ON THE FAST TRACK

We look at the evolution of passive investing – which we term as indexation – over the past decade and assess whether its exceptional growth over the last three years is expected to continue.

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Credit: Gaelle Marcel

FIGURE 9: 10-YEAR GROWTH IN INDEX INVESTMENT STRATEGIES (ASISA SA GENERAL EQUITY AND LARGE CAP EQUITY)

Sources: Old Mutual Customised Solutions; Morningstar

n the South African retail market indexation investment strategies have grown by 46% p.a. over the last 10 years (see Figure 9). Is this growth likely to be sustained during 2019 and what innovative developments can be expected in the passive investment segment of the market going forward?

01 / PASSIVE AGGRESSIVE: WHY INDEXATION IS SO POPULAR

Spurred by an increasing acknowledgement of the long-term benefits of low-cost solutions, the take-up of indexation is expected to continue growing at a healthy clip. This increased uptake can be attributed to the following factors:

THE REGULATORY ENVIRONMENT

The Global Financial Crisis (2008) acted as a catalyst for additional regulatory intervention; regulatory bodies have since then been pressuring the investment industry to be more cognisant of investment risks. Examples of this have been Basel 3 and SAM (i.e. Solvency Assessment and Management), which placed greater focus on transparency and risk management in the banking and insurance industries. Within the South African investment context the Retail Distribution Review and the Savings Default Regulation have both highlighted the importance of investors being charged fair and transparent costs.

INVESTOR PERFORMANCE PRESSURES.

There has been growing concern about investment strategies not adding enough value relative to their costs. This concern has been fuelled by investors being exposed to expensive, complex investment structures, many of which have failed to add value over the long term. As a result, investors have increasingly prioritised:

> TECHNOLOGY IS ALSO PLAYING A CRITICAL ROLE IN REDUCING COSTS ACROSS MULTIPLE INDUSTRIES.

- **Greater transparency** – a greater need to understand the drivers of risk in an investment strategy
- **Cost efficiency** – ensuring that the costs are justified by the level of value-add being generated by the asset manager
- **Consistency** – strategies that deliver consistent performance, especially relative to a predefined benchmark.

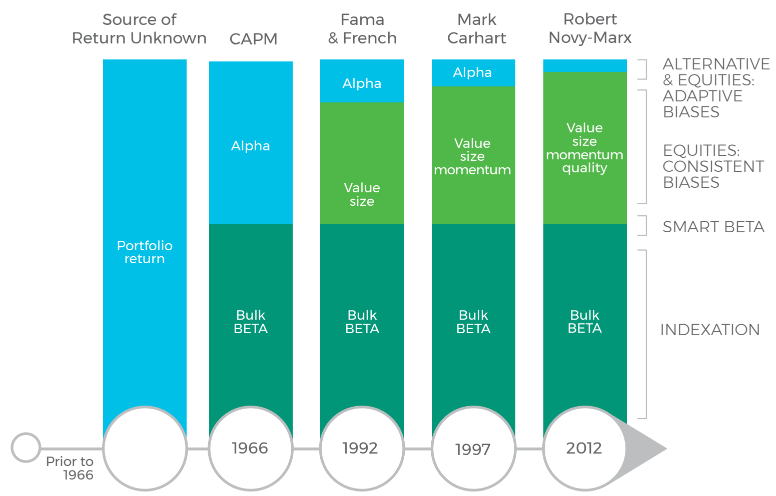
MEDIA AND RESEARCH

We live in a world in which Warren Buffet has publicly backed index investing (see the sidebar titled "A Million-Dollar Bet"). And research is continually demystifying and re-defining the source of alpha (see Figure 10). Now, with growing emphasis being placed on factor research and evidencing of how alpha is expected to be diminished, this all translates into growing publicity and popularity for indexation.

TECHNOLOGY

In today's world technology has made the dissemination of information close to instant, which makes it difficult to generate excess returns as before. Technology is also playing a critical role in reducing costs across multiple industries, and investors expect this trend to apply to the investment industry as well. Indexation strategies have become particularly ideal vehicles to use in computer-generated portfolios and advances in technology have allowed for large-scale customisation in exchange traded funds (ETFs) that satisfies desired investment outcomes.

FIGURE 10: THE MORPHING STATE OF ALPHA



Sources: Eugene Fama and Kenneth French, The Cross Section of Expected Stock Returns, Journal of Finance, June 1992; Mark Carhart, On Persistence of Mutual Fund Performance, Journal of Finance, March 1997; Robert Novy-Marx, The Other Side of Value: The Gross Profitability Premium, Journal of Financial Economics, April 2013.

A MILLION-DOLLAR BET

In 2007, legendary investor Warren Buffett made a US$1 million bet against Protégé Partners that hedge funds wouldn't outperform an S&P index fund. Buffet won.

Buffett's choice fund, the Vanguard 500 Index Fund Admiral Shares, returned 7.1% compounded annually, while the basket of hedge funds his competitor chose returned an average of only 2.2%.

