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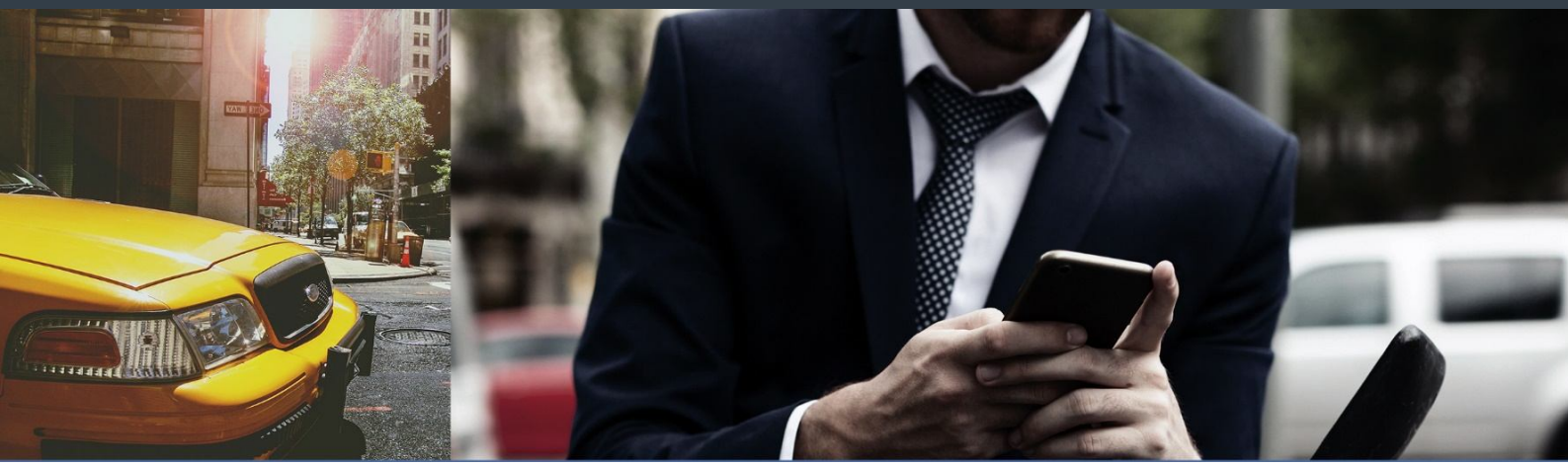

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Active considerations in passive investing

Written by: Kingsley Williams, Chief Investment Officer at Satrix

In the main, index benchmarks are used by the end investor or their financial adviser to keep portfolio managers honest.

If actively managed fund returns trail their chosen yardstick for a reasonable length of time, investors have the right to know why. If ahead, the conversation is generally easier.

Benchmarks should continue to fulfil this traditional role. But stopping there denies them a chance to reach their full potential. In South Africa, they play a critical role in both fund selection and managing the expectations of the end investor.

Created unequal

Broadly speaking, any unit trust or exchange traded fund (ETF) that has exposure to the SA equity market can benchmark themselves against one of four FTSE/JSE indices, which represent 99% of the domestic equity opportunity set.

They are as follows:

1. All Share Index (ALSI)
2. Capped All Share Index (CAPI)
3. Shareholder Weighted Index (SWIX)
4. Capped Shareholder Weighted Index (Capped SWIX)

Investors tend to gravitate towards the **ALSI** to calibrate their returns, probably because it's been around the longest, is the most quoted local equity index and is easier to understand.

CAPI is constructed using the same methodology as the ALSI (and so holds the same companies), but individual companies may not exceed a 10% weighting in the index. This means small- to mid-cap shares hold more sway, while no single company will have an outsized influence on the index's performance.

