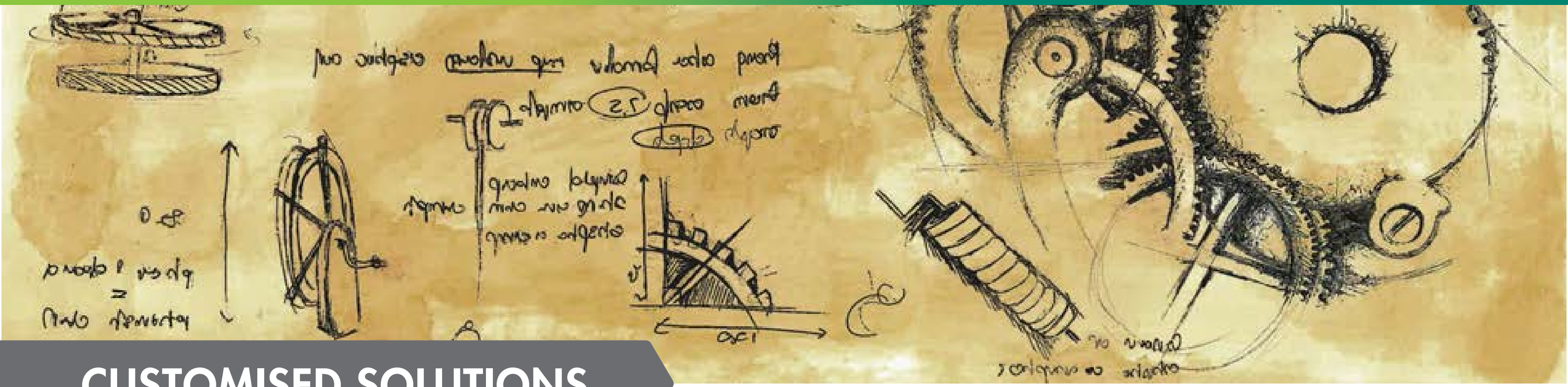


THE CASE FOR INDEX INVESTING: **WHY INDEX INVESTING?**

By Kim Johnson and Kingsley Williams

INTRODUCTION

South Africa has observed rapid growth in both the number and value of its unit trusts since the first two funds were launched in 1965. Since then, the industry has undergone rapid expansion, seeing the total number of unit trusts reach 1 361 as at March 2016 with a combined assets under management totalling R2 trillion (Association for Savings and Investment South Africa (ASISA), 2016). However, at present the vast majority of unit trusts are actively managed and investors are still reasonably unfamiliar with index funds. This limited exposure to index investing influences the belief among investors that actively managed funds persistently outperform passive or index funds in South Africa.

Four fundamental premises can be identified in evaluating arguments for active and index investment strategies.

- Active investing is a zero-sum game
- Active manager selection risk
- Cost
- Style consistency

The age old debate of whether to invest in active or passive is no longer relevant and the focus needs to shift as to what is right for the investor.

We believe that there is a place for both active and index investing and that by combining the two strategies it provides the investor with better diversification, lower risk and lower overall cost.

ACTIVE INVESTING IS A ZERO-SUM GAME

Investment performance over time is a positive-sum game - real wealth is created through exposure to capital markets, which share in the growth of economies and markets. Conversely, active investing is very much a zero-sum game relative to the market - for every participant that outperforms the market, there must be a participant that underperforms. The net result of all this active trading in the marketplace yields the market average or index performance.

