Multi-Manager Mindset

STANLIB
Multi-Manager
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Focused Investing
STANLIB Multi-Manager

Additional diversification
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Although the global asset management industry is worth a staggering $75 trillion, it has experienced lots of challenges and changes over the last decade, resulting in investors and advisers continuing to look for better outcome-orientated solutions, greater diversification and less expensive products. An example of the latter is the estimated $200 billion global shift towards some sort of passive solution in 2015.

At STANLIB Multi-Manager we have recognised this trend and are well positioned to assist with the structural shift towards more efficient outcome-based solutions, whether in our capacity as discretionary investment service provider to independent financial advisers or in the form of offering model portfolios and white-labeled unit trust solutions.

In this issue of Mindset we are not trying to unpack the sales pitch for active versus passive investing. As a multi-manager our focus is on making solutions available to investors that will meet their outcome expectations – meaning we have the flexibility to make use of various asset classes, managers and strategies (including passives, enhanced indexation and Smart Beta) to build solutions for investors. That is why we do not spend time debating which is better - active or passive.

We spend time thinking about how we can utilise this ever-increasing investment opportunity set, so that we can build competitive solutions for our investors in an increasingly complex investment universe.

In this edition of Mindset, the Multi-Manager investment team weighs in on the active and passive conversation with our views. Joao Frasco, our Chief Investment Officer, takes the middle ground between the battle raging between active and passive managers on which strategy is “best” and points out the pitfalls and flaws in the arguments made when engaging in this debate.

Jennifer Henry, one of our Portfolio Managers, elaborates on the opportunities passives can offer when used together with active management to construct portfolios.

Richo Venter, Head of Research and Development, looks at the various decisions which are required by an investor when investing in either passive or Smart Beta products and the impact of making the wrong investment decision.

Finally, Kent Grobbelaar, our Global Portfolio Manager based in London, presents a case for the inclusion of both passive and active within global portfolios and the benefits for investors.

This is a jam-packed issue with a semester’s worth of theory in four practical articles.

Please look out for our next issue at the end of the third quarter and send us your feedback. We welcome your inputs and feedback.

You can send your comments to the Editor of Multi-Manager Mindset, Erica Stuart at: erica.stuart@stanlib.com
Unfortunately, this discussion is usually tainted by personal incentives of providers “talking to their books”. As the second largest multi-manager (by assets under stewardship) in South Africa, we have chosen not to offer funds that are either fully active or fully passive, but rather focus on our investors’ needs and combine active and passive as required to deliver on their objectives. We put clients first, not just a plethora of products to maximise the aggregation of assets.

I will briefly introduce the topic, point out the pitfalls when engaging in this debate and the flaws in some of the arguments. This should provide you with a fuller understanding of the difference, and the nuances worth appreciating when considering the alternatives available. I will also briefly touch on why we consider passive investing within some of our funds and the considerations which we find attractive.

Is active investing a zero sum game?

Let us be clear upfront that passive investing doesn’t exist. I’m not making the weaker point that it doesn’t exist in a vacuum, which by itself would be a controversial statement to some (and yet completely true), but rather that it doesn’t exist at all.

Investing is an active process - always. Passive investing merely points to certain decisions in the investment process that are “outsourced” and somewhat passive i.e. someone is still making very active decisions around these. In Richo’s article, he will explore this thread in more detail as it is critical to this discussion and understanding that “passive” investing is actually a misnomer at best and a unicorn at worst.

There is a theme that I will point to throughout this article which is very important and I will introduce it here. Active investing is not a zero sum game. Although it deserves repeating, I will save the reader the drama. It deserves repeating because an important person in finance (a Nobel Laureate) titled one of his papers “Active management is a zero sum game”, and it has become the mantra of a legion of passive investors ever since, without an appreciation for the absurdity of the statement beyond a very narrow application, which is itself absurd.

I know that I should not be firing shots without backing them up, so follow my reasoning below.

I will begin the argument at the detailed level where it is typically used, and zoom out to the more general levels where it is never considered. The argument is typically made in the context that the average active manager cannot outperform the index, because the index is the average of all active managers. This seems innocent enough, but of course it is completely fallacious. There is no index without trading by active managers (and all other investors, lest we believe that the market only consists of active managers), so it is the index that represents the sum of what all investors are doing, not the other way around. Investors are somehow working to beat something that doesn’t exist until some action is taken. If everyone stopped acting at once, what would the index do? Nothing!

