CUSTOMISED SOLUTIONS

TRACKING SUCCESS:
INDEX INVESTING 101
**THE STORY OF PEANUT BUTTER AND JAM**

Choose just one from these perfect pairings: peaches and cream; macaroni and cheese; fish and chips; salt and pepper; peanut butter and jam; Tom and Jerry. It’s not fair is it? Well, fortunately it’s not always a case of either-or. The story of the peanut butter and jam sandwich, an iconic childhood staple, illustrates that perfectly…

Few would have guessed though that these two ingredients would revolutionise the sandwich. While this pairing seems so perfect now, it took a surprisingly long time for someone to put them together, and several decades more before doing this became decidedly popular.

In the early 1900s, peanut butter was billed as a dish for the rich. Back then, it was paired with crowd-winning favourites such as cucumbers, cheese and celery. Then in the 1920s and 1930s peanut butter dropped in price and became more available to the masses, shortly after jam had become popular and pre-sliced bread all the rage. With the onset of the Great Depression, peanut butter on bread became a staple in many American households because it provided a hearty, filling meal with a cheaper-than-meat substitute for protein.

Then came World War II when jam was commonly included in US soldiers’ rations along with the trusty high-protein peanut butter that had proved so filling during the Great Depression, and, of course, pre-sliced bread. The perfect storm.

Before long the peanut butter and jam (jelly) sandwich became a popular meal among US soldiers. And when these soldiers came home, their wartime snack remained a firm favourite and soon became an instant hit with everyone else. Children loved how good it tasted, parents loved how easy it was to make, and everybody liked that it was cheap.

Along a similar vein, we introduce another duo that many would have previously believed was a case of either-or: active and index investing. We argue that just like peanut butter and jam, a blend of both active and index investing has numerous benefits for investors… read on to find out more.

Active and index investing go together like peanut butter and jam!
INDEX INVESTING EDUCATIONAL SERIES

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Old Mutual Customised Solutions is a leading asset manager in index investing with over R75bn in assets under management. Trusted by some of SA’s largest and most respected professional investors to deliver returns in line with their chosen benchmarks, our Index Investing capability prides itself in offering our clients a highly personalised and dynamic investment management service.
WHY INDEX INVESTING?

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.

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.
While there are active managers who have outperformed the benchmark and have a track record of delivering alpha, the challenge lies in selecting outperforming managers. By including a passive component to an investment portfolio, an investor reduces their risk of getting that wrong and underperforming.

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.
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 to be quite similar. However, as can be seen below, active managers are making asset allocation calls that at any given point in time could be significantly different from that of the long-term investment strategy.

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
• There are cost saving in combining active and passive funds
• Diversification offers 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.

ASSET ALLOCATION TOTAL (NET)

<table>
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<tr>
<th>Asset Class</th>
<th>Active Manager 1</th>
<th>Active Manager 2</th>
<th>Active Manager 3</th>
<th>Active Manager 4</th>
<th>Active Manager 5</th>
<th>Active Manager 6</th>
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<tr>
<td>Equity</td>
<td>63.5</td>
<td>63.2</td>
<td>63.5</td>
<td>67.9</td>
<td>63.2</td>
<td>67.9</td>
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<tr>
<td>Bond</td>
<td>12.3</td>
<td>10.5</td>
<td>12.3</td>
<td>23.4</td>
<td>12.5</td>
<td>23.2</td>
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<td>Real Estate</td>
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<td>0.8</td>
<td>17.8</td>
<td>17.8</td>
<td>19.6</td>
</tr>
<tr>
<td>Cash</td>
<td>7.2</td>
<td>10.9</td>
<td>7.2</td>
<td>17.1</td>
<td>17.1</td>
<td>37.8</td>
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<td>6.4</td>
<td>1.7</td>
<td>6.4</td>
<td>6.4</td>
<td>3.1</td>
</tr>
</tbody>
</table>

Source: Morningstar – Asset Allocation 31 March 2016
NOTES:

**DID YOU KNOW?** According to draft regulation 37, the rules of all defined contribution retirement funds, including annuity funds, must change to provide for a default investment portfolio. To be exempted from this requirement an application must be written to the Registrar of Pension Funds.

Source: Draft amendment to the regulations issued in terms of section 36 of the pension funds act, 1956 (act 24 of 1956). National Treasury: treasury.gov.za

**DID YOU KNOW?** US equity managers have consistently and significantly underperformed, net of fees, over 10 years. It must be noted that even before fees they would have significantly underperformed.

