

The history of 'securities rand' and the effects the securities rand differential has had on overseas investment in South Africa

The comments made in this article are believed to be correct and are made on the basis of experience over a number of years. They should be read as offering guidelines rather than as definite statements or interpretations of the regulations.

It must be emphasised that any queries or interpretations relating to exchange control should be made via commercial or merchant banks, who will refer such matters to the Reserve Bank if necessary.

1 HISTORY

In June 1961, stringent exchange control regulations were introduced in South Africa to stem the large outflow of capital following the event of 'Sharpeville' and ahead of South Africa's withdrawal from the Commonwealth. Our gold and foreign exchange reserves had fallen to the dangerously low level of R153 million at the end of May 1961.

As far as non-residents are concerned, the regulations have had the following main effects (which do not refer to South African emigrants):

- 1 Until February 1976, the proceeds of shares sold locally were blocked, and blocked rand could only be reinvested in other securities listed on The Johannesburg Stock Exchange or placed on call or deposit with an authorised bank.
- 2 Blocked rand could be used to subscribe for Republic of South Africa non-resident bonds. (These are non-interest bearing and tenders on a monthly basis at R85% are normally accepted. The bonds must be held by the same non-resident continuously for a period of five years to maturity when the proceeds become transferable.)
- 3 Blocked rand could be used to subscribe to government, municipal and public utility stocks and provided these had not less than five years to mature, the redemption proceeds were transferable to the non-resident provided he had held the stock continuously for at least five years to the date of maturity.
- 4 Blocked rand could be utilised to take up additional shares issued to a non-resident against rights which accrued on existing holdings of quoted shares, provided the new shares were of the same class and in the same company as the shares held and would rank pari passu with the existing shares.
- 5 Dividends and interest earned were freely transferable subject to non-resident shareholders' tax (NRST), of 15% in the case of dividends and 10% NRIT in most cases of interest. (Interest earned from government, municipal or public utility stocks is not subject to NRIT.)

Since February 1976, the authorities have distinguished between blocked rand and securities rand. The term blocked rand now refers to funds held locally by South African emigrants and such funds are subject to various restrictions. Direct transferability of securities rand between non-residents is now permitted, whereas previously non-residents had had to reinvest their blocked rand in listed securities which, following non-resident endorsement, were freely exportable for sale in an overseas market.

Items 1 to 5 above in regard to blocked rand are now applicable to securities rand.

Securities rand are traded officially on The Johannesburg Stock Exchange with bid and offered prices expressed in US cents. Broker's notes are issued in US currency.

It should also be mentioned that authorised banks will release to immigrants securities rand to the value of R20 000 on arrival without reference to the Reserve Bank but they may apply for the release of additional and larger amounts after the expiry of three years' residence. This concession has been extremely beneficial at times when the security rand differential has reflected a sizeable discount. Some immigrants have been fortunate to import their capital at a premium to them of approximately 50%.

Originally such transactions were effected in equities but later, due to cost considerations, gilts were used. Now the immigrant can arrange for the purchase of securities rand against payment of the currency of the country of his previous domicile.

For example, if an immigrant from the United Kingdom wished to transfer sufficient sterling through official banking channels to have R20 000 in South Africa, he would have to outlay £13 442 (exchange rate R1,49 to £1). However, if he were to purchase securities rand at a price of 69 US cents (40% discount) to arrive at a figure of R20 000, he would only have to spend £8 086. A 40% discount from the Johannesburg price is equivalent to a 66% premium over the overseas price. ($115 \div 69 = 1,66 = 66\%$; $69 \div 115 = 0,60 = 40\%$)

2 THE EFFECT ON SHARE PRICES AND ARBITRAGE AS A RESULT OF THE INTRODUCTION OF SECURITIES RAND

As mentioned earlier, securities bought or owned by non-residents must be endorsed as 'non-resident' owned shares. 'Non-resident' endorsed securities are freely exportable and may be sold on overseas markets. However, the immediate result of the control over capital transfers (as well as the then state of our gold and foreign exchange reserves) resulted in a differential emerging between the level of share prices ruling locally and overseas. Investment sentiment was at a low level with confidence both locally and overseas

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strained. Rather than have the proceeds of the sale of shares blocked by selling in Johannesburg, non-residents preferred to sell in overseas markets and share prices in those markets fell as a result of selling pressure until supply and demand came into equilibrium.