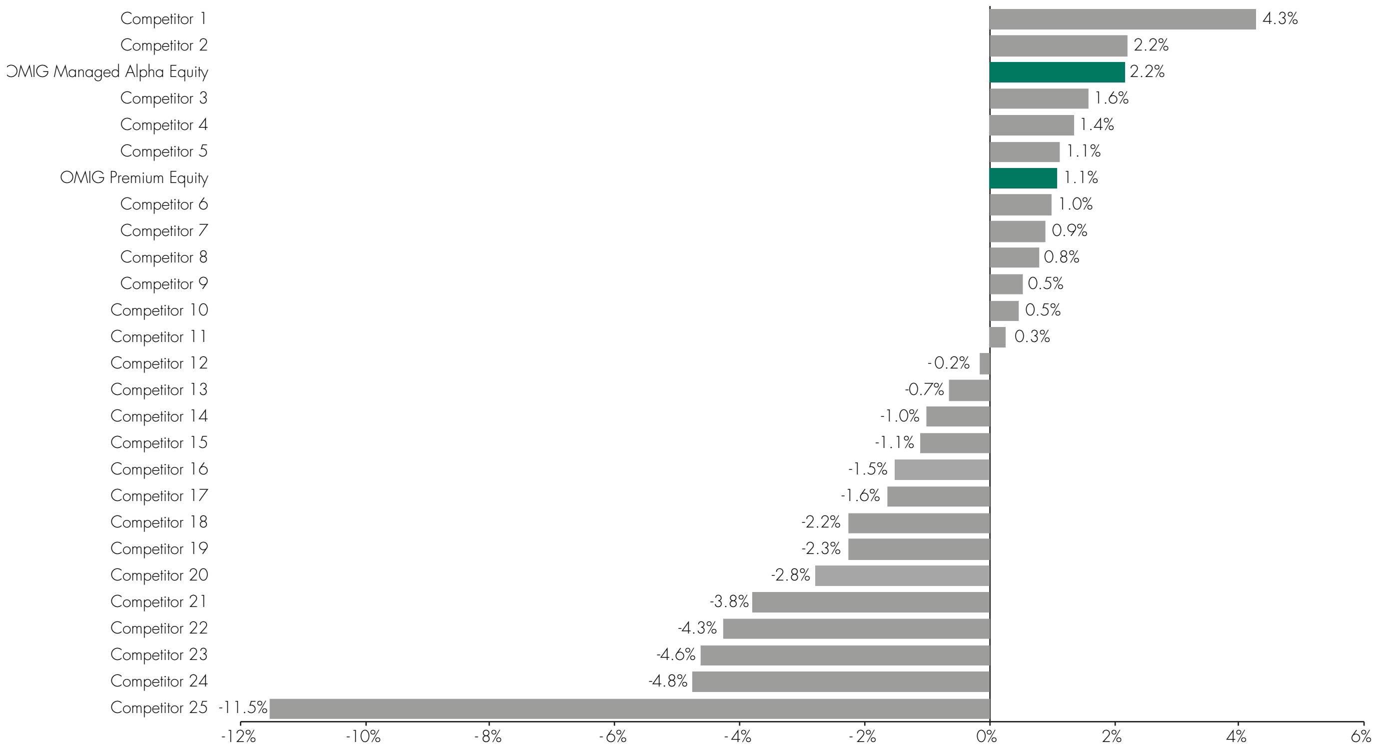
William Sharpe developed the theory, called The Arithmetic of Active Management which states that before costs the average actively managed investment would equal the return of the passively managed investment, and that after costs the return of the actively managed investment would be less than the return on the passively managed investment.

Purely from a mathematical viewpoint about 50% of active investors will under-perform the index before costs. When taking into account the additional costs of active investing, more than 50% of active investors will under-perform the index over time.

Evaluating his claim in the South African context of these two investment strategies, active and index investing, we compared the performance of all actively managed funds benchmarked to the FTSE/JSE Shareholder Weighted Index to their benchmark in the Alexander Forbes survey as at the end of April 2016.

The analysis reflects that before fees, 52% of active managers have underperformed the benchmark over the five year period.