**ANNUAL AVERAGE RETURN: INDEX FUNDS VS NON INDEX FUNDS**

- **US Non Indexation**
- **US Indexation Funds**

<table>
<thead>
<tr>
<th></th>
<th>12 Months</th>
<th>3 Years</th>
<th>5 Years</th>
<th>10 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return (annualised)</td>
<td>15%</td>
<td>10%</td>
<td>10%</td>
<td>5%</td>
</tr>
</tbody>
</table>

Source: Bloomberg (net of fees)
CHOOSING AN INDEX TRACKING MANAGER

INTRODUCTION

Investing via an index tracking strategy is increasingly becoming a major financial market theme in South Africa. Over the last three years, as at 31 December 2015, retail indexation strategies had attracted more than R10 billion in flows. This trend is primarily driven by investors looking for simpler and lower cost investment strategies that deliver good performance relative to actively managed investment strategies. And we believe that index investing will be a longer-term theme as a result of the following:

• An increase in regulatory oversight. In the draft regulatory reform, National Treasury has explicitly proposed in the draft regulatory reform that trustees consider index investing when selecting the default pension fund investment strategy.

• South Africa to follow the global trend. According to a global report produced by PwC, index investing is expected to grow from 11.42% to 22.32% by 2020. We have already seen this trend emerge in South Africa and expect it to continue in line with global norms.

• Active managers have struggled to outperform relative to their benchmarks. According to SPIVA Statistics and Reports, as at 31 December 2015, 74.58% of South African equity funds underperformed the S&P South African Domestic Shareholder Weighted (DSW) Index over five years (net of fees). This highlights the fact that index investing can generate favourable performance over the long term.

An investor who has decided to select an index fund would typically consider the benchmark of the index fund and the track record of the index tracking manager (i.e. how closely has the manager successfully replicated the performance of the benchmark and minimised costs).

Some of the factors that should be considered when testing the ability of an index manager to continue closely tracking a given benchmark are:

• Level of assets under management (AUM)
• Length of the track record
• Experience and expertise of the investment team
• Risk management and the investment process
• Protecting the interests of the clients through responsible investing

LEVEL OF AUM

The level of AUM is critical as index management is a low margin business. AUM will have a direct bearing on the profitability and sustainability of an index tracking manager. For example, an index tracking manager who charged a portfolio management fee of 0.10% per annum on an investment strategy would earn revenue as follows:

• If the investment strategy’s AUM is R100 million, the portfolio management fee earned would be R100 000 per annum.
• If the investment strategy’s AUM is R1 billion, the portfolio management fee would be R1 million per annum.

Earning a higher portfolio management fee due to larger AUM gives the index tracking manager greater capacity to do the following:

• Employ investment professionals with impressive expertise and experience
• Use modern systems and technology to ensure investment strategies meet their objectives
• Reduce the overall trading costs incurred by investors
• Research new ways to add additional value for clients
• Provide investors with a high quality customer service experience.

However, while revenue generated from AUM enables capacity, it is not enough to implement an index tracking portfolio successfully.

THE EXPERIENCE AND EXPERTISE OF THE INVESTMENT TEAM

It is crucial that the key investment individuals within the investment team are committed to staying with the business over the long term. This improves the stability of an indexation manager’s investment process. The indexation team’s role is key because, while it may not be obvious at first, managing a successful index fund is not merely a passive process, but requires a number of active investment decisions to be made by the investment team, such as:

1 Source: Morningstar
• Optimal processing of client contributions and withdrawals
• Optimal handling of corporate events
• Dealing with illiquid securities
• Cost-benefit analysis of reducing tracking errors while minimising costs
• Opportunities to add additional value, e.g. scrip lending
• Optimal trading strategies at index rebalance.

Getting any of these active decisions wrong could result in amplified differentials of the index fund relative to its benchmark. It is therefore vital that the investment team has both quantitative and qualitative risk analysis skills together with a good understanding of the market.

**LENGTH OF THE TRACK RECORD**

The length of the indexation manager’s track record can reveal the following:

• **Investment risk:** The length of time a manager has been around reflects the true risk profile of an investment strategy.

• **Discipline in the investment approach:** Consistency through varying economic and market conditions reflects the disciplined approach of the manager.

• **Business risk:** A sound process for risk assessment, control and monitoring that relates to the business of investment management must be in place. Transaction risk, compliance risk, reputation risk and strategic risk all contribute to business risk.

