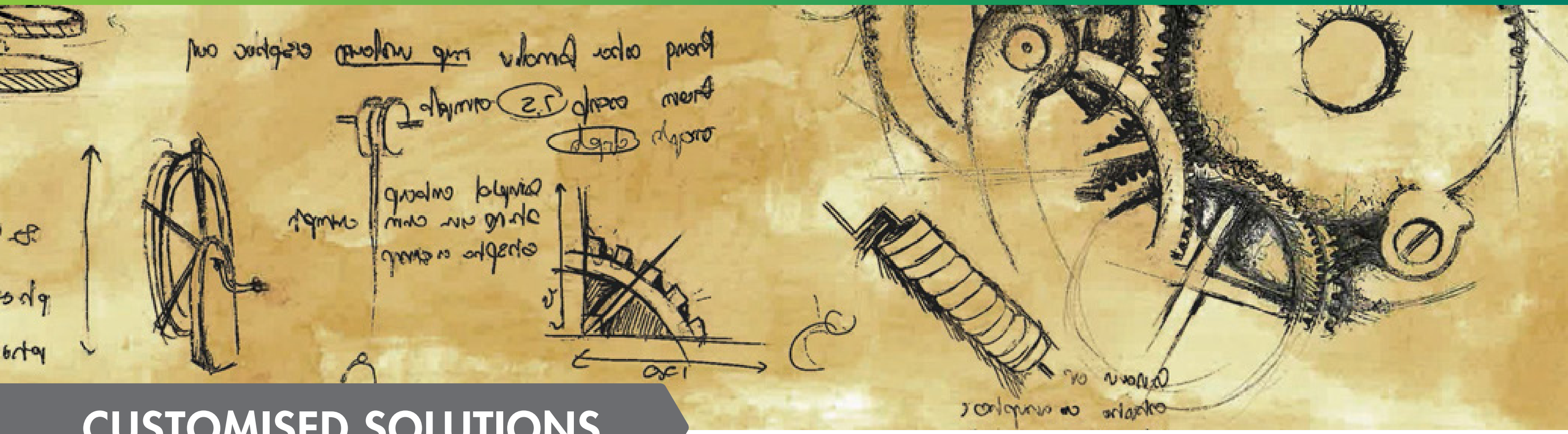


CUSTOMISED SOLUTIONS

THE CASE FOR INDEX INVESTING: **THE COMMON MISCONCEPTIONS**

Zafroulah Hassiem and Kingsley Williams

INTRODUCTION

Index investing has recently been placed in the spotlight mainly as a result of the questionable performance of the active management industry, proposed regulatory changes and investors becoming a lot more cost conscious in recent years. However South Africa is still dominated by actively managed investment strategies and so investors are generally less familiar with index investing. As such, with legislation encouraging the consideration of index investment strategies, it is important to address any misconceptions that the industry and investors may have regarding index investing.

MISCONCEPTION 1:

The performance of a market cap-weighted index will be equal to that of the average investor (limiting the upside potential for an investor)

Most investors select active managers in the hopes of earning returns greater than the average investor.

THE REALITY IS:

- In South Africa there is no evidence to support the belief that a market cap weighted index will generate an average return over the long term.
- Figure 1 compares the average managers' performance (for various Association of Savings and Investment South Africa (ASISA) categories, after fees) to indices; we find that the indices would have outperformed the average manager by between 1.5% and 2.3% p.a. over a 10-year period, which is well in excess of a typical index fund's total expense ratio, resulting in an index fund being well ahead of average managers' performance.

FIGURE 1: Market cap weighted indices have outperformed the average collective investment scheme over the long-term

Source: Morningstar April 2016

MISCONCEPTION 2:

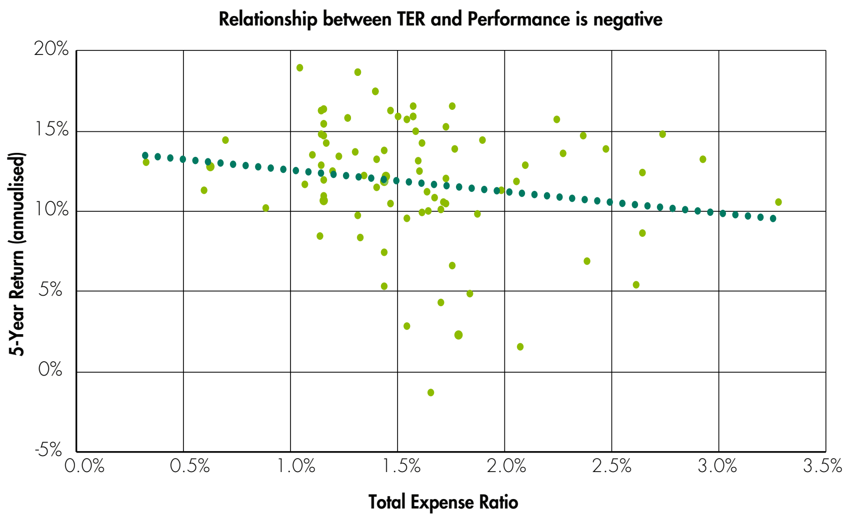
The higher the cost, the higher the expected performance

The belief is that you get what you pay for. Active strategies that perform exceptionally well tend to demand higher fees (which translates into higher costs for an investor). Some investors therefore associate higher costs with higher expected performance.

THE REALITY IS:

- In South Africa there is no evidence to support the belief that higher costs translate into higher performance.
- Figure 2 illustrates the relationship between the performance and costs by comparing the five-year return of South African Equity managers (ASISA SA Equity General category) to their total expense ratios. Our results show that the relationship between performance and costs is negative.

