



A Member of the  OLD MUTUAL Investment Group

PRESS RELEASE

27 January, 2009

Look for lower-cost products in today's lower-return environment

These days, the issue of fees paid for investment products has become even more important for investors, given that costs will most likely have a far greater negative impact on investment performance in what is forecast to be a far lower-return environment over the medium-term, according to Craig Chambers, Deputy MD of Umbono Fund Managers. Yet South African pension funds and retail investors could be needlessly paying too much in fees for their investment portfolios, research by Umbono Fund Managers shows.

Costs will substantially erode lower returns

"Most SA market analysts are forecasting real equity returns over the next two or three years of below 10% per year - far lower than the exceptional 20%-plus returns of the 2003-2008 bull run," Chambers points out. "It's fair to assume that equity returns will revert back to their long-term rolling real average of 8% per year prior to 2003. As a result, we estimate that active fund management fees plus trading costs* as a percentage of the expected 8% return (on a R100m fund) come in at **14% per year**, while index tracking fees on the same basis come in at **2.8% per year**," (see fee details below).

By contrast, the same fees deducted from a 20% return come in at 5.6% for active asset managers and 1.1% for index tracking funds."So whereas investors may not have minded having their returns reduced by approximately 6% in the previous high-return environment, these days fees should be a major consideration in their investment decisions," he says.

Index tracking funds as a low-cost portfolio core

Lower-cost solutions, like index tracking funds, have become increasingly popular in most developed markets as more and more pension funds and retail investors choose to use them as the low-cost "core" of their portfolio in a "core-satellite" approach to investing, says Chambers.

"In this approach," he explains, "investors opt for a 'core' solution that provides a low-cost return that mirrors a benchmark like the general equity or bond markets, or a combination of benchmarks. There is no active fund management, just a precise and steady tracking of index movements over time. Investors then look for higher, benchmark-beating returns (or 'alpha') from actively managed funds, for which they pay higher fees, as 'satellites' for their portfolio. The combination - typically 30% core and 70% satellite - makes sense as the investor benefits from both lower fees and the potential for outperformance."

Unlike the rest of the globe, however, where between 20% and 30% of all retirement plans utilise some type of index-tracking solution as a passive core, South African investors have been slow to adopt this approach. Active managers

often argue that the local equity market is structurally different and does not lend itself to core-and-satellite-type portfolio construction, observes Chambers.

Yet, he says, the facts of our market would suggest the opposite – the SA market has debilitating investment constraints that make it more difficult for investors constructing portfolios of several active fund managers to avoid creating a de-facto passive core. In reality, the small size and concentrated nature of the JSE means investors are likely to create (unwittingly) an aggregated portfolio of which a portion unavoidably tracks the top shares in the JSE.

“This suggests that for a pension fund to pay high active fees on *all* its assets is a waste of money - given that a component of the fund’s aggregated equity return comes merely from the passive investable universe,” asserts Chambers. “By not using an index-tracking core, Umbono’s research has shown that at least one-third of a pension fund investor’s equity investments are needlessly incurring active management fees and portfolio trading costs (including brokerage, custodial and tax costs) that are 70% to 80% higher than a passive index tracking solution.”

Creating active portfolios with an unavoidable passive core

Umbono’s research shows that a current blend of three or four large active equity managers in South Africa are invested in a total of 130 to 135 shares. The largest 80 stocks within this blend account for over 96% of the aggregated portfolio. Compared to the 5,000 stocks in the Dow Jones Wilshire 5000 Index, it is a very limited universe.

Explains Chambers: “Since the advent of the FTSE/JSE Shareholder Weighted Index (SWIX) almost seven years ago, the majority of active managers have adopted it as their benchmark. So, when fund aggregators construct a blend of three or four active managers, one manager may, for example, have a slight overweight position in Altech relative to the SWIX, while another will be slightly underweight, but in aggregation they look very similar to the SWIX. This is especially true for the largest 80 stocks.”