Early arbitrage transactions were effected at differentials of approximately a 40% discount until the rate settled at about a 25% discount. A graph reflecting fluctuations in this rate is produced under Table 1. A narrowing or widening of the differential reflects the demand/supply relationship between the local and overseas markets and therefore acts as a confidence indicator. The rate should not move to a premium over the official exchange rate (say between the rand and the dollar) because payments can be made at the official rate through normal banking channels.

Today most international arbitrage is based on dollar prices compared with local prices and the following example is offered as an explanation:

Local price 100 SA cents = 115 US cents (official exchange rate \$1,15 to R1)

Overseas price 92 US cents
 Percentage discount: $\frac{115 - 92}{115} \times 100 = 20\%$

Based on the above example, the price of securities rand quoted on The Johannesburg Stock Exchange would normally be 91 US cents buyers, 93 US cents sellers.

Following the introduction of capital transfer controls in June 1961, arbitrage operations were effected in a rather laborious manner called four-way arbitrage. This included a purchase in London and the sale of the shares in Johannesburg, thereby creating a blocked rand credit balance at a rate of say 20%. The arbitrageur would then purchase other shares in Johannesburg (paying for the purchase with his blocked rand credit), which he would hope to sell in London at a rate of 18% in order to make a profit. Shares were merely a vehicle for creating a currency at a rate in order to use that currency at a different rate on a return transaction. While South African arbitrageurs remained in a situation where their intention was to profit from share price differences between markets, overseas arbitrageurs had to concentrate on fluctuations in the blocked rand rate.

The same situation applies for securities rand, but the overseas arbitrageur has become far more sophisticated in his risk operation. He now takes a view on a rate and will create securities rand at that rate, either by selling shares in Johannesburg or buying securities rand. His view will then be that the rate is going to narrow towards parity in order to make a profit.

INVESTMENT DOLLAR PREMIUM

The position of all non-United Kingdom overseas arbitrageurs is identical and prices of South African shares ruling in Northern America and Europe will be at similar levels expressed in US dollars, and will reflect a similar discount on Johannesburg prices.

In the United Kingdom, however, the imposition, in June 1972, of the investment dollar premium on South African securities altered the situation. A UK purchaser of South African securities must now pay for them with investment dollars purchased from the 'dollar pool'.

In London, South African securities are quoted 'cum premium' i.e. the share price includes the investment dollar premium. If the dollar premium is stripped off the price one arrives at an ex-premium price, which in the case of South African securities would be similar to the discount price quoted in other overseas markets: the difference between the ex-premium price and the Johannesburg price reflects the securities rand discount. The initial impact of the investment dollar imposition was to widen the blocked rand rate (as it was then known) and subsequently as the demand for investment dollars increased, the blocked rand discount widened further as reflected in the Chart.

It is necessary to distinguish between the quoted investment dollar premium and the real premium. The difference between these is due to the fact that it was decided to keep the investment currency conversion rate at \$2,60 to the £ and to bring into the equation the floating £ exchange rate.

The real premium is calculated as follows:

$$\text{Real premium} = X (100 + \frac{\$ \text{ prem}}{2,60}) - 100$$

Where X = ruling £/\$ rate
 \$ premium = dollar premium expressed as a percentage

The formula used to strip the dollar premium from the cum premium and convert it to a comparable Johannesburg price is as follows:

$$100 \left[\left(\frac{\text{London price}}{\text{Jhb. price}} \right) \times \left(\frac{\text{Old } \text{£}/\$ \text{ rate (i.e. 2,60)} \times 100}{\frac{\$ \text{ prem.} + 100}{100} \times \text{Rand}/\$ \text{ rate}} \right) \right]$$

The second part of the equation is:

$$\frac{\text{Old } \text{£}/\$ \text{ rate}}{\frac{\$ \text{ prem} \times 100}{100} \times \text{Rand}/\$ \text{ rate}} \times 100$$

This, however, can be simplified by using the 'factor' reported by Reuters daily which gives all but the Rand/\$ rate. When the Rand/\$ rate is applied to the factor and the result then applied as in the original equation, the discount is obtained:

$$100 - \left[\frac{\left(\text{Conversion factor} \right) \left(\text{London price Cum premium} \right) \left(\text{Spot } \text{£}/\text{Rand rate} \right)}{\text{Johannesburg price}} \right] 100$$

The following excerpts from an article in 'Lloyds Bank Review' by P. K. Woolley on 'Britain's Investment Currency Premium' are worth quoting:

'There is, in effect, a pool of foreign exchange available for use for portfolio investment abroad, the size of which is determined first by the value of overseas investment at the time of the introduction of the exchange control regulations, secondly, by the subsequent changes in the value of the securities represented in the pool, and thirdly, by subtractions from or additions to the pool by various means by the authorities.'

