glacier by Sanlam

The {Inside} Story

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The future of offshore investments in SA

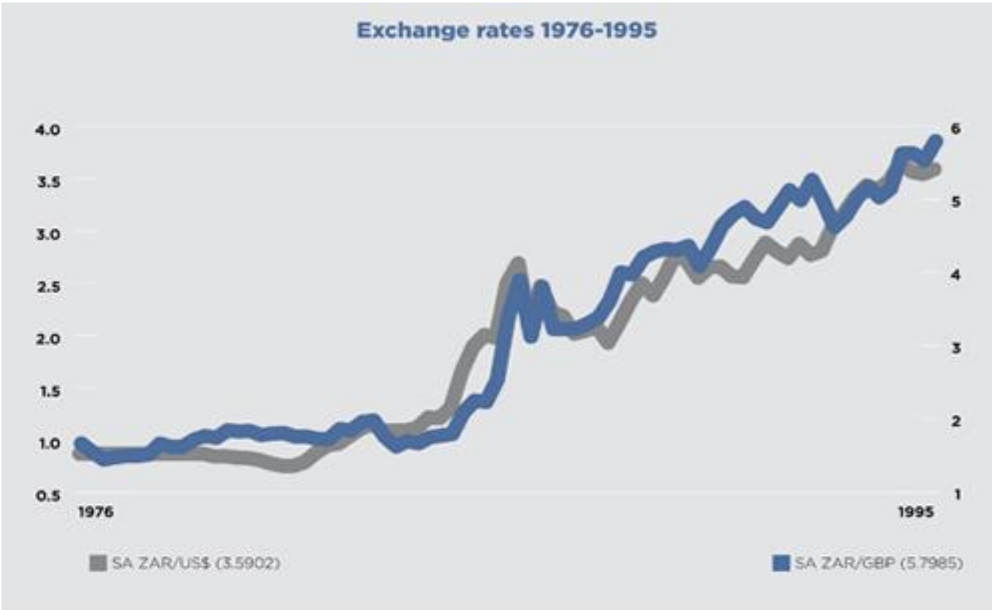
Offshore investment is no longer the hot topic it used to be. Why have South Africans become so apathetic on this subject? Let's reflect on developments in the arena of offshore investment in South Africa in an attempt to answer the question: 'do South Africans still need to bother with offshore investment or was this just a phase we lived through?'

The illegal era

Offshore investment was almost completely illegal in the old South Africa due to exchange control regulations. That is not to say that it was not South Africa's third national sport, after cricket and rugby. Between 1976 and 1994 – through a wide range of procedures – South Africans exported fortunes abroad.

Our appetite for offshore investment prior to 1994 was driven by:

- Political fears. Post the 1976 township riots many feared that South Africa would degenerate into chaos and they would one day have to flee the country.
- The enormous devaluation of the rand during the period 1976 to 1995.



Devalution of the Rand against the US Dollar and Sterling 1976 to 1995

- Blatant tax evasion was easily facilitated and seldom ever detected. Representatives from tax havens openly marketed their services in South Africa, which aggravated this.
- Stringent exchange control regulation.

Even after 1994, exchange control contravention remained a popular pastime. Many liked the new image of the rainbow nation, but their enthusiasm did not extend to a faith in the rand.

It was not until finance minister Trevor Manuel created the R250 000 offshore investment allowances in 1997 that offshore investment began to come out in the open. Initially the allowance was quite the rage. Every last cent was invested offshore through the offshore allowance (only R250 000 at the time) and asset swap packages.

Initially at least, some South African investors earned handsome returns on their offshore investments due to further devaluation of the rand and extensive investment in equities linked to the NASDAQ index. This did not last long and some lost substantial sums following the NASDAQ crash in early 2000. The appetite for offshore investment crumbled.

In 2001 South Africa implemented the residence based taxation system that seeks to tax a South African resident taxpayer on worldwide earnings. This was followed by the promulgation of transfer pricing legislation. The offshore investors faced the daunting prospect of falling foul of both exchange control regulations and tax legislation followed by extensive fines or even prison sentences if caught. The rebuilding of SARS also made detection a real prospect.

Fortunately the problem was mostly solved by the exchange control and income tax amnesty of 2003/2004. Approximately 43 000 South African taxpayers managed to legitimize their offshore investments.

