



24 May 2019
Volume 1006

How to make more money offshore

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Humans are genetically and biologically programmed to identify risks – it's part of the reason we've been such a successful species. But our skill of scouring for danger can be problematic. In a world where you can sit in the comfort of your home and feel threatened through digital devices, it is all too easy for us to become overwhelmed by risk that either doesn't exist or isn't relevant to us. Very few of us have a consciousness awareness of how humans tend to sensationalise negative news and extrapolate it into worst case scenarios.

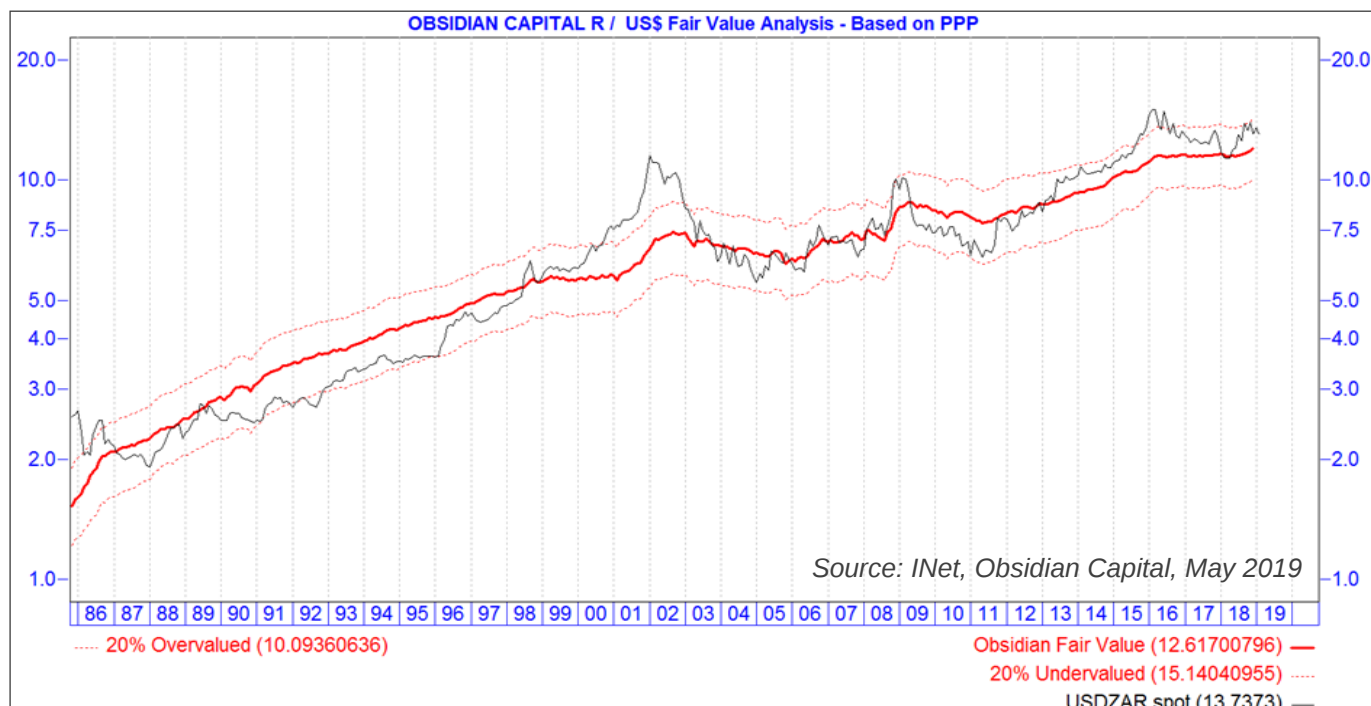
This dynamic is powerful in South Africa. We've all had emigration moments, whether fantastical or not. The message of this piece is that building an offshore investment portfolio should be done based on the attractiveness of the investment opportunity, not on our prevailing emotions about our topsy-turvy economy.

