March 2022

The Offshore Opportunity for Retirement Funds

South Africa's Finance Minister, Enoch Godongwana, surprised the entire savings industry with the announcement that retirement funds could increase their offshore allocation to 45%. Previously, Regulation 28 set this at a maximum of 30% with an additional 10% allowed in Africa. African exposure was very limited, so the change effectively means an opportunity for most investors to increase their direct offshore exposure from 30% to 45%.

This is a very significant change and we expect it to have wide-ranging impacts on retirement savers, local and offshore asset managers, administration platforms and even markets. In this month's commentary, we take a deeper look into this change and what the impact may be.

What is Regulation 28 and why does it matter?

Regulation 28, issued under the Pension Fund Act, sets out the maximum allocation that retirement funds are able to invest in particular assets or asset classes. It applies to retirement funds like pension, provident and preservation funds, as well as retirement annuities.

The main objective of Regulation 28 is member protection. It aims to protect an individual's retirement savings from the potential negative consequences of a lack of diversification in their investments. This is done through imposing limits on the maximum exposure a retirement portfolio can allocate to certain asset classes, with a specific focus on higher risk asset classes. The table below sets out the specific limits that apply to the main assets classes following the February 2022 changes.

Table 1: Regulation 28 asset class limits

Asset Class	Maximum Allocation
Cash	100%
Debt issued or guaranteed by the Republic	100%
Debt instruments from banks	75%
Equities (local and offshore)	75%
Property (local and offshore)	25%
Offshore assets (including max 10% in Africa)	45%

The changes are broadly positive for South African investors. Increasing the percentage of retirement capital than can be invested offshore, allows investors to access a wider opportunity of potential investments which should ultimately lead to higher quality, more diverse portfolios. Consider the fact that the Johannesburg Stock Exchange (JSE) has around 160 companies that asset managers can actively invest in. In contrast, the MSCI All Country World Index (ACWI), the predominant benchmark for global equities, currently has over 2900 constituent companies, and that only accounts for 85% of the global investable equity opportunity set.

A Rush to Offshore?

It is still too early to know how retirement funds and asset managers will react to the changes. It is estimated that if everyone increased their offshore exposure from current levels to the 45% maximum there could be between R450bn and R600bn in scope to move into offshore investments out of local investments. Apart from the potential for the Rand to weaken as money is externalized, the vast majority of the cash taken offshore would come from the sale of local equity holdings which would put downward pressure on the JSE All share index. In simple terms, outflows resulting from the change could be negative for both the SA stock market and the currency.

However, there are likely to be mitigating effects too. Firstly, many local asset managers currently see significant value in SA equities and with the Rand close to fair value, it is not obvious to increase your offshore exposure to the maximum at this point.

Secondly, it is worth considering the positive message that this policy move by government sends to both local and offshore investors.

For local investors, there has been a reticence from many to invest in retirement products despite the tax benefits due to the limitations enforced by Regulation 28 (specifically the 30% cap on offshore) as well as a fear that the government is going to force investors to allocate their retirement savings into local infrastructure or other prescribed assets. Many investors have therefore chosen to allocate their savings outside of the retirement savings environment with a higher offshore allocation.

However, the government has continued to increase the amount allowed offshore - the revised version of Regulation 28 came into effect in 2011 with an initial offshore limit of 15%. This limit has been increased in increments over time to the current 45%, allowing investors an increased opportunity to diversify into offshore assets. This consistent government stance should provide local investors with a level of comfort and encourage investors to invest in retirement products with the associated tax benefits.

For offshore investors, the well-documented challenges that the South African economy faces, and the ongoing political travails has resulted in a prevailing negative sentiment towards South Africa as an investment destination. As a result, our equity and bond markets have experienced net outflows from foreign investors. In order to improve sentiment, it is crucial that the economy is opened up and that government is consistent in implementing policy. The Regulation 28 changes are a definite move in the right direction and will go some way to improving sentiment to encourage foreign investors to return to our market.

This being said, we do expect net outflows out of our equity market over the course of time, but it is not yet clear the extent that the positive policy step by government benefits our markets.

Investor Behaviour and Unintended Consequences

As with any material change, there is the possibility of unintended consequences emerging from these changes that are worth considering.

