Saving and Investing Offshore – An Outline

The following material covers terms and concepts in saving and investing, and issues in saving and investing offshore. It begins with the need to save, goes on to different kinds of investment, gives parameters for investment selection, and then looks at what the offshore investment world can offer.

1. The Need for Saving and Investing

Few people dispute the need to save against a rainy day; most also accept the wisdom of saving for major future expenses. Large ones are typically:

- Education fees (for yourself for further courses of study, perhaps; or, if you have any, for your children)
- Large lump sum purchases (particularly property)
- The costs of retirement (retirement meaning the point at which you cease earning a regular income through employment).

Although these expenses are easy to anticipate in the abstract, in practice few people are as prepared as they would like to be – and some are not prepared at all – when the time comes for them.

There are several reasons why this situation arises:

Not starting early enough.

The younger you are, the further off major future expenses may seem – although be in no doubt they will arrive in due course. You will receive not many more than 500 pay cheques during a monthly-paid working life even if you work all the way through. The majority of people do not start taking their future needs seriously until their mid to late thirties, by which time they have had and mostly spent at least a third of their pay cheques already. It is these early pay cheques, however, which work the hardest in investment terms as they compound over the longest period of time (see the section on Compounding below). The later you leave the commencement of disciplined saving, the more you need to save on a regular basis to achieve the same end result. While your income level may rise as you get on in years, your financial responsibilities and/or tastes almost certainly will also. You may not have more disposable income to save at some unspecified future point. The earlier you can start, the better.

Not enough income/unforeseen expenditures.
It is an unfortunate fact of life that almost everyone receives a lower level of personal income than they would like. It is also unfortunate that the unexpected does happen and never seems to stop doing so – you dent the car/the washing machine breaks down/the taxman pounces, etc. These factors are not going to change. They do point to the need for a planned and disciplined savings programme, however, as without one, money tends just to disappear. They also point to the need for realism about the achievability of future financial goals.

The belief (or hope) that your national government will provide a safety net.
You may not have children, or if you do, you may intend to send them to a state school. You may not get involved in the purchase of property or may buy a home through a long-term mortgage, perhaps partially paid by tenants. Once you retire (as defined above), however, you have earned your last pay cheque. If you have an employment-related or private pension arrangement, good. If not, you will have to live off your savings, as current developed country retirement pension levels are at the moment scarcely adequate (assuming you are entitled to one), and will slowly deteriorate as the demographics of ageing throw an increasing burden onto a steadily shrinking workforce. Retirement is not cheap, as you have much more time on your hands than you have been used to, and hopefully still have the health and verve to do all those things that work had prevented you from doing. How much money will you need? – A difficult question to answer as you don't know how long you will live (it's best to be optimistic!), but certainly you will need more money than your state pension will get you; and augmenting whatever private or employment-related pension you may have is strongly advisable.

Inflation.
Economic cycles come and go. The last decade and a half saw low inflation in the West and deflation in Japan; the one previous, disinflation (= declining inflation). The present decade began with fears of asset deflation in the West. Inflation is a permanent possibility likely to return and is being ushered in by burgeoning Asian demand for raw materials; it is almost a certainty that in the next thirty years there will be another surge in inflation at some point. Those who remember the 1970s in W.Europe and the US will know how deadly inflation can be: while deflation destroys the value of assets, inflation destroys the value of savings. Three consecutive years of 20% inflation will reduce the purchasing power of a nest-egg by just about half. This is a powerful reason for maximising retirement savings, and for ensuring that throughout they are judiciously invested.

2. Forms of Saving and Investing

Saving means putting money away for the future. Investing means placing money into assets with the expectation of a future return, either in the form of an income stream, which may be reinvested, or of a capital gain, or both. It should be apparent from these two definitions that saving and investing are overlapping terms. They use the following **conventional asset classes** (= kinds of investment).

The most obvious form of saving is **cash**. Cash placed in a bank or post office is reasonably safe, especially if there are government guarantees involved, and will get whatever return the bank or post office will give you. Unfortunately cash is the worst performing asset class, returning an annual average of 1.4%, 1918~1998 inflation adjusted.[1] At that rate, it will take 49.5 years for the value of your money to double in real terms.

