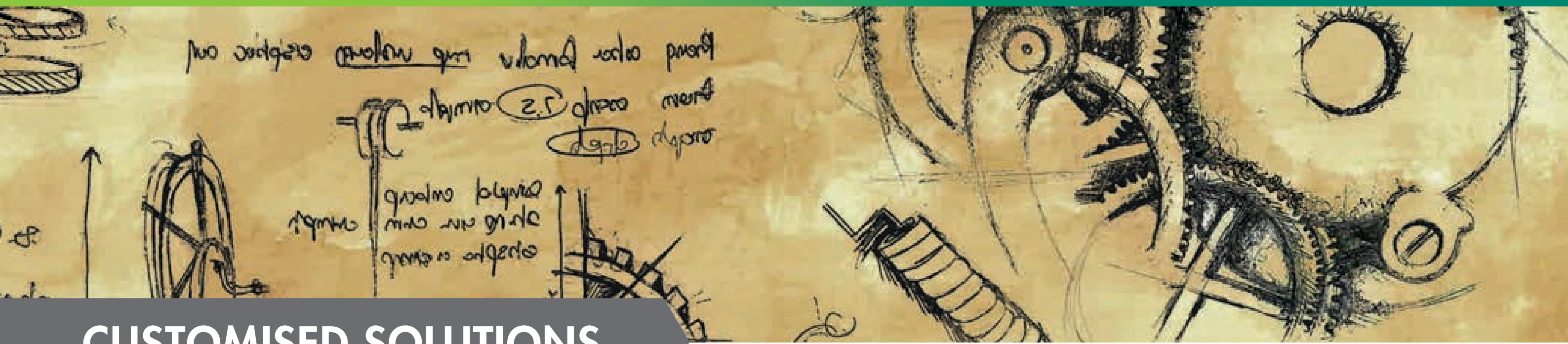


CUSTOMISED SOLUTIONS

THE CASE FOR INDEX INVESTING: **BLENDING ACTIVE AND INDEX BALANCED FUNDS**

Shariefa Parker and Kingsley Williams

EXECUTIVE SUMMARY

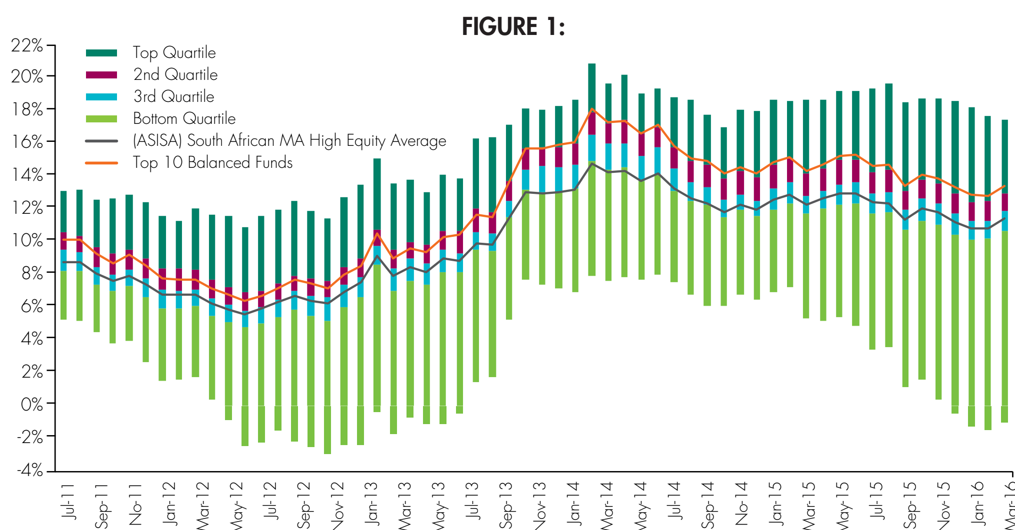
Active and index investing have often been viewed as a case of either-or, with investment houses proposing one of these two investment strategies, not both. At Old Mutual Customised Solutions, we believe that implementing both active and index investment strategies within an investor's portfolio can provide significant value to the investor. The objective of active strategies is to outperform a particular benchmark through security or asset class selection and timing, whereas the argument for index investing is lower fees and generating consistent market returns. In this paper, we consider the merits of each strategy and the effects of blending active and index balanced funds to deliver lower costs and enhanced returns.

