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Israel Will Need Significant Foreign Investment in the Coming Decade

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With the notable exception of the high technology sector, Israel receives only modest amounts of foreign portfolio investment. In fact, over the past two years foreigners pulled approximately $9 billion out of Israeli securities. Most of this divestment was unrelated to the global anti-Israel campaign now called BDS (Boycott, Divestiture and Sanctions). The largest wave was, ironically, due to Israel's acceptance into the Organization for Economic Cooperation and Development (OECD), marking Israel's graduation from emerging market to developed market status. Emerging market funds sold their Israeli holdings to mirror the revised indexes. The second divestment wave came as global stock markets tumbled during the European currency crisis.

Foreign involvement in Israeli securities has always been volatile. According to data from the Bank of Israel, foreign investors purchased a net $9 billion worth of Israeli stocks and bonds in 2010, whereas they sold $5.6 billion in 2011. In 2009 foreigners bought $2 billion, about equal to the annual average over the past decade. In total, foreigners hold $24 billion of Israeli securities or 6% of a total $388 billion worth of stocks and bonds. (According to data from the Tel-Aviv Stock Exchange Israel has a stock market capitalization of $156 billion, $218 billion in government bonds and $90 billion of outstanding corporate bond issues).

Despite limited foreign investment Israeli Gross Domestic Product (GDP) grew from $112 billion in 2001 to just under $250 billion in 2011. Israelis successfully financed this robust economic growth largely from their own resources. Much of the capital came from the Israeli banking system, but corporations increasingly rely on bond issues rather than commercial bank loans. The trend toward securities is likely to accelerate in the coming decade, further expanding the menu of investment choices available to investors. The capital required will most likely exceed Israel's domestic supply and increased foreign investment will be necessary to maintain Israel's economic momentum.

Disintermediation is Boosting the Importance of Securities Markets

Throughout Israel's history banks played a leading role in financing Israeli economic growth. Starting about ten years ago, however, the banks could not keep up with the growing demand for capital. Economists call the shift away from bank credit toward capital markets and alternative financial institutions "disintermediation." The process of disintermediation is new, but well under way in Israel.

According to data from the Bank of Israel, in 2001 banks financed 45% of corporate investment in Israel, equity capital financed about 35% and only 6% came from corporate bonds. Companies with publicly traded stock amounted to – at most – 20% of total corporate equity, a number likely overstated by a large margin since most "public" companies listed a very small percentage of their shares.

Ten years later, however, the picture was already quite different despite two major economic and financial market meltdowns along the way. Bank loans fell from 70% of total commercial credit in Israel in 2001 to 48% by 2010 (the latest data available from the Bank of Israel). During the same period corporate bond issues grew from $9 billion to $46 billion. Stock market capitalization increased from $50 billion to just under $200 billion in 2011, with publicly traded equity accounting for 35% of total corporate equity in Israel (up from the 20% mentioned above). TASE turnover increased from $50 million per day to just under $500 million per day. In other words, securities markets took substantial market share away from banks over the past decade.

Israel Could be a $500 Billion Economy – If Foreigners Invest

In the coming decade Israeli GDP is on track to reach $500 billion, but only if it can successfully finance this growth. Israel's banks are shifting their focus to consumer and mortgage finance, areas where they have comparative advantage. Commercial credit from banks, on the other hand, is losing market share to bond markets and alternative financial institutions (examples include leasing companies, trade credit or accounts receivable factoring).

Based on current trends banks may finance just 15% of Israeli corporate investment in a decade's time. Meanwhile, Israeli corporations could issue in excess of $125 billion in new bonds in the coming ten years versus $58 billion in the previous decade. Equity funding requirements will likely grow on a similar scale as will stock market capitalization. Given the size of these funding requirements, however, it is extremely unlikely that Israelis can support this level of financial activity without foreign investment.

Israelis are getting wealthier. According to the Bank of Israel, household assets were $736 billion in 2010, up from $400 billion in 2001. Home ownership accounted for 25%, bank deposits an additional 15% with the remainder invested in private pension plans and securities. Israeli households save an average 11.5% of their income (for comparison the U.S. savings rate is about 4%), producing about $20 billion per year in surplus funds. Based on their current allocation, about 60% of these assets are available for securities investment either directly or through pension funds.

According to our estimates at Israel Investment Advisors, LLC domestic capital sources should be sufficient to fund 75% to 85% of Israel's needs in the coming decade. To fund the remaining 15% to 25% foreigners will need to purchase approximately $4 billion to $5 billion per year of Israeli securities. This is a little more than double the average pace of the past ten years, but well in line with several of Israel's stronger years in the mid 2000's.

Who will be Israel's "Foreign" Investors?

Philanthropic institutions channel about $1 billion into worthy Israeli causes each year, but investment opportunities available to investors are rapidly outpacing this significant flow of funds. Moreover, Israel will need Jewish capital more than ever to fund economic growth. After all, who are these "foreign" investors likely to be? Certainly portfolio managers looking for opportunity will continue to include Israel in their global calculations, but American Jewish investors – both individual and institutional – are the most likely source to fund Israel's growing domestic capital gap.

As the past two years of stock market turmoil have demonstrated investment in Israeli securities carry similar risks relative to investment in many other markets, therefore requiring research and discipline. Unlike philanthropy, however, investment offers the promise of long-term returns based on reasonable valuations and strong balance sheets. We believe there is a place for both philanthropy and investment within each Jewish investor's "portfolio." In the coming ten years, however, Israel will require foreign capital on a scale significantly greater than historically channeled through traditional philanthropy. If raised in adequate quantities it will create thousands of new jobs, boost incomes and wealth (for Israelis and investors) and build an economy that can support escalating defense costs and challenges. In the 1970's and 1980's Hong Kong and Singapore emerged as global financial centers for Chinese investors living outside the mainland. We believe Israel could become a similar global financial center, but only with the active participation of American Jews.