OPINION

COBUS CILLIERS: The JSE: Local is lekker, but how local is it really?

The free lunch that diversification provides seems a good strategy

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Picture: BLOOMBERG/WALDO SWIEGERS

“Diversification is the only free lunch.” This quote from Nobel prize laureate Harry Markowitz is one that most investors should take to heart. Markowitz won his Nobel prize for pioneering work on modern portfolio theory, and a large part of it was on the benefits of diversification. So he might be a little biased.

On the other side of the coin, we have some of the greatest investors of all time, namely Stan Druckenmiller, Warren Buffett, George Soros and Bernard Baruch. They made their fortunes by means of concentrated positions. Buffett said in his 1996 Berkshire Hathaway meeting: “We think diversification — as practised generally — makes very little sense for anyone that knows what they’re doing. Diversification is a protection against ignorance.”

The problem with these examples is that they suffer from survivorship bias. We only hear of the “great investor” that made it to the pinnacle of their respective fields. Very seldom do we hear about the 99% of the other people in the market. The retail investor.

For those that are not in the market 24/7, the free lunch that diversification provides seems like a good strategy.

Which brings us to the topic at hand — diversification. It can mean different things to different investors. A fund or an investment portfolio can be diversified according to asset classes, sector exposure, size (market capitalisations), investment strategies and investment factors. What this article seeks to highlight is the see-through geographical diversification offered by the JSE.

The UN has 193 official member countries. If you read the Coca- Cola 10K (what the Americans call an annual report), the company will tell you that they sell their product in “more than 200 countries and territories”. This brings me to the common misconception about geographical diversification. Where a company is listed is not the see-through exposure an investor is getting.

When you buy a JSE-listed company for your investment portfolio, the underlying exposure to SA might be lower than you think. The company can be listed in SA, but the underlying exposure could be as high as 90% offshore. The concept is easy to understand, though many retail investors have not had enough time to consider all the details.

Where a company derives its revenue and profits, and how various factors influence these numbers can sometimes not be as clear-cut as most investors would believe. Take Metair as an example, a JSE-listed company that tends to stay under the radar of most investors. Metair has two divisions, namely the automotive components (SA exposure), and energy storage (mostly offshore exposure).

The energy storage vertical's largest subsidiary is a Turkish company that exports a substantial portion of its products to European vehicle original equipment manufacturers, thereby producing a large amount of hard currency. So how should an investor in Metair view the Turkish subsidiary? As European, Turkish or SA exposure? In our opinion, the answer is a mixture of European and Turkish underlying exposure, combined with the group that reports in SA rand.

Another example of a sector that has both local and offshore exposure characteristics is mining. Regional nuances on mining rights regulation, taxation and costs are all local in nature. Taking Kumba and Afrimat as examples, these companies produce either all or most of their profits from selling iron ore, a US dollar-based commodity … and the biggest buyer globally is China. With sales in dollars, the buyers predominantly being China, and costs in SA rand, should investors view Kumba and Afrimat as 100% local exposure? In our opinion, no, it should not.

In conclusion, investors have more options on the JSE for geographical diversification on a see-through exposure, than what is commonly believed.

While some companies have direct offshore exposure, such as British American Tobacco or Richemont who produce more than 95% of their profits and revenue outside SA, other companies need to be researched in more detail, given the nuanced nature of their respective business model. Though one thing is clear, the JSE offers more opportunities for underlying geographical diversification than most retail investors realise.

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