South African Equity funds: A fork in the road

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For Financial Advisors and their Clients

Key takeaways

- The recent changes made to ASISA's Fund Classification Standard, and the introduction of a new South African Equity category catering for funds that invest exclusively in local shares, are seen as a positive development and improve comparability between different South African Equity fund offerings.
- Increases to offshore investment limits, and the subsequent increased usage of offshore exposure within certain South African Equity funds, have been a significant driver behind the dispersion in returns seen between these funds and have, at times, played a significant role in a fund's relative performance ranking relative to peers.
- The new Fund Classification Standard has the potential to reshape the South African Equity fund landscape in several ways that could affect investors, allocators, and asset management firms.

The Association for Savings and Investment South Africa (ASISA) recently made changes to its Fund Classification Standard. Effective 1 October 2024, the changes saw the introduction of new fund categories, some name changes, and the retirement of the 'Regional' portfolio classification. However, perhaps the most noteworthy of these changes was the introduction of a new South African Equity fund category.

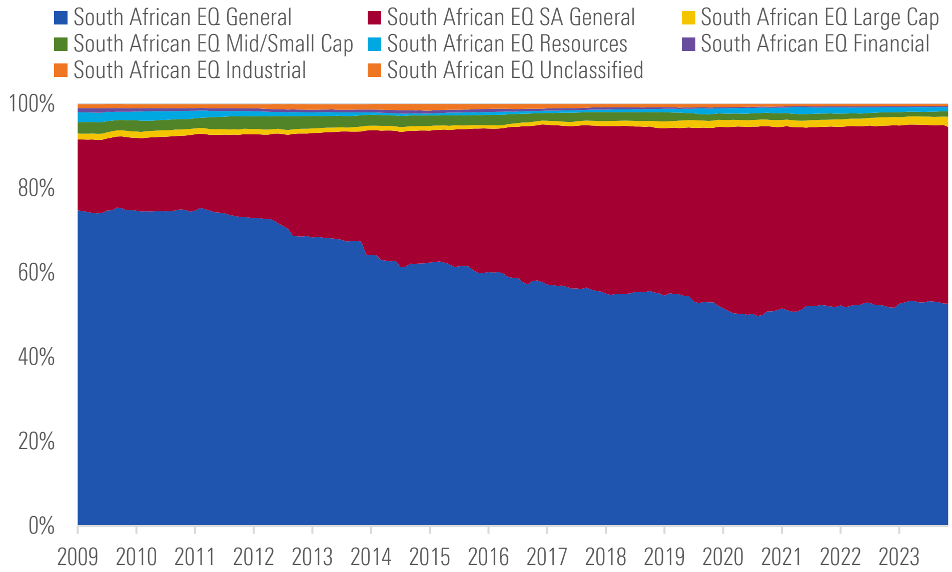
The new 'South African – Equity – SA General' category was introduced for local funds that invest exclusively in South African shares. Its long overdue introduction is a welcome step that improves comparability between South African Equity funds and has been necessitated by the increases seen in offshore investment limits over time. Most recently, in 2022 we saw this limit increase to 45%. The 'South African – Equity – General' category, which previously housed all South African General Equity funds, remains the fund category for those South African Equity funds that wish to make use of this offshore allowance. Previously this category saw a mix of South African Equity funds, with those that remained domestic-only competing with funds that were, in many instances, making full use of the offshore allowance that the category allows. Peer group comparisons under the old category became less and less meaningful as returns and a fund's relative ranking in the category were being driven by the performance differences between the local and global equity markets that also, in turn, got amplified by currency fluctuations.

This piece will take a deeper look at the changes made to the South African General Equity categories, why they were necessary, what these categories look like now, and what the future may hold for South African Equity funds. In the interests of brevity, the rest of this piece will refer to funds in the new 'South African – Equity – SA General' category as 'SA-only' equity funds and those remaining in the old 'South African – Equity – General' category as 'General' equity funds.

How did we get here?

Despite the recent troubles of the South African equity market, ranging from lower-than-average returns to a rise in JSE delistings, South African Equity funds remain relatively well-supported. As of October 2024, there was over R500bn in assets in South African Equity funds, with the two General Equity fund categories accounting for roughly 95% of these assets. As can be seen in Exhibit 1 below, niche equity fund categories such as those focused on stocks with certain market caps or within certain sectors have seen their market share, and the number of funds in these categories, dwindle over the years.

