Q & A

Beating the index

We will consider pros and cons of the traditional asset-class and composite benchmarks used for measuring institutional portfolio performance in SA, as well as the emergence of alternatives to the traditional market capitaliaation-weighted indices.

Questions for fund managers:

There is evidence that, over time, the typical SA Equity institutional portfolio has beaten its agreed long-term benchmark, whether this is the ALSI, SWIX, CAPI or other variation thereof. Why would this be so? Could this be related to flaws in the construction of these benchmarks? Or is this just a spurious phenomenon, e.g. the result of "data mining" or "survivor bias"?

JOHN McNab, co-chief investment officer at Investec Asset Management says the argument has been made many times in the South African market that it is impossible for fund managers to beat the index consistently over time. This argument is based on the logic that for every outperforming manager there must be an underperforming manager, but presupposes that the entire stock market is held only by institutional portfolio managers.

"This is clearly not the case, as there are several owners of stock, including corporates, offshore funds and retail fund managers. Although not a guarantee for outperformance, institutional fund managers have the luxury of longer investment horizons and the ability to construct more diversified portfolios. Many buyers of equities are doing so for other reasons such as corporate action or neutralizing liabilities, often with limited discretion as to what price is paid.

"Also, the times during which indices beat the portfolio managers by a substantial margin are normally due to the concentration of the indices, especially in resources stocks, in the South African market. While this does not fully explain outperformance over time, it does given an indication of when all portfolio managers are likely to be consistently beating the benchmark."

McNab says given that there are other players in the market and that institutional fund managers seem to beat this market, one can infer that the other participants such as offshore managers, corporates and retail funds find it more difficult given their location, different objectives, fund flows and shorter-term investment horizons.

PROFESSOR Evan Gilbert, research analyst at Cadiz Asset Management says outperformance suggests that investment managers are doing something right!

"The South African equity market is small, and concentrated. This combination creates opportunities for outperformance on the basis of relatively simple investment decisions. For example, simply calling the FINDI – RESI weights correctly relative to these benchmarks can lead to relative outperformance.

"We don't believe this is either an index construction or data mining issue. Survivorship bias leading to the overstatement of actual outperformance may be present if the evidence hasn't been collected properly – but this is unlikely to be the core reason for this outperformance."

ABSA Investments' CIO Errol Shear says: "In our view, a well selected portfolio of shares will outperform an index over time because of a fundamental flaw at the heart of index-investing.

For example, for five years the Absa Select Equity Fund has returned an average of 19.1% p.a., which is 4.2% p.a. above its benchmark, the FTSE/JSE All Share Index.

Index investing suffers from a simple flaw. Assume the price of a share rises. Automatically the value of that company on the stock market increases. Index trackers now have to hold more of that stock if they blindly track the index. The more expensive the stock becomes, the more of that overpriced stock needs to be bought by index trackers.

The Absa Select Equity Fund is a value fund. We strongly believe that we should invest in good companies, but also that we should invest at a fair price. The higher the share price rises, the more likely we are to see lack of value and sell that stock.

Therefore, index trackers would typically be buying the stock which we are selling, because we as value investors believe it no longer offers fair value.

In essence, the smart value investor buys low and sells high while the index tracker can be induced by market shifts into buying high and selling low.

The main indices are not necessarily badly constructed. They simply fail to address the fundamental problem that index buyers may be buying at high prices.

JONATHAN Kruger, portfolio manager and analyst (equities) at Prescient Investment Management says data taken from the Alexander Forbes SA Equity Manager Watch confirms that the average SA Equity Institutional portfolio has beaten the All Share Index by 1% over the last 15 years.

However one should be careful in using the terms average or a "typical" manager loosely. This universe of "typical managers" is constantly changing as managers move above and below the average, making it difficult to select a single manager who will perform in line with the average.

"Yes, this kind of performance analysis can be fraught with survivorship bias and data mining. To avoid this, one has to be objective in selecting the time period over which the data is analysed (going back as far as possible) and should include all managers who existed at the time the return was calculated (not simply taking current managers and calculating their returns going back).

"There are a number of reasons why an institutional portfolio may have beaten the benchmark. Firstly, the South African market was considerably less efficient, in the 90's and earlier years of the decade, than it is currently, allowing professional managers to exploit these opportunities through stock picking.

"However with the market becoming more efficient, there are fewer opportunities and managers are tending closer to benchmark weightings than before. Another reason for outperformance of the benchmark is that managers may be structurally down weighting certain sectors (e.g. resources). This may cause a manager to outperform or underper-

form when this sector is in or out of favour, rather than attributing performance to the manager's stock picking skill. For example resources performed well from 2000 to mid 2008 and following the 2008 crash other sectors performed better," says Kruger.

He contends that a benchmark should be representative of the investable universe.

"A market cap (MCAP) benchmark is the most reflective, by having a higher weighting to larger companies. Historically investors have moved away from price weighted indices to MCAP weighted indices for this exact reason, like moving from the Dow Jones Industrial Average to the S&P500.