Currency movements on their own can make or break the returns of our offshore investments; just ask anyone who converted rands to pounds at R19.85 in 2001 (still out the money) or at R24.50 in early 2016 (still very out the money). Below we'll explore four variables that you can use to help avoid losses when investing offshore. The first leg of any offshore investment is to exchange your ZAR for another currency. We begin there.

1. Currency valuation

Like any asset, you want to buy offshore currency when it's cheap. And the only way to value currencies, in our opinion, is using purchasing power parity (PPP) analysis. This simply looks at the inflation rates of the two countries in question and spits out a fair value of the exchange rate based on the inflation rate differential. If the difference in inflation figures is say 3%, then the country with the higher inflation number is predicted to weaken by 3% per annum (against the currency with lower inflation) according to PPP analysis.

This concept is best illustrated visually. Below we have the fair value (bold red) of the rand/dollar exchange rate. It is upward sloping (indicating a depreciating rand over time) because South Africa has a structurally higher inflation rate than the US.



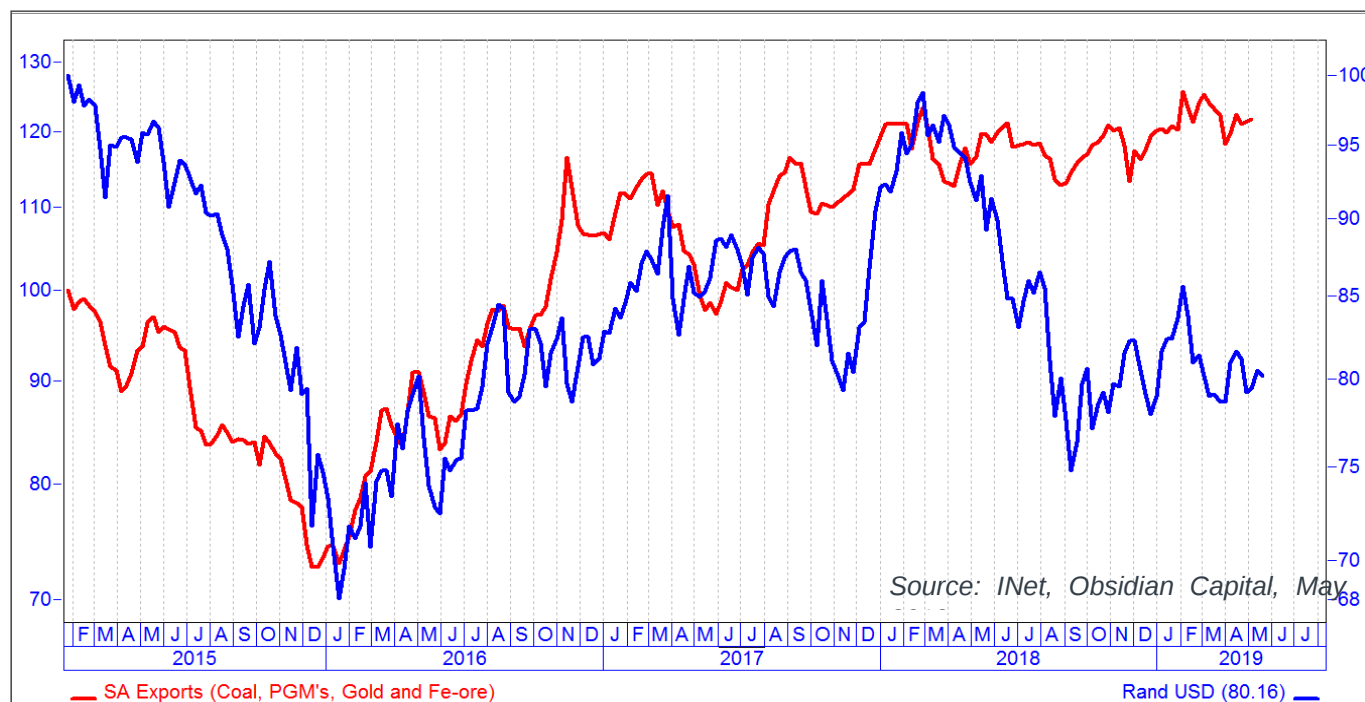
The thin black line is the actual exchange rate, and as you can see, it hardly ever trades at fair value. How then should you use this chart in deciding when to take money offshore?

