Platform

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Plexus Independent Insight in an Uncertain World

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IT DOESN'T HAVE TO BE BLACK OR WHITE

For too long now, the debate on active and passive investment strategies has focused on their specific characteristics and mutual exclusivity, rather than on the common areas that undoubtedly exist between these strategies. The discourse has been binary, placing these two approaches at opposite ends of the investment philosophy spectrum.

So by industry decree, the active versus passive discussion has largely become a black or white outcome. And placing oneself in either the active or passive camp says much about how one views the investment world and about one's own instinctive personality and behavioural biases. Passive investors are generally a frugal bunch – they remember being told by Dad that, "if you look after the pennies, the pounds will take care of themselves". They may even have a scientific bent to their psychological make-up.

For a variety of reasons they tend to take a dim view of active managers, specifically the latter's ability to forecast future cash flows and identify mispriced assets. They may even view active managers as modern-day snake oil salesmen, and are sceptical of the big brand asset-gathering machines that are so prevalent among today's mainstream fund managers.

Conversely, active managers are the swashbuckling risk takers. Their mantra may be, "you have to spend some money to make some money". They would claim to possess the skill and nous to beat the market (and their peers) over time. And surely, if one is able to identify − in advance − the best active managers, they certainly can earn you fantastic returns over time.

The active group views passive investors with disdain. Some even see them as "leeches" feeding off the investment body, doing nothing to improve market efficiency and price discovery. Their main objection is that by trading irresponsibly at times and exacerbating market bubbles and busts, passive investors actually cause the volatility of stocks to increase.

Protagonists of passive investing will show global statistics demonstrating that over time (five years or longer), few active managers − only about 22% to 28% − will, after costs, beat the equity hurdles they set as their benchmark. In South Africa making this claim is somewhat more difficult – on the surface at least. Over the past ten years to 31 May 2011, we looked at the general equity, large cap, growth and value categories of ASISA's equity fund classification as the fund universe and the FTSE/JSE All Share (ALSI) Index as the benchmark. Over this time, 30 of 53 funds (57%) beat the benchmark − a very impressive outperformance ratio by global active manager standards.

That is until one looks more carefully into the database of funds that ***were*** in this universe in May 2001 and discovers that 51 of the funds that were there in 2001 are no longer present! Fund mergers, manager changes, mandate changes and fund closures (often due to bad performance) have removed nearly half the funds that were around in 2001. This loss of data has massively impacted the outcome and the resultant survivorship bias renders these statistics useless for any serious comparison purposes.

Over the past five years to 31 May 2011 (where far less survivorship bias exists), we see a more predictable picture emerging where only 21 of 84 funds in these combined categories managed to beat the ALSI. Based on these results, the pro-passive team may puff out their chests and say I told you so. But is passive investing the answer? On closer inspection, over this same five-year period, of the eight index tracker funds in the category (some ALSI and some Top 40 trackers) not one beat the ALSI and the average underperformance of the ALSI was 1,08% per annum! Stated another way, your average passive portfolio will deliver at best broad index returns minus 1%.

So what common ground, if any, exists between the active and passive disciplines? The most obvious common ground is that, on average, both active and passive strategies underperform their benchmark indices. But perhaps that's a defeatist observation. They underperform for different reasons. The best way to analyse the specific causes of underperformance is to look at a brief list of the pros and cons of each discipline.

Passive investing

Pros	Cons
• access to a diversified portfolio	• misallocates capital structurally
• low turnover	• participates fully in bubbles and busts
• low transaction costs	• little portfolio flexibility
• large investment capacity	

Active Investing

Pros	Cons
• flexibility security selection	• higher turnover
• flexibility in asset allocation	• higher fees reduce net returns
• identifies mispricing opportunities	• investment capacity limited
• risk management (downside risk)	

