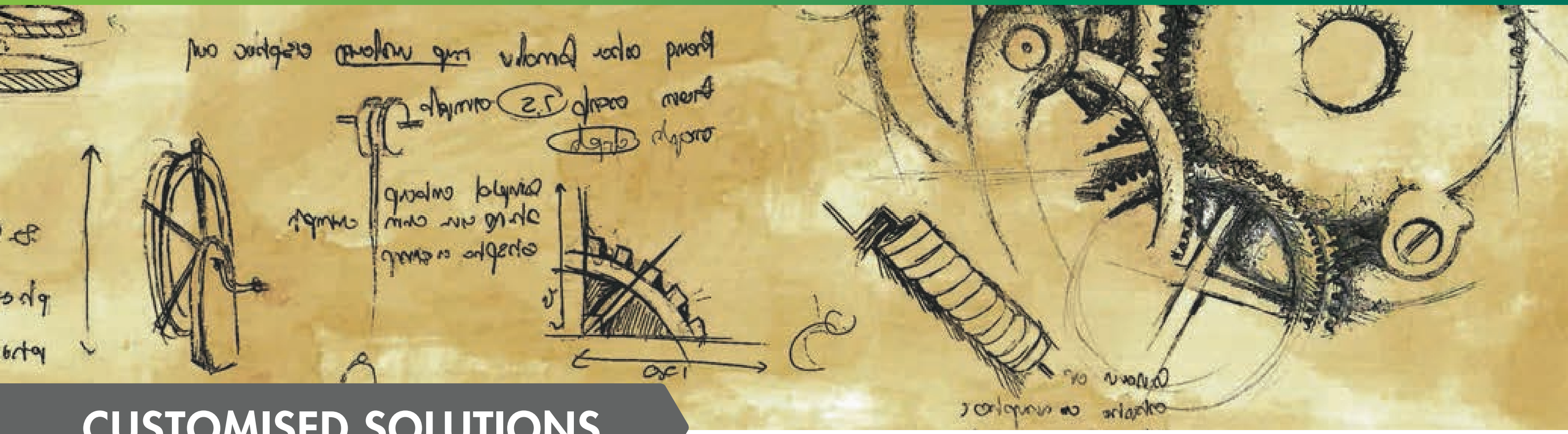

CUSTOMISED SOLUTIONS

THE CASE FOR INDEX INVESTING: **CHOOSING AN INDEX TRACKING MANAGER**

Anelisa Balfour and Kingsley Williams

INTRODUCTION

Investing via an index tracking strategy is increasingly becoming a major financial market theme in South Africa. Over the last three years, as at 31 December 2015, retail indexation strategies have attracted more than R10 billion in flows[1]. This trend is primarily driven by investors looking for simpler and lower cost investment strategies that deliver good performance relative to actively managed investment strategies. And we believe that index investing will be a longer-term theme as a result of the following:

- **An increase in regulatory oversight.** National treasury has explicitly proposed in the draft regulatory reform that trustees consider index investing when selecting the default pension fund investment strategy.
- **South Africa to follow the global trend.** According to a global report produced by PwC[2], index investing is expected to grow from 11.42% to 22.32% by 2020. We have already seen this trend emerge in South Africa and expect it to continue in line with global norms.
- **Active managers have struggled to outperform relative to their benchmarks.** Within the Association of Savings and Investments South Africa (ASISA) general equity category, over 80% of active managers have underperformed relative to the FTSE/JSE Shareholder Weighted All Share Index (SWIX) over three-, five- and 10-year periods. This highlights the fact that index investing can generate favourable performance over the long term.

An investor who has decided to select an index fund would typically consider the benchmark of the index fund and the track record of the index tracking manager (i.e. how closely has the manager successfully replicated the performance of the benchmark and minimised costs).

Some of the factors that should be considered when testing the sustainability of an index manager to continue closely tracking a given benchmark are:

- Level of assets under management (AUM)
- Length of the track record

[1] Source: Morningstar

[2] PwC, 2014. Asset Management 2020: A brave new world. Retrieved from http://www.pwc.com/asset-management

- Experience and expertise of the investment team
- Risk management and the investment process
- Protecting the interests of the clients through responsible investing

LEVEL OF AUM

The level of AUM is critical as indexation management is a low margin business. AUM will have a direct bearing on the profitability and sustainability of an index tracking manager. For example, an indexation manager who charged a portfolio management fee of 0.10% per annum on an investment strategy would earn revenue as follows:

- If the investment strategy's AUM is R100 million, the portfolio management fee earned would be R100 000 per annum.
- If the investment strategy's AUM is R1 billion, the portfolio management fee would be R1 million per annum.