**RISK MANAGEMENT AND INVESTMENT PROCESS**

Index investing is a technology-driven business. The best index tracking managers have sophisticated systems in place that allow them to assess and manage the risk on their portfolios on an ongoing basis, as well as ensure adherence with the investment process. The systems in place should be able to perform both pre- and post-trade analysis, as well as detailed performance attribution.

Portfolio risk management software can greatly help the index tracking manager consistently construct portfolios that mimic their respective benchmarks and avoid any unintended risks. The investment process should be robust so as to avoid unintended errors or a deviation from the agreed investment process.

**RESPONSIBLE INVESTING AND PROXY VOTING**

The process of index investing does not require the indexation manager to engage directly with the management of the invested companies. Indexation managers do not take a view on the companies invested in, but focus instead on replicating the index. As such, indexation managers that are responsible stewards of the assets being managed must have a proxy voting policy that is intended to protect its clients’ long-term economic interests.

In addition to proxy voting, indexation managers that invest responsibly should have a research team that engages with the management of the investee companies on behalf of the investors to address major environmental, social and governance (ESG) considerations, as well as encourage business and management practices that support sustainable financial performance over the long term.

This overlay approach to proxy voting and engaging company management on ESG issues ensures that the investment manager can most effectively use its voice as an actively engaged shareholder. It must be noted that indexation managers with larger AUM are likely to have more influence as management are more likely to heed larger shareholders.

**CONCLUSION**

Identifying a good indexation manager is not an easy process. However, a good indexation manager would exhibit the following characteristics:

• **Scale relative to client mandate.** The manager must be an industry leader in terms of their level of AUM in indexation investment strategies.

• **A skilled and highly experienced team.** A stable team that has an in-depth understanding of the inherent risks involved in managing an indexation portfolio.

• **Length of the track record.** A longer track record can reveal the quality and consistency of investment returns.

• **Clear investment process.** A clear approach to investing and appropriate risk management strategies to cater for different events.

• **Responsible investing.** Protecting clients’ long-term interests through proxy voting and management engagement.
DID YOU KNOW? 84.15% of large-cap funds in the US have underperformed the S&P500 over five years. And locally, 74.58% of South African equity funds underperformed the S&P South African Domestic Shareholder Weighted (DSW) Index over five years.

Figures as at 31 December 2015 (Net of fees)

Source: SPIVA Statistics and Reports
DID YOU KNOW? The aim of the proposed retirement industry regulation by National Treasury is to lower charges associated with the asset management of retirement funds and to improve the market conduct of the retirement industry. A refined draft is expected to be released before the end of 2016.
THE COMMON MISCONCEPTIONS

INTRODUCTION
Index investing has recently been placed in the spotlight mainly as a result of the questionable performance of the active management industry, proposed regulatory changes and investors becoming a lot more cost conscious in recent years. However South Africa is still dominated by actively managed investment strategies and so investors are generally less familiar with index investing. As such, with legislation encouraging the consideration of index investment strategies, it is important to address any misconceptions that the industry and investors may have regarding index investing.

MISCONCEPTION 1:
The performance of a market cap-weighted index will be equal to that of the average investor (limiting the upside potential for an investor)
Most investors select active managers in the hopes of earning returns greater than the average investor.

THE REALITY IS:
• In South Africa there is no evidence to support the belief that a market cap weighted index will generate an average return over the long term.
• Figure 1 compares the average managers’ performance (for various Association of Savings and Investment South Africa (ASISA) categories, after fees) to indices; we find that the indices would have outperformed the average manager by between 1.5% and 2.3% p.a. over a 10-year period, which is well in excess of a typical index fund’s total expense ratio, resulting in an index fund being well ahead of average managers’ performance.

MISCONCEPTION 2:
The higher the cost, the higher the expected performance
The belief is that you get what you pay for. Active strategies that perform exceptionally well tend to demand higher fees (which translates into higher costs for an investor). Some investors therefore associate higher costs with higher expected performance.

THE REALITY IS:
• In South Africa there is no evidence to support the belief that higher costs translate into higher performance.
• Figure 2 illustrates the relationship between the performance and costs by comparing the five-year return of South African Equity managers (ASISA SA Equity General category) to their total expense ratios. Our results show that the relationship between performance and costs is negative.