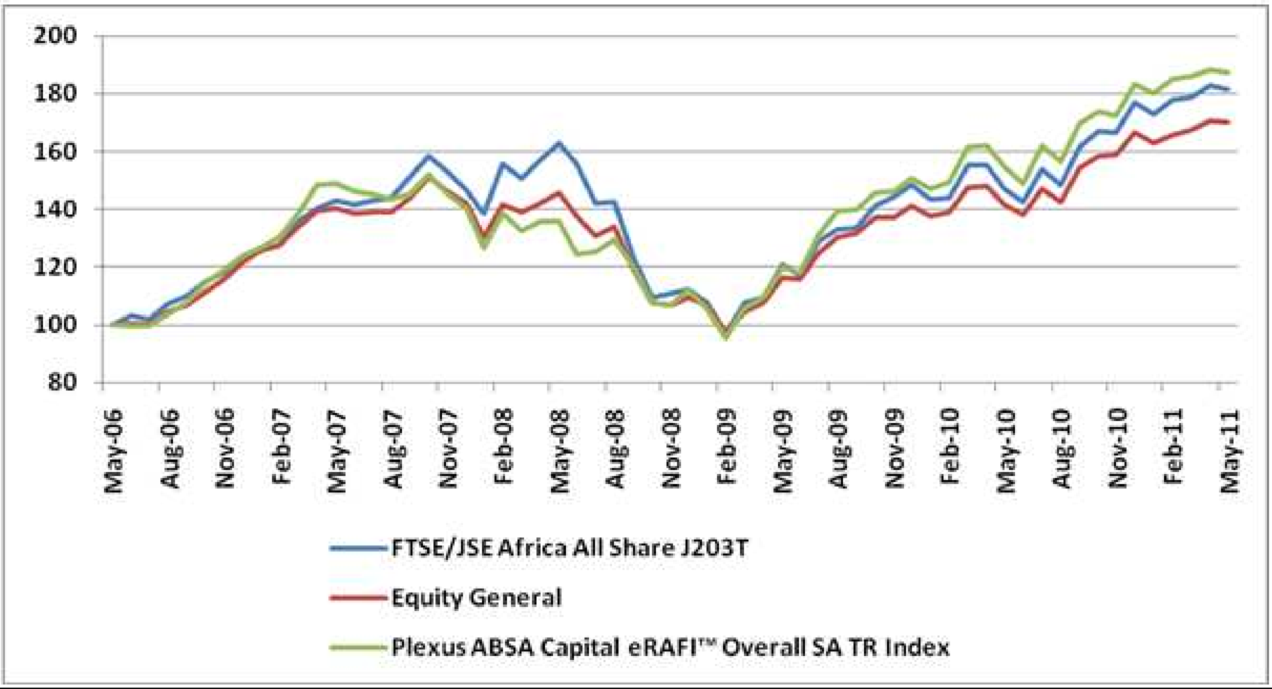
It seems obvious that an investment strategy that could take advantage of the benefits of both passive and active strategies could put investors in a better position in the long run. In the final assessment, the cost control and lower fee aspects of passive strategies are their best characteristics, while the better capital allocation in the active strategy is by far its largest benefit. But is a synthesis of these two worldviews practical?

Passive investing traditionally uses market value as the means to allocate its capital. This market value is determined utilising a market capitalisation[1] weighted methodology. In order to calculate the weight of each share in the index, each individual company's market cap is divided by overall markets' capitalisation. The share price in this methodology becomes the critical variable in determining this market value since the number of shares in issue does not change regularly. It follows therefore that if the share price is not correctly estimating the company's value (too high if the company is in demand and loved or too low if the company is out of favour and loathed), one would be over allocating to the relatively loved companies and under allocating to the relatively loathed companies – all relative to their intrinsic value, which is clearly unknowable at a point in time.

[1] - Market capitalisation is the share price multiplied by the number of shares in issue of that security.

Obviously this implies that cap weighting offers a relatively inefficient capital weighting mechanism since in good investment practice, we should ultimately try to allocate more of our money to the cheaper and less to the more expensive companies over time. This is precisely what active managers try to achieve; by analysing a company's financial results they are theoretically able to exploit these market inefficiencies. Their processes aim to identify companies that offer better financial positions, better profit stability and future growth prospects. But due to the higher costs of this analysis, higher portfolio turnover and poor sell discipline this benefit is most often lost. On average therefore, active managers are not able to extract the value that undoubtedly lurks in the market.

Figure 1



(FTSE/JSE ALSI and Plexus Overall eRAFI™ Index gross of any implementation costs – past performance is not a guide to future performance) academic paper published in 2004 by Rob Arnott and Jason Hsu of US-based Research Affiliates. They demonstrated that passive indices with enhanced risk/return characteristics could be constructed by utilising other means of estimating company value rather than its market capitalisation. The outstanding characteristic of these RAFI® indices is that they are able to marry the benefits of passive with the benefits of active strategies. Over a full business cycle, consistent return enhancements over traditional cap -weighted indices have been demonstrated while still retaining the benefits of indexation mentioned, i.e. diversified exposure, lower turnover and lower transaction costs.

The RAFI® methodology has stirred up some controversy. John Bogle, founder of world-leading passive investment firm Vanguard, recently described RAFI® as “witchcraft” in an interview. But the results are indisputable. The world’s largest index providers (FTSE, Russell and MSCI), leading global investment consultants and academics are now swiftly adopting “smart index” methodology as core strategies. Bogle is perplexed as his firm is losing market share to fundamental index® or price-indifferent strategies.

RAFI® indices all over the world are demonstrating consistent outperformance of cap-weighted benchmarks and impressive performance relative to the active manager peer groups too. They provide a neat synthesis between the active and passive strategies of old and can be used in isolation or in combination with other strategies to provide enhanced risk and return benefits to both retail and institutional investors.

Over the past three, five and ten years respectively, the Plexus eRAFI® Overall SA Index has delivered 7,7%, 0,3% and 7,9% per annum outperformance of the ALSI (gross of fees). On a three-year basis, the Plexus Enhanced RAFI® SA Strategy Fund, a CIS which tracks this Plexus eRAFI® Overall SA Index, is easily in the top quartile of equity funds (19/104 funds). This was achieved with a volatility of 18,1% compared to the ALSI volatility of 21,5%.

eRAFI®’s TER is around 1,08% for the full retail share class and substantially less for larger institutional investments. eRAFI®’s outperformance comes at a cost in line with market cap-weighted index offerings that are guaranteed to produce returns of less than the index they track. eRAFI® provides investors with a portfolio that is a cost-effective proxy for expensive top-quartile active managers while being an index strategy very likely to beat market cap-weighted indices by some margin over rolling seven-year periods. So there is no need to be black or white any longer, RAFI® is the new gray!