ACTIVE RETURNS OVER FIVE YEARS RELATIVE TO THE FTSE/JSE SHAREHOLDER WEIGHTED INDEX



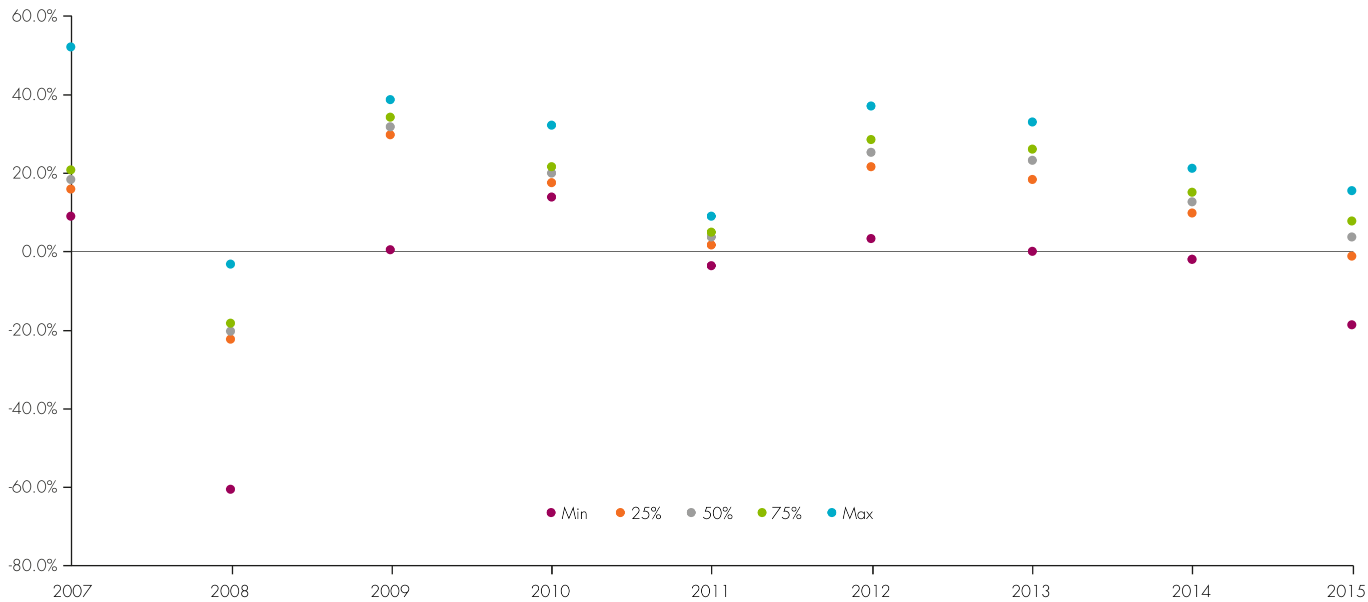
Source: Alexander Forbes Equity Survey (SWIX Funds), April 2016

ACTIVE MANAGER SELECTION RISK

While there are active managers, who have outperformed the benchmark and have a track record of delivering alpha, the challenge lies in the ability to select the next winning manager. By including a passive component to an investment portfolio, an investor reduces their risk of underperformance.

The dispersion in actively managed returns is clearly illustrated below. With 30% - 40% dispersion in returns between active equity managers, it is evident that there is more risk in selecting an active manager. An investor selecting the wrong asset manager could be subject to disastrous circumstances.

DISPERSION OF PERFORMANCE OF SA ACTIVE EQUITY MANAGERS



Source: Alexander Forbes Survey, April 2016

LOW COST

Over the last few years, there has been a growing emphasis on the cost of savings and investments.

The National Treasury has been reviewing the conduct of the retirement industry in the last couple of years. After consultation with industry stakeholders a draft regulation has been released. The aim of the proposed regulation is to lower charges associated with the asset management of retirement funds and to improve the market conduct of the retirement industry.

