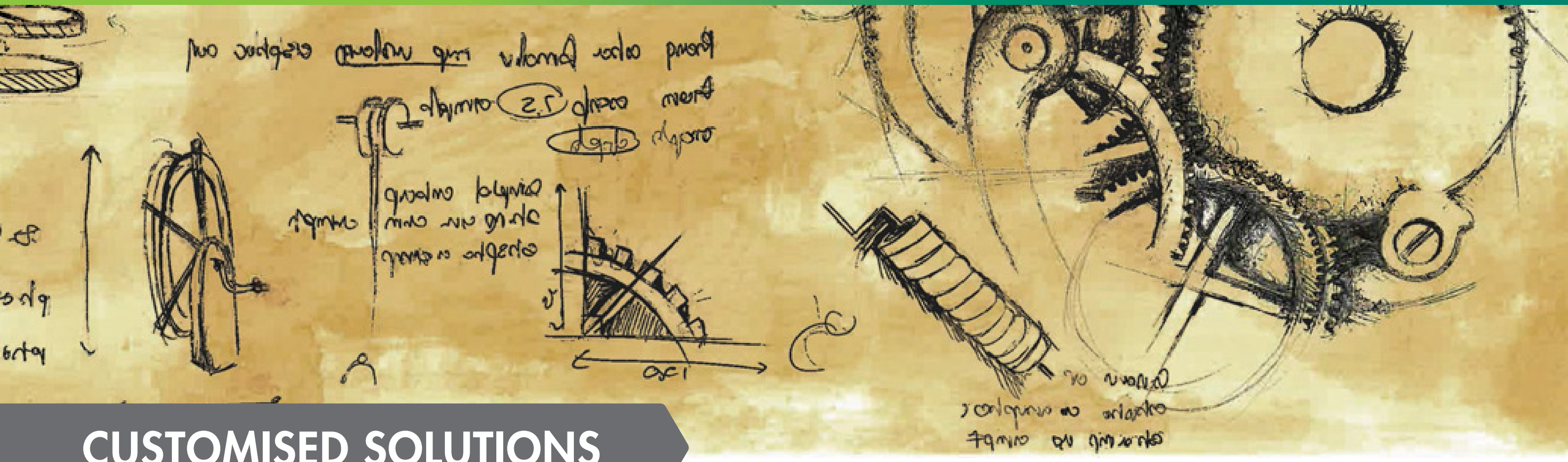

CUSTOMISED SOLUTIONS

SOUTH AFRICAN **EQUITY INDICES**

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DOMESTIC EQUITY INDEX OVERVIEW

INTRODUCTION

There has been much debate and consultation within the investment industry on the various indices available in the South African market. As South Africa's largest index tracking manager, we discuss the most widely used indices in South Africa, namely the FTSE/JSE series of indices, and more specifically the broadest of these: the FTSE/JSE All Share Index (ALSI), FTSE/JSE Capped All Share Index (CAPI) and FTSE/JSE Shareholder Weighted Index (SWIX).

To begin with, however, it is important to describe what the role of an index should be in the investment context and the properties an index should possess. Following this we will look at the methodologies currently being used to construct the above indices.

The JSE is in the process of reviewing the current methodology and we review the most significant potential changes and discuss how they may affect the different indices. We also look at possible additional changes that could improve the current set of indices.

THE ROLE OF AN INDEX

The definition of a financial market index, according to Investopedia, is an imaginary portfolio of securities representing a particular market or portion of it. The most basic use of an index is as a measure of the performance and characteristics of an asset class or the overall market; put simply, a benchmark for evaluation purposes. Having a standard benchmark for various markets and asset classes plays an important role in assessing the asset allocation and implementation skills of asset managers, as well as providing a relevant base for performance measurement. An index that is representative of an asset class affords market participants with products that can be used as passive investments to gain broad market exposure. In addition, market participants who require actively managed portfolios can use such indices as a reference point, as well as a benchmark against which to measure manager performance.

An index should also be both investable and representative of the opportunity set. The weights of a constituent in an index should ideally be adjusted for restricted shares – privately held shares and other shares not available to the domestic market for investment –to meet the investability criteria. The introduction of the SWIX range of indices back in 2002 were intended to address this need for free-float adjusted indices. To meet the representative criteria, market capitalisation indices are favoured over alternative weighted indices as they capture the proportional weight that a constituent forms within the broad market.