Quite simple really. When the black line is above the fair value the rand is cheap and you should be circumspect about taking money offshore. The higher it climbs, the more careful you need to be because the risk of future rand strength is increasing. The reverse also holds true: the further the black line falls below fair value (red line), the more expensive the rand is becoming and the heavier your hand can be when externalising your clients' funds. The difficulty here is that our emotions will be telling us to do exactly the opposite, particularly at the extremes when the rand is either very overvalued (yes, it happens!) or very undervalued.

2. Commodity prices

PPP analysis is useful provided the country in question doesn't lose control of their inflation. However, its weakness is that currencies can take years to mean revert to fair value. So, while it's a great starting point, we need a fuller picture to further improve the probability that we're taking money offshore at the right time.

Luckily, we have a very dependable variable that influences the rand in the short- to medium-term that we can weave into our decision making – the prices of the commodities that South Africa exports. By name, these are gold, the PGM basket, coal, and iron ore. If the prices of these metals rise, it usually translates into a stronger rand. The bad news is that commodity prices can be volatile and difficult to predict. But first, let's look at the strength of the relationship:



We've drawn this short-term graph so you can see just how reactionary the rand is to the price movement of our commodity export basket. A similar relationship is visible in the long run. To get a grip on where commodity prices are headed, we look at the following: 1) Global Growth – if accelerating, commodity prices will usually find support; 2) Valuation of the US dollar – an expensive greenback means there is more chance of it depreciating, another boon for commodity prices; 3) Producer Margins and Capex – relatively low producer margins (think Anglo, BHP, Vale, etc.) means they will be careful about investing capital to increase supply. This in turn keeps the market tight and provides an underpin for prices.

3. Direction of other emerging market currencies

Many other emerging market (EM) currencies are driven by forces similar to those that drive the rand. So, when we're forming a directional view of our currency, it helps to look at the behaviour of other EM currencies. This is particularly useful when you have political 'excitement' that can *temporarily* derail a currency from its fundamental drivers. We emphasise the word temporary because, in our experience, currencies nearly always reconnect with their drivers when the political hullabaloo inevitably quietens. This is therefore a great tool to discount the emotion that comes with country-specific political risk.

How does this bit of analysis work in practice? Well, if we think we've just entered a sustained period of rand weakness – and we're toying with the idea of moving money offshore as a result – we'd consult other emerging market currencies. Our investigation would focus on whether there is evidence of sustained weakness in their currencies and whether the drivers of those currencies have also turned negative.

For a great example of this dynamic, consider the below graph. In red we have the Brazilian real/dollar exchange rate, and in blue the rand/dollar pairing.