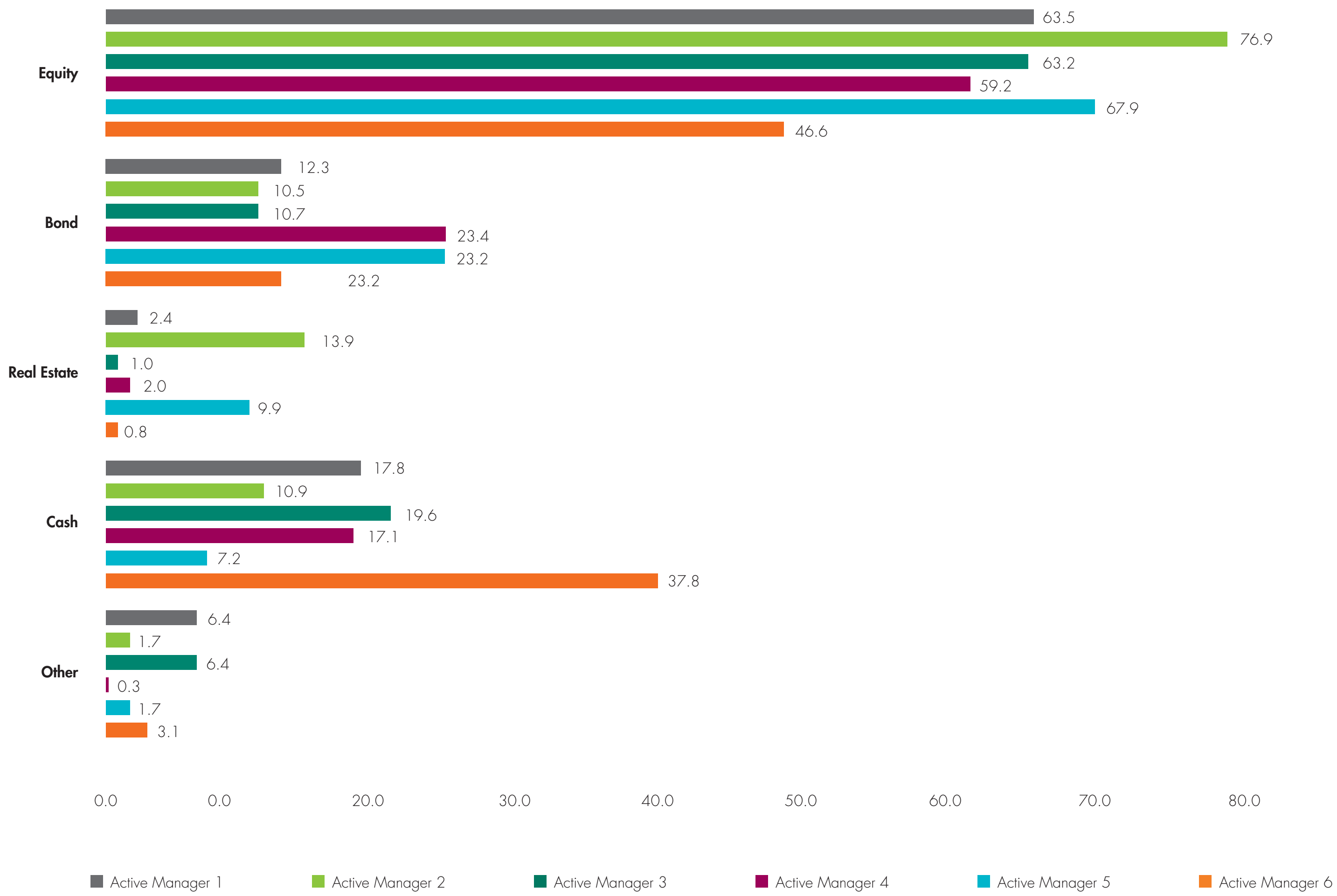
Regulation 37 attempts to introduce lower costs to investor portfolios by introducing the requirement that all default investment portfolio need to consider index investing as part of their investment strategy.

As index investing does not have the additional costs incurred with active management it is inherently lower in total costs. The draft retirement reform regulations will require trustees to consider using index and enhanced index investment strategies in their investment portfolios.

STYLE CONSISTENCY

While the six largest actively managed balanced funds in the High Equity Multi-Asset Class of the South African unit trust sector fall into the same sector classification, their asset allocations are significantly different. One would expect, the exposure to equities in the same ASISA category would be quite similar. However, as can be seen below, active managers are making asset allocation calls which at any given point in time could be significantly different from that of the long-term investment strategy.

ASSET ALLOCATION TOTAL (NET)



Source: Morningstar – Asset Allocation 31 March 2016

However, in an index balanced fund, the strategic weights and ranges of each asset class are predetermined based on the risk profile of the fund and are closely managed within those ranges. Therefore, investors know that they are getting returns in line with the asset allocation in which they originally invested.

CONCLUSION

In his book Winning the Loser's Game, Charles Ellis writes: "The basic assumption that most institutional investors can outperform the market is false. The institutions are the market. They cannot, as a group, outperform themselves. In fact, given the cost of active management – fees, commissions, market impact of large transactions, and so forth, 85% of investment managers have and will continue over the long term to underperform the overall market." This statement by Ellis indeed supports our findings in the South African market, where 52% of active managers have underperformed the market before fees.

What the winning active strategies will be over the next decade is difficult if not impossible to predict, which further complicates active manager selection. Including index funds into an investment portfolio reduces the risk of the investor selecting underperforming active funds. Including index investment strategies also frees up an investor's active risk and fee budget to be allocated to higher conviction active managers to deliver on their long-term investment strategy.

The merits of combining both active and passive strategies can be summarised as follows:

- Winners over the next decade are not known, making manager selection very difficult
- Cost saving in combining active and passive funds
- Diversification benefits across various strategies.

There are both logical and emotional reasons why investors either prefer active or index investing. The emotional issues tend to push investors towards active investing, while logic and empirical evidence will pull investors towards making use of index investing.

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