THE BIG DEBATE - ACTIVE VS PASSIVE INVESTMENTS

National Treasury's discussion paper on retirement industry charges described how many investors are prejudiced by excessive fees, choice and complexity, by poor disclosure and governance, and by conflicts of interest.

The Board of Trustees is mindful of the Funds' investment portfolios and fees and are continuously looking at ways to meet member needs and lower management fees. One of the solutions would be to introduce passive investment management of some of the Fund's portfolios.

We include a short overview of the difference between active and passive investment here. This article does not intend either to provide financial advice or to support or favour one strategy above the other - but simply to provide information about both.

What is active investment management?

The active investment manager exploits market inefficiencies by purchasing stocks (equities and bonds) that are undervalued or by short selling securities that are overvalued. Either of these methods may be used alone or in combination. Depending on the goals of the specific investment portfolio, active management may also serve to create less volatility (or risk) than the benchmark index. The reduction of risk may be instead of, or in addition to, the goal of creating an investment return greater than the benchmark.

Investors trade stocks for two main reasons. One is fundamental: to get in and out of the share and bond markets. They invest to deploy spare cash or consciously save a part of their income for future use. They exit when they need their money. They can expect to receive the market return, more or less, over their holding period (before fees).

The second reason to trade is more speculative: switching between asset classes and securities in the hope this will deliver an above-average return.

Speculators take a keen interest in what experts have to say, because they play the game of valuing and trading asset classes. It's called market timing and part of the active investor's toolkit, intended to deliver an above-average return. Their other tool is called stock picking. The two concepts are similar except that stock pickers evaluate securities as cheap or expensive, and trade accordingly.

What is passive investment management?

Passive investment management is an investment strategy that tracks a market-weighted index or portfolio. The idea is to minimize investment and trading fees and to avoid the adverse consequences of failing to correctly anticipate the future. The most popular method is to mimic the performance of an externally specified index. Investors typically do this by buying one or more index funds.

By tracking an index, an investment portfolio typically gets good diversification, lower turnover (good for keeping down internal transaction costs), and lower management fees. With lower fees, an investor in such a fund would have higher returns than a similar fund with similar investments but higher management fees and/or turnover/transaction costs.

Did you know? Three people shared the 2013 Nobel Prize for Economics, including Eugene Fama, whose 1960s research set the premise for index funds by concluding that trying to beat the market was an exercise in futility.

In summary.

An index fund seeks to mirror the performance of the stock market by investing directly in the shares that make up the market and the active fund/manager trades the market in the hope of earning an above-market return.

Why is this important?

Your long-term investment return ultimately depends on two factors: your investment mix (how much you are invested in shares, bonds and cash respectively) and how much that return is reduced by fees.

Historically, a high equity portfolio (75% invested in shares) has delivered almost 6% pa over the long term, compared to a medium equity portfolio (50% in shares) of only around 4% pa. Investors who hold less equity because they fear markets going down usually end up with a much lower replacement ratio at retirement.

The problem is that these returns are before fees. The average retirement fund portfolio active management fee in SA is 2% p.a. compared to lower cost options of less than 1% p.a. for index-tracking portfolios.

In other words, the saver in a medium-cost, medium equity fund can expect a long-term real return of just 2% pa, compared to 5% in a low cost, high equity fund. The second saver will receive almost double the pension, without saving more!

The long-term investor's view

Committed long-term investors don't base their asset mix on what appears cheap or expensive, but on their investment time horizon. They find the most effective and cheapest way to own these asset classes. They diversify adequately. They stick to the plan and re-balance as required. Above all, they don't worry what experts have to say on the current market levels.

"Sensible investing is simple, but not easy to stick to. Diversify widely, keep costs low, rebalance in a disciplined fashion, spend less, save more and make less heroic assumptions about future returns."

Clifford Asness, Quantitative financial theorist and co-founder of AQR CAPITAL Management

The Fund's Investment Committee is currently reviewing its investment strategy and will keep you updated on progress made with the possible introduction of passive investment portfolios.