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WEALTH MANAGEMENT

Counting the cost of the cabinet reshuffle and credit rating downgrade on local investment returns

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Investors will be concerned over the recent news of the 'authoritarian' cabinet reshuffle and consequent credit rating downgrade from S&P on the 3rd of April. This has important implications for all asset classes, and therefore prospective investor returns. This comment aims to provide some insight for investors to help understand how it will affect their investments.

What has happened thus far:

- A major reshuffle in cabinet ministers seen as a destabilising move by the government. Primarily this drives uncertainty on economic policy, and the stability of state institutions (e.g. Eskom). Increased uncertainty increases the risk attached to South African linked investments, typically resulting in a fall in prices (and therefore returns).

- The currency as well as government bonds and local dependent shares (like banks) have sold off to reflect worsening prospects. This impacts most investors.

Asset classes most effected are those which are least diversified, and most linked to the South African economy. Shares, by and large, are well diversified and in aggregate earn their revenues offshore, so a currency depreciation benefits the holder of shares. Holders of bonds (i.e. debt instruments, which are effectively loans to companies or the government by investors) do not have high levels of diversification and are most exposed to recent events. Most investors have exposure to all of these asset classes.

Looking at asset classes individually:

Asset Class	Impact on returns	Reason
Local Currency (Rand)	Positive	As the Rand depreciates, it serves to boost the value of local investments. In Rand terms, investors will see higher returns from offshore assets. Be aware though that the buying power of the Rand is lower, and in global terms you are worse off. Also note that the Rand has been particularly strong over the past year, and has now reverted back to its longer term trend level.
Local and Offshore denominated bonds	Negative	With a sub-investment grade rating, investors will require higher rates to lend our government money. This pushes up the cost of financing (for all manner of projects in SA – social development, housing, education, etc.). In aggregate society is worse off with higher interest rates
Local Property	Negative	Property returns are closely linked to local economic growth, local interest rates and inflation. With a depreciating currency, and heightened pressure on economic growth, property loses some attraction.
Local Equity	Positive	More than half of the SA equity market is driven by offshore earnings. This makes these earnings streams more valuable in Rands when the currency sells off. As a result, equity returns are generally strong, but partially driven by currency and not fundamental strength.
Offshore Equity	Positive	Returns generated by offshore companies will typically provide strong returns when converted back to Rands.
Interest Rates	Negative	The outlook for future interest rate reductions (or even retention of a stable policy) becomes poorer as the weakened currency tends to drive inflation up (e.g. we need to pay more for petrol as it is priced in US$). This places further pressure on the average consumer who already has high debt levels, and asset prices in general.

In the short to medium term it is likely that there will be substantial volatility around asset values, including our currency. This will cause investors to be very nervous, and at times like this the incidence of poor investment decision making is at its highest. Responding to fear (for example, selling shares and moving to cash) tends to reduce long term investment returns on the whole. As the table above illustrates, most investors will be reasonably well off – in rand terms at least.

This logic follows provided there is an appropriate financial plan in place. An investment portfolio designed to fulfil this plan has the diversity and risk management mechanisms in place to deal with this type of negative event. This is one of three primary ways to ensure investment objectives are achieved, and not compromised, in response to bad news. The other two mechanisms are ensuring the appropriate mix of asset classes is chosen for the investor; and that the appropriate fund managers are used to make investments. All of these elements have been comprehensively considered when building our investor portfolios.

Where to from here?

We are faced with a High Road, and a Low Road. The Middle Road – where SA wobbles through and then recovers, seems less likely to occur given the extremities of the recent moves and the implications for our economy.

- The High Road: the cabinet changes cause the ANC to split, potentially a recall of the President and we set off on a long term road to recovery with respect to economic policy and governance. In this event, the currency will recover, as will bond prices and other domestic assets, providing relief for the average consumer. The probability of this scenario has surely increased over the past week, and fund managers will be wary of being too negative on local assets. Over the past 12 months, local fund managers have become more positive on SA, seemingly being too lenient on the underlying potential for political turmoil. A select few have retained a strong negative view on SA.

- The Low Road: a sustained period of status-quo political governance where the global investment community increasingly loses faith in corporate and political SA as an investment destination. Capital outflows continue to weaken our currency and we head into a genuine recession. Governance remains poor in terms of policy setting and execution. Secondary effects are also material – brain drain, inflation, tax increases being examples of the real cost of the recent changes. Clearly not an ideal scenario for the average citizen, this points towards offshore diversification as a key component of an investment portfolio.

Are there any opportunities?

Contrarian thinking will lead you to consider opportunities at this point, a difficult mindset to master when all are heading for the exits. Times of stress do tend to throw up decent opportunities to acquire investments at decent value. The place to be looking will be those domestic dependent companies which sell off and distressed sellers of leveraged assets (like property – although this would take sustained pressure over a period of time). Buying bonds will take a deeper contrarian view (cheap for a reason?), as will bringing offshore currency back to SA – for the reasons explained above – these investments simply are undiversified from SA and the risks are genuine. Mostly, it pays to let the fund managers implementing your plan to make these decisions and overall the golden rules of wealth management remain the same: plan, do your homework, diversify, stay the course.