We would love to believe economic theory that suggests we are all rational economic agents and make logical decisions, however it is commonly accepted that investors suffer from behavioural biases. One of the biggest value destructive biases is chasing performance: effectively selling funds at the bottom of their performance cycle in order to buy funds at the top of their performance cycle. It is very common for an investor to sell out of a fund that has underperformed over one or two years to buy the top performing fund over that period, despite their investment horizon being long term. There are volumes of research that show this behaviour leads to suboptimal investment outcomes because top-performing funds can become bottom-performing funds very quickly.

We expect that changing the maximum offshore allocation to 45% will lead to significant performance dispersion across funds. Although there are always outliers, the asset allocation of the majority of retirement fund portfolios has been broadly similar, with the vast majority of funds allocating close to the 30% cap in offshore equity. As a result, the potential for wide performance differences was lower. However, we anticipate that funds will now make more active asset allocation decisions (rather than sit at the 45% cap). We expect to see offshore equity range from 25% to 45% in Regulation 28 portfolios - given how significant the difference in returns from offshore equities and SA equities can be over one-year periods as a result of both market return difference and Rand movement, we are likely to see significant short term performance dispersions between funds that all set out to deliver similar objectives over the longer term.

Our concern is that the value destruction caused by investors reacting to short term performance by changing funds will be exacerbated by this change. We believe that this is where detailed fund research and understanding of the long-term drivers of performance becomes even more crucial.

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Drawing Income in Retirement

Regulation 28 balanced funds have historically been used by many investors for their post retirement. These funds were not necessarily the most efficient way to provide for retirement income given they are not designed with a focus on delivering a regular income, plus the Regulation 28 limits do not have to apply to living annuities (so no need to have the 30% offshore maximum restriction). While not optimal, they did a reasonable job of managing risk and return for post-retirement investors.

However, we are concerned the increase in the offshore maximum to 45% will introduce a level of volatility in many Regulation 28 balanced funds that could have a negative impact on investors that are drawing a Rand income from their portfolio. The effect that fluctuations in the Rand / Dollar exchange rate and the relative returns of global and SA equity need to be considered.

As an example, the total return generated by the S&P 500 (a proxy for US equities) last year in ZAR was 8.3% compared to the JSE All Share Index which returned 15.9%.

We don't normally consider a one-year return on equities, but when someone is drawing a monthly income from their portfolio, the shorter-term returns do matter. Over the last year, the allocation to offshore in your post retirement portfolio would have made an impact on the % of portfolio sold each month. This additional volatility needs to be considered and it remains a question for us as to whether 45% invested offshore is appropriate for an investors post retirement portfolio if it is their sole capital and they draw a meaningful Rand amount each month.

Test of skill

The changes to the offshore limits in Regulation 28 will influence asset management businesses in South Africa in a number of ways. It is also more than likely that these changes will only start to come out in the wash over time as managers adjust to one of the most substantial shifts in the local asset management landscape in recent years. At the moment our fund research is focused on three key areas that are highlighted by the change:

1. *Asset allocation skill:* as discussed earlier, balanced fund managers will now be required to make an active asset allocation decision on offshore. They can no longer remain static near the 30% over time. The decision to upweight offshore beyond the 30% and then vary over time up to the 45% maximum will require a skill many may not have developed. In addition, there is now a decision needed as to whether other offshore assets (bonds, credit, property, cash, etc.) should be included. Up until now, most managers only included equity in their offshore. It therefore remains to be seen whether the skill and experience exists within local asset managers to implement.

2. *Breadth of team:* We spoke about the positives for the investor of a broader investment opportunity set, but that needs to be considered alongside the ability of the current investment teams to adequately cover this new opportunity set. Do SA asset managers have the team (size, experience, skill) to deliver to investors on this broader opportunity?

3. *Asset flows:* there is a potential for certain asset managers to experience significant outflows. Will boutiques that run SA equity mandates be negatively impacted by a shift in mandate from SA equity to offshore? Will asset manager without a developed offshore capability or an offshore partner be able to retain balanced funds with up to 45% invested offshore? There will certainly be winners and losers emerging over time.

In our opinion, the change to Regulation 28 will have a profound impact on the South African savings industry. It may well be positive for investors but there are a number of issues for investors, their advisers and asset managers to consider over the coming months. Our research efforts will focus on working through these issues and providing advisers and investors with additional clarity on how to navigate these changes.

