned in excess of 15% year-to-date (performance as at 10 March 2021). As the local market receives macroeconomic tailwinds in the form of a supportive commodity cycle, as well as having come off a low base after the sharp COVID-19 repricing, it’s a good time to review the longer-term return prospects of the local market, relative to offshore markets.

With the ALSI Index currently trading at 26 times earnings (more than three standard deviations above the historical mean valuation), the market seems optically expensive. Importantly, however, these valuations have largely been driven by selective large-cap stocks and forward earnings multiples look appealing (although this measure would be dependent on your forecast for future earnings, consensus views have forward multiples trading at a sharp discount to the historical mean). Global equity markets, on the other hand (the US in particular), have delivered surprisingly strong returns for a number of years and this includes the tumultuous 2020. Consequently, these markets have much fuller valuations than local markets currently (for example, forward earnings multiples are well in excess of 20 times on the S&P500).

Why investors go global

Despite the above, recent ASISA statistics clearly indicate that investors are increasingly favouring a more global-oriented approach to portfolio construction. Not only have global funds more than doubled their share of the local collective investment scheme (CIS) industry in the last ten years, but they have also increased their AUM levels six-fold over this period. Interestingly, of the flows going into global funds, the majority have gone into equity-oriented strategies. Perhaps this is unsurprising given the incredibly strong returns that the NASDAQ index has delivered in recent years. Global equity funds have in fact experienced a nine-fold increase in asset size over the last ten years. The question many readers would be asking, is whether this trending change in capital allocation makes sense given the valuation dynamic mentioned above and given the encouraging returns that the local market has delivered so far this year. Unfortunately, high-level market valuation does not necessarily tell the full story at present, with returns potential largely dispersed from sector to sector, and dependent on earnings growth prospects of the underlying ALSI constituents. Clearly, recent local returns do not reconcile with what investors have experienced on a longer-term basis, where local equities have underperformed cash on a rolling five-year basis. In addition, the local universe has been shrinking steadily over time – with the universe 43% smaller than it was 20 years ago. As a result, local fund managers are chasing returns with less market breadth to work with and an increasing dependency on consistent stock selection skill. Investors are well-versed with the bleak economic outlook locally, very much hinging on whether structural reforms can be implemented timeously by the current political dispensation. These developments will be instrumental in cultivating a suitable environment for the earnings growth potential of companies, which we mention above.

Size (of the investable universe) matters

It may seem that even though shorter term trends may be supportive for local return expectations, longer term structural factors in many ways justify the wave of assets that have flowed off local shores in recent years. This serves as an important reminder, that investors should be mindful to distinguish between the valuation outlook for local assets and an appropriate strategic weighting of said assets within a well-diversified portfolio. A helpful anecdote to explore at this point is the phenomenon of homeward bias. This refers to the extent to which local investors default to investing in more familiar local markets, rather than utilising the enhanced opportunity set available via global markets. A recent study by Nedgroup Investments showed that on average, homeward currency bias in South Africa is as high as 129 times, which can be compared to 26 times in Australia, 6 in the UK and just 1.2 times in the US. Clearly, this is largely driven by the fact that the local market makes up such a small weighting of the global investable universe (less than 1%), but there is certainly a strong case to be made, that from a strategic point of view, local investors remain disproportionately exposed to local markets, relative to their global peers.

What to consider before investing abroad

An important question then becomes: what could the best avenue be for local investors to access offshore markets? The abovementioned ASISA figures are in reference to locally domiciled CIS's, and in the past, we have explored the key differences in accessing offshore markets via feeder funds, relative to externalising and investing directly in foreign currency. Further to this decision, however, there are many vehicles which investors can consider using to access global markets either directly or in rands. A worthwhile example to discuss is the endowment structure. We specifically highlight this vehicle as a myriad of potential benefits are often overlooked by investors, including material tax efficiencies over the lifetime of the investment. Investors making use of the Glacier platform, who have the desire to invest directly offshore, can do so either via LISP (linked investment service provider) solutions (such as the Glacier Offshore Investment Plan), or through the Life wrapper, where clients can harness the benefits of the endowment structure through the Global Life Plan.

1. Tax efficiency

In terms of tax characteristics, endowments have a tax rate of 30%, thus carrying capital gains tax (CGT) of 12% and significant benefits for individuals who are in higher income tax brackets. The Global Life Plan also removes any tax reporting liability, as tax on the solution is paid by the insurer. This contrasts with the LISP investment, for which personal tax rates would be applicable, and where CGT would be applied based on personal rates and the foreign currency gains of the investment. In addition, investors would be required to report any gains on their tax returns. From a trust perspective, when the entity has natural beneficiaries, they invest in an individual policyholder fund with CGT at 12% through the Global Life Plan. Under normal circumstances, the trust pays CGT at 36% or if the proceeds are passed through to the trust, the beneficiary's effective CGT rate is triggered.

2. Estate planning efficiency

The Global Life Plan also presents estate planning efficiency, as you can nominate beneficiaries for ownership of the wrapper or its proceeds. Furthermore, ownership transfer to beneficiaries will not trigger CGT, nor will they have to wait for the estate to be wound up before accessing liquidity after death. In addition, there is no requirement for an offshore will, handling of foreign inheritance tax or foreign probate. Executor fees are also not applicable where beneficiaries are nominated. Once again, this is in contrast to a conventional LISP investment, where beneficiaries aren't nominated, and administration is dealt with by the local executor (fees will be applicable here). There are also benefits when it comes to the opportunity set, with the Global Life Plan offering a wide investment universe. This includes a broad selection of global unit trust funds, model portfolios, exchange traded funds (ETFs), stockbroking and structured notes. There is also further access to guided investment solutions such as the Navigate Optimised Portfolio range, although these solutions would also be available through the LISP, via the Offshore Investment Plan.

3. Insolvency protection

Finally, endowments such as the Global Life Plan provide creditor protection benefits after three years, whereas a platform investment has no insolvency protection.

Consider offshore investing carefully

An investment in global markets is not a decision to be taken lightly. Not only does the current economic climate present significant challenges to capital allocators around the world, but investors need to look beyond what current market valuations may suggest. It remains critical to reconcile portfolio construction decisions with the investor’s strategic asset allocation requirements. Naturally, the investor’s financial planning goals will inform these decisions. Importantly, however, selecting the appropriate investment vehicle will play an integral role in increasing the probability that an investor’s unique objectives are sufficiently met. It’s prudent to appoint a qualified, appropriately authorised financial adviser to help you make decisions regarding your investments, including offshore solutions.

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