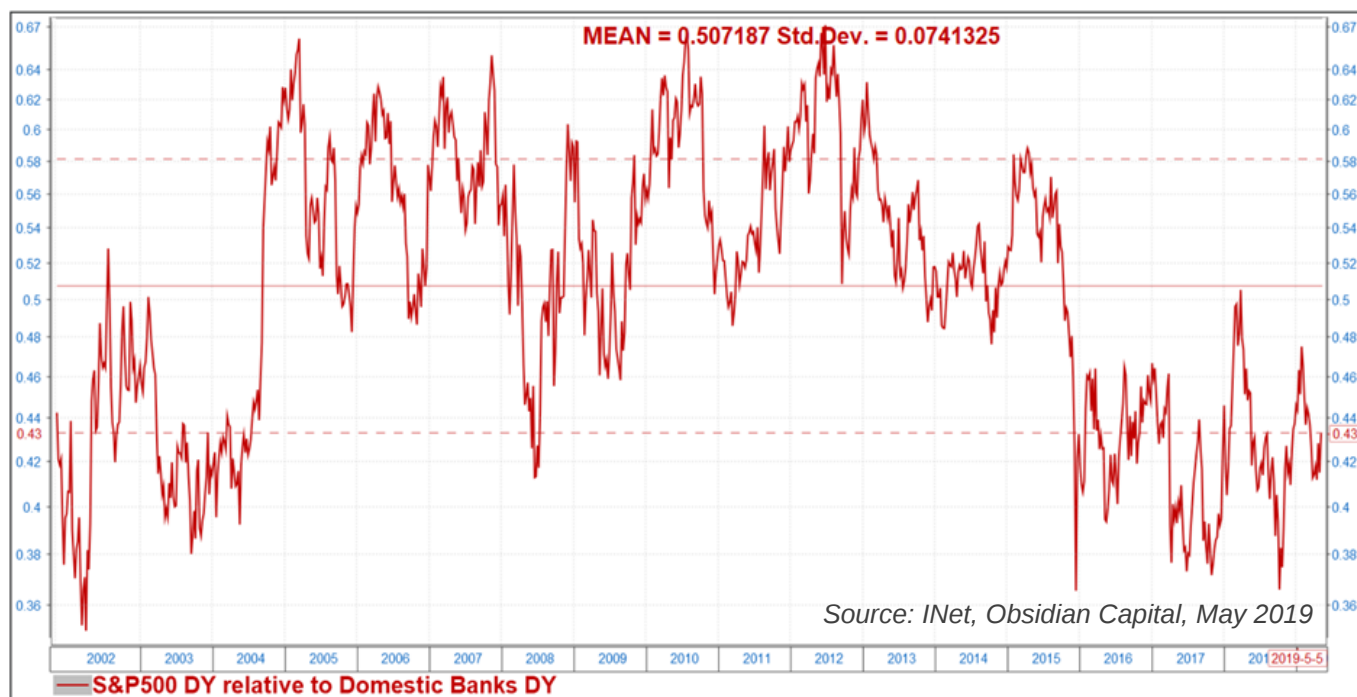


During the well-extolled Ramaphoria period, straddling the end of 2017 and start of 2018, the rand strengthened meaningfully. It would have been tempting to say that his victory had ushered in a period of rand strength. But if you consulted the behaviour of, for example, the Brazilian real, a currency very well correlated to ours, it may have tempered your view. In this case, the bigger forces hurting the Brazilian real (and other EM currencies at the time) shortly overcame the rand's politically inspired rally. Political outcomes can cause sharp, short-term currency fluctuations, but they are hardly ever responsible for establishing a multi-year trend.

4. Relative valuations and growth

If you are taking money offshore to invest in anything other than cash, then the valuation and growth of the asset class into which you are considering an investment should also be considered. For most investors, this would mean comparing the equity valuations and growth of the desired offshore market with those of your domestic equity market. We prefer to use dividends to gauge valuation and growth as this removes the inconsistencies often inherent in reported earnings due to differing accounting standards (GAAP vs IFRS).