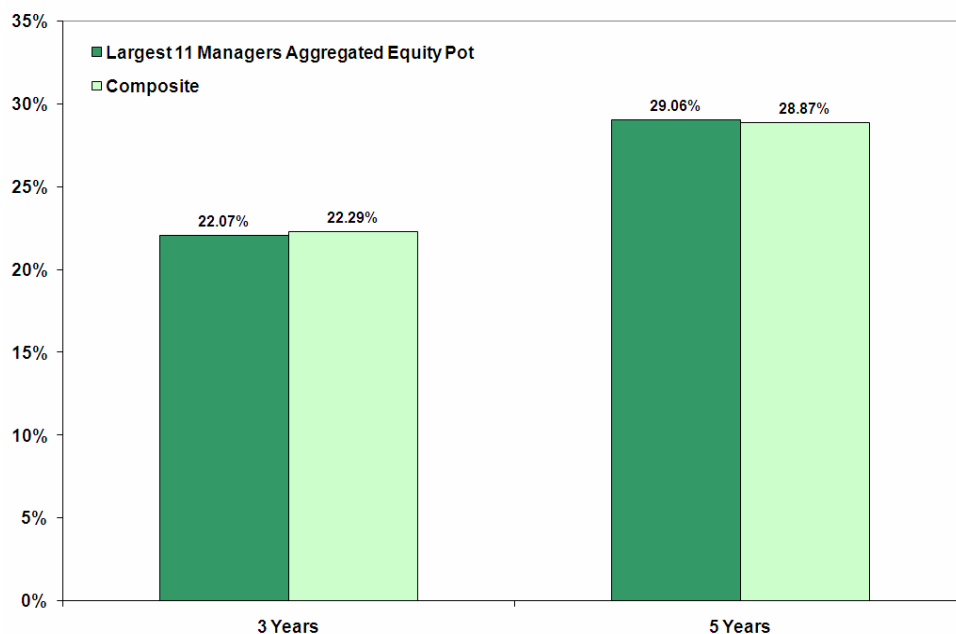
Umbono’s research reveals that an aggregated blend of active managers will most likely have a Tracking Error (TE) relative to the SWIX of around 2.5%. TE is a statistical measure that shows how different a fund’s share weights are relative to the benchmark’s weights – the higher the TE, the bigger the difference from the benchmark. (In the US, an active manager will have a TE of 5% or higher, while a 2.5% TE fund would be defined as an Enhanced Index Fund).

“If we then take one-third of this active portfolio and try to match up the weights relative to the SWIX, we get an even lower TE of 0.48% (a 0.50% TE fund would be defined as a full-replication Index Fund). OMIGSA’s attribution analysis confirms this – for the month of December 2008, 86% of the aggregated managers’ performance can be attributed to the SWIX Index.” The performance of active funds also supports this research, notes Chambers. Since the SWIX Index launch, aggregated active manager returns net of fees (unit trusts and pension funds) have shown no *consistent* outperformance over this Index (see illustration below).

“The irony of this research is that the rationale for using index tracking within the overall investment blend has little to do with active versus passive performance,” Chambers says. “Given our equity market’s limitations, whether one-third of the fund is invested in a low-cost SWIX tracker or one-third is an expensive de-facto passive SWIX core – the future total *gross* return will be very similar. However, on a *net* basis, the fund with the intentional low-cost SWIX tracker will have superior long-term returns.”

“So no matter how fund aggregators try to combine active managers across different fund management styles, in the SA context the aggregated blend will always have a portion of the portfolio that is close to 100% passive. Therefore, at the very least, SA investors could be saving 70% to 80% of fees on 30% of their equity holdings (via their pension fund or their unit trust funds) by opting for an index tracking solution as a 30% core holding in their portfolios,” he concludes.

Aggregated Manager Returns Vs. Composite (30% SWIX + 70% Aggregated Blend) – Net of Fees, 31 August 2008



***NOTE ON FEES:**

Conservatively, at least one-third of a South African investor’s equity investments are needlessly incurring the following costs:

Active fund management fees

On average – for a R100m pension fund – active fees are 390% more expensive, relative to equivalent tracker fees (Source: Alexander Forbes Retirement Fund Survey).

This also applies to retail investors – for example – average active general equity unit trust fees are 86% more expensive than the Old Mutual Umbono RAFI unit trust fund.

Portfolio trading costs

On average – an active portfolio (which includes the de-facto passive SWIX core) will have a turnover rate of at least 200% more than a tracker fund (15% for a tracker versus approximately 50% for a buy-and-hold active manager). So, for the one-third passive component, the investor is needlessly paying away 200% more in brokerage, custodial and tax costs. (Source: OMIGSA)

Over-and-above that, brokerage costs are typically at least 100% higher for active managers. Please note that these are hidden costs, as performance is quoted after these costs (even the ACI definition of TER (Total Expense Ratio) does not include these costs).

Rob Rusconi's research showed that the cost of neutralised trades (active managers buying and selling to each other) can be as much as 2.20% pa. (Source: "Whose Money is it Anyway?" 2007). However, given the lack of published data regarding hidden trading costs, we have been extremely conservative in our estimate, thus utilizing only 25% of the 2.20% i.e. 0.55%.

For further information, please contact Craig Chambers at (011) 562-6039.