Exhibit 1 | Market share of South African Equity funds by ASISA SA Equity fund categories



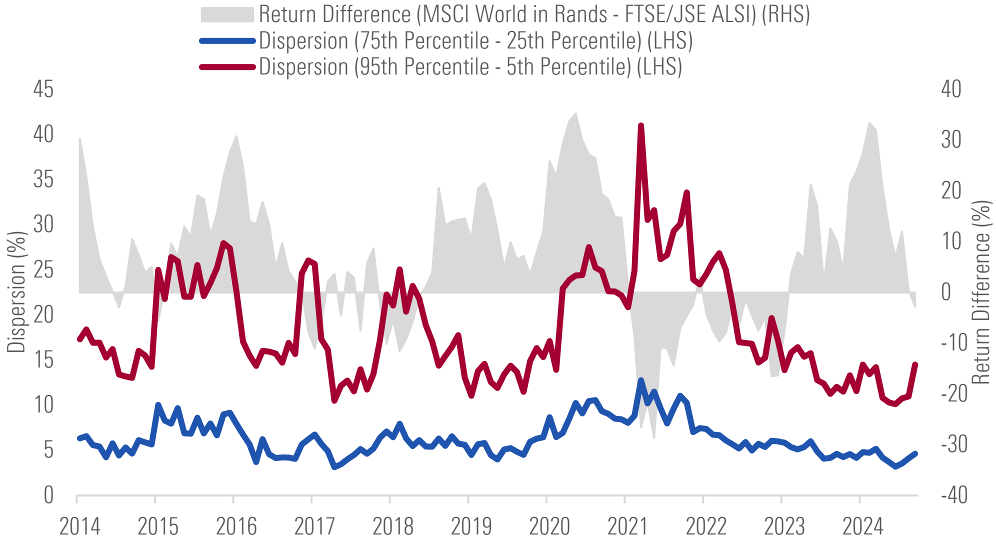
Source: Morningstar Direct Asset Flows. Data as of 31 October 2024. Market: South Africa Open-end ex FoF (domiciled). Past performance is not a reliable guide to future performance. For illustrative purposes only and not indicative of any investment.

What is also noticeable in the above chart is the increasing market share of SA-only funds. SA-only funds currently account for 42% of the assets held in South African Equity funds and have closed in on the market share of General equity funds over time. While it is difficult to attribute this to one factor, the rise of passive investing (where these funds are more likely to be SA-only funds) and the general preference of allocators to separate their local and offshore equity allocations may have played a role in the increased popularity of SA-only funds.

However, as the popularity of SA-only funds grew, so too did the dispersion between the returns of South African Equity funds. The main driver behind the increase in dispersion seen between funds in the old category appears to have been the regulatory increase in offshore limits, and the subsequent increase in use of that offshore allowance, by those funds in the category whose mandates allowed it. Exhibit 2 below captures the dispersion of returns between South African

Equity funds at different points in time by measuring the difference in rolling 12-month returns across different peer group percentiles. Overlaid with this, the shaded grey area on the chart captures the rolling 12-month return difference between the MSCI World Index in Rands and the FTSE/JSE All Share Index (ALSI). Where this grey area is positive it denotes the outperformance of the MSCI World Index versus the ALSI, and vice versa.

Exhibit 2 | Dispersion of rolling 12-month returns for South African Equity funds