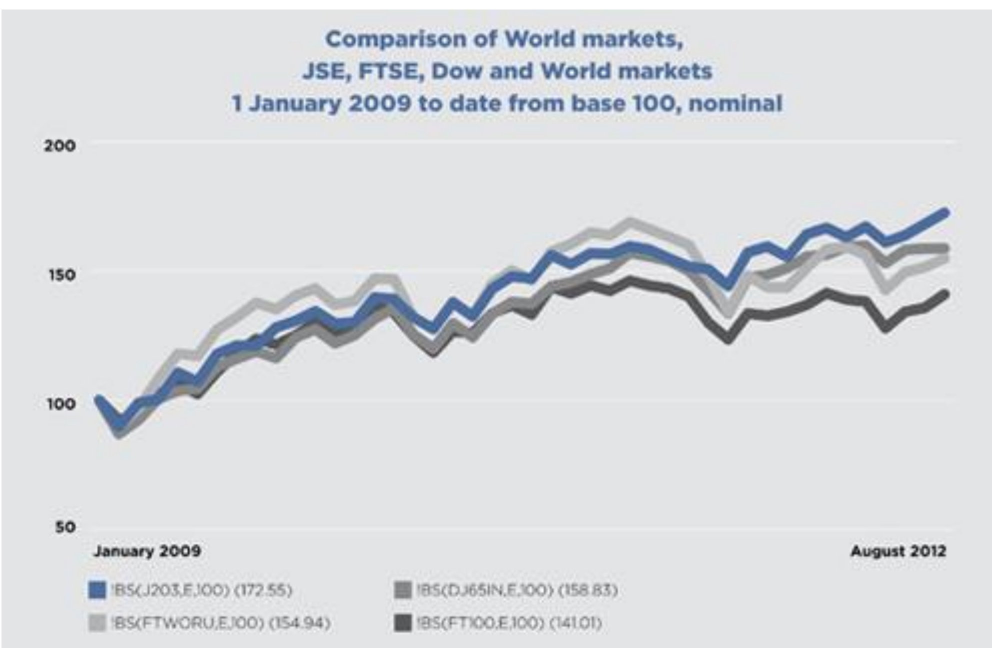
Post 2004 the offshore investment allowance was increased to R750 000 and later to R4 million per taxpayer of good standing over 18 years old. Today the allowance is generally sufficient for most South African investors. The Reserve Bank has even commented that the allowance has not been increased further as 'there would be little take-up'.

The apathy era
Why have so many South Africans lost their appetite for offshore investments?

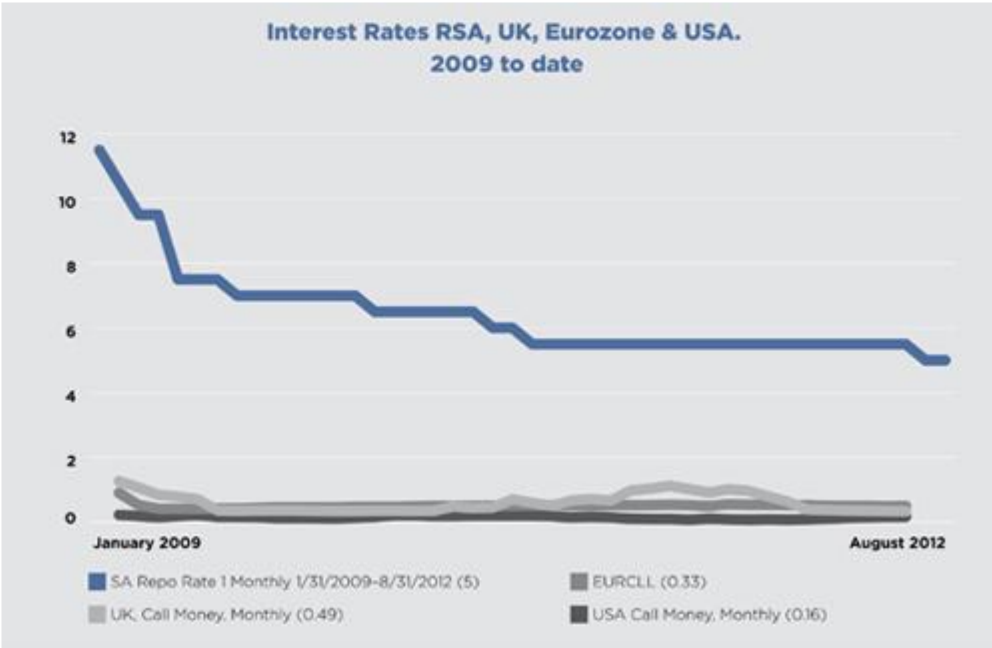
The plain and simple truth is that, on the whole, local investment has outperformed offshore investment in the short and medium term.