THE REALITIES OF ACTIVE BALANCED FUNDS

Actively managed balanced funds aim to time the market by tactically adjusting their asset allocation mix to take advantage of different economic cycles and drivers of the market, and thereby delivering higher real returns. In exchange for the promise of delivering higher returns, investors are charged higher fees. However, timing the market consistently is extremely difficult and the potential benefits can be outweighed by the costs and the risk of getting it wrong, to the detriment of investors' returns.

In figure 1 we compare the nine largest conventional balanced funds to the Association of Saving and Investment South Africa (ASISA) South Africa Multi-Asset High Equity benchmark over a 10-year period. From this graph we can see that some funds generated a loss or no returns over multiple five-year periods. The spread between the best and worst performing fund is enormous, which highlights the risk of getting asset allocation timing as well as fund or manager selection wrong.

FIGURE 1:

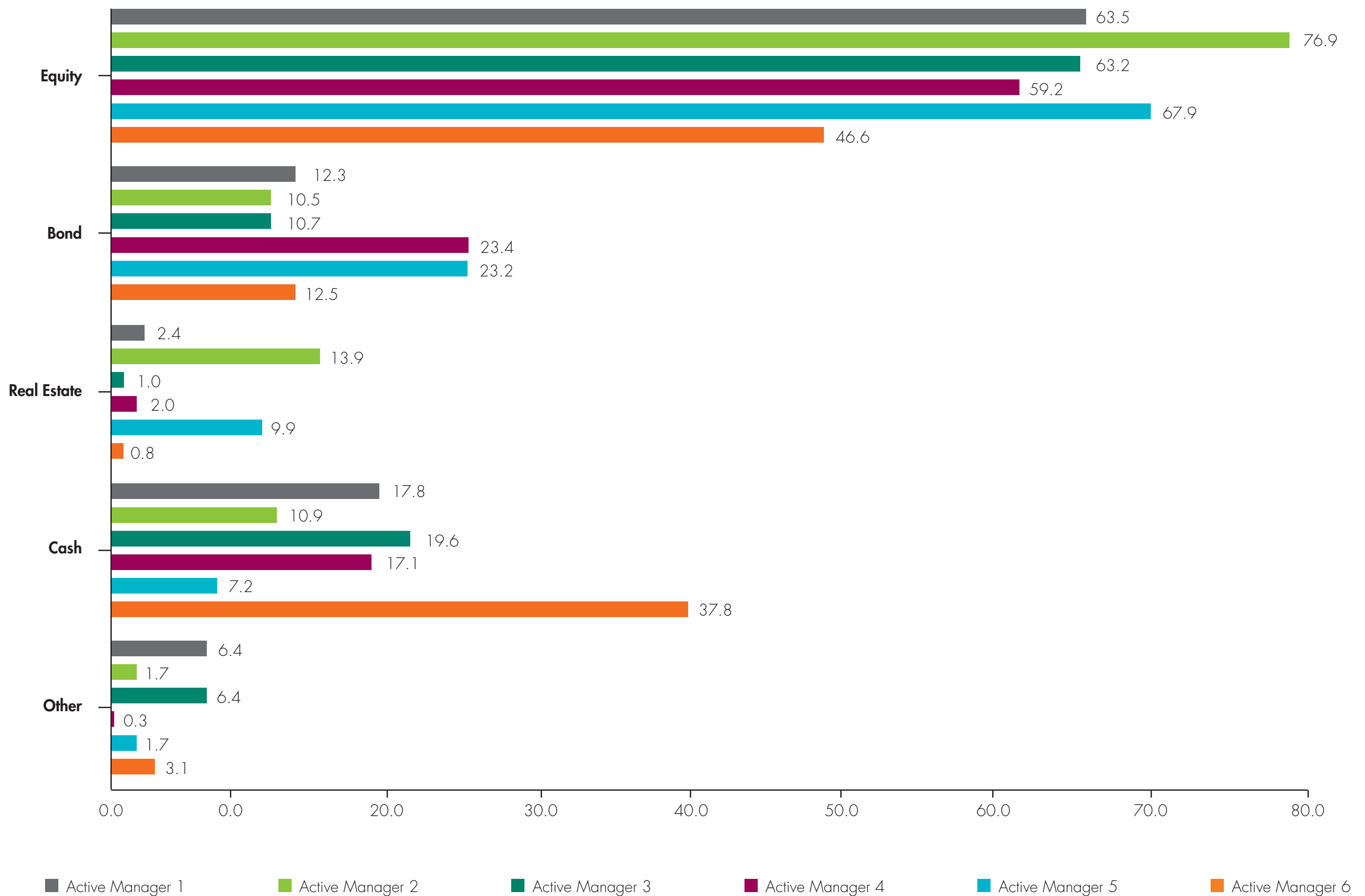


Source: Morningstar – Equally-weighted the nine largest Balanced funds

DO GREAT THINGS

Figure 2 illustrates the asset allocation of the six largest active balanced funds in South Africa, and how widely these allocations can differ from one manager to the next. The equity exposure, for example, ranges from 46.6% to 76.9% and cash ranges from as low as 7.2% to as high as 37.8%. Depending on how markets perform, these funds can react very differently to each other. Due to the unpredictable nature of these funds, an investor takes on risk and will be exposed to divergence in performance in their portfolio.

FIGURE 2:



Source: Morningstar – Fund allocation as at 31 March 2016