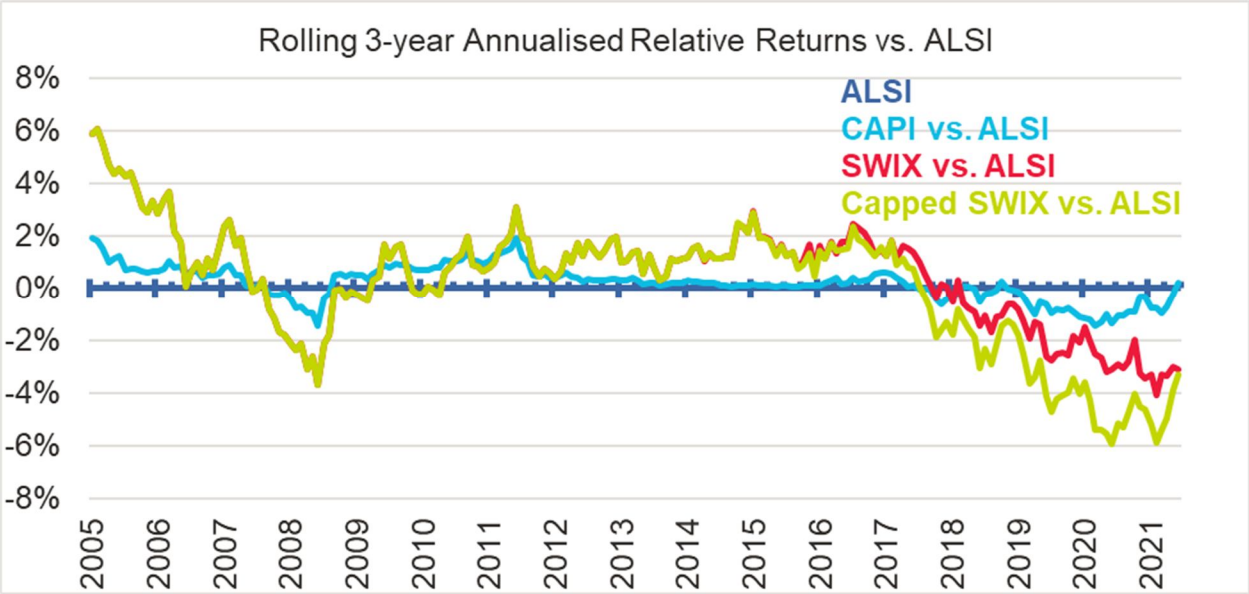
To arrive at the weightings in the **SWIX** index, only the number of shares held in local share registers are used to calculate each company's market cap. As a result, dual-listed counters (with shares sitting in foreign registers) are diluted relative to their weightings in the ALSI and CAPI.

The **Capped SWIX** uses the same construction template as the SWIX, diluting dual-listed, but limits constituent weightings to a maximum of 10%.

All four indices are made up of the same companies, with differences confined to the weights among those securities.

Divergent performance

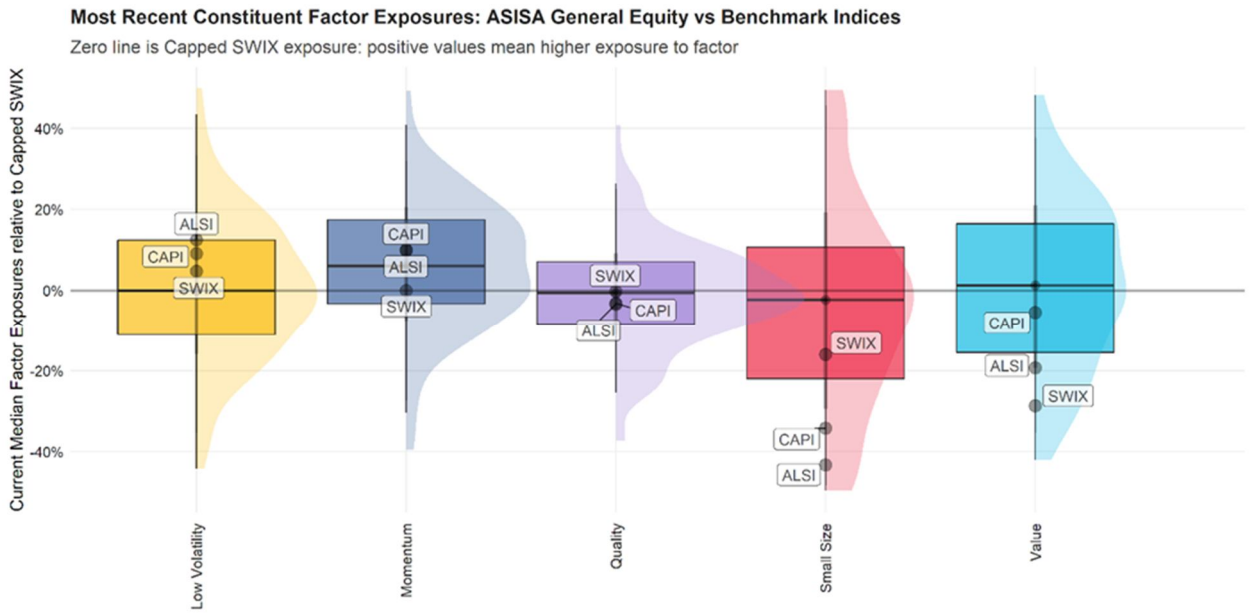
These differences are not semantics. Using three-year rolling returns since 2005, the performance of the Capped SWIX has diverged from the ALSI return by as much as ±6% per annum. That's a big number, no matter how you cut it. The difference between the CAPI and ALSI is a more modest ±2% per annum but over an investor's lifetime, that number can lead to very different wealth outcomes.



Capped SWIX performance equivalent to SWIX performance prior to February 2012 | Annualised returns indicate the average annual return after compounding.
Source: FTSE/JSE gross total returns, Feb 2002 – Jun 2021

Interestingly, our analysis of active funds across a range of styles or factors shows that the Capped SWIX is the benchmark most representative of active funds. This can be seen in the following chart by comparing the median active fund (the middle horizontal line in each box) to the zero-axis representing Capped SWIX. Since market capitalisation weighted indices are constructed according to the size of companies, it is telling that Capped SWIX corresponds most closely to the median active fund across this dimension, whereas ALSI and CAPI are significant outliers.