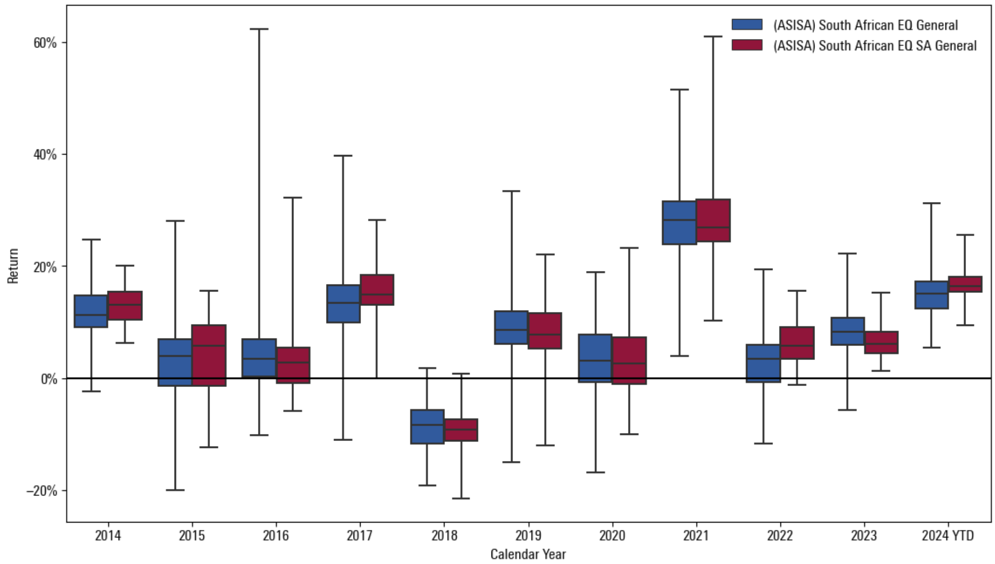
Source: Morningstar Direct, author's calculations. Data as of 30 September 2024. Market: South Africa Open-End Funds, ASISA Sector (South Africa) = (ASISA) South African EQ General and (ASISA) South African EQ SA General, Oldest Share Class. Past performance is not a reliable guide to future performance. For illustrative purposes only and not indicative of any investment.

Generally, what is noticeable in the chart above is that the dispersion in fund returns between South African Equity funds tends to spike during periods where the performance difference between local and global equities is at its widest. This is generally understandable, given that the investable universes of these funds can be vastly different depending on whether the fund is, or isn't, allowed to invest offshore.

With this as the backdrop, the creation of the new ASISA fund category goes some way to improve comparability between South African Equity funds. Exhibit 3 below depicts a box-and-whisker plot showing the range of returns delivered by funds in both the General equity category (where offshore is permitted up to the regulatory maximum of 45%) and the new SA-only category (where the funds invest exclusively in South African shares). The boxes in the chart depict the second and third quartiles of the categories, with the bisecting line showing the median observation for the period. The whiskers extending above and below the boxes represent the entire range of observations for each fund category during the period, from the highest to the lowest returns.

What can generally be seen in the chart is a far wider range of outcomes for General equity funds versus those of SA-only equity funds. This is understandable, given that the investable universe of SA-only equity funds is far more homogeneous than that of General equity funds, whose opportunity set is far broader.

Exhibit 3 | Box-and-whisker plot showing the distribution of calendar year returns for the ASISA South African – Equity – General and ASISA South African – Equity – SA General categories

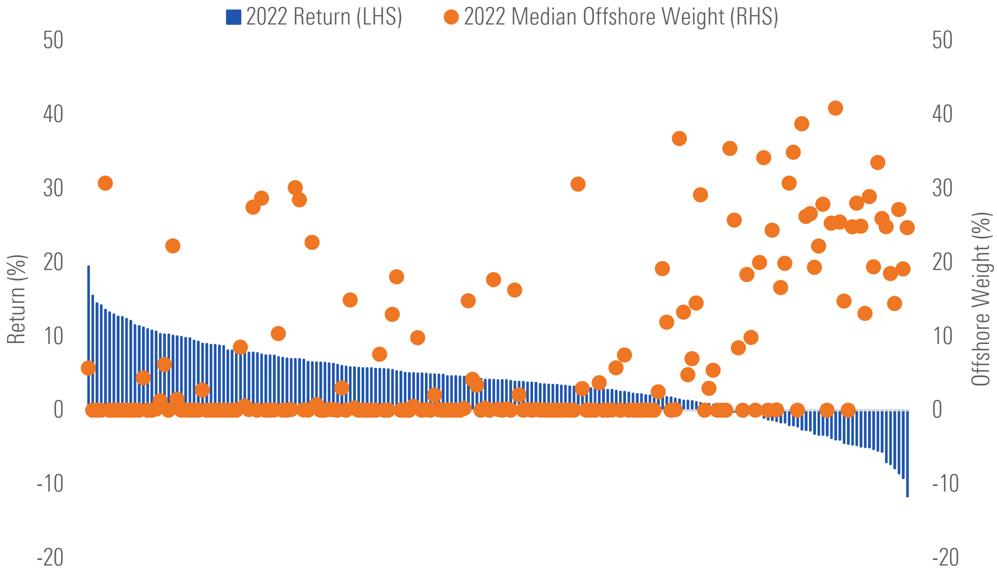


Source: Morningstar Direct, author's calculations. Data as of 30 September 2024. Market: South Africa Open-End Funds, Oldest Share Class. For illustrative purposes only and not indicative of any investment.