PROPERTIES OF A GOOD BENCHMARK

Before delving into the particulars around the current selection of indices and the ideal benchmark in a South African context, it is worth touching on the essential properties that a benchmark should possess. These properties are easily summarised through the acronym SAMURAI, which can be broken down as follows:

- **Specified in advance:** A good benchmark is one that is specified and known prior to the start of an evaluation period.
- **Appropriate:** The benchmark should be consistent with the asset manager's investment style and mandate.
- **Measurable:** The return of the benchmark should be quantifiable on a reasonably frequent basis.
- **Unambiguous:** The constituents and associated weights of benchmark assets or factor exposures should be clearly defined.
- **Reflective (of current investment opinions):** The manager has current knowledge of securities/factor exposures.
- **Accountable:** The manager should be accountable for the constituents and performance.
- **Investable:** It is possible to simply hold the benchmark

Other factors that are important to consider when evaluating benchmark quality, as listed by Jeffrey Bailey, include:

- High coverage
- Low turnover
- Similarity of managed portfolio and benchmark style exposure
- High correlation between the managed portfolio and the benchmark
- Reduced observed active risk

High coverage and low turnover are of particular importance, especially when one considers the increasing importance index tracking is playing in the investment landscape. Sufficient liquidity in index counters would therefore also need to be addressed, and ties in somewhat with the "investable" property mentioned above.

To summarise, a benchmark should be constructed in a simple, transparent method that market participants are able to replicate.

Sources:
Managing investment portfolios: A dynamic process (CFA institute investment Series), Third edition, by John L. Maginn, Donald L. Tuttle, Jerald E. Pinto, Dennis W. McLeavey.
Evaluating Benchmark Quality, by Jeffery V. Bailey, Financial Analysts Journal, May-June 1992, pp. 33- 39.

ANALYSIS OF SOUTH AFRICAN EQUITY BENCHMARKS

Before we define the broad market indices and their differences, it is important to understand the difference between local and foreign (also known as inward-listed) companies. National Treasury and the JSE classify companies as either foreign or inward-listed, which determines what their free-float is within the broad market indices. An anomaly is the so called "grandfathered" companies, which are classified as local, as they were originally South African businesses, but took their primary listing offshore prior to October 2011. The "grandfathered" companies are treated differently in the various broad market indices, as defined below.

DEFINITIONS

FTSE/JSE All Share Index (ALSI): This represents 99% of the full market capitalisation value (gross market capitalisation before applying any investability weights) of all ordinary securities eligible for listing on the main board of the JSE. It includes the full free-float shares in issue of "grandfathered" companies, while inward-listed and foreign companies have a SWIX free float (see definition of SWIX below).

The FTSE/JSE Capped All Share Index (CAPI): This follows the FTSE/JSE All Share Index (ALSI) construction methodology and only differs with regard to the capping of individual security weights at 10%. The key reason for using capped indices is that by diversifying a portfolio away from the largest companies, the overall risk of the portfolio is reduced However, turnover is increased, as well as investability reduced, due to smaller, less liquid companies being up-weighted.

The FTSE/JSE Shareholder Weighted All-Share (SWIX): This uses the same constituents as the ALSI, but differs by using the STRATE (South Africa's Central Securities Depository) share register to reduce constituent weights of foreign or inward-listed companies. The SWIX free-float therefore excludes all scrip that is held on foreign share registers for inward-listed companies. The SWIX free-float factor is achieved by taking the percentage of shares held on the STRATE register. The SWIX indices are therefore intended to be an indication of the shares held locally.

Therefore, the inward-listed or foreign companies are not weighted consistently within the ALSI, as the "grandfathered" companies (which were never classified as foreign) are included with their full free-float, rather than their locally held shares in issue as represented by the SWIX free-float. In contrast, SWIX treats all inward-listed or foreign companies (including the "grandfathered" companies) identically, by using their SWIX free-float. For example, the ALSI free-float for Anglo American plc (a "grandfathered" company) is 0.96, while its SWIX free-float is only 0.42. Conversely, British American Tobacco plc (an inward-listed foreign company) has an ALSI free-float of 0.15, which matches its SWIX free-float. The only difference between these two companies is when they inward-listed within South Africa.

Therefore, SWIX is more consistent in the way it handles inward-listed or foreign companies, by setting the free-float for all these companies as the percentage of shares held on the STRATE register, regardless of the timing of when these companies listed offshore, or inward-listed within South Africa.

INDEX REVIEW

Market benchmarks world-wide continue to evolve as circumstances and best practice change over time.

The FTSE/JSE indices are not immune to change and as such the JSE has recently announced index construction changes, based on feedback received from a market consultation process conducted at the end of 2015. The final changes will be implemented at the September 2016 Quarterly Index Review.

The following is a summary of the most notable changes to the index construction methodology:

- The constituents of the Top 40 Index will be selected based on net market capitalisation as opposed to gross market capitalisation, changing the focus from a "largest company" index to a "most investable company" index
- The constituents of the SWIX 40 will be selected using SWIX-adjusted market capitalisation, and as such the constituents of the SWIX 40 may differ from those of the Top 40 index
- The 160-minimum number limit on the constituents of the ALSI has been removed. Index selection is now based solely on the target 99% market representation level and may therefore include fewer constituents
- Constituents of the ALSI will be reviewed semi-annually instead of annually, with reviews occurring in March and September.