"There isn't a flaw related to the construction of these MCAP benchmarks as the investable equity market is a zero sum game around the index, excluding trading costs. Alternative indices may have biases like value, fundamental or growth indices. These indices reflect a certain style of investing rather than the market. Giving a weighting based on a growth, fundamental or value metrics will be reflective of that style of investing rather than the market as a whole."

CRAIG Chambers, managing director, Dibanisa Fund Managers says that when the company was launched almost ten years ago, there was only one benchmark available – the All Share Index.

"Back then it was not even a total return index – meaning that dividends were not even included in the overall return. The benchmark was not adjusted for free-float and obviously also had a huge resources sector bias. Given the volatility of resources, the active managers were typically always structurally underweight resources.

"So, comparing the managers to the All Share index was like comparing apples to oranges. However, after 2002, things changed drastically. The FTSE/JSE introduced an index with a much lower resource skew, called the SWIX Index. This index strips out foreign ownership and is a much better approximation of the investable universe available to SA managers. Most managers slowly began to adopt this benchmark as the 'peg-in-the-ground', the starting point upon which they would try to add excess returns.

"Fast forward eight years and the picture is very interesting. From 2002 until September 2010 the SWIX Index has beaten the median General Equity fund by over 30%. Even if you deducted, say, 1% per annum for retail tracker fees, the outperformance is still large.

"What we have playing out here is William Sharpe's zero-sum-game and the tyranny of compounded costs. Given that the SWIX Index is a great approximation of the equity holdings of the aggregated pot of active managers, over time a fund tracking the SWIX will begin to beat the median manager because the tracker fees are generally 50% lower than active fees."

Chambers says it should also be noted that survivorship bias does play a role and if the poorly performing funds that have been removed from the ranking surveys were added back – the SWIX outperformance would be even more pronounced."

MAHESH Cooper, head of institutional client servicing at Allan Gray says historically the ALSI has had a higher weighting to resource counters. More recent benchmarks such as the CAPI and the SWIX effectively 'downweight' the resource exposure relative to the ALSI but continue to have a large cap bias.

"We believe that different equity benchmarks will outperform one another over short periods of time as different sectors fall in and out of favour. Over the long term, it is unlikely that one benchmark will have a sustainable advantage over another.

"As a result, we are comfortable for an institutional client to select any reasonable equity benchmark to measure us against. Examples include the ALSI, CAPI, and SWIX. Irrespective of the choice of benchmark, there would be no difference in the way we manage the portfolio. This is because we build portfolios using a 'clean sheet' approach, as opposed to starting with a benchmark and tweaking an overweight or underweight position in a particular stock in relation to the benchmark. We want to hold shares that are trading below what they are worth."

PAUL Stewart at Plexus Asset Management says on average, typical SA equity portfolios struggle to beat the major indices over time.

"Using the after cost (Nav to Nav) unit trusts returns as the source data (to October 2010), an average can be calculated from the equity fund universe including general equity, value, growth and large cap categories. This equity fund average now shows underperformance of the FTSE JSE All Share of around 3.5% per annum over five-years and 0.5% per annum over 10-years.

"Importantly, it should be noted that the 10-year number incorporates a great deal of survivorship bias in that there was significant management company/fund consolidation in this period (SCMB/Liberty, Norwich/Fedsure/Investec, Momentum/Sage, Syfrets/UAL/Nedbank) and it is likely that where funds overlapped in the consolidation processes, the funds with the best performance track records were retained, while the funds with the below average returns were jettisoned.

"Clearly implied in this average is there were some funds that outperformed by a large margin and many funds which underperformed the average, often by smaller margins. But being in an index, investors could have comfortably outperformed the average manager."

NEIL Brown at RE·CM assumes the question is indirectly referencing the notion that the market is ultimately a zero-sum game – in other words, there should be an equal amount beating the benchmark and losing the benchmark.

He says it is difficult to answer this question without more detailed information. For instance – the time period over which this is measured or what surveys being used and what would constitute a "typical SA Equity portfolio". In any event, he say it would make sense that this is partially caused by survivor bias.

"Asset managers who have underperformed substantially may have closed particular funds due to large withdrawals or may even have disappeared themselves with significant consolidation in the industry.

"We would agree that over the long-term, investing in the markets is a zero-sum game with a loser for every winner. Also, what is not captured by these surveys is the effect of other market participants – presumably there is also a big body of investors not captured."

The so-called All-Bond Index is a misnomer, as it includes only 19 bonds (with a strong bias to RSA Government bonds) and excludes a large number of bonds listed and traded on the Bond Exchange. Do you think the ALBI is still a suitable benchmark for broad SA fixed-interest portfolios? What would you like as an alternative?

ANDREW Canter, chief investment officer at Futuregrowth Asset Management says bond indices globally tend to be random and non-representative of the underlying markets or economies.