It is actually worse than just that, so let’s go back to my comment above in parenthesis and some of what followed, which I quickly glossed over. The index doesn’t actually average anything. I would be very happy to supply formulae for index calculation methodologies, but most of them do not involve any averages at all. In addition, active managers are by no means the only investors in markets. You have day traders, banks, corporates and other institutional investors and of course one of the biggest groups of investors, index
trackers (or passive investors). You could find (even though you do not) that it is the rest of the investors that are underperforming the index and not active managers (lest you believe that it can’t be passive investors because they really do give you the index).

Let us take a quick detour to have a quick look at this. I’ve chosen the Satrix ALSI Index Fund (not to pick on Satrix, but because they are probably the biggest and most well-known passive provider in SA). If I look at their latest minimum disclosure document (to April 2016), the fund has returned 13.21% p.a. for the three years versus 14.38% p.a. for the benchmark which is the FTSE/JSE 203 (the All Share Index). That is significant underperformance for someone who may believe that you can simply buy the index, but it is actually worse than you may think.

The performance of the fund assumes (you will find this on the third page of their document under Additional Information) that income reinvestments are done on the ex-div date. But the fund does not reinvest income on the ex-div date. It cannot, because it does not get paid the dividends until a couple of weeks later. The first page of the document shows (under Fund Information) that income is actually paid out as income declarations twice per year, which means that investors need to wait until they receive the income before they can reinvest it. The actual performance for the investor could therefore be quite different to the performance of the fund. To be clear, this is not necessarily different for actively managed funds, but the point I am highlighting here is the comparison between a passive fund and the index it is tracking (not between active and passive investing). Specifically, the index assumes dividends are reinvested when declared and that everything happens magically at zero cost, but passive managers have certain constraints that differ to this assumption.

Finally, have a quick look at the fees for investing in this fund. The total expense ratio (again on the first page under Fees) is 0.72% p.a. for the retail fee class. So unless the fund can outperform the index by 0.72% (which would be weird for an index/passive fund), you should begin with an expectation of underperforming by 0.72% p.a. if they delivered the index’s performance which they have clearly not done, having underperformed by 1.17% p.a. for the last three years using the reinvestment assumption.

South African listed equity probably represents the most liquid and efficient part of our market. Turn quickly to the bond market to see how much worse this can get. The Satrix Bond Index Fund aims to track the FTSE/JSE All Bond Index and although it was launched in December 2008, their minimum disclosure document does not show returns for three and five years. So we will look at one year return numbers. The fund has delivered 1.04% versus the index’s 1.75%, underperforming by 0.71% and a total expense ratio of 0.60%. The since inception numbers are actually even worse at 11.80% versus 13.48%, underperforming by a massive 1.68%. Again, my point here is around index trackers versus the index, not active versus passive, but in this case it is instructive to look at how active bond managers have performed over one year. Most active managers actually outperformed the same index over the same time period, after fees.

This is important because active investors are investing very differently to the index, even if some control their duration (interest rate sensitivity) positions relative to the index. Their outperformance is clearly attributable (at least in part) to credit risk. That said, this is what you want from active management, not just idiosyncratic risk (which I described in our last issue), but systematic risk if that is not available cheaply through passive investing.

Active investing as a positive sum game

Apologies for the long digression, but details are important and seldom considered. It is generally much easier to be intellectually lazy and regurgitate everyone else’s flawed arguments, than reasoning through problems carefully and doing the necessary research. Let us zoom out a little further and consider the broader benefits that all active participants bring to markets, adding further evidence against the “zero sum game” statement.

Markets represent one of man’s greatest innovations, going back to the dawn of man and the barter system. As these markets have become increasingly competitive, so too have they become increasingly
efficient, but this hardly applies to all markets all of the time. It should go without saying, but it doesn’t so I will say it here; you can’t have passive investing without a very active market (look at any alternative asset market if you are struggling to see this self-evident truth).