Bonds are considered to be the next safest asset class – indeed, the short-term bonds of some governments are considered the safest investment of all (but fetch no more than cash). Longer-term bonds are structured debt obligations where the borrower returns the debt to the lender at the end of an agreed period, and in the interim pays the lender a fixed amount of interest at an agreed regular period. For this reason bonds are often referred to as fixed interest securities. The lender assumes two risks: that they will get their principal back as well as being paid the interest, and that inflation will not have reduced the value of the money they have lent by more than they had expected. If a bond is held to the end of its term and the issuer does not default, the lender will receive all their principal back plus the interest payments along the way. In that sense there is no volatility involved. However, most bonds are not held till the end of their term and are traded in bond markets. Their prices fluctuate in accordance with market perceptions of the creditworthiness of their issuer, and assessments of future inflation. Bonds, especially higher-yielding bonds, can be more volatile than blue-chip stocks. 1918~1998 inflation adjusted, bonds returned an annual average of 2.6%.[2] At this rate your money would double in real terms in just over 27 years.

Stocks are shares in a company's equity, and thus are normally referred to as **equities**. They participate in the company's earnings stream, perhaps receiving a regular dividend, and achieving a capital gain if the stock price goes up in anticipation of increasing future earnings. Stock prices may go down, however, if the outlook for a company's future performance is negative; furthermore the dividend may be cut or withheld. The company might also go out of business, in which case the shareholders are last in line in their claim on the company's assets, and normally receive nothing at all. However, the value of a healthy company will increase in times of inflation as it is derived from its assets and future business potential. Although volatile, equities have the best historical return, at 8%, 1918~1998 inflation adjusted.[3] This return would double your money in real terms in just over 9 years.

One problem with equities is that the general public is the last to find out about bad news emanating from a particular company and the investing general public is therefore most likely to suffer as a result. It is safer to spread the risk by holding shares in a portfolio of companies. For the general public, however, researching a number of companies may not be possible and the transaction costs of putting together a number of small holdings may place a significant drag on the investment. For this reason **equity mutual funds** were

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[1] *Barclays Capital Equity Report* (1998), all world markets.
[2] *Barclays Capital Equity Report* (1998), all world markets.
[3] *Barclays Capital Equity Report* (1998), all world markets.

created: a professional manager selects a portfolio of stocks according to a stated theme (country, region or sector). Risk of specific companies underperforming is thus spread, and the investor is able to benefit from the manager's expertise. Some of these equity mutual funds may be **specialist equity funds**, in for example **property**, **gold**, or **commodities**, and thus add greater diversification to a portfolio.

Another way of achieving this effect is through funds which mimic a particular stock index, called **index tracker funds**. The question concerning mutual funds is whether they can outperform their comparable index or not: many do not but some do by quite a long way; an index tracker fund on the other hand by definition cannot beat its own index.

Just as equities on a particular theme can be bundled together in a mutual fund, so can bonds, in **bond funds**. Bond funds may have a risk profile ('high yield' = risky/'junk'; 'high grade' = relatively secure, lower yield); whatever their risk, as they are made up of traded bonds, whose prices may vary with market perceptions of default risk and inflation risk, bond fund prices may go down as well as up.

To achieve further diversification and adjust to market conditions, funds may be a mix of equities, bonds and cash, with the manager varying the weightings and moving into different currencies, countries and sectors according to market conditions. Such funds are termed **managed funds**, normally labelled cautious, balanced and aggressive in terms of risk profile.

Another variation on managed funds is **with-profits funds**, where a fund manager smooths returns by setting aside some of the gains from past profitable years to top up the shortfalls from future poor years. With-profits funds will underperform in years which have positive equity and bond returns; however, although their relative performance will be better in negative years, they can still fall as they are based on the underlying managed funds. Recent problems with some with-profits funds in the UK point to the rather arbitrary nature of annual allocations by the manager and cast doubt on their foresight in making these allocations, as well as on the transparency of the process.

These are the conventional asset classes available to investors. For bonds and for most equities, investment performance depends on prices going up. There is another class of asset, however, called **alternative investments**, which can make money in up, down and sideways equity and bond markets. This flexible stance is obviously an advantage when markets are not going up.

