Does the JSE protect you?

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South African (ZA) investors often claim that they don't need exposure to **direct** foreign securities, because an investment on the JSE (Johannesburg Securities Exchange) provides a sufficient Rand hedge. Perceived wisdom is that foreign revenues of these large companies protect their shareholders from South African Rand (ZAR) devaluation. We find it rather alarming that this notion is not interrogated more thoroughly. This could be a combination of implicitly trusting an advisor and/ or the unfamiliarity with the subject matter. This article aims to unpack this idea.

An investor needs to distinguish between revenue and earnings. Companies do not distribute revenue as dividends to its shareholders – only after tax earnings. A company with foreign revenue might also have underlying expenses or costs in the foreign currency. Thus, only if a company has a foreign currency profit, can it potentially qualify as a so-called "Rand hedge". About 60% of the JSE Top 40 earnings (the 40 largest companies on the exchange) come from foreign currency. It does provide some Rand protection, but it is concentrated around certain industries and geographies.

Keep in mind that all foreign currencies are not equal. Profit in USD (after allowing for foreign borrowing costs) is in our opinion more valuable than from a currency where there is less monetary discipline. Companies such as *MTN* can testify to the pain caused by a rapidly depreciating Nigerian Naira – especially when unexpected capital controls prevented them from reducing their exposure. Also, if an investment underperforms, and the expenses (or capital losses) are in foreign currency, the scenario could actually become a severe drain on your ZAR investment. It has precisely the opposite effect. We have many examples of local companies (such as *Mediclinic*, *Woolworths*, *Tiger Brands* etc.) where foreign capital allocation turned against management.

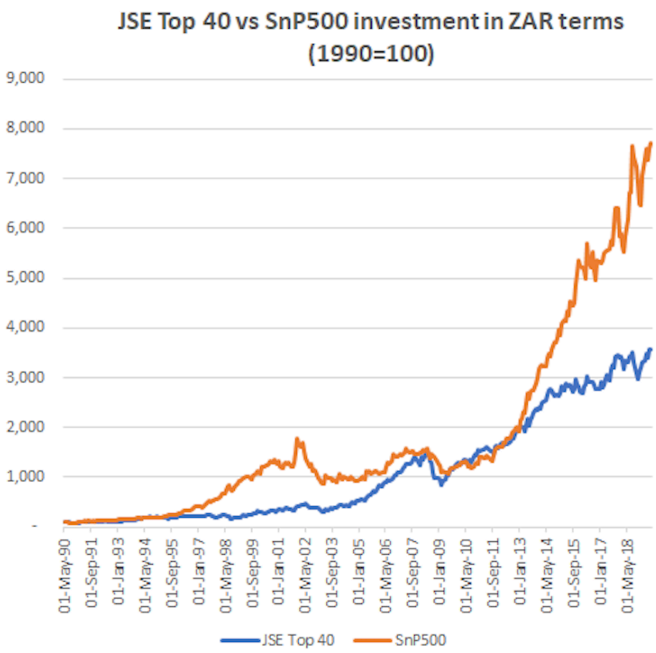
How do we assess past performance?

When we study past performance, we notice that the last ten years have been a very volatile period for the Rand. If owning dual-listed companies on the JSE really did provide the perceived protection, then this portfolio should have performed favourably against:

- Any ZAR depreciation itself (i.e. it should have appreciated when the ZAR depreciated – and vice versa);
- "Hard currency" denominated indices e.g. the Dow Jones Industrial Average (DJIA) or the S&P 500, equity indices in the United States.

"Leaping tall buildings in a single bound is nice, but can you outperform the S&P500 Index?"

The following charts indicate the past performance of our JSE Top 40 against the S&P 500 index (in ZAR terms). The start dates are 1990 and 2009 respectively. Data confirms that the Top 40 appreciated by more than the depreciating Rand, which could lead us to the belief that the index was a successful hedge. However, if you compare a "broad basket" of US companies, that portfolio would have significantly outperformed the JSE Top 40 in ZAR terms[1]. An S&P 500 investment dating back to 1990 (with dividends reinvested) would have been worth about twice the investment of the JSE Top 40 basket[2]. Keep in mind that Naspers significantly contributed to the ZAR performance of our local JSE (without Naspers, the relative performance would be worse because of **one company**).