Markets provide many benefits including the transfer of goods, services and risk. Active investors represent the creators of markets. Insurance (or risk transfer) actually represents one of the most important features of capital markets (transferring risk from one person or organisation to another and from one point in time to another). Passive investors mainly take from markets, and provide very little in return. In economics, this is known as the “free-rider” problem. They “benefit” from the efficiency that sometimes exists in markets, while criticising that efficiency and not recognising the irony.

Although passive investing can provide some liquidity, this is generally very limited because by its very definition, the underlying shares should not be traded, except at the points of index rebalancing, when the liquidity provided is actually very concentrated. The liquidity at other periods merely represents money either flowing into, or out of, passive investing. It does not represent active trading opportunities. This brings us to the most important point around what passive investing does not provide (and which most active investors provide in boat loads – although not all do so), which is “price discovery”.

Passive investments are required (by definition) to get and remain fully invested, without concern for price. They need to perform in line with the index they are tracking. They therefore don’t provide price discovery in the markets, they are price takers and those prices are set by active investors. Active managers love passive investors, because they can trade against them. Passive investors actually make markets less efficient, providing savvy active investors with great trading opportunities.

This is why you will eventually find an equilibrium between active and passive investing (although this equilibrium could change over time), and why you will find a higher proportion of active investing in less efficient markets. For example, it should not be a surprise to find the highest level of passive investing in the US large cap space, and the lowest in emerging markets. Just look at how little is invested passively in African equity and how none is invested passively in private equity – which actually also talks to the point that you can’t have passive investing without active investors.

**Why passive?**

So why would anyone invest passively if so many negatives can be associated with it. Well, there are actually a couple of very good reasons, but none of them relate to the usual comments espoused by passive providers hoping to get you to invest passively. They represent the very reasons why we as STANLIB Multi-Manager do not have a passive range, but rather utilise passives within our portfolios and funds for our investors. We’ll unpack the reasons to invest a portion of your funds passively below:

> **To reduce the total cost of investing**

Most investors should only be concerned with net returns, without worrying about the absolute cost of achieving those returns as they are already factored into the net returns. Many investors do however have an aversion to high costs, especially when it is difficult to know whether future net returns will be higher or lower than passive alternatives. Going back to the Satrix passive example, would you rather have paid Satrix 0.72% p.a. for a 13.2% p.a. return achieved over the past three years, or Allan Gray 2.40% p.a. (more than three times more) for a 15.1% p.a. return achieved over the same period? Some investors will hate paying so much more, while others will be very happy to have made 1.9% p.a. more after fees i.e. they will have approximately 5% more in their bank or investment account.

Sometimes, there is a fee arbitrage opportunity within a specific market, where you invest a core portion of your portfolio passively at low cost, and the rest very actively at a much higher cost. This is a cost effective combination and provides the same expected return than the alternative of investing the entire amount with more benchmark cognisant managers at a higher average cost. We don’t think this opportunity exists in South Africa, so don’t follow this approach locally.
Lack of knowledge of the best active managers in the market

Individual investors in South Africa who do not know how to choose from over 165 equity unit trusts (including “passives”, may rather just choose to invest passively with one of the names they recognise). Institutional investors, could do this in foreign markets that they do not cover but would like to get exposure to. I.e. we don’t have the skill or capacity to ascertain who the best active managers are in Japan or China, so perhaps they would decide to invest passively there. Although this may appear to be sub-optimal (especially in less efficient markets where the biggest opportunities to invest actively lie), it is actually more consistent than drawing an active manager name out of a hat or worse, picking one based on past performance.

To create more “balanced” portfolios

There may be other opportunities on the continuum between passive and active (e.g. Smart Beta or risk factor investing) that allows us to create more balanced portfolios. By balance we mean portfolios free of unwanted systematic biases. For example, most South African active managers are underweight Naspers, partly because it is such a big weight in the index. Passive weighting to Naspers introduces substantial single stock risk to a portfolio. Smart Beta or risk factor alternatives may provide something in between. For example, up weight your exposure relative to active managers while still not giving you the full exposure that passive brings.

Another area where this has been particularly useful, is in our property portfolio which must be 100% invested locally (as it is used as an asset class building block for many of our other portfolios that may be getting their offshore exposure elsewhere). We’ve moved all of our passive exposure (about 15% of the total fund) completely away from the SAPY (South African Property Index) and towards the PCAP which places a greater weight towards inward listed property shares. This allows us to participate more fully in rand hedges in a portfolio that cannot invest offshore.

