

Venturing overseas

by Andrew Hardy, CFA

With the skies and borders mostly open for international travel again, I've been visiting our parent company's home market of South Africa this past week, a welcome opportunity to catch up with colleagues and clients in person. The hot topic has been investing overseas, following the local central bank's recent relaxation of offshore investment limits; now investors can take up to 45% overseas. One of the many questions this brings into focus – for investors there but also around the world – is the risks that come with having so much of a portfolio invested overseas, and how best to manage them.

The high-level risks one must consider fall into the same categories as those found in the domestic market (macroeconomic, political, market related, geological etc.) but now with many more underlying shapes and colours. While the number of risks is multiplied across many geographies and regions, they're of course not additive due to diversification benefits.

It's important to remember that risks aren't necessarily all bad; investing is all about deliberately exposing oneself to many such risks on the basis that they are rewarded over the long term. For instance, over a very long period of the last 122 years, investors in US equities have achieved approximately a 7% annual real (above inflation) return¹ – handsome reward for bearing the associated risks!

Currency risk is often the first thing investors worry about when going overseas, however it's by no means unique to international portfolios. Consider the contrasting fortunes (on average) of net importing business in the domestic market, relative to net exporters for a given move in the domestic currency. This is the manifestation of an indirect currency exposure. The greater concern attached to direct exposure to international currencies is reasonable, given it can be one of the more volatile risk factors in the short term, however, it usually has less impact over the long run.

Often risks can lie undetected beneath the surface; a portfolio of hundreds of stocks across multiple geographies might appear well diversified but could still be heavily exposed to a common underlying risk factor, such as if they were all heavy importers of a certain raw material. Another more subtle example would be taking an overweight to 'value' stocks while underweighting interest rate duration – both are likely to detract from performance at the same time e.g., when bond yields are falling.

The key to more effective and successful risk management in any portfolio, domestic or international, is to understand and monitor the various risks, while ensuring the right level

of exposure to each. Asset allocation is a key part of this solution, but not everything. A well-constructed portfolio should capture as much of the benefits of the desired rewarded risks as possible (for a given overall risk budget), while diversifying as much of the associated volatility away as is possible by mixing in un/low correlated assets as far as possible.

A good case can be made for strategically allocating to a broad basket of defensive or diversifying assets at any given time, especially given the range of choices an international universe brings. The allocation of a multi-asset portfolio to this area could fluctuate over time depending on the opportunities in other asset classes, but diversifying your diversifiers beyond just government bonds, to include areas such as precious metals, real assets, hedge fund strategies etc. brings huge diversification benefits for portfolios.

The various risk factors an international portfolio is exposed to will manifest themselves to varying degrees through time and will drive divergence in returns relative to other asset classes, countries, or broad benchmarks. Rather than fearing this, the associated volatility can be welcomed by those in a position to take advantage of the valuable tactical asset allocation opportunities it brings.

As a current example, we believe the Japanese equity market represents an exciting long term investment opportunity. In aggregate the market appears undervalued relative to its earnings power and asset values, but a position becomes more compelling when you factor in that the economy and stock market is relatively lowly correlated to Western markets. On top of that, there's arguably a greater potential reward for active management there, due to the depth, breadth, complexity, and low sell side coverage of the market.

The bottom line is that international investment risks can and should be managed, not eliminated. As with investments in the domestic market, good risk management requires a long term, consistent process with carefully considered and deep diversification across asset classes, strategies and currencies. Furthermore, we believe in always having a very deep understanding of the strategies or securities we hold before investing in them, as being selective about what you hold in the first place is one of the best and most underappreciated forms of risk management. Most of us have encountered our share of surprises or troubles on foreign expeditions, and have learnt it pays to set off well prepared...

Source: Momentum Global Investment Management, Bloomberg Finance L.P.
¹ Yale University, <http://www.econ.yale.edu/~shiller/data.htm>



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