MISCONCEPTION 3:
Index investing only works in efficient markets
Some investors believe that index investing fails to add value relative to active managers in inefficient markets, such as emerging markets.

THE REALITY IS:
• There is no clear evidence to support the belief that index investing cannot add value relative to active managers in inefficient markets.
• S&P Global Indices performed an analysis to test what percentage of active managers in emerging markets outperformed their respective domestic benchmarks over a five-year period. Figure 3 illustrates that more than half of the active managers in each country underperformed relative to their benchmark.
MISCONCEPTION 4:
Index investing does not work in a bear market
Some investors believe that index investing underperforms relative to active managers in a bear market. Under these conditions, active managers are expected to implement defensive positions to accommodate for this environment.

THE REALITY IS:
• There is no evidence to support the belief that index investing will always underperform active managers in a bear market.
• During the financial crisis (calendar year 2008), the FTSE/JSE Shareholder Weighted Index (SWIX) outperformed 62% (see Figure 4) of the active managers in the ASISA SA Equity General category.

FIGURE 4: INDEX INVESTING CAN OUTPERFORM ACTIVE MANAGERS DURING BEAR MARKETS

2008 Financial Crisis - Index Investing performed relatively well

% of Managers who outperform relative to SWIX

% of Managers who underperform relative to SWIX

Source: Morningstar April 2016

MISCONCEPTION 5:
The fact that market cap weighted indices are inefficient is not a reason to use index investing
Market cap weighted indices have higher exposure to larger companies and companies which have historically performed well (relative to other companies). As a result, some investors believe that these indices will be overexposed to companies with very limited upside. In other words, investors believe market cap weighted indices are inefficient.

THE REALITY IS:
• Even though market cap weighted indices are inefficient, active managers have still underperformed across various asset classes as illustrated in Figure 1.

MISCONCEPTION 6:
On Autopilot
There are investors who believe that index management is a purely automated process which requires no human intervention.

THE REALITY IS:
• On a daily basis, index portfolio managers use risk management systems to assess how best to implement corporate actions, significant flows and changes to the index. More than 300 corporate actions occur in the FTSE/JSE SWIX All Share Index (and over 9,000 occur in international indices) on a yearly basis.
• Managing these can be challenging as benchmarks assume that all changes happen at no cost and can be implemented immediately, whereas a real portfolio is subject to factors such as the following:
  • Costs
  • Tax
  • Market timing
  • Liquidity constraints
  • Settlement periods
  • Currency effects.
• Index replication is highly complex and requires extensive expertise, experience in trading, risk management and quantitative research skills.
DID YOU KNOW? According to draft regulation, the proposed default investment portfolio must have these characteristics:

- The default investment portfolio – including its high level objective; underlying asset allocation; fees and charges; and the risks and returns – must be appropriate for the members whose retirement saving are invested in it.
- The default investment portfolios must be good value for money and purely for investment purposes.
- All fees and charges and their impact on members’ benefits must be disclosed accurately and regularly.
- Trustees must at least consider the use of passive or enhanced passive investments of listed assets as part of the default portfolio.
- Performance fees and loyalty bonuses and other complex fees are not permitted in default investment portfolios.
- The assets in the default investment portfolio must be regulation 28 compliant.
- Members cannot be locked into the default investment strategy and the default investment portfolio is to be reviewed regularly.

Source: Draft amendment to the regulations issued in terms of section 36 of the pension funds act, 1956 (act 24 of 1956). National Treasury: treasury.gov.za
DID YOU KNOW? Index investing has continued to grow in the US.

AUGUST 2010
- Indexation: 17%
- Non Indexation: 83%

AUGUST 2015
- Indexation: 23%
- Non Indexation: 77%

Source: Bloomberg
DOMESTIC EQUITY INDEX OVERVIEW

INTRODUCTION

There has been much debate and consultation within the investment industry on the various indices available in the South African market. As South Africa’s largest index tracking manager, we discuss the most widely used indices in South Africa, namely the FTSE/JSE series of indices, and more specifically the broadest of these: the FTSE/JSE All Share Index (ALSI), FTSE/JSE Capped All Share Index (CAPI) and FTSE/JSE Shareholder Weighted Index (SWIX).

To begin with, however, it is important to describe what the role of an index should be in the investment context and the properties an index should possess. Following this we will look at the methodologies currently being used to construct the above indices.

The JSE is in the process of reviewing the current methodology and we review the most significant potential changes and discuss how they may affect the different indices. We also look at possible additional changes that could improve the current set of indices.