Buffett and Protégé Partners originally put about US$320,000 each into bonds that would appreciate to US$1 million over the course of their wager, but because the bonds appreciated much faster than expected, they decided to buy 11 200 Berkshire B shares, which are now worth US$2.22 million.

Source: Wall Street Journal, https://www.wsj.com/articles/only-a-market-crash-can-stop-warren-buffett-from-winning-this-1-million-bet-1487851203

02/ WHERE TO FROM HERE

The pressures detailed above have supported the growth in index investing. And we expect the following innovations to fuel continued growth in this area:

FACTOR INVESTING

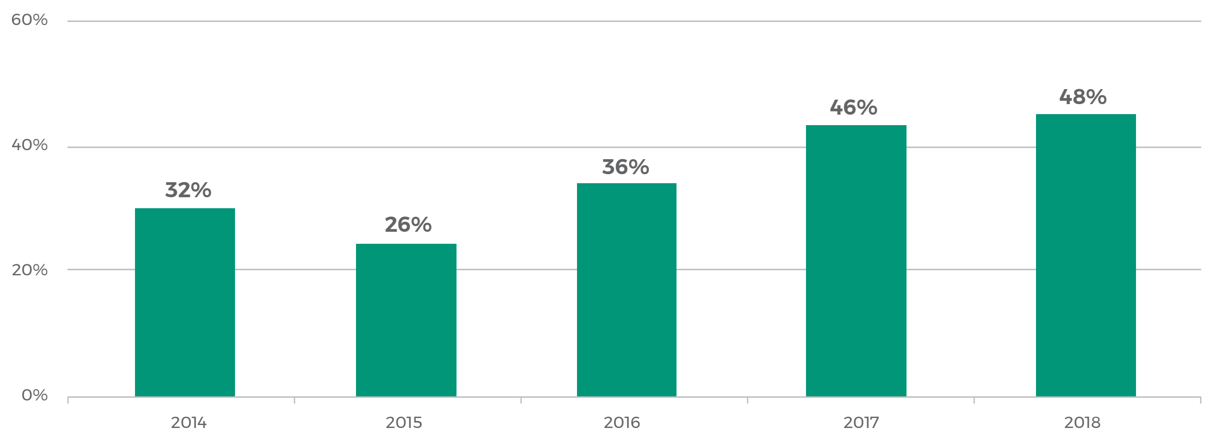
Globally, there has been an increase in the number of solutions that follow low-cost investing strategies, such as smart beta. According to Morningstar, smart beta assets under management globally grew from US$280 billion in 2012 to US$999 billion at the end of 2017 – a total increase of 257% over the five-year period. We expect this trend to pick up in the South African industry. This would appeal to investors who do not desire using market cap weighted indices but would still like to benefit from the reduction in costs.

ESG INDICES

Broad acceptance of Responsible Investment practices in the market (over 1 200 asset owners, investment managers and professional service par billionaires have become signatories of the United Nations-backed Principles for Responsible Investment (PRI)) has translated into strong demand for sustainability-themed investment products. And innovation in the indexation investing space in recent years has allowed index-tracking investment managers to incorporate ESG factors into their investment process. And so, the market now has on offer low-cost indices that offer ESG-led mandates and champion Responsible Investment. As at December 2017, MSCI reported that about US$98 billion of assets is benchmarked against the MSCI ESG indices.

Credit: Joshua Ness

FIGURE 11: EXISTING ALLOCATIONS TO SMART BETA



Source: FTSE Russell: Global Smart Beta Surveys of Asset Owners, 2014-2018

MULTI-ASSET CLASS INDEX INVESTING

Recent regulatory amendments, known as the retirement fund default regulations, have significant implications for South African investors. In terms of the regulations, retirement funds will have to consider "cradle-to-grave" investment goals; they need to assist members during both the accumulation phase and the retirement phase of their investments in a cost-efficient manner, whereas previously they were required to assist members only during the accumulation phase. In this context, low-cost life-staging offerings are growing in importance. And using a multi-asset class fund is a highly efficient and robust solution.

> BOTH ACTIVE AND PASSIVE STRATEGIES HAVE A ROLE TO PLAY AND PARTNERING WITH THE RIGHT MANAGER TO FIND THE RIGHT BALANCE BETWEEN THE TWO STRATEGIES IS KEY.

IT TAKES A MIXED BAG

Today, it would be reasonable to say that the majority of the investment community do not see indexation as merely a fad, but rather a useful investment strategy that can help investors achieve their goals. If you are still not sure of this, just check out Figure 9 again. However, as passive/index investing grows more popular, we don't think investors should give up on active investing. Both active and passive strategies have a role to play and partnering with the right manager to find the right balance between the two strategies is key. Investors with a blend of both active and index investments have the opportunity to both outperform the market index and reduce the risk that they will underperform the market, all while reducing their total investment costs.