FIGURE 2: The relationship between performance and cost is negative



Source: Morningstar April 2016

MISCONCEPTION 3:

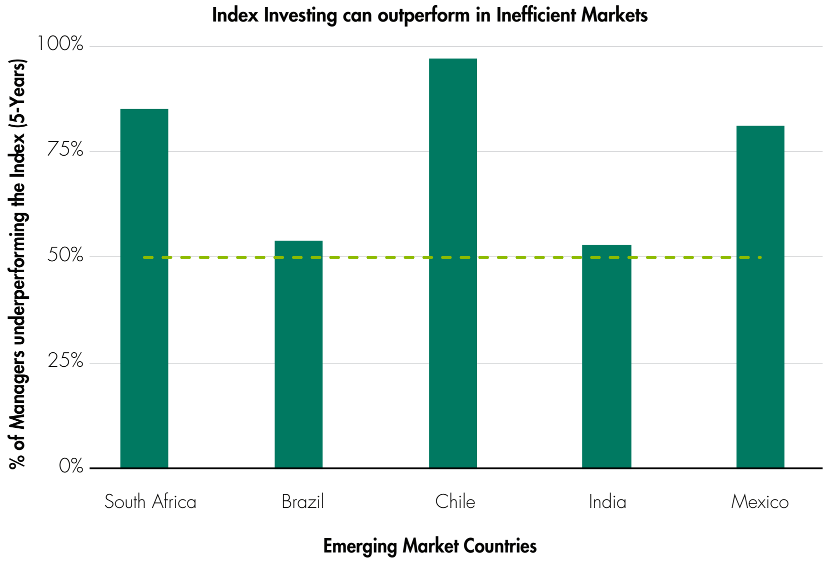
Index investing only works in efficient markets

Some investors believe that index investing fails to add value relative to active managers in inefficient markets, such as emerging markets.

THE REALITY IS:

- There is no clear evidence to support the belief that index investing cannot add value relative to active managers in inefficient markets.
- S&P Global Indices performed an analysis to test what percentage of active managers in emerging markets outperformed their respective domestic benchmarks over a five-year period. Figure 3 illustrates that more than half of the active managers in each country underperformed relative to their benchmark.
- Furthermore, regardless of whether a market is efficient or not, William Sharpe's Arithmetic of Active Management dictates that at most only 50% of actively managed funds can outperform the market before costs.

FIGURE 3: Index investing can add value in both efficient markets



Source: S&P Global Indices

MISCONCEPTION 4:

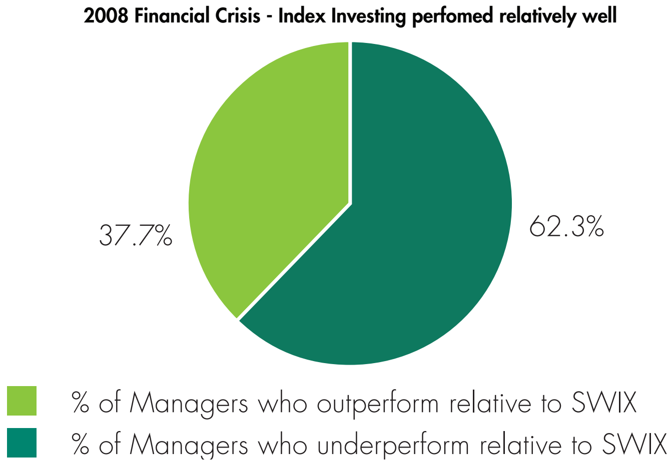
Index investing does not work in a bear market

Some investors believe that index investing underperforms relative to active managers in a bear market. Under these conditions, active managers are expected to implement defensive positions to accommodate for this environment.

THE REALITY IS:

- There is no evidence to support the belief that index investing will always underperform active managers in a bear market.
- During the financial crisis (calendar year 2008), the FTSE/ JSE Shareholder Weighted Index (SWIX) outperformed 62% (see Figure 4) of the active managers in the ASISA SA Equity General category.

FIGURE 4: Index investing can outperform active managers during bear markets



Source: Morningstar April 2016

We do acknowledge, however, that the percentage of underperformance (62.3%) is lower than the long-term average. There is also more scope in multi-asset portfolios for active managers to outperform index funds during bear markets.

MISCONCEPTION 5:

The fact that market cap weighted indices are inefficient is not a reason to use index investing

Market cap weighted indices have higher exposure to larger companies and companies which have historically performed well (relative to other companies). As a result, some investors believe that these indices will be overexposed to companies with very limited upside. In other words, investors believe market cap weighted indices are inefficient.

THE REALITY IS:

- Even though market cap weighted indices are inefficient, active managers have still underperformed across various asset classes as illustrated in **Figure 1**.

MISCONCEPTION 6:

On Autopilot

There are investors who believe that index management is a purely automated process which requires no human intervention.

THE REALITY IS:

- On a daily basis, index portfolio managers use risk management systems to assess how best to implement corporate actions, significant flows and changes to the index. More than 300 corporate actions occur in the FTSE/JSE SWIX All Share Index (and over 9 000 occur in international indices) on a yearly basis.
- Managing these can be challenging as benchmarks assume that all changes happen at no cost and can be implemented immediately, whereas a real portfolio is subject to factors such as the following:
    - Costs
    - Tax
    - Market timing
    - Liquidity constraints
    - Settlement periods
    - Currency effects.
- Index replication is highly complex and requires extensive expertise, experience in trading, risk management and quantitative research skills.

OLD MUTUAL CUSTOMISED SOLUTIONS (PTY) LIMITED
Physical Address: Mutualpark, Jan Smuts Drive, Pinelands, 7405
Tel: +27 21 509 5022

Kingsley Williams
kwilliams@oldmutualinvest.com

Kim Johnson
kjohnson2@oldmutualinvest.com

OLD MUTUAL
INVESTMENT GROUP