THE ROLE OF AN INDEX

The definition of a financial market index, according to Investopedia, is an imaginary portfolio of securities representing a particular market or portion of it. The most basic use of an index is as a measure of the performance and characteristics of an asset class or the overall market; put simply, a benchmark for evaluation purposes. Having a standard benchmark for various markets and asset classes plays an important role in assessing the asset allocation and implementation skills of asset managers, as well as providing a relevant base for performance measurement. An index that is representative of an asset class affords market participants with products that can be used as passive investments to gain broad market exposure. In addition, market participants who require actively managed portfolios can use such indices as a reference point, as well as a benchmark against which to measure manager performance.

An index should also be both investable and representative of the opportunity set. The weights of a constituent in an index should ideally be adjusted for restricted shares – privately held shares and other shares not available to the domestic market for investment – to meet the investability criteria. The introduction of the SWIX range of indices back in 2002 were intended to address this need for free-float adjusted indices. To meet the representative criteria, market capitalisation indices are favoured over alternative weighted indices as they capture the proportional weight that a constituent forms within the broad market.

ANALYSIS OF SOUTH AFRICAN EQUITY BENCHMARKS

Before we define the broad market indices and their differences, it is important to understand the difference between local and foreign (also known as inward-listed) companies. National Treasury and the JSE classify companies as either foreign or inward-listed, which determines what their free-float is within the broad market indices. An anomaly is the so called “grandfathered” companies, which are classified as local, as they were originally South African businesses, but took their primary listing offshore prior to October 2011. The “grandfathered” companies are treated differently in the various broad market indices, as defined below.

DEFINITIONS

FTSE/JSE All Share Index (ALSI): This represents 99% of the full market capitalisation value (gross market capitalisation before applying any investability weights) of all ordinary securities eligible for listing on the main board of the JSE. It includes the full free-float shares in issue of “grandfathered” companies, while inward-listed and foreign companies have a SWIX free float (see definition of SWIX below).

The FTSE/JSE Capped All Share Index (CAPI): This follows the FTSE/JSE All Share Index (ALSI) construction methodology and only differs with regard to the capping of individual security weights at 10%. The key reason for using capped indices is that by diversifying a portfolio away from the largest companies,
the overall risk of the portfolio is reduced. However, turnover is increased, as well as investability reduced, due to smaller, less liquid companies being up-weighted.

**The FTSE/JSE Shareholder Weighted All-Share (SWIX):** This uses the same constituents as the ALSI, but differs by using the STRATE (South Africa’s Central Securities Depository) share register to reduce constituent weights of foreign or inward-listed companies. The SWIX free-float therefore excludes all scrip that is held on foreign share registers for inward-listed companies. The SWIX free-float factor is achieved by taking the percentage of shares held on the STRATE register. The SWIX indices are therefore intended to be an indication of the shares held locally.

Therefore, the inward-listed or foreign companies are not weighted consistently within the ALSI, as the “grandfathered” companies (which were never classified as foreign) are included with their full free-float, rather than their locally held shares in issue as represented by the SWIX free-float. In contrast, SWIX treats all inward-listed or foreign companies (including the “grandfathered” companies) identically, by using their SWIX free-float. For example, the ALSI free-float for Anglo American plc (a “grandfathered” company) is 0.96, while its SWIX free-float is only 0.42. Conversely, British American Tobacco plc (an inward-listed foreign company) has an ALSI free-float of 0.15, which matches its SWIX free-float. The only difference between these two companies is when they inward-listed within South Africa.

Therefore, SWIX is more consistent in the way it handles inward-listed or foreign companies, by setting the free-float for all these companies as the percentage of shares held on the STRATE register, regardless of the timing of when these companies listed offshore, or inward-listed within South Africa.

**INDEX REVIEW**

Market benchmarks worldwide continue to evolve as circumstances and best practice change over time.

The FTSE/JSE indices are not immune to change and as such the JSE has recently announced index construction changes, based on feedback received from a market consultation process conducted at the end of 2015. The final changes will be implemented at the September 2016 Quarterly Index Review.

The following is a summary of the most notable changes to the index construction methodology:

- The constituents of the Top 40 Index will be selected based on net market capitalisation as opposed to gross market capitalisation, changing the focus from a “largest company” index to a “most investable company” index
- The constituents of the SWIX 40 will be selected using SWIX-adjusted market capitalisation, and as such the constituents of the SWIX 40 may differ from those of the Top 40 index
- The 160-minimum number limit on the constituents of the ALSI has been removed. Index selection is now based solely on the target 99% market representation level and may therefore include fewer constituents
- Constituents of the ALSI will be reviewed semi-annually instead of annually, with reviews occurring in March and September.