There are many other reasons to invest passively, but not once have I mentioned the usual rhetoric regurgitated around active managers underperforming some fictional index on average and ex-post (after the fact). Let us rather focus on doing the hard work of finding the opportunities for our clients and executing these cost effectively to deliver on their financial security.

Conclusion

Investors reading commentaries from professional money managers on either side of the aisle, are probably already sceptical about who is “right” and which arguments are valid. They probably remain confused however because of the amount of misinformation provided.

We prefer to understand markets and the opportunities provided by all market participants, and turn squarely to face our clients and investors to understand what they are trying to achieve. It is then easy to know how to build portfolios to meet investment objectives, instead of building strategies around what will attract the most assets and make us the most money.

We then do not need to pick sides, or provide a plethora of solutions to ensure we maximise the share of their wallets, but can rather focus on utilising all available options to maximise the chances of our clients meeting their goals/objectives. It also allows us to focus on the longer-term nature of these objectives, instead of the short-term nature of the latest rankings tables.

“We prefer to understand markets and the opportunities provided by all market participants and turn squarely to face our clients and investors to understand what they are trying to achieve.”

- Joao Frasco
Passives and Smart Beta widens our opportunity set

By Jennifer Henry, Portfolio Manager, STANLIB Multi-Manager Equity Fund

As portfolio managers within a multi-management business, it is our duty to consider the full opportunity set when constructing portfolios to meet client requirements or fulfill our mandates.

We are also in the differentiated position of being able to consider traditional assets such as equities, bonds and property, alternative assets or a variation on traditional assets such as the range of passive products from index replication through to factor or Smart Beta investing. Unlike a pure active single fund manager that is restricted to the traditional asset classes, a multi-manager can combine passive and Smart Beta with active managers provided that the client’s mandate allows it and there is a good rationale for blending these products with active managers.

How we think about active and passive opportunities

It is important to note that we assess the attractiveness of a manager or the construction of our portfolios from a variety of perspectives. For example, in constructing an equity fund, we assess an active manager’s ability and flexibility to source as many alpha opportunities as possible, particularly given that the South African listed equities market is relatively small.

This viewpoint came very much to the fore, after we completed an extensive round of due-diligences on the viable equity manager universe about two years ago and when we completed the same rigorous research two months ago.

We identified a perspective, which we call the ‘value-to-momentum’ continuum, and when we assessed managers according to this, we found that many active managers typically had a ‘valuation’ bias to their portfolios.

What this simply means is that most South African managers would buy a stock if it looked cheap relative to an in-house intrinsic or fundamental valuation, coupled with a margin of safety to account for uncertainty in the valuation.

It is important to state that we don’t box managers into this continuum, or expect them to stay at the same point in the continuum over time. Instead, we seek managers that explore every opportunity within our market, in an attempt to add value to their clients’ invested money.

We highlight that managers with a larger value-bias in their investment philosophy have avoided high quality stocks, because they typically trade at expensive multiples. These value-oriented managers have also sold out of winning stocks early and therefore have not benefitted from the price momentum that quality stocks have enjoyed. Another factor impacting on active managers is the composition of the SWIX index, which has a rather hefty weight to Naspers (ranged from 12% to 17% over the past year). Our buy-rated active managers have a strong risk consciousness and are reluctant to hold this stock at benchmark weight or overweight in their portfolios, given the absolute risk in the stock.

Therefore as a result of valuation bias coupled with issues around the SWIX benchmark, active managers on average delivered returns 4.6% and 1.6% behind the SWIX benchmark in 2014 and 2015 respectively.
Practical passive examples and learnings from implementation

To compensate for this value bias, we implemented a SWIX passive mandate in the STANLIB Multi-Manager Equity Fund to capture some of the momentum left on the table by active managers. Prior to implementing these passives, the STANLIB Multi-Manager Equity Fund had exposure to two Smart Beta products, which were implemented in March 2013, to get exposure to “value” and “momentum” risk premiums. Given the high tracking error of these strategies, they were implemented in much smaller weights in the Equity Fund.

