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Local vs Offshore Investing: The Risks



According to the South African Reserve Bank (Sarb), load shedding is here to stay.

The central bank expects load shedding to increase from 157 days in 2022 to 250 days in 2023. It estimates that this will increase inflation by around 1.1% annually. As the country's rate of inflation is already among the highest in the world, many South Africans are currently wondering: "Is it time for my savings to go abroad?"

The debate surrounding offshore investing is by no means unique to South Africa. In a survey conducted by Charles Schwab, the company found that Americans invest 85% of their portfolios in domestic equities. German and Japanese investors also largely preferred domestic assets. In fact, most investors exhibit what is known as a home bias (also called the familiarity bias). This describes the tendency for investors to allocate most of their portfolio to domestic assets. Some exhibit this bias due to concerns regarding transaction costs or legal restrictions, while others simply prefer to stick with what they know. There are also additional risks to consider.

The risks of offshore investing

Investing in foreign assets exposes the investor's portfolio to foreign exchange risk. This is the risk of loss due to currency fluctuations. An example is in order. If you bought bank BLOM shares for 100 Lebanese pounds (LBP) at the start of the year, they would be worth 130 LBP today. A fantastic return of 30% in only five months. The only issue is that the value of the Lebanese pound declined by around 90% against the rand during the same period. This results in a loss on the investment of roughly 87%. The rand's decline of about 7% against the US dollar during the same period seems quite rosy by comparison. There are also foreign exchange controls to consider.

While there are no limits on the amount of money one could invest in domestic assets, the same cannot be said for foreign assets. South African citizens are restricted by the Sarb's exchange control regulations. Under these restrictions, citizens over the age of 18 have two types of foreign currency allowances. The first is a Single Discretionary Allowance of up to R1 million a year and the second is your Foreign Investment Allowance (often referred to as the Capital Allowance) of up to R10 million a year. This may limit an investor's ability to rebalance their portfolio, likely reducing the return of the portfolio.

Investing domestically is not without its risks, however.

The risks of investing domestically

The main issue that arises due to over-investing in domestic assets is a lack of diversification. If your portfolio only contains South African assets, then the value of your portfolio will be tied primarily to the performance of the South African economy. As the JSE makes up less than 3% of the global equity market, this is the investment equivalent of putting all your chips on 0 in roulette.

Diversification reduces risk by allocating investments among various asset classes, industries, and geographic regions. Combining investments, which are not correlated to each other, will reduce the risk of the entire portfolio. Simply put, we reduce the impact of a single factor by introducing more factors into the mix. But how could introducing additional risk into a portfolio reduce the portfolio's risk? This is due to correlation.

Perfect correlation means that 100% of the time, the variables in question move together by the exact same percentage and direction. If all risk factors were perfectly correlated the process of diversifying your portfolio would be a zero-sum

game. A gain on one investment would exactly equal the loss on another investment. Luckily for us all this is not the case. In practice, the correlations between risk factors are far from perfect. This effectively allows investors to combine various volatile investments into a less volatile portfolio than the sum of its parts. The concept also holds when investing in foreign assets. By combining various country-specific risks we can effectively reduce our portfolio's exposure to those risks.



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Rynhard recently joined Global & Local as a technical analyst.

Rynhard holds a BCom Honours degree in Economics with Risk Management. He has passed the SAIFM registered person exams, as well as the level 3 CFA exam.

His hobbies include football, computers, and watching classic movies.

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