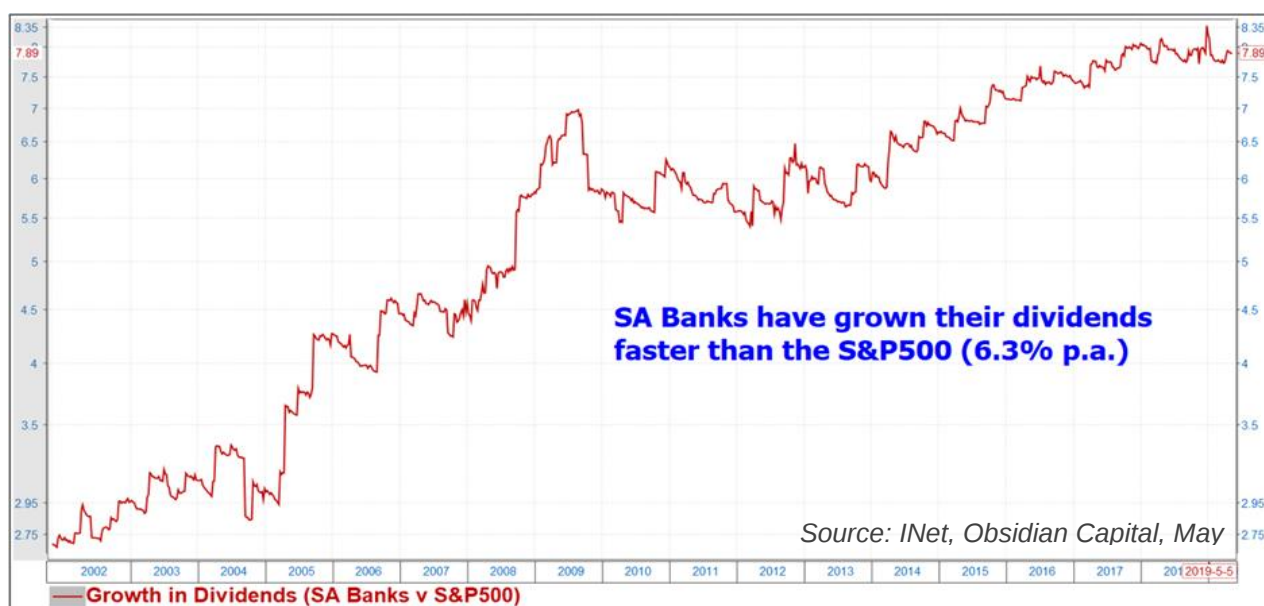
Starting with a relative yield analysis, we plot the dividend yield of SA banks (as a proxy for our domestic equity) relative to the dividend yield of the S&P500 (a potential offshore market you may want to invest in). The lower the red line trends, the cheaper domestic equity is, relative to the S&P500.



As a demonstration of how to use this chart, we would be hesitant to sell our SA banks in favour of the S&P500 at the current point in time. The latest figure of 0.43 means that US equities are offering less than half the yield of our domestic equity. If the red line were to move higher, SA domestic equity would be outperforming the S&P500. Of course, if this happened, S&P500 equity would start to look better from a valuation perspective.

But remember that yield is only half the story. It is imperative to also consult the relative growth of the earnings and dividends in the competing equity markets. This helps to put the yield into context as growth can more than compensate for a difference in yield from a total investment return standpoint.

In the chart below, an upward trending line means that SA banks are growing their dividends faster than S&P500 dividends. The line has, however, flattened in recent years so it looks like a neutral outcome at present. For interest's sake, we think there are more headwinds for S&P500 earnings going forward than for SA banks, which should see the red line resume its trend higher. The sweet spot for investments, on a relative basis, is relative undervaluation coupled with superior relative growth.



To recap

Deciding to take money offshore must be done in consultation with the merits of the investment appeal, not based on the often-irrational fear of an SA apocalypse. Four useful and fundamental factors to consult are:

1. the valuation of the rand on a PPP basis against the offshore currency you are thinking of buying
2. the outlook for the prices of the commodities that South Africa exports
3. the behaviour of other EM currencies with similar drivers to the rand (Brazil is probably your best indicator)
4. the valuation and growth of the offshore asset you're considering, *relative* to the valuations and growth of the assets in your domestic market.

Pulling all these together can help you make an informed decision about whether it's a good time to take money offshore. And, in the process, add value in periods where it is often destroyed.

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



Warren Kelly

Warren graduated from UCT with a B.Bus.Sci in Finance. His early career experience was as a business analyst in the FMCG and hospitality industries where he focussed on improving company profitability. He joined Obsidian Capital in March 2014. Warren heads up Obsidian's business development and marketing function, part of which involves providing a window into the thinking of the investment team. Warren is married, has two children, enjoys running, reading, and travelling, and is increasingly drawn to the study of human psychology.