INVESTMENT VIEWS

An integrated approach to multi-asset class funds

THE QUICK TAKE

Our clients' portfolios have benefited from the increase in offshore allowance to 45%

This success can be attributed to our integrated approach to portfolio management and a decades-long investment by the business in our global investment capabilities

The increased allowance amplifies the need for active asset allocation in order to avoid unintended exposure to risk

AS A FIRM dedicated to investment excellence, we have continuously evolved our investment process over time. Our proactive investment in our global capabilities more than a decade ago has ensured that our investment offering has not only kept pace but excelled as markets and regulations have evolved. This capability currently spans all the major asset classes and geographies globally, and it is underpinned by the same investment philosophy that has yielded long-term outperformance for our clients since our inception in 1993.

It's been two years since we saw the increase in allowable offshore investments for South African savers from what was effectively 30%[1] to the current 45%. We believe that the change has been a major positive for our clients. It has also served as a catalyst for profound change, both in terms of industry structure and the ways in which multi-asset class portfolios are managed.

Our portfolios have performed very well since the change, as they have benefitted from:

1. Implementing a fully integrated portfolio process that leverages both our global asset class capabilities and our active asset allocation skills.
2. Heavy investment over many years in our global investment and operational capabilities, which allowed us to adapt quickly and take full advantage of the opportunity provided.

[1] The average South African retirement fund had very low exposure to African assets prior to the announcement.

THE ROLE OF OFFSHORE ASSETS IN A RETIREMENT PORTFOLIO

Offshore assets play a critical role in a retirement fund portfolio. The range of sectors and securities that are available globally is an order of magnitude greater than those available in South Africa. For example:

- The MSCI All-Country World Investable Market Index[2] has over 9 000 constituents and a total market capitalisation of over $78tn. In contrast, the FTSE/JSE All Share Index has 122 constituents and a total market capitalisation of around $315bn, with the top 10 stocks accounting for around 50% of the index.
- The local credit market is narrow, with just under 100 issuers. This contrasts with deep global credit markets, which have thousands of issuers.

"Asset allocation is a critical, high-impact activity. It is the most important decision that one makes in investments."

Offshore exposure reduces the reliance of a retirement portfolio on the performance of a narrow universe of stocks and a single economy (SA represents 0.3% of global GDP). It increases the opportunity set, offering exposure to asset classes, sectors and economic drivers that are not present in South Africa, and it therefore provides the opportunity to build more diversified and robust portfolios.

Foreign exposure also protects the purchasing power of retirement savings when the rand depreciates, helping manage a key risk for any retired investor.

However, it's important to highlight that the decision on how much to allocate offshore is not a straightforward 'take as much as you can out of SA' decision. In periods of rand strength, exposure to offshore assets can negatively impact portfolio performance. Additionally, given South Africa's higher inflation rates relative to developed countries, the higher nominal yields on domestic assets must be considered carefully when making offshore allocation decisions.

Thus, although foreign assets are vital both as a source of investment opportunity and diversification, they do come with inherent risks, requiring careful consideration of how much foreign exposure is appropriate at any point in time.

FROM SCARCITY TO ABUNDANCE

In 1995, South African retirement funds were first allowed to include offshore exposure in their portfolios. While the limit at the time was a paltry 5%, this signalled the start of the liberalisation of exchange controls in the investment industry. Over the years we saw small, incremental increases in the offshore allowance.

The dramatic increase to 45% in 2022 represents a wholesale change for the industry. This means that managing funds cannot be approached as just 'business as usual':

- *The revised cap will require much more active asset allocation.*
- *It increases the need for genuinely integrated portfolios.*

ACTIVE ASSET ALLOCATION

Asset allocation is a critical, high-impact activity. It is the most important decision that one makes in investments. Even if a portfolio's individual asset classes deliver alpha, it will underperform if the manager gets the key asset allocation views wrong.

When the offshore cap was set below most managers' assessment of an optimal offshore allocation, offshore allocations tended to be fairly stable over time and each time exchange controls were relaxed, the industry simply increased offshore exposure to levels close to that limit.

We believe that the change in the offshore allowance has increased both the opportunity and the need for more active asset allocation. In the last two years, active asset allocation has contributed meaningfully to performance in our funds. We believe that more of this will be required in the future in what is likely to be a volatile and demanding market environment.

[2] The MSCI All-Country World Investable Market Index provides comprehensive coverage of global equity markets

Observations of the impact that the change will have on asset allocation include:

- The dispersion between managers' offshore allocations will vary more widely.
- When offshore capacity was scarce, global equities typically crowded out the other global asset classes. This should no longer be the case. Consequently, not only will the choice between local and offshore allocations have to be managed more actively, but also the offshore allocation between equities, bonds, credit, property, and the alternative asset classes. These allocations will then, in an iterative manner, impact the asset allocation decision for the local allocation to those same asset classes.
- The increased offshore allocation will require a more thoughtful management of the active currency position. The rand is a volatile currency. Dramatic swings will have an outsized impact on portfolio returns. But this is a complicated issue. Although many will be tempted to simply 'hedge' the rand to insulate the fund from the currency's volatility, this would expose the fund to risk. The rand is the release valve for South Africa's many structural challenges. Any fund that locks in the current exchange rate loses much of the value that the portfolio's diversification into offshore assets was aimed at achieving in the first place.