We highlight for investors that the inclusion of passives with these smaller Smart Beta wings, blended with core-like and flexible active managers allowed us to create more balance in our Equity Fund. Overall the key learnings on the use of passive strategies have been:

→ Irrespective of the type of opportunity investors are considering, apply a consistent process in understanding the return and risk of those opportunities.

→ Passive investing may have inherent risks, and Smart Beta in particular could have high tracking errors, which needs to be considered carefully for benchmark cognisant investors i.e. those investors not able to tolerate massive underperformance of the benchmark.

→ Inclusion of passive mandates needs to have a sound basis for implementing within a portfolio, with a good understanding of the potential outcomes of the overall portfolio.

Another example of the implementation of passives within STANLIB Multi-Manager products is the inclusion of both the South African Property Index (SAPY) and Capped Property Index (PCAP) passives at different times, in our Property (domestic only) fund.

During an analysis of the property environment, we felt that active property managers had had a particularly good run versus the SAPY and that the alpha driven by capturing acquisition mispricing would have been limited. Therefore, we raised the South African Property (SAPY) passive exposure within the STANLIB Multi-Manager Property Fund.

The nature of the industry started to change as many inward listed property companies presented attractive fundamentals. These inward listed property companies usually own assets (shopping malls, offices etc) in countries such as Eastern Europe and the UK, that delivered good offshore earnings growth, and looked even more attractive as the rand weakened.

We also found that these companies were better represented in the Capped Property Index (PCAP) and we switched from the SAPY passive to the PCAP passive.

We believe that the implementation of passives in the Property Fund and thinking behind which benchmark to use driven by fundamental factors, well illustrates that passive in itself is an active decision.
In conclusion…

Passive and factor investing has been around for a number of years and at STANLIB Multi-Manager we have been an early adopter of these strategies and continue to use these additional opportunities to build the best possible outcome for investors.

While we highlighted learnings or outcomes from the implementation of passive investing, we stress that the full opportunity set needs to be reassessed continuously. For example, in a round of equity manager due-diligences in April 2016, we have found that more active managers are thinking about the quality angle of companies, which could imply less return from the momentum or quality factor in future years. This then requires a reassessment of our funds, in which passive mandates could play a role.

We strive to keep on top of these changing dynamics and will look to manage these passive positions, as actively as we have done in the past.
How should investors choose passive funds?

By Richo Venter, Head of Research and Development, STANLIB Multi-Manager

Active investing relies on a portfolio manager making share selections based on his or her view on which shares will out-perform in future. Passive investing is generally sold to investors as a cost efficient method to gain exposure to the market or sub sectors of the market, with no stock selection. “Smart Beta” (or factor) investing has been around for many years, but has recently gained more publicity. The debate about whether one should invest passively, actively or using Smart Beta is an on-going debate.

Picking active managers that will perform in the long run is not an easy task and requires specialised research and analysis. Similarly, certain Smart Beta products have outperformed or underperformed during different periods historically, while certain factors have been shown to outperform over the very long-term. Although we highlight some of the difficulties when investing in passive or Smart Beta products, we think there is a place in the market for all three approaches.

Passive investing - selecting an appropriate index and provider

There are various decisions an investor needs to make when investing in passives. Determining the best or most appropriate passive index for a particular investor looking into the future is extremely difficult.

As an example, over the past few years the JSE FTSE Shareholder Weighted All Share Index (SWIX) was the best performing broad based JSE index. With hindsight, tracking this index sounds very promising, but in reality it would not have been such an easy decision 10 years ago. At that point the majority of market participants benchmarked their investment returns relative to the JSE FTSE All Share Index (ALSI), which has subsequently underperformed the SWIX.

When investing in an index tracking portfolio or investment, various decisions need to be made:

- **Which index to track** - There are multiple indices to choose from in South Africa. Some of the broader indices include the well-known ALSI, the SWIX, MSCI SA Index as well as the S&P SA Index.