[1]*ZAR depreciation is in line with relative inflation. So the outperformance of an index should cover inflation and compensation for accepting equity-like investment risk.*

[2]*An investor should aim to do as well as it can given the global investment opportunity set. Simply outperforming ZAR depreciation is sub-optimal if a foreign denominated portfolio performed significantly better due to superior earnings growth.*

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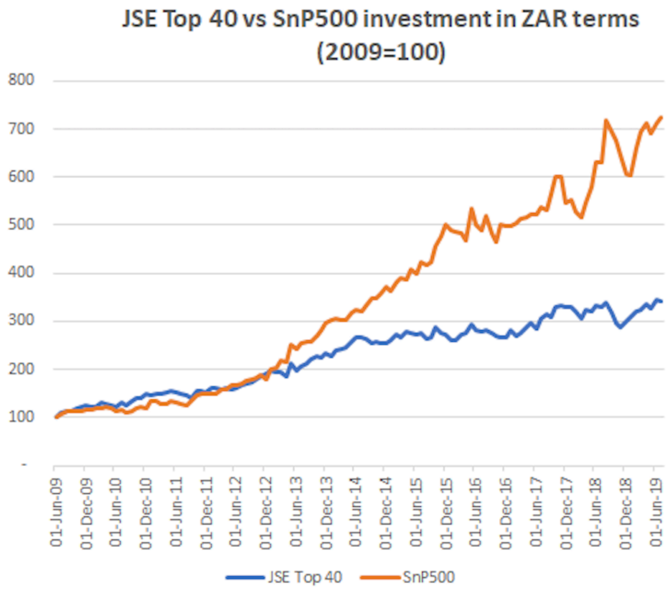
Roughly the same holds true for investments after the 2008/09 global financial crisis. The JSE ALSI fared significantly poorer, probably reflecting the fact that it earns far less hard currency profit than the Top 40. Whilst local equity returns topped ZAR depreciation, being rewarded for taking equity risk sets the bar much higher. Each percentage point return in USD is intrinsically worth more than each 1% return on the JSE.



We can do the same analysis and compare European companies with the JSE. The outcome is likely to be less pronounced. Europe seems to be sliding inexorably towards a demographic crisis. Its decision-making bodies are in gridlock (most of the time). Also, its lack of productivity growth and inflexible labour market means the European Central Bank (ECB) initiatives were far less effective than the US Federal Reserve Bank.

Keep in mind that past performance is not a reliable indicator of future performance. It is human nature to anchor our expectation of the future in past experiences. The relative outperformance of ZA companies (compared to foreign companies leading up to 2008) might prevail. However, ZA battles with so many issues (an inflexible labour market, suffocating government and state owned enterprises debt, youth unemployment over 50%, systemic corruption, and a lack of confidence in government policies to name a few) at this moment so that such outperformance would be an exceptional result and on a balance of probabilities unlikely.

Protection against modest devaluation of the ZAR is, of course, only part of the story. What if the Rand becomes substantially weaker? Consider Turkey and Argentina as examples. The really big risk is if the ZAR experiences a very sharp devaluation – due to one (or a combination) of major events, such as:

1. A change of mandate by the South African Reserve Bank;
2. Expropriation without compensation gets out of hand (it is no longer an insignificant risk);
3. A USD liquidity crisis due to an international event(s) beyond our control.

The abovementioned outcomes will impact valuations on the JSE. If scenario (1) occurs, one might expect the JSE to rally (to account for loose monetary policy initially spurring an increase in money supply and therefore consumer spending), but event (2) will put question marks around property rights, likely causing stress on our financial markets and the willingness of the IMF (International Monetary Fund) to fund borrowing. Likewise event (3) won't yield a positive result for our local JSE either.

Our conclusion

Given the reasonable past performance of the JSE, compared to overseas equity markets we cannot bank on a favourable outcome over the next decade. Unfortunately we deal with assumptions. A portfolio that does not contain at least a modest proportion of exposure to **direct foreign equities** (US or otherwise) and preferably denominated in USD, effectively bargains on the fact that the South African financial market will resume relative real outperformance compared to global markets (based on the fact that the ZAR will remain resilient). Prudent investment management would suggest this is unwise. Hence, we recommend a financial plan that appropriately assesses the potential risks and related tax matters.