**FREE-FLOAT REQUIREMENT**

There is a free-float requirement that all listed companies need to maintain in order to be included in the indices. Currently, if a company has a free-float of less than 5% it is not eligible for inclusion. Should the free-float be between 5% and 15% it is also not eligible, unless the investable portion of the company is large enough for its exclusion to impact the accuracy of the benchmark. The rule that captures this scenario includes companies with a free-float of between 5% and 15%, but only if the company’s investable market capitalisation is greater than the median company’s investable market capitalisation in the ALSI.

The exceptional free-float restrictions relating to inward listings when applying the 5% and 5%-15% minimum free-float rules have now been dropped. Inward listings could thus enter the indices with a FTSE/JSE free-float of 5% or less as long as their global free-float meets the minimum free-float criteria. Inward shares will, however, require a minimum of 1% of their issued shares to be accounted for on the South African share register.

With regards to local companies, maintaining the free-float restrictions is beneficial as this serves to improve liquidity and ensure companies are sufficiently investable before being included in an index. However, when reviewing inward-listed companies using the global free-float as the qualifying criteria makes sense. Due to the fungible nature of these securities it is possible to purchase these companies on international exchanges, even though the free-float within South Africa may be low. Using a median measure also counters the skewed measurement that results from using an average market capitalisation measure.

**POSSIBLE CHANGES**

While the JSE has implemented certain changes to the current methodology, there could be further changes or even the possible introduction of additional indices.
Concerns have been raised regarding the concentration of individual securities within certain indices, particularly the SWIX. While the SWIX in its current and proposed form is reflective of the investable universe for South African investors, there is a case to add an additional derivative of the SWIX to ensure it remains compliant with prudential limits, viz. Regulation 28. This approach would determine the limits based on regulatory requirements, which limits the concentration of any one security to 15% of the total portfolio. However, given that total equity exposure is limited to 75% within a Regulation 28 compliant fund, this means within the equity portion alone an individual security could have a weight of up to 20% before being in breach of Regulation 28 (assuming all equity exposure was in South Africa), and even higher if the local equity portion is less than 75%.

Such an approach to constructing an index is not without precedent. If any changes to the SWIX to introduce capping were adopted, regulatory requirements, rather than an arbitrarily determined capping level, may be optimal. This would give investors an index they could track while taking full advantage of the regulatory allowances available to them. Given the FTSE/JSE SWIX index exists primarily for South African investors, having it change in line with regulatory changes shouldn’t cause any adverse impacts. Capping at 15% would provide sufficient room for growth while remaining Regulation 28 compliant, although the index should accommodate intraquarter rebalances, in the event it breached the 20% limit (the lowest limit from a total portfolio perspective).

Introducing this capped index as an additional index, rather than amending the current SWIX index itself, would be beneficial as it would give investors and asset owners the choice of which benchmark they’d prefer.

CONCLUSION

The choice of benchmark for a particular investor is a critically important decision and is very much a function of what that investor is setting out to achieve. Liquidity, diversification, turnover, regulatory structure, whether the index is used for tracking or purely benchmarking purposes and the objective of the investor’s overall portfolio, are all factors that need to be considered when choosing an index.

The ALSI represents 99% of the full market capitalisation value of all ordinary securities eligible for listing on the main board of the JSE. As mentioned above this will include the foreign shareholding of the “grandfathered” companies, while more recent inward-listed companies are weighted according to their SWIX free-float, resulting in inconsistencies.

In the South African context this index is also highly concentrated with the top 10 securities accounting for over 50% of the index as of 31 Dec 2015.

The CAPI is essentially the capped version of the ALSI and as a result will suffer from the same inconsistencies. The difference is that it is trying to increase diversification by introducing a 10% cap on security weights. The 10% cap has reduced the top 10 weights slightly, although they are still over 50% of the index. Unsurprisingly, the performance of CAPI has been very similar to ALSI over the last 10 years. For the capping to have an effect the cap weight would have to be significantly reduced. A 7% cap reduces the top 10 holding to be in line with the SWIX at just under 50% while the cap weight would have to be dropped to 4% to bring the top 10 under 40%. The result of capping also has the consequence of increasing the weight of smaller, less liquid securities in the index.

