MERCHANT WEST INVESTMENTS

15 November 2023

WHEN MORE RISK IS LESS RISKY

How to better manage the volatility of offshore investments

Portfolio risk optimisation is a core component of wealth management. This is partially because matching the volatility of a client's assets to their life stage, liability profile and risk appetite, is critical to ensuring that they remain invested through market cycles. In this regard, wealth managers need to carefully consider the potential volatility associated with various asset classes.

Commonly, volatility measures are considered in isolation for this purpose. For example, long-term market data suggest that equities are more volatile than bonds, which, in turn, are more volatile than money-market instruments. Wealth managers, using this data, may be tempted to conclude that portfolios with more cash (or ultra-low volatility instruments like floating-rate notes) are necessarily less volatile than portfolios with more fixed rate bonds. The truth, however, is more nuanced.

Markowitz's Modern Portfolio Theory teaches us that two negatively correlated assets can be combined to create a portfolio which delivers the average expected return at a below-average volatility level. In the South African wealth management context, this powerful dynamic is becoming increasingly important. As pension fund and individual offshore limits have been eased, a greater proportion of South Africa's savings pool has been shifted into global assets. However, the volatility associated with offshore assets can be daunting, as the Rand gyrates aggressively to the whims of daily changes in global sentiment. Fortunately, there are simple ways for local savers to mitigate this volatility risk.

In a recent webinar (watch: When More Risk is Less Risky or go to https://bit.ly/47xMOZr), we used more than 20 years of market data to illustrate the important role that local fixed-rate bonds can play in reducing the overall volatility of a client's wealth. This finding was particularly evident in cases where a client has a large offshore equity exposure. For example, in cases where a client has 50% of their wealth allocated to the MSCI World Index, a portfolio which allocates the remaining 50% to South African fixed-rate bonds delivered a positive monthly return (in Rands) for 70% of our sample. By contrast, the portfolio which was split evenly between global equities and local cash delivered a positive return just 66% of the time (even though cash was less volatile as a standalone asset class).

What explains this counterintuitive result? In simple terms, the client which balanced their offshore equity exposure against a sizable local bond exposure has exploited the negative correlation which exists between these asset classes. In portfolio theory terms, the client has moved towards the "Efficient Frontier", minimising aggregate portfolio volatility in pursuit of higher risk-adjusted returns. In fact, between all the asset classes we considered (including US Treasuries, SA equities, SA bonds, SA floating rate notes and SA cash), it was the local bonds which did the best job of offsetting the volatility inherent in a high offshore equity exposure.

Of course, back-testing financial market performance is not a science, by any means. The correlation coefficients between asset classes are dynamic, and past performance is no promise of future returns. However, the principles of negative correlation in a wealth management context are as powerful as ever.

Furthermore, while cash and cash-like instruments can minimise the volatility of your wealth in some contexts (particularly where offshore exposures are low), clients who are unwilling to exploit negatively correlated asset classes may be sacrificing substantial expected returns. As many South African savers head to the offshore markets, local bonds may continue to provide an exceptional counterbalancing force, helping clients to more calmly navigate their way through volatile market conditions.

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