INVESTMENT INFORMATION:

FEEDER vs DIRECT FUNDS

Offshore investing may have been in the spotlight again recently, but diversifying your portfolio across regions, currencies and industries has always been a good strategy. Maintaining your spending power as the rand depreciates, is another good reason to keep a portion of your portfolio in foreign currency.

The second is to invest in ZAR, which is then 'swapped' into foreign currency – known as an asset swap. Investors can access asset swap investments privately or via SA feeder funds.

FEEDER FUNDS AND DIRECT FUNDS – WHAT'S THE DIFFERENCE?

A feeder fund is a South African unit trust fund that feeds into a direct offshore fund. The investment is made in ZAR which the investment company then converts into foreign exchange, using their asset swap capacity.

It's a less complex way of investing offshore as no SARS clearance is needed on the part of the individual. The investment minimums required are also generally lower than for a direct offshore investment, making feeder funds more accessible to a broader market. Essentially, they provide a way for investors to get offshore exposure in their local portfolios, and they can be used in general savings investments, such as an investment plan and well as in retirement income portfolios.

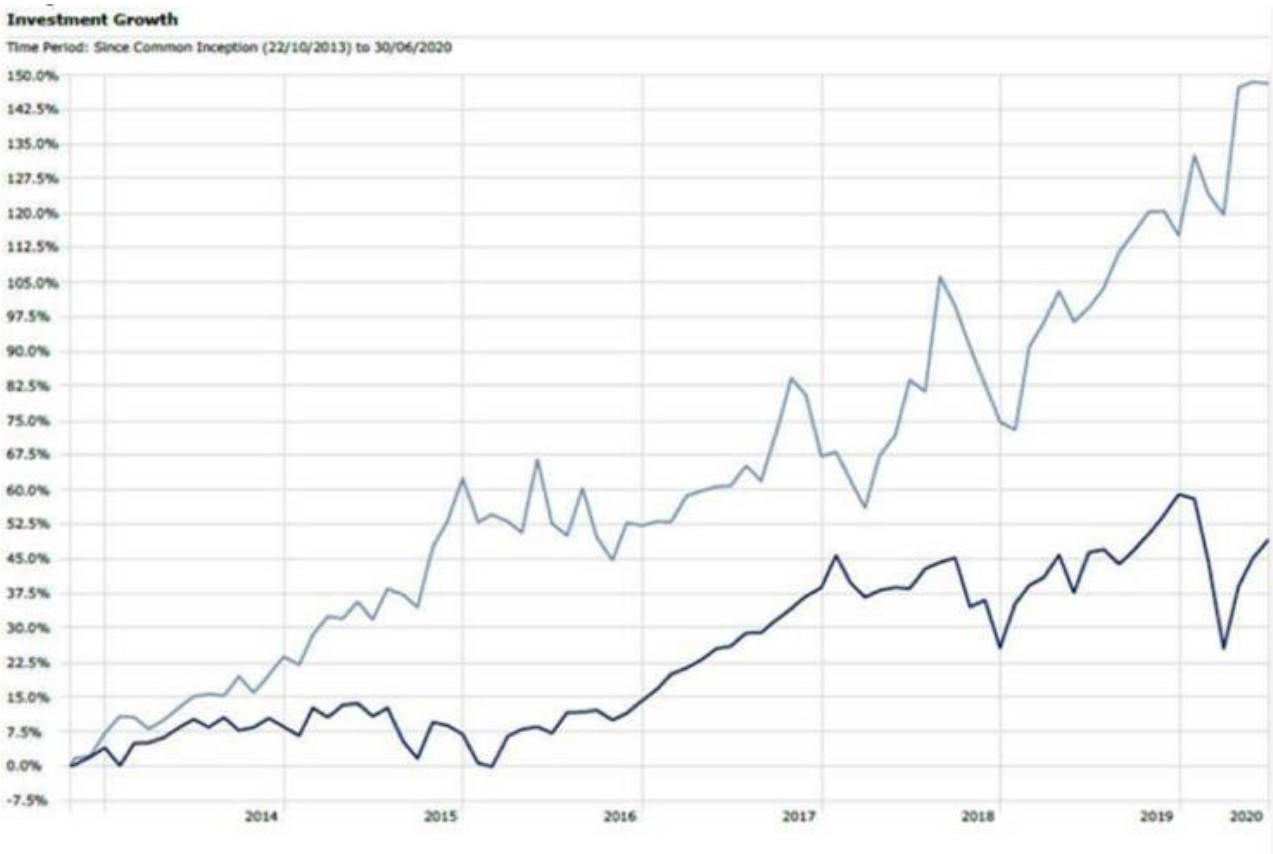
A direct fund, as we've said, requires SARS clearance for amounts over R1m, and generally a higher investment amount is needed. However, as will be shown in this article, the direct fund can be more efficient from both a tax (assuming a weakening ZAR) and cost point of view.