The SWIX index uses the same constituents as the ALSI, with the only difference being the free-float factor that is applied to securities classified as foreign. Importantly, this applies to “grandfathered” securities as well as any inward-listed securities post October 2011, where their free-float is determined by factoring in the percentage of shares held on the STRATE register as a proxy for how widely held each foreign security is within South Africa. As such, the SWIX index represents the most consistent approach to specifying the free-float shares in issue within the South African market and is by far the most widely used benchmark used by South African institutional investors. We believe this makes for a compelling case to use SWIX as a default benchmark, notwithstanding proposed improvements which could be introduced to further improve its diversification characteristics.
PROPERTIES OF A GOOD BENCHMARK

Before delving into the particulars around the current selection of indices and the ideal benchmark in a South African context, it is worth touching on the essential properties that a benchmark should possess. These properties are easily summarised through the acronym SAMURAI, which can be broken down as follows:

- **Specified in advance:** A good benchmark is one that is specified and known prior to the start of an evaluation period.
- **Appropriate:** The benchmark should be consistent with the asset manager’s investment style and mandate.
- **Measurable:** The return of the benchmark should be quantifiable on a reasonably frequent basis.
- **Unambiguous:** The constituents and associated weights of benchmark assets or factor exposures should be clearly defined.
- **Reflective (of current investment opinions):** The manager has current knowledge of securities/factor exposures.
- **Accountable:** The manager should be accountable for the constituents and performance.
- **Investable:** It is possible to simply hold the benchmark.

Other factors that are important to consider when evaluating benchmark quality, as listed by Jeffrey Bailey, include:

- High coverage
- Low turnover
- Similarity of managed portfolio and benchmark style exposure
- High correlation between the managed portfolio and the benchmark
- Reduced observed active risk

High coverage and low turnover are of particular importance, especially when one considers the increasing importance index tracking is playing in the investment landscape. Sufficient liquidity in index counters would therefore also need to be addressed, and ties in somewhat with the “investable” property mentioned above.

To summarise, a benchmark should be constructed in a simple, transparent method that market participants are able to replicate.

**DID YOU KNOW?** South Africa’s average equity funds have lagged the Index by 3% p.a. (net of fees) over the last 10 years.

![Graph comparing South African General Equity Unit Trusts and ALSI SWIX - Parent Index](Source: Morningstar, Old Mutual Investment Group | February 2016)
BLENDING ACTIVE AND INDEX BALANCED FUNDS

EXECUTIVE SUMMARY
Active and index investing have often been viewed as a case of either/or, with investment houses proposing one of these two investment strategies, not both. At Old Mutual Customised Solutions, we believe that implementing both active and index investment strategies within an investor’s portfolio can provide significant value to the investor. The objective of active strategies is to outperform a particular benchmark through security or asset class selection and timing, whereas the argument for index investing is lower fees and generating consistent market returns. In this paper, we consider the merits of each strategy and the effects of blending active and index balanced funds to deliver lower costs and enhanced returns.

THE REALITIES OF ACTIVE BALANCED FUNDS
Actively managed balanced funds aim to time the market by tactically adjusting their asset allocation mix to take advantage of different economic cycles and drivers of the market, and thereby delivering higher real returns. In exchange for the promise of delivering higher returns, investors are charged higher fees. However, timing the market consistently is extremely difficult and the potential benefits can be outweighed by the costs and the risk of getting it wrong, to the detriment of investors’ returns.

In figure 1 we compare the 10 largest conventional balanced funds to the Association of Saving and Investment South Africa (ASISA) South Africa Multi-Asset High Equity average over a 10-year period. From this graph we can see that some funds generated a loss or no returns over multiple five-year periods. The spread between the best and worst performing fund is enormous, which highlights the risk of getting asset allocation timing as well as fund or manager selection wrong.

FIGURE 1: COMPARISON OF THE 10 LARGEST BALANCED FUNDS TO ASISA SOUTH AFRICA MULTI-ASSET HIGH EQUITY AVERAGE OVER 10-YEARS (FIVE YEARS ROLLING)

Source: Morningstar – Equally-weighted the nine largest Balanced funds.