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The pool is believed to have a value of about £6 000 millions — the current market value of UK investors' holdings of foreign securities based on exchange rates in the official market.

'Over most of the past twenty-seven years UK investors have, in aggregate, wished to hold foreign securities to a value greater than that of those in the pool and as a result there has typically been a premium on investment currency. In other words, since the demand for investment currency has exceeded the supply when valued at the official exchange rate, the price of this currency has been bid up, creating a premium which is the same whatever the currency denomination of the security.

'The level of the premium at any time is the percentage by which the aggregate desired holdings of foreign securities in the portfolios of UK residents exceeds the current level of the pool when this is valued at the concurrent spot rate.'

THE 25% SURRENDER VALUE RULE

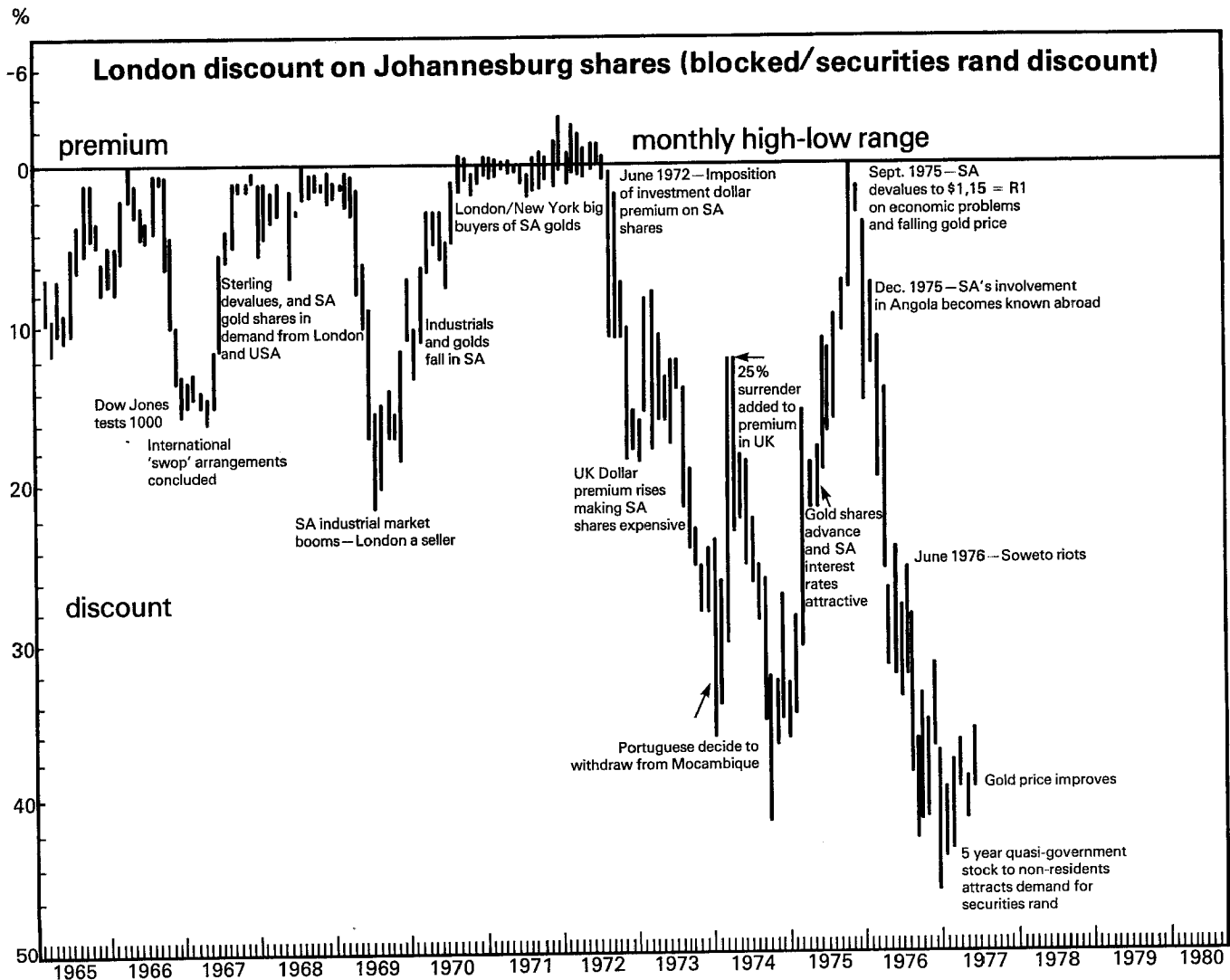
What was of far more concern, and has had a most adverse effect, was the imposition of a 25% dollar premium surrender rule by the United Kingdom authorities in February 1974. This required that UK investors pay to the authorities 25% of the dollar

premium proceeds of a sale of foreign securities. It is a tax on foreign investment and had the effect, as far as the dollar premium pool was concerned, of contracting the size of the pool and causing the premium to harden. The graph reflects the correlation between the rising premium and widening securities rand discount.

