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Why active management beats passive in South Africa

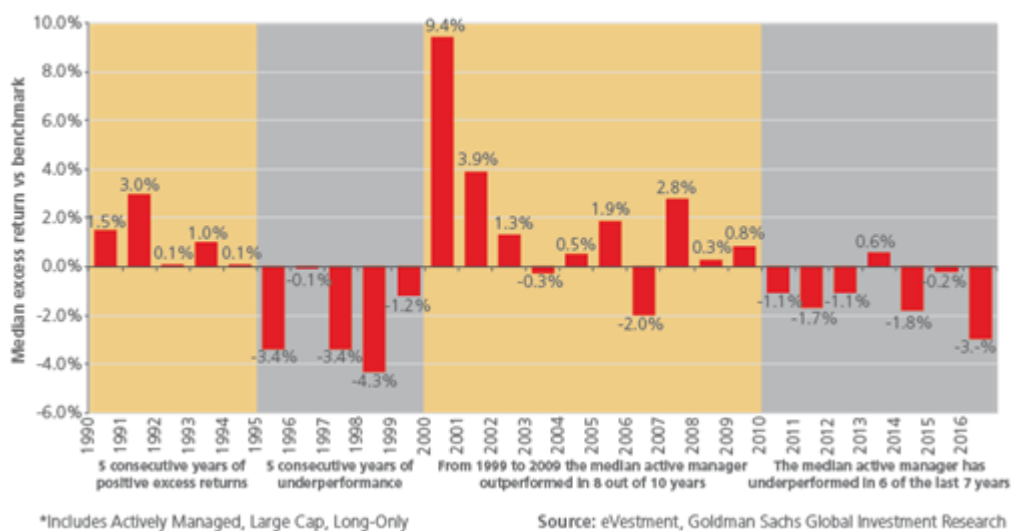
Dispelling some misperceptions about active and passive investing in the local market.

Passive investing is gaining ground in the South African market, mainly due to the (generally) lower fees involved compared to actively managed funds, but also based on some misperceptions stemming largely from the US experience, where this investment approach has become very popular. Passive funds including unit trusts, exchange traded funds (ETFs) and all types of index tracking solutions now comprise a US\$2.5 trillion market.

Bond market tracking funds are also gaining ground, as are multi-asset solutions in which passive funds attempt to replicate “balanced” funds across equities, bonds, property and cash to diversify risk. On top of this, “smart beta” products have proliferated where investors can choose to invest following a specific formula or rule developed by an asset manager: for example, a fund that tracks an invented benchmark comprised of “green” companies,

“high dividend yield” companies, “ethical” companies, etc... and the list goes on.

Graph 1: Excess Return vs Benchmark for Active US Funds*



Today’s passive investing approach has strayed far from the original intent of the methodology’s founding fathers, which was to give investors exposure to a very broad, diversified range of equities using a simple market capitalisation-based index tracking methodology at a low cost. These days the majority of investors have moved away from buying the broad market to various narrow sub-categories at a higher cost. Only just over 25% of the US passive equity market (by value) is invested in such products simply tracking the broad market (e.g. S&P 500 Index), while the balance has gone into more concentrated and/or complicated, higher-cost products with less diversification – and therefore higher risk. As competition among the major US product providers has driven fees ever lower, they have been compelled to develop and promote higher-fee solutions like smart beta – purporting to offer better returns or less risk – in order to protect their bottom lines. Smart beta, in particular, is inherently risky for investors in that it requires them to make an active decision about which benchmark to follow.

Active funds do outperform the market

One of the common misperceptions driving the growing popularity of passive investing is that actively managed funds, with higher fees, are not delivering market outperformance (or “alpha”), to merit these higher fees, nor are they beating passive products on an after-fee basis. So while the dominant narrative in the news appears to be that “active funds never outperform the market

index”, the truth is that they do. As with most investments, performance is cyclical. Graph 1 shows that the active asset managers in the US outperform the equity index during certain periods and underperform in others. It highlights that the decade of the 2000s was an excellent one for active US equity fund managers, with the median active manager outperforming their peer passive funds strongly in eight of the 10 years. More recently, however, the cycle has been one of underperformance for active managers. The median active US equity fund manager has underperformed the index in six of the last seven calendar years. And 2016 was particularly difficult, as they delivered their worst underperformance since 1998, at -3% for the year.

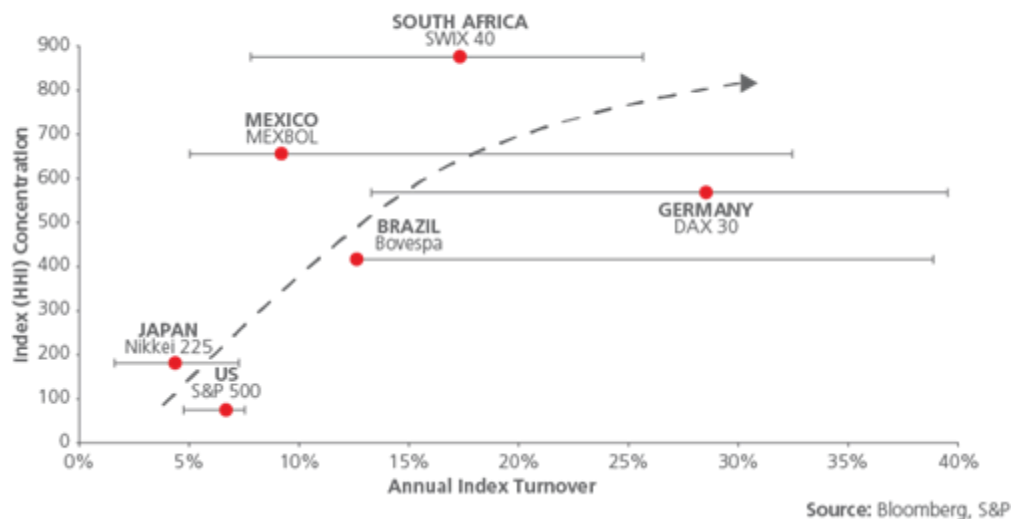
Still, this should not negate the fact that many active managers in the US have delivered market outperformance, and beaten their passive equivalents, over time. Over the past five years to the end of 2016, 43% of active equity funds did outperform their median passive peers after fees, and this was true for 63% for active bond funds after fees. Additionally, it’s important to note that, by definition, passively managed funds will never outperform the benchmark they are tracking due primarily to the impact of fees – no matter how low these fees may be.