There are many scenarios to consider. Perhaps the simplest demonstration is a comparison of the major indices over the past three years.

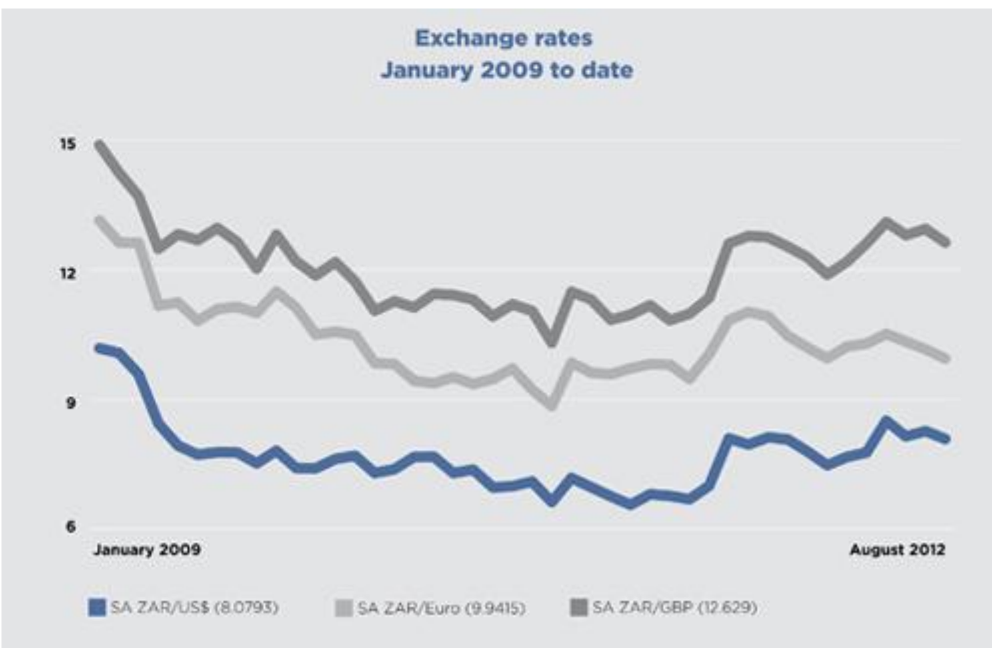
Starting at a base of 100 in January 2009 the Johannesburg Securities Exchange All Share Index has outperformed the Dow, the FTSE 100 and world market indices by a substantial proportion albeit in nominal terms.



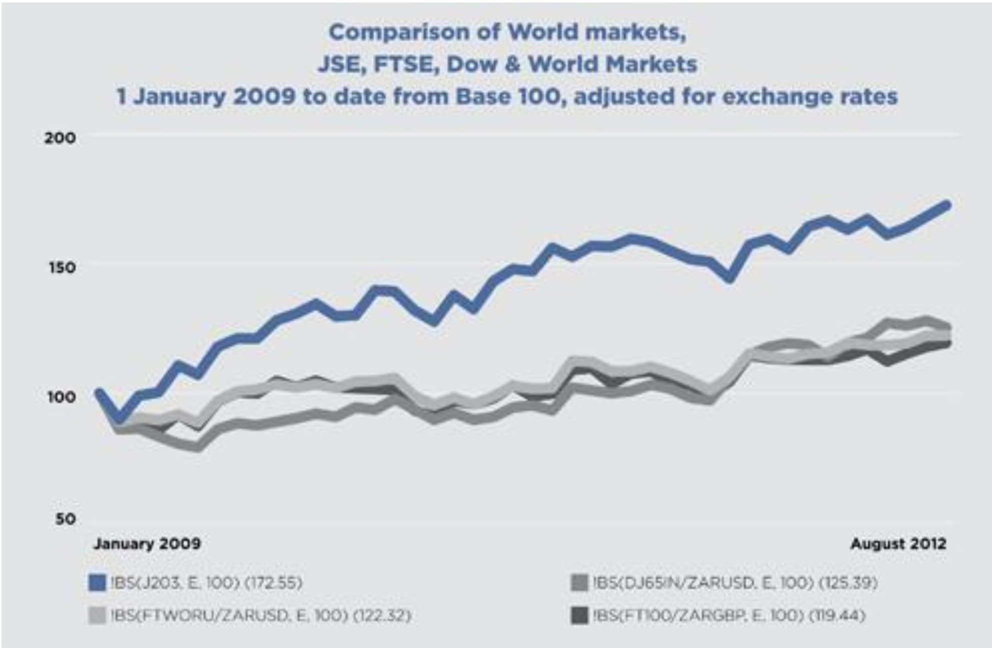
And finally South African interest rates are substantially higher than those offered in the United States and Eurozone.