To reduce risk, an investor could invest in multiple active balanced funds, which would have the effect of dampening the asset allocation calls of any one manager. However, by doing this the investor will then realise a "market average" asset allocation, which is exactly what an index balanced fund aims to deliver to investors, but at a substantially reduced cost.

BLENDING ACTIVE AND INDEX BALANCED FUNDS

Replacing active managers purely used for diversification purposes with a balanced index fund delivers the benefits of diversification as well as lowering overall costs.

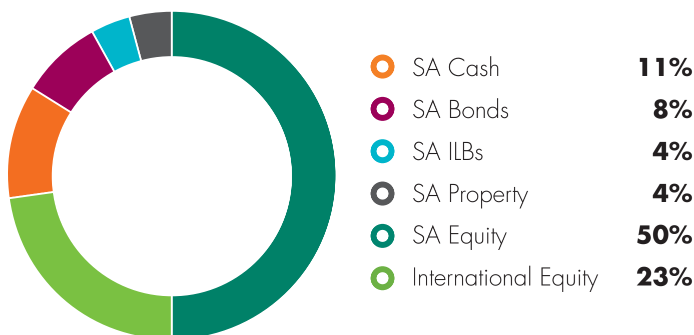
Index balanced funds differ from actively managed balanced funds in two main ways:

- The fund doesn't strive to time the markets through tactical asset allocation;
- Each asset class in managed by tracking an established index.

The strategic asset allocation of an index balanced fund is established to achieve the highest probability of meeting a real return target above inflation over a given period, for example, CPI+5% over any five-year period. Furthermore, the risk of underperformance within each asset class is removed due to the index tracking objective of each asset class.

Figure 3 represents the strategic asset allocation of each asset class within the Old Mutual Balanced Index Fund. Each asset class can fluctuate within a predetermined range, which allows asset classes that are doing well to continue running, before being brought back to their strategic allocation. The asset allocation is rebalanced annually or when an asset class moves outside of its strategic range. The fund complies with Regulation 28 rules in South Africa.

Figure 3: Balanced Index Fund Strategic Asset Allocation



Source: Old Mutual Investment Group, June 2016

THE COST BENEFIT

Incorporating a lower cost index balanced fund into an investor's portfolio of active balanced funds will reduce the cost to the investor, without detracting from returns.