Almost all of the research around passive investing to date has been based on data from the US, where market characteristics differ quite significantly from those in South Africa. Simply assuming that this research equally holds true in local conditions is yet another misconception that shouldn’t be accepted at face value by South African investors. There are several key differences between the markets that would dictate caution on the part of South Africans towards a passive approach.

No South African tax advantage for passive investors

One important difference between the US and South African investment contexts is that ETFs – a popular passive vehicle in the US – enjoy a substantial tax advantage over actively managed unit trusts. This arbitrage has been one of the key drivers of the US move towards ETF investments. Yet this advantage does not exist in South Africa, where the two are subject to identical tax treatment. This makes for a less compelling case for local investors to use ETFs compared to the US.

Graph 2: SA Equity Market: High Concentration Risk and Turnover



SA equity indices have very high concentration and turnover

Graph 2 highlights that the FTSE/JSE SWIX Top 40 Index is one of the most highly concentrated in the world (notably, the highest we could find). This means that investors who track the index get far less diversification in their equity holdings than other broad market equity indices like those in Mexico, Germany or Brazil, never mind the US, which is the least concentrated. The SWIX Top 40 Index has a concentration (as measured by the conventional market concentration indicator, the Herfindahl-Hirschman Index (HHI) on the vertical axis) of nearly 900, compared to the S&P 500's HHI measure at below 100.

Currently Naspers, the largest company in South Africa by market capitalisation, makes up over 20% of the SWIX Top 40 Index: it would take the 16 biggest companies in the S&P 500 Index to make up the equivalent weighting of Naspers in that market. This includes Apple (the world's largest company by market capitalisation), which comprises only 4% of the S&P 500. Prior to the rise of Naspers, it was the resources sector that dominated the local market, comprising nearly 50% of the SWIX Top 40 Index value at the top of the resources cycle. Our high market concentration makes simple equity index tracking investments much more risky in South Africa than in many other countries.

At the same time, South Africa's SWIX Top 40 Index also has a much higher annual turnover than the US and many other countries, as companies qualify to move in and out of the FTSE/JSE SWIX Top 40 Index more often. Graph 2 also illustrates

this high comparative rate, with our local index's annual turnover having a median of around 18% compared to around 7% for the S&P 500 (as measured on the horizontal axis). This drives South African index tracking costs comparatively higher as passive managers must rebalance (or adjust) their portfolio holdings in line with the ever-changing composition of the Top 40 biggest shares, resulting in higher numbers of costly transactions during the year which detracts from performance. And when passive portfolios are rebalanced infrequently, timing delays in rebalancing can also produce wider differentials between index returns and passive tracker returns (called tracking error), as passive funds miss out on some index returns since they fail to exactly replicate the index 100% of the time. Passive funds always demonstrate some degree of tracking error. Given these disadvantages, one would expect passive solutions in South Africa to deliver poorer results than those in the US.

Importantly, the dashed line in Graph 2 demonstrates how these two characteristics of market concentration and index turnover impact on active manager outperformance in theory: the further one moves along a continuum from the US market (lowest concentration, very low index turnover) to South Africa (highest concentration, very high index turnover), the easier it should be for active managers to outperform the market index. It makes sense that a passive approach could provide better results in highly diversified, lower-cost markets, while an active approach would tend to outperform in less diversified, higher-cost markets. So one could expect that in South Africa, a higher proportion of active managers would be likely to outperform the market index – and therefore passive solutions – than in the US.

The majority of SA active managers have outperformed

An analysis of the performance of ASISA equity funds confirms this, showing that a higher percentage of active equity funds succeed in outperforming their benchmarks after fees compared to the US market. Taking the five largest unit trust funds in the ASISA General Equity category aggregated with Prudential's two equity unit trusts as a sample representing 43% of the total assets in the category, 71% of these General Equity unit trusts outperformed their own benchmarks after fees over the five years to the end of 2016. This

rose to 86% outperformance for the five-year period to 31 May 2017 – a very high proportion.

These results should help to combat the misperception that active South African equity managers continually underperform their benchmarks. The above findings also demonstrate that active management does add value in the South African market on an after-fee basis. In fact, given the characteristics of our equity market, investors need active management to ensure risk is diversified away as much as to generate active returns. Of course, because of the cyclical nature of asset return cycles there are likely to be periods when passive solutions may outperform their active counterparts (as Graph 1 confirms for the US market), but active management should continue to prove valuable for South African investors as they build wealth over time.

To find out more about Prudential's actively managed [unit trust funds](#), contact our Client Services Team on 0860 105 775 or at query@prudential.co.za.