The 10 largest balanced funds cover two thirds of the category assets and are more representative than the arithmetic average.
Figure 2 illustrates the asset allocation of the six largest active balanced funds in South Africa, and how widely these allocations can differ from one manager to the next. The equity exposure, for example, ranges from 46.6% to 76.9% and cash ranges from as low as 7.2% to as high as 37.8%. Depending on how markets perform, these funds can behave very differently to each other. Due to the unpredictable nature of these funds, an investor may unwittingly take on risk and be exposed to divergence in performance in their portfolio.

To reduce risk, an investor could invest in multiple active balanced funds, which would have the effect of dampening the asset allocation calls of any one manager. However, by doing this, the investor will then realise a “market average” asset allocation, which is exactly what an index balanced fund aims to deliver to investors, but at a substantially reduced cost.

**BLENDING ACTIVE AND INDEX BALANCED FUNDS**

Replacing active managers purely used for diversification purposes with a balanced index fund delivers the benefits of diversification as well as lowering overall costs.

Index balanced funds differ from actively managed balanced funds in two main ways:

- The fund doesn’t strive to time the markets through tactical asset allocation;
- Each asset class is managed by tracking an established index.

The strategic asset allocation of an index balanced fund is established to achieve the highest probability of meeting a real return target above inflation over a given period, for example, CPI+5% p.a. over any five-year period. Furthermore, the risk of underperformance within each asset class is removed due to the index tracking objective of each asset class.
Figure 3 represents the strategic asset allocation of each asset class within the Old Mutual Balanced Index Fund. Each asset class can fluctuate within a predetermined range, which allows asset classes that are doing well to continue running, before being brought back to their strategic allocation. The asset allocation is rebalanced annually or when an asset class moves outside of its strategic range. The fund complies with Regulation 28 rules in South Africa.

**FIGURE 3: BALANCED INDEX FUND STRATEGIC ASSET ALLOCATION**

- **SA Cash** 11%
- **SA Bonds** 8%
- **SA ILBs** 4%
- **SA Property** 4%
- **SA Equity** 50%
- **International Equity** 23%

Source: Old Mutual Investment Group, June 2016

**THE COST BENEFIT**

Incorporating a lower cost index balanced fund into an investor’s portfolio of active balanced funds will reduce the cost to the investor, without detracting from returns.

To put these savings in context, fees should be seen as a percentage of the returns above inflation (real returns), which is ultimately what investors are paying a balanced fund manager to deliver.

As illustrated in Figure 4, a fee of 0.9% with a real return expectation of 5-6% translates into a cost to the investor of between 15-18% p.a. of return, while a fee of 0.35% with the same real return expectation would only cost the investor 6-7% p.a. of return.

In Figure 4 we illustrate blending our Balanced Index (with an institutional unit trust management fee of 35bps p.a. with an equally weighted blend of the 10 largest active balanced funds (with an average fee of 90 basis points p.a.) over a 10-year period, with a 35% and 65% allocation respectively.

By incorporating the index balanced fund into the portfolio:
- The performance over the 10-year period improved from second quartile to top quartile.
- A 35% allocation to a balanced index fund equates to a 21% (22bps) total fee reduction in management fees.

**FIGURE 4: FEES AS A PERCENTAGE OF REAL RETURN EXPECTATION**

Source: Old Mutual Investment Group
Blending index funds into an active portfolio results in investors realising these savings without compromising their returns, they ultimately enhance their savings objectives, which serves to facilitate a better quality of life.

**FIGURE 5: THE EFFECT OF INCLUDING A PORTION OF INDEX BALANCED FUNDS**

![Chart showing the effect of including a portion of index balanced funds]

**Sources:** Old Mutual Investment Group and Morningstar

**BENEFITS OF BLENDING ACTIVE AND INDEX STRATEGIES**

- **Lower costs:** Index balanced funds have lower costs than active balanced funds, thereby reducing the overall cost of a blended strategy, which puts more of the return in the investor’s pocket. This ties in with Retirement Fund Reform objectives to reduce investment costs.

- **Diversification:** Holding an index balanced fund within an investor’s portfolio dampens the risk associated with holding a single active balanced fund. Using an index balanced fund is a far more cost effective way to diversify a blend of balanced funds.

- **Consistency and Peace of Mind:** An active manager has discretion to change their asset allocation – this can result in outperformance but equally in underperformance. However, a balanced index fund maintains its asset allocation by staying within its strategic ranges. Furthermore, each asset class performs in line with the index representing that asset class due to the index tracking nature of the investment strategy. This ensures the investor consistently gets what they paid for, which translates into increased peace of mind.
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