In looking at the chart above, the calendar years of 2022 and 2023 are interesting case studies of what was required to be a top-performing South African Equity fund in those particular years.

2022 was a year in which the local equity market outperformed the global equity market in Rands. The ALSI returned a positive, but unexciting, return of +3.6% in 2022. In contrast, the MSCI World Index produced a negative return in Rands as global equity markets suffered a material drawdown, returning -12.7%. Against this backdrop, you were generally better off holding very little offshore. Exhibit 4 below corroborates this. The chart shows the 2022 returns of South African Equity funds ordered from highest to lowest, with each respective fund's median offshore weight for the year depicted by the orange dot. Generally, the funds with the highest offshore exposure found themselves near the bottom of the pile in 2022, with the median offshore weight of a top quartile fund in 2022 being 0%.

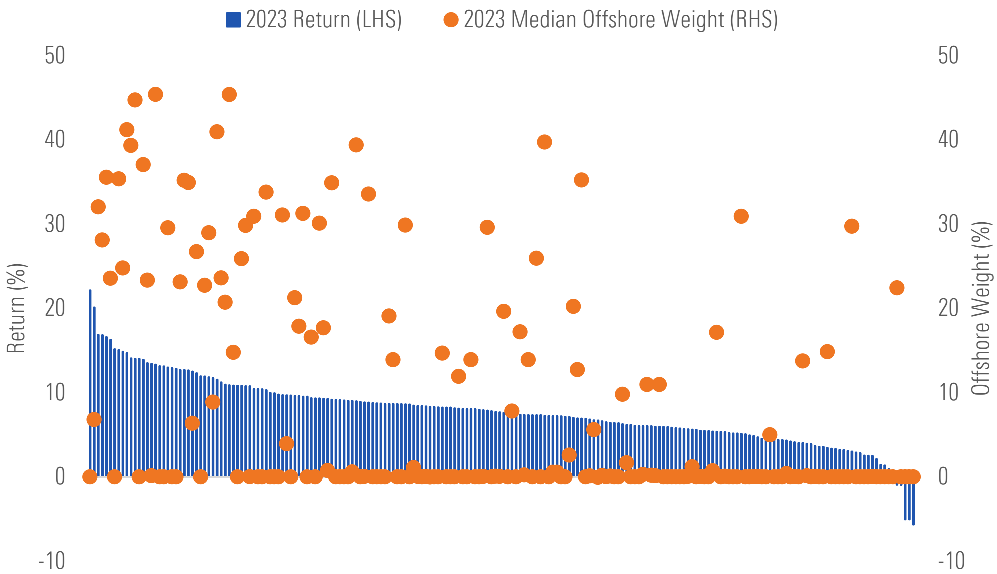
Exhibit 4 | South African Equity fund returns and median offshore weights for 2022



Source: Morningstar Direct, author's calculations. Data as of 30 September 2024. Market: South Africa Open-End Funds, ASISA Sector (South Africa) = (ASISA) South African EQ General and (ASISA) South African EQ SA General, Oldest Share Class. Past performance is not a reliable guide to future performance. For illustrative purposes only and not indicative of any investment.

In contrast, 2023 was a very different year. While the ALSI delivered a decent return of +9.3% that year, global equities rebounded strongly as the MSCI World Index delivered a return of +33.0% in Rands. In that market environment, you would generally have been better off with some offshore exposure in the fund. Exhibit 5, again, confirms this, with the funds with higher offshore exposure generally finding themselves on the left-hand side of the chart this time around. The median offshore weight of a top quartile fund in 2023 was 23%.