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data provided by Refinitiv

MARKET REPORT

31/Mar/22

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
FTSE/JSE All Share Index (ALSI)	ZAR	3.8%	3.8%	18.6%	14.2%	11.4%	11.9%	15.4%	13.1%
FTSE/JSE SA Listed Property	ZAR	**-1.3%**	**-1.3%**	27.1%	**-3.8%**	**-4.9%**	5.0%	26.3%	21.3%
SA All Bond Index (ALBI)	ZAR	1.9%	1.9%	12.4%	8.4%	8.9%	8.1%	8.0%	7.9%
SA Cash Index (SteFI)	ZAR	1.0%	1.0%	3.9%	5.2%	6.1%	6.1%	0.4%	0.4%
Balanced Benchmark	ZAR	**-0.5%**	**-0.5%**	13.8%	11.5%	10.1%	11.5%	10.6%	8.8%
SA Inflation (1 month lag)	ZAR	1.4%	1.4%	5.6%	4.7%	4.2%	5.0%	1.2%	1.4%
GLOBAL MARKET INDICES BASED TO USD									
Global Equity (Datastream World)	USD	**-5.0%**	**-5.0%**	10.6%	15.5%	13.0%	11.5%	15.4%	13.3%
Emerging Markets Equity (Datastream EM)	USD	**-6.9%**	**-6.9%**	**-11.1%**	5.3%	6.4%	3.7%	16.6%	15.9%
Global Property	USD	**-5.7%**	**-5.7%**	15.1%	7.7%	8.7%	8.6%	15.4%	14.1%
Global Bonds (Barclays Global Bond Index)	USD	**-7.6%**	**-7.6%**	**-7.9%**	0.9%	2.1%	1.3%	5.5%	5.7%
Global Cash	USD	0.1%	0.1%	0.2%	0.9%	1.3%	0.9%	0.3%	0.2%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	3.8%	3.8%	18.6%	14.2%	11.4%	11.9%	15.4%	13.1%
Global Equity (Datastream World)	ZAR	**-13.1%**	**-13.1%**	9.5%	16.1%	15.0%	18.9%	16.2%	14.8%
Emerging Markets Equity (Datastream EM)	ZAR	**-14.8%**	**-14.8%**	**-12.0%**	5.8%	8.2%	10.6%	14.2%	13.1%
Global Property	ZAR	**-13.6%**	**-13.6%**	13.9%	8.2%	10.6%	15.8%	17.0%	14.9%
SA All Bond Index (ALBI)	ZAR	1.9%	1.9%	12.4%	8.4%	8.9%	8.1%	8.0%	7.9%
Global Bonds (Barclays Global Bond Index)	ZAR	**-15.4%**	**-15.4%**	**-8.8%**	1.3%	3.9%	8.1%	15.6%	14.0%
COMMODITIES									
Gold (US Dollars)	USD	6.5%	6.5%	13.9%	14.4%	9.3%	1.6%	12.6%	14.6%
Gold (Rands)	ZAR	**-2.5%**	**-2.5%**	12.7%	14.9%	11.1%	8.3%		
CURRENCIES									
Rand / Dollar	ZAR	8.4%	8.4%	1.0%	**-0.4%**	**-1.7%**	**-6.7%**	15.6%	15.0%
Rand / GBP Pound	ZAR	11.0%	11.0%	5.6%	**-0.8%**	**-2.8%**	**-4.6%**	14.8%	14.6%
Rand / Euro	ZAR	10.4%	10.4%	6.3%	**-0.1%**	**-2.5%**	**-4.8%**	14.3%	13.7%

Spot Rates		31-Mar-22	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US$	Rand	14.61	15.96	14.77	13.41	7.67	11.37
Rand/GBP	Rand	19.23	21.58	20.38	16.78	12.26	16.15
Rand/EUR	Rand	16.26	18.15	17.35	14.34	10.22	9.91
RATES							
Libor 6m $	US$	1.47	0.34	0.21	1.42	0.73	2.33
Repo Rate	Rand	4.25	3.75	3.50	7.00	5.50	11.50
Prime	Rand	7.75	7.25	7.00	10.50	9.00	14.00
All Bond Index Yield	Rand	10.08	9.96	11.64	9.38	8.07	9.74
COMMODITIES							
Gold ($/oz)	US$	1 941.15	1 822.39	1 704.74	1 247.25	1 663.80	302.50
Platinum	US$	983.00	959.00	1 182.00	940.00	1 640.00	516.00
Oil (Brent Crude) $	US$	107.46	78.40	63.52	52.62	123.40	25.55
INFLATION							
SA Inflation	%	5.7	5.9	3.2	6.2	6.1	9.4

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