Earning a higher portfolio management fee due to larger AUM gives the indexation manager greater capacity to do the following:

- Employ investment professionals with impressive expertise and experience
- Use modern systems and technology to ensure investment strategies meet their objectives
- Reduce the overall trading costs incurred by investors
- Research new ways to add additional value for clients
- Provide investors with a high quality customer service experience.

However, while revenue generated from AUM enables capacity, it is not enough to implement an index tracking portfolio successfully.

THE EXPERIENCE AND EXPERTISE OF THE INVESTMENT TEAM

It is crucial that the key investment individuals comprising the investment team are committed to staying with the business over the long term. This improves the stability of an indexation manager's investment process. The indexation team's role is key because, while it may not be obvious at first, managing a successful index fund is not merely a passive process, but requires a number of active investment decisions to be made by the investment team, such as:

- Optimal processing of client contributions and withdrawals
- Optimal handling of corporate events
- Dealing with illiquid securities
- Cost-benefit analysis of reducing tracking errors while minimising costs
- Opportunities to add additional value, e.g. scrip lending
- Optimal trading strategies at index rebalance.

Getting any of these active decisions wrong could result in amplified differentials of the index fund relative to its benchmark. It is therefore vital that the investment team has both quantitative and qualitative risk analysis skills together with a good understanding of the market.

LENGTH OF THE TRACK RECORD

The length of the indexation manager's track record can reveal the following:

- **Investment risk:** The length of time of existence reflects the true risk profile of an investment strategy.

- **Discipline in the investment approach:** Consistency through varying economic and market conditions reflects the disciplined approach of the manager.
- **Business risk:** A sound process for risk assessment, control and monitoring that relates to the business of investment management must be in place. Transaction risk, compliance risk, reputation risk and strategic risk all contribute to business risk.

RISK MANAGEMENT AND INVESTMENT PROCESS

Indexation is a technology-driven business. The best indexation managers have sophisticated systems in place which allow them to assess and manage the risk on their portfolios on an ongoing basis, as well as ensure adherence with the investment process. The systems in place should be able to perform both pre- and post-trade analysis, as well as detailed performance attribution.

Portfolio risk management software can greatly assist the indexation manager to consistently construct portfolios that mimic their respective benchmarks and to avoid any unintended risks. The investment process should be robust so as to avoid unintended errors or a deviation from the agreed investment process.

RESPONSIBLE INVESTING AND PROXY VOTING

The process of index investing does not require the indexation manager to engage directly with the management of the invested companies. Indexation managers do not take a view on the companies invested in, but focus instead on replicating the index. As such, indexation managers that are responsible stewards of the assets being managed must have a proxy voting policy that is intended to protect its clients' long-term economic interests.

In addition to proxy voting, indexation managers that invest responsibly should have a research team that engages with the management of the investee companies on behalf of the investors to address major environmental, social and governance (ESG) considerations, as well as encourage business and management practices that support sustainable financial performance over the long term.
This overlay approach to proxy voting and engaging company management on ESG issues ensures that the investment manager can most effectively use its voice as an actively engaged shareholder. It must be noted that indexation managers with larger AUM are likely to have more influence as management are more likely to heed larger shareholders.

CONCLUSION

Identifying a good indexation manager is not an easy process. However, a good indexation manager would exhibit the following characteristics:

- **Scale relative to client mandate.** The manager must be an industry leader in terms of their level of AUM in indexation investment strategies.
- **A skilled and highly experienced team.** A stable team that has an in-depth understanding of the inherent risks involved in managing an indexation portfolio.
- **Length of the track record.** A longer track record can reveal the quality and consistency of investment returns.
- **Clear investment process.** A clear approach to investing and appropriate risk management strategies to cater for different events.
- **Responsible investing.** Protecting clients' long-term interests through proxy voting and management engagement.

OLD MUTUAL CUSTOMISED SOLUTIONS (PTY) LIMITED

Physical Address: Mutualpark, Jan Smuts Drive, Pinelands, 7405
Tel: +27 21 509 5022

Kingsley Williams
kwilliams@oldmutualinvest.com