LET'S LOOK AT A COMPARISON

In the graph below, we've used the Satrix MSCI World Equity Index Feeder Fund in ZAR (light blue line) as a proxy for an international investment in world markets. This feeds into the Satrix World Equity Tracker (dark blue line) which reports in USD. Essentially, they're both the same fund, with one reporting in ZAR and the other in USD.

Looking at the returns since inception – at an initial glance – we see that the feeder fund appears to have outperformed the USD fund. But remember, the graph below is in the base currency. In Table 2 below we convert the USD back to ZAR to get a clearer view of the situation.

Graph 1



Source: Morningstar

COSTS MATTER

The return from the direct fund is higher in ZAR terms due to it having a lower fund fee than the feeder fund. The direct fund has a total expense ratio of 0.82% versus the feeder fund's total expense ratio of 0.90%. If the total expense ratios of the two funds were identical, the values of the two funds would be identical in ZAR terms. But this scenario is highly unlikely due to the cost of the asset swap associated with the feeder fund and because of the added administration fees of having two unitised vehicles, one locally and one offshore. Although the above cost difference may seem small – on a compounded basis, this saving could have a material impact over time. Investment platform costs were not taken into consideration in this example.

Table 1

Feeder fund vs direct offshore fund since inception: 22 October 2013 to 30 June 2020

1. Satrix World Equity Feeder Fund	22/10/2013 to 30/06/2020	2. Satrix World Equity Tracker USD
R1 000 000	FX R9.73	$102 775
148.10%	Return	49.10%
R1 481 000	Gain	$50 463
R2 481 000	Gross End Value	$153 238
	FX R17.36	R2 660 212

1. Satrix World Equity Index Feeder Fund to 30 June 2020 – 148.10%
2. Satrix World Equity Tracker C USD to 30 June 2020 – 49.10%

We've seen that costs can make a difference – but what about tax?

TAX CONSIDERATIONS

The investor in the direct fund would have converted ZAR to USD in 2013 (investment commencement date) and will then only pay capital gains tax (CGT) on the USD gains. When investing directly, currency movements over the investment period are not taken into account for tax purposes. In the case of a feeder fund, currency gains are included for CGT purposes.

In Table 2 below, the feeder fund has a gain of R1 481 000 against the direct fund's gain of $50 463. CGT will be at the effective rate applicable to the investor, but we've used 18% (the maximum) in our example.

The CGT payable is R157 687 on the direct fund (the $9 083 gain multiplied by the R17.36 exchange rate on the day), versus R266 580 on the feeder fund, which is over R100 000 more.

This shows that the direct fund is more favourable when it comes to capital gains tax (assuming a weakening currency over time) as well as cost.

Table 2

Capital gains tax comparison

30 June 2020	1. Feeder fund	2. Direct fund
Gross Ending Value	R2 481 000	$153 238
Gain	R1 481 000	$50 463
CGT (max 18%)	R266 580	$9 083
X R17.36		R157 687
Net Withdrawal Value USD		$144 155
Net Ending Value ZAR	R2 214 420	R2 502 531
Difference		+ R288 111

TO RECAP

A feeder fund offers global diversification, a hedge against a weakening rand, and provides a relatively simple way for the average investor to include an offshore component in their portfolio, with a lower investment amount than required by a direct investment. The above examples have shown, however, that the costs are generally higher and the tax could be more onerous (if the currency depreciates) than with a direct offshore fund.

As always, an investment strategy should be particular to each individual's needs and goals, and we urge you to speak to a qualified financial adviser to ensure your strategy will best serve your needs.