Presentation on Active versus Passive Investing prepared by Investment Solutions

MEMBER OF ALEXANDERFORBES

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WITH CONFIDENCE

Active and Passive

Definitions

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- **Passive management** is investing in a **rules based manner**

- Aims to replicate returns of a specified benchmark
  - Each asset class to match specified index
  - Match performance of long-term strategic asset allocation

- **Active management** aims to beat the returns of an asset class or an index

  - Share selection: Selecting shares that will earn a return higher than that of an index
  - Market timing: Timing asset class exposure to earn a return higher than that of a fixed asset allocation

Changing paradigm

Range of options

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Market Cap -weighted indexes	Non-cap weighted	Actively managed
All Share Index (ALSI)	Rules-based strategies	
Shareholder Weighted Index (SWIX)	Equally weighted	
	e.g. RAFI, Satrix Divi	

Passive management

In its most basic form

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Share Name	Benchmark weight	Fund Weight
Naspers	12.25%	12.25%
MTN	7.17%	7.17%
Sasol	4.49%	4.49%
British American Tobacco	3.89%	3.89%
SAB Miller	3.49%	3.49%
Standard Bank	3.61%	3.61%
Steinhoff	3.34%	3.34%
Firstrand	2.99%	2.99%
Anglo American	2.34%	2.34%
BHP Billiton	1.87%	1.87%

Passive management

Ways that you can match an index

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- Full replication
- Stratified Sampling
- Synthetic

Passive management

Ways that you can access passive portfolios

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Index fund

Exchange Traded Fund

Exchange Traded Note

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Exchange Traded Fund (ETF)

Instrument listed on the stock exchange which provides exposure to basket of securities

Exchange Traded Note (ETN)

Note issued by a bank which provides exposure to basket of securities

Active position

Difference between a portfolio weighting and benchmark weighting

Active management

Example

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Share Name	Benchmark Weight	Fund Weight	Active Position
Naspers	12.25%	8.45%	-3.80%
Steinhoff International	7.17%	4.27%	-2.90%
MTN Group	4.49%	4.18%	-0.31%
Standard Bank Group	3.89%	4.00%	0.11%
British American Tobacco	3.49%	3.77%	0.28%
Sasol	3.61%	3.19%	-0.42%
FirstRand	3.34%	2.55%	-0.79%
Old Mutual	2.99%	2.55%	-0.44%
Mondi	2.34%	2.52%	0.18%
Anglo American	1.87%	2.38%	0.51%

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Fundamental Indexation

A type of equity **index** in which components are chosen based on **fundamental** criteria as opposed to market capitalization

Fundamentally-weighted indexes may be based on **fundamental** metrics such as revenue, dividend rates, earnings or book value

Fundamental indexation

Example: Satrix Divi

"Index selects the ***top 30 high yield instruments based on a one year forecast dividend yield****. The consensus forecast of stock market analysts, from both the buy and sell side of the industry, is collected in the McGregor BFA Survey. The analysts provide forecasts purely based on cash dividends, therefore excluding special dividends, capital reductions and capital repayments"*

"The index universe consists of companies in the ***FTSE JSE Top 40*** *and* ***FTSE/JSE Mid-Cap indices****, excluding property companies"*

"The index is ***reviewed twice annually*** *in March and September"*

Source: Satrix website

Which index to track?

Active decision

- When following a passive investment strategy, **the most important decision is which benchmark to track**

- Need to consider:
  - How the index is constructed
  - How often the index is rebalanced
  - Concentration issues at both sector and stock level
  - Liquidity issues

- The All Bond Index (ALBI) is generally difficult for managers to track
  - Not always possible to source all of the underlying holdings
  - Difficult to rebalance the portfolio when the index is rebalanced

Active and Passive

Misconception

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Passive ≠ not making decisions

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Passive management - Advantages and Drawbacks

Advantages	Drawbacks
Lower fees	Accept the configuration of indices regardless of quality of holdings and risks
Shouldn’t have to explain below benchmark performance	Not always possible to track index properly
Lighter touch approach	Wide range of passive options, choosing the flavour of passive investing is an active decision
	Not all asset classes can be passively replicated

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Active management - Advantages and Drawbacks

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Advantages	Drawbacks
Possibility of outperforming	Monitoring requirements
Possible protection in falling markets	Finding managers that can consistently add value is difficult
	Higher fees

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Global perspective

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- The first index portfolio was pioneered by the **Samsonite Pension Fund** in 1971
  - A US$6 million portfolio designed to match the NYSE Index

- Index tracking is more commonplace in the developed world
  - An estimated **10-15%** of all US pension assets are passively managed

- Concentrated industry with more than 75% of passive assets are managed by three players

BlackRock	State Street	Vanguard
$2.3trn	$1.7trn	$1.6trn

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SA perspective

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- **Active funds dominate** institutional and retail market share in South Africa
  - As at 2013, we estimate under R200bn invested in passive mandates (excluding the PIC)
  - Small proportion of retirement fund industry assets (approx R4 trillion)

- Passive management has **struggled to gain traction**
  - Equity centric market and investors attracted to returns of top managers
  - Fee levels started off relatively high in SA compared to other markets, but decreasing

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SA perspective

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- Many managers who started out as passive managers gradually turned to active management over time
  - Kagiso, Prescient, Vunani (formerly Peregrine iQ)
- Of the large asset management houses, Old Mutual Global Index Trackers (formerly Dibanisa) and Sanlam Investment Management (SATRIX) have the largest investment in passive
- The PIC remains the single largest index tracker investor, investing on behalf of the GEPF
  - Currently manage an equity portfolio of more than R500 billion (2012/13)
  - Majority of this is managed on a ‘index tracking’ basis

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SA perspective

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- History shows that **active managers have generally done well**
  - However **not everyone** can beat the market all the time
  - Does depend on the **period** being considered
  - Relatively short period to consider
- There has been much **debate** around why South African asset managers have been able to outperform over time
  - Some of the things that make South Africa unique are the size of the GEPF and life company assets, and that we have had large sector biases
- As the market becomes more efficient, it should be **more difficult** to outperform consistently
- Results depend on period being considered

Active and Passive

Decision making framework

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- **What will benefit the fund?**
  - Could combining passive and active exposure provide a suitable outcome
- **Is there a passive alternative?**
  - No readily replicable index for private equity, direct property given illiquidity
  - No passive alternative for balanced portfolios / absolute return portfolios
- **What is the suitability of the passive alternative?**
  - Concentration in the Index e.g. Naspers in the Shareholder Weighted Index
  - Selecting an index is an active decision in itself
- **Is active management expected to outperform the index?**
  - Focus active management on those asset classes and strategies that provide the best opportunity to add value
  - Have reasonable value add expectations

Active and Passive

Decision making framework

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- **Does your investment philosophy / culture support active management?**
  - Time, resources
  - Time frame
  - Ability to handle periods of underperformance

- **Fees**
  - Are you willing to pay higher fees for active management?

Active and Passive

Summary: Is it possible for a manager to add value

- Passive investing in a South African context is less developed than other markets
  - Lack of data makes it difficult to draw meaningful comparisons

- If choose to invest passively, the choice of which benchmark to track is the most important decision a Trustee board can make

- We believe that there is a place for both in portfolios but depends on type of portfolio
  - Costs must be balanced against potential value add

- Alpha, even if small, can have a significant impact on members' expected retirement benefits