Across the other factors, such as low volatility and value, there is much closer and more consistent alignment to Capped SWIX than any of the other indices, with momentum being the only exception. However, the closer correspondence of ALSI and CAPI to the median active fund within the momentum actor does not apply to any of the other factors.



Source: FTSE/JSE, Morningstar & Satrix, Jun 2021

That raises both an obvious and more subtle question:

- Should the ALSI be the default benchmark for active equity managers? Maybe not.
- Could a Capped SWIX tracker serve as a cost-effective way to get equity exposure? Probably.

The key takeaway here is that investors should expect different return and volatility profiles depending on which of these four indices a fund chooses to benchmark itself against. This is true for index trackers and active funds that tilt their portfolios around the security weightings in their chosen benchmark.

With the above in mind, how can the index benchmark of your fund be used to explain performance?

What to expect from your benchmark

The different construction rules for each index manifest in sector and style biases. Understanding those biases will make it easier to explain the performance of the funds using them as benchmarks.

Sector	ALSI	CAPI	SWIX	Capped SWIX
Resources	34%	35%	24%	27%
Technology (mostly Naspers)	17%	12%	23%	12%
Financials (ex-property)	14%	17%	21%	24%
Industrials (ex-technology)	31%	32%	28%	32%

Source: FTSE/JSE & Satrix, June 2021

ALSI: Our domestic stock market is dominated by large-cap shares. To illustrate this, consider that Apple makes up just over 6% of the S&P500, while Naspers accounts for around 15% of the ALSI. That concentration in one share increases the risk of the index**.**

The shares currently dominating the ALSI have a tech and commodity flavour. As a result, the index (and the funds that use it as a benchmark) need Naspers to perform and commodity prices to keep rallying. Moreover, with around two-thirds of the index's revenue earned offshore, a weaker rand is often supportive of its performance.

CAPI: The 10% cap on individual weightings imposed by this index means it has significantly less exposure to Naspers, resulting in less single-stock risk. While removing excess concentration to any one share in excess of 10%, the CAPI retains a similar degree of foreign revenue exposure to the ALSI.

SWIX: This index has the highest exposure to Naspers (in excess of 20% as at 30 June 2021) and therefore carries the largest single-stock risk of the four options. That concentration is somewhat countered by a more even spread between resources, financials, and industrials (excluding technology) due to the dilution of the dual-listed shares.

Naspers has a high PE ratio and low dividend yield, and because it holds so much weight in the SWIX, the index takes on those characteristics. Naspers also exhibits high growth attributes, giving the SWIX more of a growth and less of a value style bias. It goes without saying that a healthy SWIX needs a healthy Tencent.

Capped SWIX: By limiting the exposure to Naspers and down-weighting the dual-listed shares, this index looks to have the most balance of the four options.

The higher exposure to financials, industrials, and smaller domestic-facing businesses means the Capped SWIX's performance is more oriented towards the SA economy. Moreover, with only half of index earnings coming from offshore, it is more balanced in terms of exposure to currency movements. While the exposure to resources is slightly below the ALSI and CAPI, strong commodity prices should be supportive of our domestic growth prospects.

Benchmarks and advice

As index investing gains traction as an investment approach in South Africa, investors appreciate the role different index-tracking strategies can play within their portfolio, whether using Capped SWIX to provide a more efficient core or any of the other three to provide something differentiated with which to blend. Company, sector and style differences among the four broad headline indices highlight how different these benchmarks are and how their performance may diverge, even though they all invest in the same companies.

For this reason, investors shouldn't see index investing as either a homogenous option nor a passive endeavour – the choice of which benchmark to track is very much an active one and will likely have a significant impact. The possibilities and outcomes are even greater when considering indices offering investment strategies outside of the broad market indices we've considered here, such as subsets of the broad market or factor-based/smart-beta indices. Therefore, it is vital to understand what is inside and how an index is constructed – transparency is a principle that goes hand-in-hand with index tracking. With all these considerations, the benefit of advice in the overall portfolio construction process cannot be understated.

In addition to measuring performance, benchmarks need to be discussed more often during the fund selection process and can be used to better explain investment returns to the end investor.

If you're engaging with an active manager, understanding the role of the chosen benchmark in their portfolio construction will help align expectations around fund performance. If you're considering a fund that tracks one of these indices, be aware of their sector and style biases and how those might impact performance.

In essence, there's more to the yardstick than the stick.

Glacier Research would like to thank Kingsley Williams for his contribution to this week's Funds on Friday.

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Kingsley Williams is CIO of Satrix, the leading provider of index-tracking products in South Africa. Satrix is a wholly-owned subsidiary of the Sanlam Group. Before joining Satrix in November 2017, Kingsley spent almost 10 years at Old Mutual Investment Group where he became the CIO of their indexation capability. He has vast experience in quantitative research, product development and index-tracking portfolio management, servicing South African and global institutional clients. Over his 20-year career Kingsley has also held positions at Stanlib Asset Management and Merrill Lynch, which included positions in London and New York.