Exhibit 5 | South African Equity fund returns and median offshore weights for 2023



Source: Morningstar Direct, author's calculations. Data as of 30 September 2024. Market: South Africa Open-End Funds, ASISA Sector (South Africa) = (ASISA) South African EQ General and (ASISA) South African EQ SA General, Oldest Share Class. Past performance is not a reliable guide to future performance. For illustrative purposes only and not indicative of any investment.

There are several things that become clear when looking at the charts above:

- Firstly, peer group performance comparisons for South African Equity funds became increasingly difficult over time. In certain years, the extent of a fund's offshore exposure was a key determinant in its peer group ranking in that particular year. As a result, peer group rankings became less indicative of a manager's skill and more reflective of how much of their offshore allowance they were using.

- Secondly, many funds in the category weren't making use of the offshore allowance that the old category did allow. This would have either been driven by the manager's preference, or by the mandate of the fund. Either way, comparisons between SA-only equity funds and General equity funds became less of a like-for-like comparison as offshore limits increased and General equity funds made increased use of their offshore allowance.

- Finally, using offshore allowances in years favouring global equities didn't always guarantee better performance outcomes. For instance, in 2023, many funds with offshore exposure still underperformed the peer group average. Conversely, some managers with significant offshore allocations did well in the challenging 2022 environment. Thus, while getting the offshore exposure call right was important, effective management of that exposure was equally crucial.

Where are we now?

Effective from 1 October 2024, the new ASISA South African – Equity – SA General fund category came into existence. According to the fund classification data in Morningstar Direct, as of 15 November 2024, there are 67 different funds in the new SA-only category and 152 different funds in the General equity category. The largest funds in each of these two categories can be seen in Exhibit 6 below, along with the current offshore weights for those funds in the General equity category.

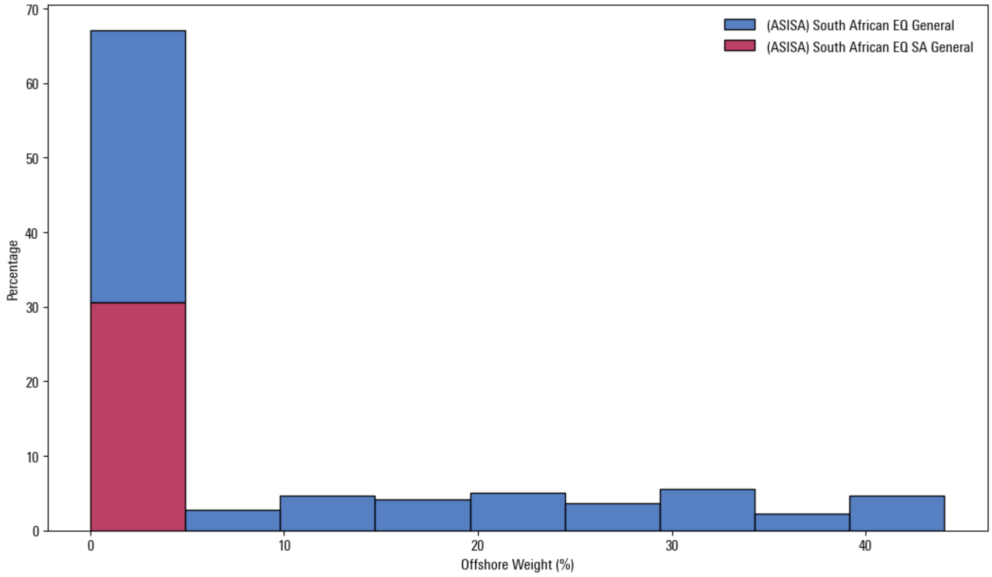
Exhibit 6 | Current fund sizes and offshore weights of the largest South African Equity funds by ASISA category

(ASISA) South African EQ General			(ASISA) South African EQ SA General	
Fund Name	**Fund Size**	**Offshore (%)**	**Fund Name**	**Fund Size**
Allan Gray Equity Fund	R46.3B	42	M&G SA Equity Fund	R38.5B
PSG Wealth Creator FoF	R26.0B	26	Coronation Top 20 Fund	R28.0B
Ninety One Equity Fund	R14.7B	29	Fairtree Equity Prescient Fund	R26.9B
Coronation Equity Fund	R11.0B	38	PPS Equity Fund	R13.6B
PSG Equity Fund	R9.6B	25	Old Mutual Investors Fund	R9.5B

Source: Morningstar Direct. Data as of 15 November 2024. Past performance is not a reliable guide to future performance. For illustrative purposes only and not indicative of any investment.

