



Platform

25 October 2011 Plexus Asset Management

Independent Insight in an Uncertain World

PLEXUS

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THE RAND: A CASE FOR DIVERSIFICATION

The last quarter has been a roller-coaster ride for investors, with global financial markets exhibiting levels of volatility similar to and some even greater than those of past major crises. Political indecision with regard to US policy, the deepening of the European sovereign debt crisis and subsequent severe downward revisions to the global growth outlook have led to heightened levels of uncertainty.

With uncertainty come elevated levels of risk aversion. The ensuing 'risk-off' scenario has led to a significant sell-off among emerging-market currencies. These include the rand, which is often seen as a proxy for overall global uncertainty due to its strong relationship with indicators like the Chicago Board Options Exchange's Volatility Index (VIX) (see accompanying graph), a popular measure of the implied volatility of S&P 500 Index options. The sell-off saw the rand depreciate by 16,5% against the US dollar over the third quarter as the VIX soared.

Naturally the rand's decline against the major currencies like the dollar and the euro led to domestic investors' offshore savings experiencing good returns (and protection in the case of declining foreign equity prices) in rand terms. It is a well-known fact that diversification of one's investments can lead to lower levels of downside volatility and ultimately greater levels of overall downside protection. For example, the Foreign Fixed Interest Bond sector exhibited a total average return of 18,2% for the quarter, compared to the Domestic Equity General sector's - 4,9%.

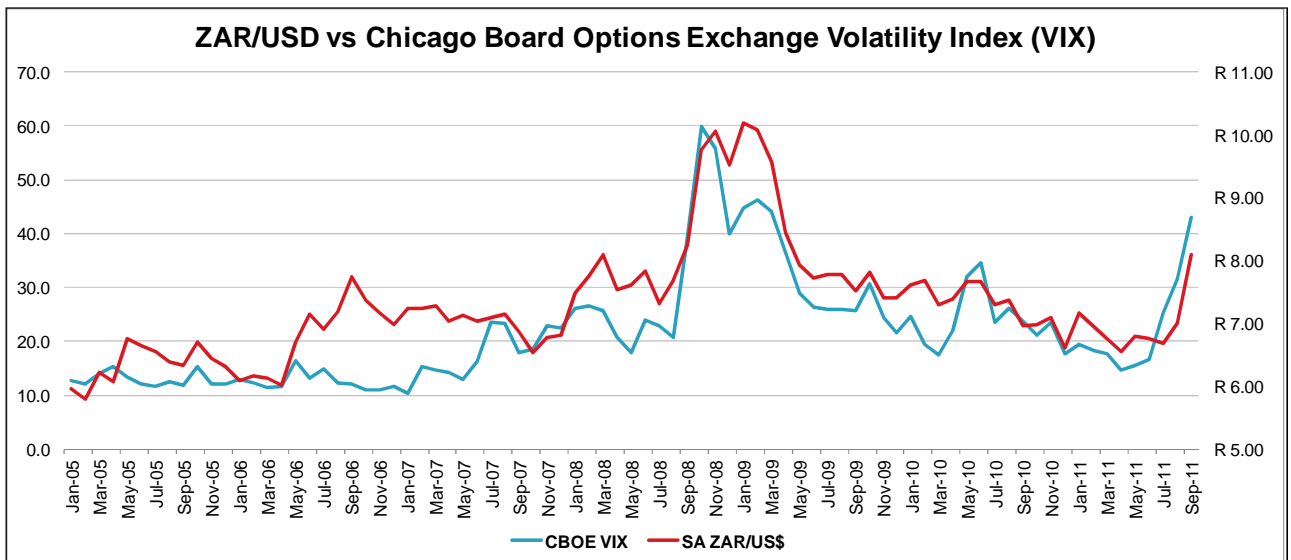
The Foreign Fixed Interest Bond sector's performance was partly due to yields on government bonds dropping off sharply (especially in the US on the longer end), which in turn led to higher bond prices. However, by far the largest portion of this outstanding performance can be ascribed to local currency devaluation translating into strong returns. In fact, even the Foreign Equity General and the Foreign Asset Allocation Flexible sectors managed to deliver positive rand returns of 0,8% and 7,4% respectively for the quarter, despite the MSCI World Index's decline of 17,1% in US dollars.

In order to show the diversification benefits, the Plexus research team drew up a correlation matrix for the past six years to end September 2011 to illustrate the correlation between some of the various broader second-tier unit trust categories (see Table 1 below). As the results show, with the exception of the Domestic Fixed Interest category, the foreign investment sectors exhibited lower correlations to the majority of the domestic categories. This is partly due to the rand's impact on performance during return translation from foreign currencies to rand, specifically during times of global uncertainty when the currency's devaluation provides some temporary protection for offshore investments and allows for less negative or possibly even positive returns.

What is also quite clear from the results is the relatively strong negative correlation exhibited by the Foreign Fixed Interest sector when compared to each of the broader domestic subcategories. This highlights the diversification benefits the sector offers, especially for portfolios that comprise domestic equity exposure, and which are likely due to the rand's translation effect as well as the negative relationship between local equities and global bonds.

Various asset managers have felt the rand to be overvalued for some time, which could in part, along with the extremely high levels of financial market volatility as indicated by indicators such as the VIX Index, have been the cause of the severity of its sell-off. Other factors that also play a role include real interest rates relative to those of other countries, inflation expectations, and global commodity prices.

Obviously one cannot count on the rand to always follow a devaluation of this magnitude when investors' risk appetites change in line with global economic events, as this is also highly dependent on the currency's perceived valuation levels at the time. The motivation for foreign diversification should therefore not be the potential for currency devaluation alone; there should also be a sound investment case for the particular asset class or geographic region that you select. In general, international diversification is a good idea and when done correctly, taking risk tolerance and investor objectives into account, it can greatly limit downside exposure and offer greater overall portfolio protection.



Source: I-Net Bridge

Table 1

Sector	Domestic Asset Allocation	Domestic Equity	Domestic Fixed Interest	Domestic Real Estate General	Foreign & Worldwide Asset Allocation	Foreign & Worldwide Equity	Foreign & Worldwide Fixed Interest
Domestic Asset Allocation	1						
Domestic Equity	0.98	1					
Domestic Fixed Interest	0.22	0.18	1				
Domestic Real Estate	0.57	0.51	0.69	1			
Foreign & Worldwide Asset Allocation	0.49	0.44	-0.31	0	1		
Foreign & Worldwide Equity	0.57	0.56	-0.2	0.07	0.88	1	
Foreign & Worldwide Fixed Interest	-0.4	-0.47	-0.37	-0.41	0.53	0.24	1

Source: Profile Data and Plexus Asset Management