FREE-FLOAT REQUIREMENT

There is a free-float requirement that all listed companies need to maintain in order to be included in the indices. Currently, if a company has a free-float of less than 5% it is not eligible for inclusion. Should the free-float be between 5% and 15% it is also not eligible, unless the investable portion of the company is large enough for its exclusion to impact the accuracy of the benchmark. The rule that captures this scenario includes companies with a free-float of between 5% and 15%, but only if the company's investable market capitalisation is greater than the median company's investable market capitalisation in the ALSI.

The exceptional free-float restrictions relating to inward listings when applying the 5% and 5%-15% minimum free-float rules have now been dropped. Inward listings could thus enter the indices with a FTSE/JSE free-float of 5% or less as long as their global free-float meets the minimum free-float criteria. Inward shares will, however, require a minimum of 1% of their issued shares to be accounted for on the South African share register.

With regards to local companies, maintaining the free-float restrictions is beneficial as this serves to improve liquidity and ensure companies are sufficiently investable before being included in an index. However, when reviewing inward-listed companies using the global free-float as the qualifying criteria makes sense. Due to the fungible nature of these securities it is possible to purchase these companies on international exchanges, even though the free-float within South Africa may be low. Using a median measure also counters the skewed measurement that results from using an average market capitalisation measure.

POSSIBLE CHANGES

While the JSE has implemented certain changes to the current methodology, there could be further changes or even the possible introduction of additional indices.

Concerns have been raised regarding the concentration of individual securities within certain indices, particularly the SWIX. While the SWIX in its current and proposed form is reflective of the investable universe for South African investors, there is a case to add an additional derivative of the SWIX to ensure it remains compliant with prudential limits, viz. Regulation 28. This approach would determine the limits based on regulatory requirements, which limits the concentration of any one security to 15% of the total portfolio. However, given that total equity exposure is limited to 75% within a Regulation 28 compliant fund, this means within the equity portion alone an individual security could have a weight of up to 20% before being in breach of Regulation 28 (assuming all equity exposure was in South Africa), and even higher if the local equity portion is less than 75%.

Such an approach to constructing an index is not without precedent. If any changes to the SWIX to introduce capping were adopted, regulatory requirements, rather than an arbitrarily determined capping level, may be optimal. This would give investors an index they could track while taking full advantage of the regulatory allowances available to them. Given the FTSE/JSE SWIX index exists primarily for South African investors, having it change in line with regulatory changes shouldn't cause any adverse impacts. Capping at 15% would provide sufficient room for growth while remaining Regulation 28 compliant, although the index should accommodate intra-quarter rebalances, in the event it breached the 20% limit (the lowest limit from a total portfolio perspective).

Introducing this capped index as an additional index, rather than amending the current SWIX index itself, would be beneficial as it would give investors and asset owners the choice of which benchmark they'd prefer.

CONCLUSION

The choice of benchmark for a particular investor is a critically important decision and is very much a function of what that investor is setting out to achieve. Liquidity, diversification, turnover, regulatory structure, whether the index is used for tracking or purely benchmarking purposes and the objective of the investor's overall portfolio, are all factors that need to be considered when choosing an index.

The ALSI represents 99% of the full market capitalisation value of all ordinary securities eligible for listing on the main board of the JSE. As mentioned above this will include the foreign shareholding of the "grandfathered" companies, while more recent inward-listed companies are weighted according to their SWIX free-float, resulting in inconsistencies.

In the South African context this index is also highly concentrated with the top 10 securities accounting for over 50% of the index as of 31 Dec 2015.

The CAPI is essentially the capped version of the ALSI and as a result will suffer from the same inconsistencies. The difference is that it is trying to increase diversification by introducing a 10% cap on security weights. The 10% cap has reduced the top 10 weights slightly, although they are still over 50% of the index. Unsurprisingly, the performance of CAPI has been very similar to ALSI over the last 10-years. For the capping to have an effect the cap weight would have to be significantly reduced. A 7% cap reduces the top 10 holding to be in line with the SWIX at just under 50% while the cap weight would have to be dropped to 4% to bring the top 10 under 40%. The result of capping also has the consequence of increasing the weight of smaller, less liquid securities in the index.

The SWIX index uses the same constituents as the ALSI, with the only difference being the free-float factor that is applied to securities classified as foreign. Importantly, this applies to "grandfathered" securities as well as any inward-listed securities post October 2011, where their free-float is determined by factoring in the percentage of shares held on the STRATE register as a proxy for how widely held each foreign security is within South Africa. As such, the SWIX index represents the most consistent approach to specifying the free-float shares in issue within the South African market and is by far the most widely used benchmark used by South African institutional investors . We believe this makes for a compelling case to use SWIX as a default benchmark, notwithstanding proposed improvements which could be introduced to further improve its diversification characteristics.

Source:
S.A. Equity Manager Watch Survey, by Alexander Forbes, November 2015.

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