At the same time, despite various threats to the rand, the often-predicted massive devaluation against other currencies just has not happened. In fact, over a three-year period the rand has actually appreciated against major currencies.



Thus, if the performance of the JSE ALSI is plotted against major indices and adjusted for exchange rate, it is quite clear that South Africans – over the last three years – have done much better by keeping their funds at home.



Following the market uncertainty, post the Global Credit Crunch, many investors are too frightened to invest in anything but interest bearing accounts and guaranteed products. In spite of the SA REPO rate falling to 5%, this remains a very attractive alternative to the almost non-existent interest rates offered abroad.

- Returns generated from offshore investments are fully taxable, since the implementation of residence-based taxation in 2001. However, any losses sustained are 'ring-fenced' from deduction against South African sourced income.
- The administration cost of offshore investment is generally higher than local investment. This is a big factor given disappointing returns over the past three years.
- The balance of payments current account – that turned into a black hole prior to the departure of former Reserve Bank Governor Tito Mboweni – has improved under Gill Marcus.

- Political concerns that sent the rand tumbling every time an ambulance broke down outside the presidential residence 'Tuynhuys' seem to be far behind us.

Given the above, it is hardly surprising that many South Africans have adopted the 'local is lekker investment strategy.' And the demand for the now R4 million offshore investment allowance seems to be limited to those unfortunate souls who have to send bailout packages to their kids in Australia.

Are South Africans missing the plot on offshore investment?
There are certain aspects of investment philosophy in South Africa that have not changed. And probably never will.

The favourable performance of South African markets is heavily dependent on commodity prices driven by the enormous growth rates in China and India. This could change.

During the 1990s when the Reserve Bank was under the leadership of Dr Chris Stals, active intervention was attempted to protect the rand through increasing interest rate strategies. But, after the appointment of Tito Mboweni as Reserve Bank Governor in 2000, the Reserve Bank strategy has changed – leaving the rand unprotected and favouring lower interest rate strategy in pursuit of economic growth in the South African economy.

Political risk remains ever present
The balance of payments current account remains reliant on short-term inward investment into South African money markets. So, the appetite of the foreign investor for the South African interest rate can change.

The fact that tax loopholes (inherent in offshore investment) have been shut down is of little consequence. Simply put, there is now an almost level playing field between local and offshore investment.

There is a new concession in the form of a new regime for the taxation of foreign dividends. It's all very complicated and will surely fail more than a few CA (SA) candidates in forthcoming examinations.

But the important point is that since 1 March 2012, foreign dividends are no longer fully taxable. Foreign dividends now have the same profile for the investor as local dividends and cannot be taxed at more than the 15% dividend tax rate. Even foreign withholding tax on dividends can be deducted from the South African tax liability.

Finally the investor has to consider a trade-off. There is a correlation between the differential between South African interest rates (+/- 5%) and offshore interest rates (0-1%) and the anticipated annual devaluation of the rand against the major currency basket. However South African interest is fully taxable compared to the partially taxable capital gains tax event of a foreign exchange gain.

Conclusion

There remains a definite need for an exposure to offshore markets in any investment portfolio. Perhaps it's simply the emphasis that has changed. Today we can almost exclude tax and exchange control considerations and incentives. But the risk inherent to rand denominated investments is always with South Africans.

At the very least, the investor must consider offshore investment as a hedge investment or form of insurance. The investor must acknowledge that investment is not only about how much is made in good times, but also how much is not lost in bad times.

The rand isn't bomb proof and the risk of a currency decline is as much a threat to an investment strategy as ever. Therefore, offshore investments remain extremely relevant even if world markets remain in difficult times.

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