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2011: TIME TO DIVERSIFY OFFSHORE

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A strong chance that the rand will depreciate, the logic of diversification and attractive relative valuations offshore all indicate that now is a good time to increase your international equity exposure. In fact, as reflected in our newly-updated asset class view (see below), we believe that it will be the best-performing asset class in real terms over the next five years.

Long-Term Asset Allocation View
(Expected return over next five years.)

Asset Class	Real Return	View	Comment
SA		N-	Rand is becoming overvalued.
Equity	6.0%	N+	Full value on an absolute basis but still attractive relative. Grind higher.
Property	5.5%	N	Expected return continues to fall.
Bonds	2.5%	N	Limited potential for capital gains but attractive carry vs cash.
Cash	1.5%	–	Lower rates for longer means lower returns.
International*		N+	Diversification is valuable.
Equity	6.5%	+	Preferred asset class for 2011.
Bonds	1.0%	–	Longer-term bearish.
Cash	0.0%	–	Cash is still unattractive.

* The international return expectations above are in US dollar terms, any rand depreciation will add to these returns in rand terms.

In December, exchange control was further relaxed to allow investors to increase their offshore holdings. The timing of this relaxation could not have been better and investors in active asset allocation funds would likely already have had their offshore exposure increased by their fund managers. For instance, at MSI we have already taken advantage of the strong rand over the New Year period to increase offshore equity in the institutional funds we manage to 25%, which is the new limit for retirement funds.

If your risk tolerance allows, and you do not yet have maximum exposure, there are some compelling reasons to consider topping it up this year.

Diversification

First there are the obvious benefits of diversification – such as reduced risk and exposure to fast-growing companies and industries not available in South Africa (SA). Our detailed historic analysis shows that an optimal portfolio for an SA investor would hold more than 35% in international assets in order to capture these benefits. At the same time, local equity volatility is 30% higher than that of international equity, which means that investing abroad improves the risk efficiency of the portfolio.

Valuations

Looking at valuations, following 2010's exceptional performance by local equities (the FTSE/JSE SWIX gained 20.9% in rand terms and 34.5% in US dollar terms to be the best-performing major market in the world), the local equity market's previously relatively-attractive valuation has now been eroded. The current price:earnings (p:e) ratio of 17.2 times is high historically, and local companies will need strong earnings growth this year to produce good investor returns.

South African equities are no longer trading at a discount and therefore do not justify an overweight position. We are forecasting a real return of 6.0% per year over the next five years from SA equities, and 6.5% per year from international equities – both forecasts are marginally more conservative than our previous view which was returns of 6.5% and 7.0% respectively.

The rand

Our local currency was the third-strongest major currency in the world in 2010! While impressive, it also means that the real value of the rand is now expensive by historic measures. While the big global investment themes remain supportive of the rand this year, these themes are weakening. The table indicates factors that count for and against rand strength going forward.

For the rand	Against the rand
√ The global emerging markets (GEM) theme	× Gradual rate hikes elsewhere
√ Strong demand for commodities	× Possible slowdown in emerging market growth (particularly China)
√ Relatively-high local interest rates	× An upside surprise in US growth
√ The quest for yield	

So, where is opportunity?

The rand theme, relative equity valuations and the benefits of diversification all increase the appeal of offshore equity investments, but where in the world does opportunity lie? At MSI we think it may be beneficial to consider Japan and Africa – two markets that sit at the two extremes of the development spectrum, each with their own attraction.

Japan

Japan offers a contrarian trading opportunity – the equity market has experienced massive underperformance for years, and is currently trading at the same levels in real terms seen 30 years ago. Its shares are un-loved and under-owned, which is shown by the market's price:sales ratio of 0.6 times. We believe that Japan's previous headwinds have now turned to tailwinds, spurred by a better global growth environment and the potential of yen intervention. Given its cheap valuations, now could be a good time to buy.

Africa

Africa represents a longer-term opportunity for higher returns, albeit with higher risk. The continent is truly the last investment frontier, with good growth prospects but underdeveloped equity markets. With its large resource base, it offers a leveraged play on the emerging consumer – particularly through soft commodities like food.

Locally, equity likely to be top asset class

At MSI we favour local equity over property, bonds and cash, although our theme of a low-return world still applies and all asset classes will return less over the next five years than in the "naughties". This means investors need to save more in order to retire with adequate finances.

Given the market's relatively strong 2010 performance, we will see it "grind higher" in 2011. This will be driven by earnings growth, particularly from resources.

For more details on our current asset class outlook please refer to the commentary under Asset Class View at www.omigsa.com/msi.

For more information, visit www.omigsa.com/msi

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