Publication: FA News (Financial And Advisory News)
Date: Sunday, April 01, 2018
Page: 78

Diversifying portfolios is more than just colouring within the lines

Diversity is strength. Nowhere is the aphorism more appropriate than in the world of investing.

It is the principle that underpins Regulation 28 of the Pension Funds Act, which aims to protect people from poorly diversified portfolios. This is done by limiting how much they can invest in certain asset classes, particularly riskier ones, like equities, property and foreign assets.

DOWNSIDE RISK

Yet, one of the downsides of Regulation 28 is that South Africans tend to regard their portfolios as sufficiently diversified by adhering to the legislated asset class caps of 75% in equities; 25% in property; 30% offshore; 10% Africa excluding Southern Africa.

Often, investors do not consider diversifying within these broader asset classes, particularly in fixed-interest securities.

For example, an individual nearing retirement wanting to place a significant portion of their savings in a low-risk, income generating portfolio would likely look no further than an income fund or fixed deposit or money market account.

A five-year, fixed deposit investment at one of South Africa's major banks would pay interest of between 7,75% and 8,75% per year for someone 55 years and older, depending on the principal amount invested.

An enhanced income fund, typically comprising 75% stable income-bearing assets like cash and bonds and around 25% growth assets like preference shares, listed property or international assets, would likely pay a premium above cash deposit rates of just over 1%.

WIDEST POSSIBLE BALANCE

While there is nothing wrong with either of these options for someone looking for stable, predictable returns, it is possible to diversify further within the fixed interest paying space to achieve the widest possible balance between risk and returns.

Participation bonds for instance, provide stable, fixed rate returns that are also backed by the underlying asset comprising mainly of commercial and industrial property.

While income funds have exposure to listed property as well as preference shares or corporate bonds, they are exposed to the balance sheets of the entities underpinning these securities.

UNDERPINNED VALUE

Participation bonds, on the other hand, earn their income from mortgage payments of the underlying commercial properties. These are underpinned by the market value of these brick and mortar assets.

In addition, they are legislated by the Financial Services Board (FSB) and Collective Investment Schemes Control Act which stipulates that the ratio of loan to property value can never exceed 75%. Explained further, the combined value of mortgages on the underlying properties can never exceed 75% of the combined property values. This provides an inherent 25% buffer to any investor worried about a worst-case scenario in which property values might sink below their loan value.

Historic returns on participation bonds have averaged roughly three percentage points above the prevailing Consumer Price Index (CPI). This makes them ideal for people nearing retirement.

POOR RECEPTION?

So why have South Africans not been more receptive to alternative investments? This is at least partially explained by the inherent conservative nature of South African investors and, by extension, money managers.

Despite the fact that Regulation 28 upped its allocation to alternative assets to 15% in 2011 (from 1,5% previously), local money managers still allocate less than 2% of assets under management to alternative assets. This is compared to 29% in the US and 24% in Europe.

Additionally, South Africa's equity market has been the best performer worldwide in the 117-year period beginning in 1900, delivering an average annual return of inflation plus 7,2%.

What's more, that performance is in dollar terms with equities performing so well there just has not been a reason to look at alternative asset classes.

UNCHARTERED WATERS

Yet, with equity markets across the world hovering near all-time highs, we are heading into unchartered waters with many predicting a prolonged period of more moderate performance; or even a sustained bear market.

This material is not for sale or retransmission due to copyright.