The major effect, however, was the increase in costs to United Kingdom investors of investing in South African securities. With a real dollar premium rate of say 40% and a £/\$ rate of 1,717, the surrender would amount to approximately 10%. Taking into account the cost of dealing (brokerage and tax) of say 4%, the price of the share would have to rise by 14% to reach a break-even point.

The United Kingdom investor in foreign shares therefore has to watch not only fluctuations in the basic share price but in the dollar premium as well.

The United Kingdom arbitrageur has to watch three basics: the share price, the dollar premium rate and the securities rand rate. He, therefore, has to contend with a higher degree of risk than his South African counterpart. Analysts might find it of interest to study the performance, for example, of the RDM Industrial Index in relation to the securities rand rate.



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In May 1969, when the RDM Index reached a peak, the blocked rand rate was standing at a 25% discount. In other words, there was not the same level of confidence in London as locally that share prices were likely to remain at such high levels.

Other examples can be traced on the graph accompanying this article.

The period from June 1970 to June 1972 reflects the securities rand rate fluctuating narrowly either side of parity. Both London and New York were large buyers of gold shares while London had been a buyer of South African industrials ahead of a revival of local investment confidence.

The effect of the inclusion of SA shares in the investment dollar pool in June 1972 and the imposition of the 25% surrender rule in February 1974 are clearly reflected.

The reaction to political events such as developments in Mozambique, Angola and Rhodesia are also evident.

It is also interesting to note that the investment dollar premium rate fell between May and June 1975 as United Kingdom investors were selling South African gold shares and this increased the size of the pool despite the inhibiting effect of the pool being restricted by the 25% surrender rule tax. The subsequent increase in the rate was due to UK buying of American securities.

A final point is that the return to a non-resident investor in South African securities is of course based on the price ruling in his own market having allowed for the effect of non-resident shareholders' tax on dividend/interest income.

For example, if the local price of De Beers Deferred is 430 cents, the New York price based on a 40% discount would be 297 US cents, while the UK cum-premium price would be 242 p.

The return in each case at current exchange rates would be:

	Johannesburg	New York	London
	cents	US cents	pence
Price	430	297	242
Dividend	35	40,25	20,38
	%	%	%
Gross yield	8,14	13,55	8,42
Net yield after NRST	—	11,52	7,16

The level of the discount also has an effect on the return to a non-resident investing in government, municipal and public utility stocks where the proceeds become

transferable at maturity provided the stock has been held continuously for at least five years. (Such stocks do not attract NRST.)

In considering such an investment the non-resident should be aware that the securities rand rate fluctuates and also that his yield to redemption is subject to exchange rate fluctuations as a result of devaluations/revaluations between the time of purchase and maturity.

The following examples set out the return firstly to a local investor, secondly to a non-resident investor where the securities rand discount is 20% and thirdly, where the discount is 40%.

1 e.g. 5 $\frac{1}{8}$ % stock 1976/1982 (local investor)

Current clean price R72,06	
Interest received over 5 years	R25,625
At redemption	100,000
	<u>R125,625</u>

Yield to redemption (5 years 4 $\frac{1}{2}$ months)
= 12,40% p.a.

2 e.g. 5 $\frac{1}{8}$ % stock 1976/1982 (20% discount)

Current clean price R72,06 =	\$66,30
	(securities rand at 92 US cents)
Interest received over 5 years	R25,625
At redemption	100,000
	<u>R125,625</u>

= \$144,46 (\$1,15 = R1)

Yield to redemption (5 years 4 $\frac{1}{2}$ months)
= 17,64% p.a.

3 e.g. 5 $\frac{1}{8}$ % stock 1976/1982 (40% discount)

Current clean price R72,06 =	\$49,72
	(securities rand at 69 US cents)
Interest received over 5 years	R25,625
At redemption	100,000
	<u>R125,625</u>

= \$144,46 (\$1,15 = R1)

Yield to redemption (5 years 4 $\frac{1}{2}$ months)
= 24,80% p.a.