

INVESTMENT REVIEW

Better than a tracker?

Markets can be beaten, argue active fund managers. Passive managers take the stance that index-linked returns are safer. Addressing this polarisation, Robert Arnott, founder of US-based Research Affiliates, has developed an index based on determinants of a share's value — the Research Affiliates Fundamental index (RAFI), which it uses to manage US\$60bn of assets in 35 countries.

RAFI is used in a number of funds in SA, including two unit trusts, the Old Mutual RAFI 40 Tracker Fund (OMR40) managed by Dibanisa Fund Managers, and Plexus Asset Management's Plexus RAFI Enhanced SA Strategy Fund.

Over the past three turbulent years, RAFI has proved its worth with both funds' returns outpacing the JSE all share index (Alsi) or the average actively managed general equity fund (GEF).

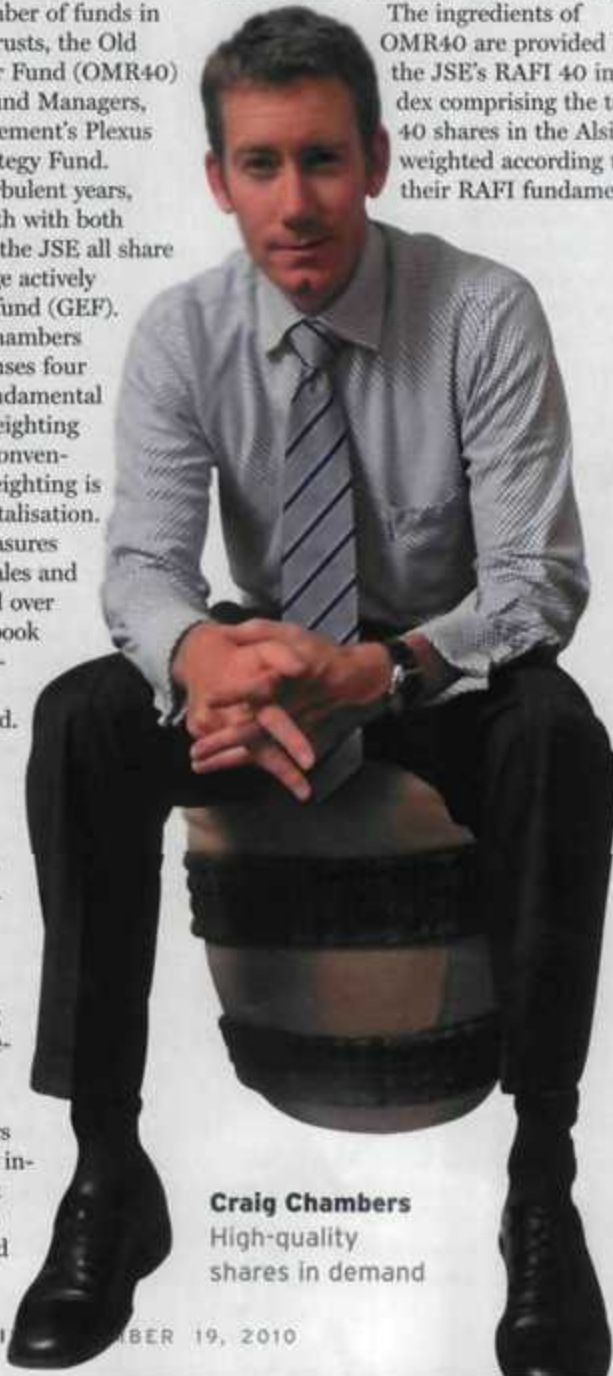
Dibanisa MD Craig Chambers says Research Affiliates uses four measures of a share's fundamental value to determine its weighting in an RAFI index. In a conventional index, a share's weighting is based on its market capitalisation.

Three of the RAFI measures used — cash flow, total sales and dividends — are averaged over five years; the fourth — book value (total assets less liabilities) — is measured when an index is reviewed. The measures are aggregated and the share's index weighting is determined by the ratio of its aggregate to the total aggregate of the same measures across all shares in the sample.

Because the RAFI approach recognises strong company performance regardless of share price, there's a bias towards shares offering value, says Chambers. Conventional indexes tend to overweight overvalued shares and to underweight undervalued shares, he says.

A value bias has favoured RAFI funds over the past three years. During the collapse in equity prices between May 2008 and early 2009, the value bias proved defensive. But in the strong recovery, the same high-quality shares were in demand, says Chambers. During periods where the market runs hard and value is of less importance to investors, RAFI funds will underperform, he says.

The ingredients of OMR40 are provided by the JSE's RAFI 40 index comprising the top 40 shares in the Alsi weighted according to their RAFI fundamen-



Craig Chambers
High-quality shares in demand



tal value. To ensure marketability, account is also taken of a share's free-float market capitalisation.

Plexus RAFI also holds about 40 shares but, in addition to the four basic selection factors, it applies measures aimed at enhancing share selection. These include earnings consistency and a "financial distress screen", which assesses risk factors such as a company's debt. According to Plexus, in emerging markets such as SA, RAFI enhancements should produce on average a 2%-3% additional return annually over a standard RAFI index.

But this was not reflected in performances of OMR40 and Plexus RAFI in the 36 months to October 30. OMR40 had the clear edge, with a total return of 11,72% compared with Plexus RAFI's 7,06%. Over the period, the average actively managed GEF delivered a 2,5% total return; the Alsi 6,01%. The best-performing GEF, Marriott Dividend Growth (MDG), produced 30,9%; the worst-performing, Stanlib Nationbuilder, -36%.

In the 12 months to October 30, Plexus RAFI took the lead with a 16,37% return; OMR40 was close behind at 15,92%. Both funds beat the 15,55% average of actively managed GEFs but were beaten by the Alsi's 19,4% total return, perhaps reflecting an exuberant market where value is of less consideration.

A number of GEFs with long records of solid returns also excelled. These include Foord Equity, which produced a 24,9% return, MDG (23%) and Coronation Equity (21,5%).

Based on their longer-term history RAFI funds are a compelling alternative to conventional index trackers. But for investors confident they can select the top actively managed funds, RAFI funds are a compromise they would probably not enthuse about. **Stafford Thomas**