"Further, their average term-to-maturity – which is the key risk issue for bond investors – is merely derived from index constituents and may bear little relation to investors' asset-liability matching needs.

"Indeed, the BEASSA All Bond Index (ALBI) is anything but "all" the bonds as its inclusion rules make it a non-diversified, very narrow index that excludes most corporate issues and all floating rate notes and inflation linked bonds. However, the ALBI serves the valuable purposes of being a long-dated, fixed rate index that is a reasonable proxy for long-term investors' bond asset-class holdings.

"Further, the All Bond Index satisfies the primary requirements for a benchmark, as it is independent, observable, replicable and tradeable. While there have been discussions around the formation of a suite of bond indices, such as credit, fixed-rate and floating rate indices, these have generally not caught on as the underlying assets would not be diverse or tradeable, and that would impair the utility and relevance of such indices.

"For those reasons, the ALBI remains the benchmark of choice for South Africa's bond investors and asset managers. However, while parties can utilise the ALBI, there should be cognisance of individual funds' risk profiles relative to the highly liquid, low-credit-risk characteristics of the ALBI, with return targets set suitably to account for the different risk of alternative investment strategies."

JOHN McNab, co-chief investment officer at Investec Asset Management says a good index must always have sufficient liquidity so that fund managers find it investable.

"At the moment, the All-Bond Index satisfies this criterion and is suitable for a broad SA fixed interest portfolio. We recognize that over time and as liquidity enters the market, this situation may change."

PROFESSOR Evan Gilbert, research analyst at Cadiz Asset Management says: "We believe the All Bond Index with its 19 constituent bonds is not a true reflection of the total value of long term debt that is outstanding, in the way that the ALSI, for example, represents more than 99.9% of the market capitalization of the JSE".

"Non-government debt comprises about 44% of the total value of outstanding long term debt, while it comprises only 15.5% of the ALBI. While this suggests the ALBI is a misnomer, and potentially a poor index, its composition isn't quite as bad as this sounds.

"It reflects the fact that liquidity in our bond market is a problem – especially for non-government debt. A value of outstanding debt weighted index may be more representative of the spread of debt instruments out there, but it would not be replicable due to illiquidity problems.

"So maybe the ALBI isn't too bad as an index after all! Bond managers have been able to outperform the ALBI by loading up on the higher yielding non-government debt, but this is not a risk-free strategy.

"The higher spreads on these instruments reflects both the liquidity and default risks of these instruments – and the lack of liquidity is a fact of life in our bond market. The alternative we would really like is a liquid market – not a new index!"

JEAN-PIERRE du Plessis, portfolio manager and analyst (Interest Bearing) at Prescient Investment Management says it would seem logical to include as many bond issues as possible in a broad market index such as the ALBI. However the desire to be broad-based needs to be balanced with the ability to make the index investable.

"This constraint limits the amount of issues that could be included in the index. The size and liquidity of some issues may not allow for sufficient trading volumes to allow efficient investment. As an example, the introduction of a smaller, less liquid issue into the index could create distortions as fund managers who are required to match the index are forced to buy or sell the issue.

"This makes rebalancing the index very difficult, as changes in the constituents of the index would require investment managers to buy and sell potentially illiquid issues. The bias of the index to include a larger amount of government issues is because the size of these issues, and their credit quality, mean there is a ready market for the trading of these bonds," says Du Plessis.

He contends the ALBI is an appropriate index for a SA fixed-income portfolio.

"It is important for the selection criteria of the constituents to be transparent and less subjective and this by its nature has a degree of inflexibility. The ALBI is constructed to ensure that the bonds which make the index satisfy the minimum requirements in terms of market capitalisation and liquidity.

"A less rigid index will be more inclusive but it could potentially make it less appropriate as a broad benchmark. A broader more inclusive bond index would be useful for managers that are granted a greater degree of investment freedom but only to the extent that the index can be duplicated so that tracking error is as a result of investment management decisions rather than the inability to transact the appropriate securities."

DEON van Zyl, head of fixed interest at Metropolitan Asset Managers says: "We would like to see a broader index containing about 25 bonds".

"The only problem in terms of corporate bonds is that the liquidity in these bonds is very low and hardly trade in sufficient amounts."

PAUL Stewart at Plexus Asset Management believes the All-Bond Index (ALBI) is too RSA bond heavy.

"Ideally we would like to see a greater emergence of a strong and vibrant corporate bond market in South Africa, where credit can become a bigger part of the fixed income landscape as it is in the major developed markets of the world.

"Since SA investors tend to be very equity centric, the required liquidity in many of the issuers is not sufficient to justify their inclusion in the bond benchmark. The equity centrism has not provided fertile ground in which the SA bond market could evolve and prosper. But with the Bond Exchange on the JSE merging and with more issuers of a corporate nature perhaps deciding to finance themselves with debt rather than equity in future, this may well cause the composition of the ALBI to change over time."