The main vehicle for alternative investments are **hedge funds** and **managed futures**. Hedge funds have earned a reputation for risk in the media due to a few "macro" funds getting mega-bets wrong. Most hedge funds and managed futures houses are not like this at all: they exist to produce consistent returns in diverse market conditions while avoiding risk and protecting capital. They aim at 'absolute returns', i.e., to make profits whatever the direction of the markets. Managed futures traders, trading in commodities, currencies, metals, bonds and equity indexes, while taking some directional bets, also seek to hedge

their overall exposure and produce an absolute return. Over the last decade the best of their kind have kept pace with high-performance mutual funds and with smoother returns.
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A further development on this theme is a **fund of funds**, where a fund manager invests into several hedge funds or managed futures programmes. This could be for one of two reasons: to gain access for people of more modest means to hedge funds that are normally only available to high net worth individuals (some hedge funds require US$5m as minimum entry), and/or to construct a strategy made up of hedge funds/managed futures with negative correlations to each other, trading in different markets and with different styles, so that the investment is fully diversified and the volatility further reduced.

Some hedge-fund or fund of fund investments come with a **capital guarantee** from a major bank. The hedge fund(s) within the investment trade independently. The bank promises to repay your entire capital after an agreed period, for example ten years. Whatever profits your investment in the hedge funds have made in that period are added to your principal. You thus have the possibility of equity-type returns, but with much less volatility, and the security of cash.

3. Investment Choice and Performance

Which investments to choose? And how to assess their performance? In light of the above descriptions, this section discusses some parameters and measures for investment selection and review.

Risk and Reward

It is axiomatic that the more risk you take the more you stand to lose, or to gain; and the less risk you take, vice versa. This relationship is of course a generalisation; in practice each investment will have a specific outcome, where a 'risky' investment might return very little, but lose nothing, and a 'safe' investment might produce an exceptional gain, or suffer a large loss. On the whole though, the 'risky' investment stands a higher chance of a large gain or loss than a 'safe' investment.

The historical inflation-adjusted returns for the major asset classes suggest a different assessment of risk and reward, however. Cash, perceived as 'safe', has, over time, the highest chance of the poorest return, with bonds a close second, while equities have the highest chance of the greatest reward. Given that you can never know how an investment will perform until it has performed, the real question for the investor is how as a matter of strategy you can aim to maximise returns by embracing apparent risk, while minimising the possibility of loss. This decision-making process involves choices in asset class selection.

Diversification

If you make a single investment, you are fully exposed to its risk/reward characteristics. This risk is spread to some extent if you choose several investments of the same kind, or

a mutual fund on a specific theme, but nevertheless it is likely that all the elements of the investment will perform roughly the same way in a given set of market conditions, meaning that risk is not spread very far. Risk is spread much further if you invest in a range of asset classes that will perform differently to each other as market conditions change. Returns may not be spectacular for any specific year, but they will be much less volatile, in other words, much more consistent. It follows therefore that the variety and balance of investments selected is the paramount consideration.

These investments may themselves comprise a spread of investments – for example some equity mutual funds in different countries and sectors, some managed funds, some conservative hedge funds, and some capital protected instruments. Placed in this way, modest sums of money can be spread across several hundred underlying investments. It is thus possible to have long-term equity exposure with its superior returns while hedging against risk.

The actual balance of investment types selected will of course depend on the investor's attitude towards risk, the investor's age and time-frames, and current market factors.

Cost Averaging

The discussion on investment choice has implicitly considered a portfolio as being a lump sum. It can be, and many people do have lump sum portfolios (many also have lump sums wasting in yen in banks/the post office) – but a portfolio can also be constructed over time by means of regular savings. Regular contributions add an extra element of diversification not available to lump sum portfolios, which is diversification over time.

Equity and bond markets fluctuate – the value of equity and bond investments go up and go down. If you save and invest on a fixed, monthly basis, you will put the same amount of money into equity and bond funds regularly. If prices fall, you buy more units of the fund. If they fall further, you buy even more units. When prices turn around and start heading back up again, you have many more units than you would have had if prices had remained stable, and these will multiply the value of your holdings. This is called cost averaging. It may seem counterintuitive, but you will make more money by investing regularly into a market that falls then rises than into a market that moves continuously upwards. Of course, if a market rises steeply and continues to do so, you will make lots of money, and if a market falls steeply and continues to do so, you will lose lots of money – but markets don't go steeply in one direction or the other for long; they fluctuate.

Market Timing

Diversification and cost averaging are important tools in saving and investing. However, gains will be enhanced if ongoing market performance considerations can be incorporated into the decision-making process – in other words, timing the markets. This requires knowledge, caution, and skill, and will not work out favourably every time; nevertheless, and notwithstanding the merits of diversification and cost averaging, it is

worth adjusting exposures to asset classes/countries/sectors in anticipation of the long-term trends they seem to display, which seem to move in half-cycles of 16-20 years. "Buy and hold" was the correct strategy for the '80s and '90s with regard to equities, but there are many reasons for thinking that despite three years of decline in stock prices, followed by a four year rise, buy and hold may not be a profitable strategy for the medium-term future. Fortunately there are sufficient choices available to diversify into. Commodities seem to move in an opposite cycle and that is where the current bull market is and this is the obvious asset-class to overweight in. With strategic management (i.e. a combination of diversification, cost averaging and market timing) the historic returns on equities can not only be equalled, but exceeded.