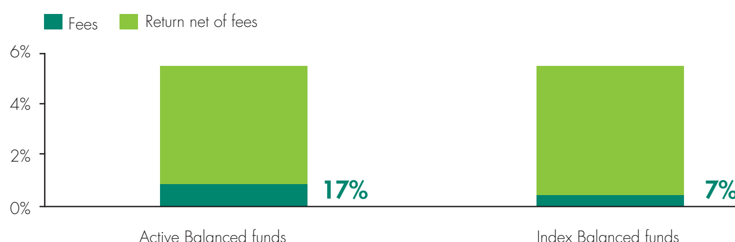
To put these savings in context, fees should be seen as a percentage of the returns above inflation (real returns), which is ultimately what investors are paying a balanced fund manager to deliver.

As illustrated in Figure 4, a fee of 0.9% with a real return expectation of 5-6% translates into a cost to the investor of between 15-18% p.a., while a fee of 0.35% with the same real return expectation would only cost the investor 6-7% p.a.

In Figure 5 we illustrate blending our Balanced Index (with an institutional unit trust management fee of 35bps p.a. with an equally weighted blend of the 10 largest active balanced funds (with an average fee of 90 basis points p.a.) over a 10-year period, with a 35% and 65% allocation respectively.

By incorporating the index balanced fund into the portfolio:
The performance over the 10-year period improved from second quartile to top quartile.
A 35% allocation to a balanced index fund equates to a 21% (22bps) total fee reduction in management fees.

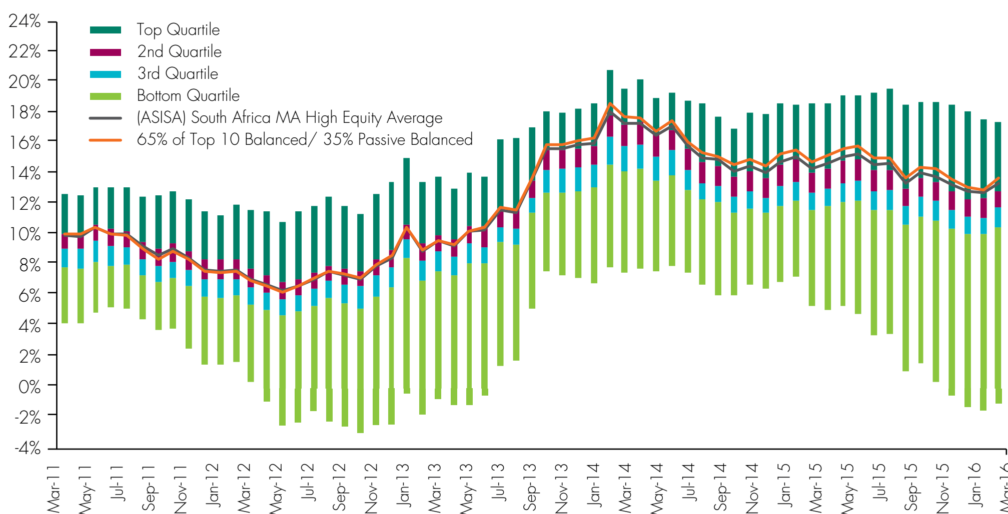
Figure 4: Fees as a percentage of real return expectation



Source: Old Mutual Investment Group

To enhance this further, blending index funds into an active portfolio, investors realise these savings without compromising their returns, they ultimately enhance their savings objectives, which serves to facilitate a better quality of life, as is clearly illustrated in Figure 5.

Figure 5:



Sources: Old Mutual Investment Group and Morningstar

BENEFITS OF BLENDING ACTIVE AND INDEX STRATEGIES

- **Lower costs:** Index balanced funds have lower costs than active balanced funds, thereby reducing the overall cost of a blended strategy, which puts more of the return in the investor's pocket. This ties in with Retirement Fund Reform objectives to reduce investment costs.
- **Diversification:** Holding an index balanced fund within an investor's portfolio dampens the risk associated with holding a single active balanced fund. Using an index balanced fund is a far more cost effective way to diversify a blend of balanced funds.
- **Consistency and Peace of Mind:** An active manager has discretion to change their asset allocation – this can result in outperformance but equally in underperformance. However, a balanced index fund maintains its asset allocation by staying within its strategic ranges. Furthermore, each asset class performs in line with the index representing that asset class due to the index tracking nature of the investment strategy. This ensures the investor consistently gets what they paid for, which translates into increased peace of mind.

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