It is interesting to note the extent of the current usage of South African Equity funds' offshore allowance. SA-only equity funds, by definition, will hold zero offshore. General equity funds, however, can hold offshore exposure up to the regulatory maximum weight of 45%. Exhibit 7 below captures the current distribution of offshore weights in South African Equity funds.

Exhibit 7 | Histogram of the distribution of current offshore weights in South African Equity funds



Source: Morningstar Direct, Author's calculations. Histogram generated using Python and Seaborn. Data as of 30 September 2024. Market: South Africa Open-End Funds. Past performance is not a reliable guide to future performance. For illustrative purposes only and not indicative of any investment.

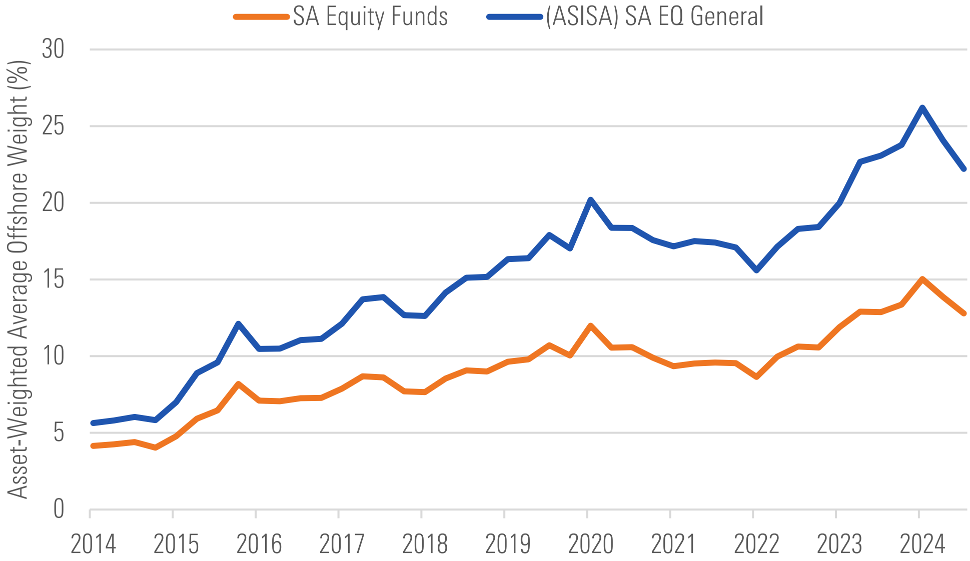
A few interesting observations can be made in the above chart:

- Firstly, among General equity funds there is no clear consensus in how these funds are making use of their offshore allowance. Offshore weights range from 0% to just under the regulatory maximum of 45%.
- Secondly, most South African Equity funds are making little-to-no use of offshore exposure. While this is understandable for SA-only equity funds, it is less understandable for those that remain in the General equity fund category.

There are two potentially plausible explanations for this second observation: 1) Those funds currently do not use their offshore allowance, but their mandates allow for it and they are retaining this optionality to potentially make use of this allowance in the future, and 2) Those funds intend to change categories, but missed ASISA's deadline for the implementation of the new fund category. The latter is entirely plausible given that some of the largest South African index funds in the market, which are SA-only equity funds given the indices that they track, currently remain in the old category with General equity funds.

Given the skewness of the above distribution and the lack of consensus on the usage of offshore by General equity funds, it is perhaps more useful to understand the trends in the use of offshore within South African Equity funds on an asset-weighted basis. This provides a picture of where the larger and, historically, well-supported funds in these categories have moved to with regard to their offshore allocations. Exhibit 8 below shows how the asset-weighted average offshore weight for South African Equity funds has changed over time, and how this has changed for the funds currently in the General equity category.

Exhibit 8 | Asset-weighted average offshore weight of South African Equity funds over time



Source: Morningstar Direct, author's calculations. Data as of 30 September 2024. Market: South Africa Open-End Funds, ASISA Sector (South Africa) = (ASISA) South African EQ General and (ASISA) South African EQ SA General. Past performance is not a reliable guide to future performance. For illustrative purposes only and not indicative of any investment.