Compounding

The longer you can invest, the better. Investment will generate income, and that is what you will take from your investments for major expenses and for when you have stopped working. But otherwise you should reinvest the returns on your holdings for as long as possible. Compounding your gains will make a staggering difference over the years. For example, US$50,000 invested with a return of 10% yields US$5,000 per year. Over 30 years, if you take the US$5,000 annually as income, you will have received $150,000, with your original capital intact. If on the other hand you do not take an income stream but continually re-invest the returns, while adding no extra funds, the return on the first year will be US$5,000, on the second year US$5,500, and on the thirtieth year US$72,104.97, with a total gain of US$743,154.60 on top of the original capital of US$50,000.

10% is an arbitrary figure, chosen as it is easy to work with. And of course in reality the performance will fluctuate year on year. To give an illustrative range, here are the same figures at 6%, 9% and 12% returns on a lump sum of US$50,000, reinvested over a period of 30 years:

	6%	9%	12%
Sum invested	US$50,000	US$50,000	US$50,000
Gain on first year	US$3,000	US$4,500	US$6,000
Gain on second year	US$3,180	US$4,905	US$6,720
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Gain on 29th year	US$15,335	US$50,252	US$143,303
Total gain	US$220,919	US$558,609	US$1,287,497
Final sum	US$270,919	US$608,609	US$1,337,497

The simple conclusion is that if you want to build up a large lump sum, the earlier you start and the longer you invest, the better. Procrastination and delay not only defer the time-frame and limit what you may invest in total; they also rob you of the full compounding effects of your gains.

4. Offshore Investment

Many people are unfamiliar with the opportunities available through offshore investment, or have a number of questions they would like answered before they overcome their initial wariness and see the advantages investing offshore can bring them. Here are some of those questions.

Why invest "offshore"?

Two reasons.

1 Tax-free growth.

Just about all nationalities enjoy potential tax advantages while they are living and working abroad. By making use of these advantages they can enhance their investment returns and accumulate wealth more efficiently. Since 1998 Japanese nationals resident in Japan have also been able to utilise the opportunities and tax protection offshore investing brings. Investments made offshore are free of capital gains and income taxes, and therefore compound at a faster rate than onshore investments. For someone living abroad for several years, the difference between onshore and offshore investing can make a substantial difference to the resulting sum. This is what the above table looks like with 20% non-deferred capital gains tax (difference in brackets):

	6%		9%		12%	
Sum invested	US$50,000		US$50,000		US$50,000	
Gain on first year	US$2,400	*(600)*	US$3,600	*(900)*	US$4,800	*(1,200)*
Gain on second year	US$2,515	*(665)*	US$3,859	*(1,046)*	US$5,261	*(1,459)*
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Gain on 29th year	US$8,919	*(6,416)*	US$25,221	*(25,031)*	US$62,508	*(80,795)*
Total gain	US$144,736	*(76,183)*	US$325,508	*(233,101)*	US$663,635	*(623,862)*
Final sum	US$194,736	*(76,183)*	US$375,508	*(233,101)*	US$713,635	*(623,862)*

Clearly, and especially for the long term, it makes financial sense to put money offshore while you can.

2 Confidentiality.

The other advantage to putting your money in an offshore domicile is that it lends greater confidentiality and a higher level of protection to your financial assets. Offshore providers and authorities are not obliged to and do not report the details of an individual's holdings within their jurisdiction (unless in the case of investigation for serious crimes). Confidentiality and a high level of protection may be desirable features if you wish to keep your financial affairs private, or if you come from a litigious society.

Is investing offshore safe?

Offshore investment vehicles are provided by the fully-backed subsidiaries of large insurance and investment companies. These typically have US$60bn~US$400bn under management and are at least as sound as most major non-Japanese banks.

The providers themselves are protected against the highly unlikely event of their insolvency by lifeboat agreements, statutory in the Isle of Man (guaranteeing 90% of assets) and custodial in Jersey and Guernsey (protecting more than 90% of assets).