THE NEED FOR AN INTEGRATED APPROACH

Many multi-asset class funds in the industry have traditionally been managed with siloed strategies, with domestic and international assets managed independently, often by different portfolio managers. At lower offshore allocations, the risk of unintended outcomes was low.

When the offshore portion can amount to almost half the overall portfolio, those offshore building blocks can no longer just be bolted on to a domestic portfolio. If the portfolio is to be cohesive and robust, then a granular understanding of every security in the portfolio is required. The portfolio construction needs to happen in an iterative manner, where every security's weighting is impacted by the other holdings in the portfolio, with careful consideration of its impact on the positioning of the overall portfolio. This requires a wholesale change in the way in which these funds are managed.

Examples of the kind of opportunities that an integrated portfolio construction process provides include:

Enhanced returns

- *Real-time asset allocation changes*. The portfolio manager that manages an integrated multi-asset class portfolio fully understands the fund's aggregate real-time positioning and can execute changes to asset allocation in real time. This capability added significant alpha to our portfolios in both the global financial crisis and the covid pandemic, where equity markets broke records for the extent and speed with which they fell, only to rally explosively within a few days of reaching their bottom. This capability is acutely needed today because multi-asset class fund benchmarks rebalance daily (i.e. the benchmark is buying/selling every asset class every day).
- *In the gap assets*. In 2022 SA government-issued dollar bonds traded at a 300 bps spread to rand-issued bonds (once hedged back into rands). Our funds switched the latter into the former until spreads narrowed to more normal levels.
- *Outsized allocation to attractively priced assets*. In 2022 global credit bonds sold off as the underlying government bonds collapsed and credit spreads widened. We built a big position, which we still hold (currently 10% of the house balanced funds). The big position size reflected our view that these holdings offer risk adjusted returns that stacked up well against equities. This kind of allocation would not be easy to make in a more siloed, building-block process.

Improved risk management

- *Holistic risk management*. In an integrated portfolio, portfolio risk can be understood and managed in a far more holistic manner. Good examples include:
    - SA sovereign risk. Although SA government bonds trade at historically high yields, we are concerned that the sovereign is over-indebted and that this debt burden will become unserviceable. Because global credit bonds offered similar rand yields, we were able

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to switch our sovereign bonds into a well-diversified basket of global credit that we thought came with much lower risk.

- Risk exposures. Our in-depth, company-specific research allows us to understand the economic drivers of each security in our portfolios. This involves going beyond superficial metrics like country of listing or domicile to truly understand a company's drivers. Modern multinational corporations often derive revenues and incur costs in multiple countries as a result of globalised supply chains. This complexity requires us to evaluate the true economic drivers of each business to effectively manage portfolio risk. By doing so, we can uncover and address risks that are not immediately obvious.

"Over 25 years, we have built out a fund range that covers all the key global asset classes and geographies."

- *Unintended exposures.* After a brutal few years for Chinese assets, we think that many high-quality Chinese stocks are extremely attractively priced. We have bought Naspers in our SA equity funds. We have noted that some global managers (both global equity and emerging markets) are buying Chinese assets. In a building block process, this could result in an overall portfolio that has unintended and excessive exposure to China. Conversely, in an integrated fund we can manage the fund's overall Chinese exposure and ensure that the most attractively priced stocks are held in the portfolio (instead of those that automatically come through the building blocks).
- *Better management of idiosyncratic risk.* In 2022 and early 2023 we believed that the oil price was depressed and that oil stocks offered value. The only oil stock listed on the JSE is Sasol, a company that is existentially challenged by its need to materially reduce its emissions. In our integrated funds we were able to switch the Sasol position out for global oil stocks that were more attractively priced and carried much less risk.

Efficient use of offshore capacity

- *Some global stocks are listed on the JSE.* Some of these (like Richemont, BHP and Prosus) are often held in offshore building blocks. In cases where these stocks are held by our global team in their offshore funds, we can elect to hold them with our local capacity. This frees up offshore capacity to be used more efficiently.

THE NECESSARY RESOURCES

It's important to highlight that very few managers have the scale and resources needed to manage genuinely integrated global portfolios. Coronation is able to do this only because:

- Over 25 years, we have built out a fund range that covers all the key global asset classes and geographies. Across these funds we have delivered meaningful outperformance over the long-term. Delivery over long time periods sets us apart from those with a standing start.
- We have been able to build out a global team with critical mass and with the research intensity and discipline needed to deliver. This team has more than 25 analysts, many of whom have been investing in global assets for 15 years.
- We have invested in the administration, compliance and IT systems needed to run truly integrated global portfolios.

LOOKING FORWARD

We are excited to be managing integrated global portfolios. The first two years have been very rewarding, both professionally for ourselves and for our clients' portfolios. None of us know what the future holds, but we believe that the full toolset that our integrated capability provides positions us well to add value for our clients in the years ahead. +

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