From the chart above, the trend of increasing offshore weights in South African Equity funds is clear to see. Driven by regulatory increases in the offshore limit, the asset-weighted average offshore weight in South African Equity funds was 13% as of September 2024. When looking only at General equity funds, this sits at an asset-weighted average offshore weight of 22% at the same point in time. It is interesting to note that this is down from the peak of 26% that was observed in March 2024. This decline may reflect the short-term outperformance of local equities over global equities since this peak, and a possible shift in favour of local assets driven by a combination of improved sentiment following a positive local election outcome and more attractive valuations on offer in local equities.

Where are we going?

At the time of writing this piece, the new ASISA Fund Classification Standard is only a few weeks old. Things are still very much in motion, and it may still take some time for funds to reclassify and for the new categories to stabilise. Once the dust settles, we believe that there are a few potential trends that could emerge in the South African Equity fund landscape:

- **Different target markets:** The new equity categories could segment the South African equity fund universe and determine the target audiences to which funds in those categories are sold. While this existed to a certain extent in the older category, it may become more pronounced under the new fund classification standard. SA-only equity funds have generally been preferred by allocators such as discretionary fund managers (DFMs) and multi-managers, who typically prefer to separate the management of their offshore equity allocations from their local equity allocations as it makes it easier to control their overall offshore allocation from a regulatory perspective. General equity funds have typically been preferred by retail investors. The new fund classification standards may create more of a formal division between who firms are looking to target with their funds in the respective categories.

- **Choice of benchmark:** The different equity categories, and the recent JSE index harmonisation exercise, may provide a nudge for South African equity fund managers to reconsider the benchmarks of their funds. Given that it would be the most representative of their investable universe, SA-only funds should be more likely to opt for a local market index as their choice of benchmark. This is backed up by the data, where 91% of SA-only equity funds are currently benchmarked against a market index. The choice of benchmark for General equity funds becomes less clear. The use of a local market index is less appropriate here, especially if the fund is making use of its offshore allowance. A higher percentage of funds in this category have a composite benchmark, made up of weightings to both local and global market indices, but the level at which these percentages are set is also an important consideration. The use of the category average as a benchmark has become more prevalent among General equity funds, with 17% of this category currently making use of a category average as its stated benchmark. While this is a reasonable performance objective, the category average is not investable and so fails to meet the criteria of what the CFA Institute's Global Investment Performance Standards considers to be an appropriate benchmark.

- **Index funds:** Linked to the above, the SA-only equity fund category is likely to become the home of index funds going forward. This is understandable, given that these funds are tracking local market indices and so the investable universe is, by definition, going to be SA-only equities.

- **Offshore exposure:** Specific to funds in the General equity fund category, where the average offshore exposure of this category settles will be interesting to monitor. As was previously noted, the asset-weighted average offshore weight in this category is currently 22%. We would expect this number to move higher as funds in this category that aren't making use of their offshore allowance move into the SA-only category. Additionally, funds that perhaps used their offshore allowance sparingly in the past may now be forced to consider who and what they are up against from a peer ranking perspective. Within the General equity category, the use of offshore exposure is likely to remain a key determinant of peer-relative performance.

- **Product proliferation:** Before the establishment of the new fund classification standard, several firms had already established SA-only and General equity versions of some of their fund offerings. However, this was not the case for all firms. With a new fund category on offer in which they may not have an existing product, there is the potential that we could see new fund launches from firms to target different types of clients. As a result, we could see even more funds for sale in a market where, bewilderingly, the number of South African Equity funds on offer already outnumbers the number of shares in the FTSE/JSE All Share Index.

In conclusion

At Morningstar, we are supportive of the changes ASISA has made to its Fund Classification Standard. Ultimately, an effective classification system allows institutions, advisors, and investors to make better performance comparisons between funds that are operating with the same investable universes and under the same constraints. Separating the SA-only equity funds from the General equity funds is a long overdue step in the right direction to ensure that performance is being assessed on a level playing field, and it will be interesting to monitor how the industry adapts to the new fund categories. It gives investors, allocators, and asset managers plenty to think about in the months and years ahead.

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