Most offshore investments have a similar or identical onshore version. The difference is the domicile of the vehicle through which you invest. In this sense investing offshore is no more nor less safe than investing onshore.

It should be noted furthermore that an estimated 50% of the world's non-governmental financial transactions take place offshore, and 60% of the world's non-governmental money is offshore.[4] There is nothing strange or additionally risky about being offshore; rather it is normal, and expatriates not investing offshore are almost certainly missing out.

What are the differences between the providers, the vehicles, and the investments? How does this work?

Just as you need a brokerage account to trade stocks onshore, and that account is run by a brokerage company, so you need an account to invest offshore, termed here the 'vehicle', and supplied by a 'provider', through which you invest.

The providers are typically large life insurance companies; some mutual fund families also have an offshore arm.

The life companies supply different kinds of vehicles with different characteristics and capabilities, of which the major ones are:

<u>Regular savings plans</u> – monthly or annual investment into a mutual fund universe
<u>Investment accounts</u> – lump sum investment into a mutual fund universe
<u>Portfolio bonds</u> – lump sum investment into almost any conventional or alternative asset.

In addition from fund houses there are:
<u>Stand-alone mutual funds</u>
<u>Stand-alone alternative investments</u>
<u>Stand-alone alternative investments with capital guarantees.</u>

Banner regularly publishes sample lists of lump sum investments. Literature for these funds and also for regular savings plans, investment accounts and portfolio bonds is available on request.

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[4] Barry Spitz, *2000 International Tax Havens Guide*

Why life-insurers?
Historically life insurance has always been treated differently to investment accounts in the tax laws of many countries. The tax law applying to the European offshore market derives from the UK, under which life insurance is non-taxable. The life insurance is basically a wrapper of 1% on top of the value of a portfolio. The portfolio itself is marked to the value of the underlying investments. Life insurers are therefore the providers of the vehicles through which you invest offshore.

Why not set up a brokerage account abroad?
You can, but they invest into onshore markets, and you will have to sign a tax form before you invest.

How much do I need to be able to invest offshore?
You can invest in a regular savings plan for as little as ¥20,000 or US$250 a month, into a mutual fund for as little as US$3,000, and into an alternative investment for A$5,000. For lump sums, you can set up a diversified portfolio for US$7,500, although most require US$15,000 ~ US$20,000 and up.

Is my money guaranteed?
Investments may go down as well as up. Returns are not guaranteed – or rather, with reference to the discussion of risk and reward above, if a return is certain, you will most likely risk long-term underperformance. If this is a serious concern, there are capital guaranteed investments available - and certainly, any but the most aggressive portfolio will benefit from the elements of diversification and capital protection such investments will bring.

In addition, it is also possible to enter a portfolio bond that will insure the value of your investments at their all-time high against the event of your death. For investors wishing to ensure that the value of the estate they pass on to their heirs cannot be reduced by losses in their final years, this an attractive feature.

Isn't investing offshore illegal?
No, it's completely legal. The securities law was changed in April 1998 so that Japan residents (including Japanese nationals) may invest as much as they like offshore.

What about recent OECD directives?
Some offshore tax havens have acquired dubious media reputations, mainly for complicity in money laundering. The Financial Action Task Force on Money Laundering (FATF) was set up in 1989 to prevent tax havens form being targetted by money-launderers. Most tax havens now have a self-regulatory "know your client" policy, requiring proof of client identity, which is privately held and protected by the provider. For the FATF, this is satisfactory. The principal European havens have drawn praise from the OECD for their self-policing anti-money laundering policies. The offshore centres used by the life providers are distinguished by their know-your-client policies and strong regulatory structures.

How do I go about investing offshore?
Contact us at Banner. A consultation is free. We will need to discuss your circumstances, responsibilities, goals and time-frames before we can make any recommendations for you. We are familiar with just about every offshore investment available and will make recommendations according to the information you have given us. The advice will be specific to you. The entire process is completely confidential.

This information is brought to you by Banner Japan.

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This document has focussed on saving and investing. The full range of provision is:

- Savings plans & pension plans
- Lump sum investments
- Portfolio management
- Education planning
- Retirement planning
- Multi-currency mortgages including low-interest ¥ loans
- Domestic and investment mortgages for Japan
- Estate planning & offshore trusts
- Health, life and critical illness insurance.

Enquiries are treated as enquiries. There is no obligation on you to take things further if the response does not meet your needs. On this basis, we would be pleased to discuss your situation with you.