- **Full index or large caps only** – Both the ALSI and the SWIX have top 40 sub-indices, focusing on the largest 40 shares in the index. Selecting top 40 indices would give an investor exposure to the 40 biggest companies on the securities exchange. These blue chip companies are often thought of as stable. Small and mid-cap shares are typically more exposed to the local economy, while the top 40 shares are more exposed to the global macro environment. By choosing to invest in a passive product tracking any one of these indices, very specific biases are selected. When the SWIX is selected as a passive portfolio, an investor invests into a rand hedge industrial shares bias as well as a large single exposure to Naspers (which had an exposure of over 17% in the SWIX at the end of May 2016). This has been a winning formula in recent years, but could turn around in future. By investing in the ALSI, a higher resources positioning (resources are usually fairly volatile) is taken relative to the SWIX - quite an important decision that will affect the performance of an investment.
When looking at the risk and return graph below, it is evident that these large cap biases have come at higher risk in the longer term (since 2004), due to the lower diversification.

**ANNUALISED NOMINAL RISK RETURN SCATTERPLOT**

January 2004 to April 2016

- **Capped or uncapped indices** – Capped indices are also available on the ALSI and the SWIX, increasing the options even further. In South Africa, capped indices typically cap exposure to a specific share at 10%. Given the high exposure to a share like Naspers in South African indices, certain asset managers, including STANLIB Multi-Manager, have started promoting the idea of benchmarking performance relative to a capped shareholder weighted index. The S&P provides such an index, called the S&P DSW. A capped index isn’t a bad idea when trying to restrict large weights to single shares and improve diversification, but could underperform during periods when the largest shares perform exceptionally well.

- **Index provider** – The FTSE JSE, MSCI and S&P are all index providers in the South African market. Different methodologies are used, which could result in different return profiles between these indices.

Once an investor has decided which passive index to track, the next step is to pick an index tracker provider. The index providers we previously mentioned construct the index, while the index tracker provider is usually an asset manager or bank that creates products to track indices.

These products could be unit trusts, segregated accounts, exchange traded funds, policies of insurance or other creative solutions they develop. Although we will not cover these options in detail, it is important to note that all these options come at a cost, meaning an investment will underperform the index by the fee charged by the product provider as well as other costs associated with running the product, like trading cost. This cost, which can be significant, is often overlooked by investors when comparing returns of active managers to indices.

**Smart Beta - selecting appropriate factors**

As Joao explained in his article and as elaborated above, passive investing is an active decision and investors need to make many active decisions. Smart Beta or factor investing, increases the onus to make the correct decisions. Smart Beta product providers provide increasingly more choices for factor returns, like value, momentum, quality and many others, and this means that the decision making process becomes exponentially more difficult as the factors expand. The reason why the impact is also much bigger, is due to the fact that factors typically have large return dispersions relative to each other and passive alternatives.

For illustration purposes we compared various factor based indices and products below. From the S&P we included a low volatility index, a momentum index (which includes a low volatility component in their offering), a quality index as well as a value index. We also included the FTSE JSE value and growth indices.
as well as two factor-based strategies from Salient Quants (Value(S) and Momentum(S)).

While certain factors like momentum have outperformed the ALSI in the last couple of years, the old favourite value factors had a difficult time both locally and globally. As various researchers have shown over the years, the value factor can take a very long time to realise – very few investors can stomach 10 plus years of under-performance. Nobel Laureate and joint father of the three factor model, Eugene Fama, has said publicly on numerous occasions that it could take over 30 years for the “value” premium to outperform. Hardly something that should be relied upon heavily or in isolation when designing a portfolio to outperform over shorter periods.

So why not just invest in the recent winner, momentum?

The answer is simple, momentum does not always out-perform. During the 2008 global financial crisis, a typical momentum strategy would have lost approximately 46% of its value, while the SWIX lost 37%. During this period the low volatility factor followed by the value factor was the most defensive. The maximum drawdown chart below illustrated the worst drawdown for each of these factors since 2004.
As illustrated in the annualised nominal risk and return scatter plot, the low volatility and quality factors look very appealing over the time longer-term period under review, but there is no guarantee that these factors will continue to outperform over the next five, 10 or 15 years. Many active asset managers are of the opinion that shares in these indices are highly overvalued. Once an investor has decided on a factor to gain exposure to, it is still very tricky to decide on the definition of the factor. There are sometimes as many definitions of factors as there are managers and index providers using them.

As an example, the well-known value factor can be constructed in many different ways. You can invest based on low price-to-book ratios (originally defined by Fama and French in their seminal 1992 paper), low price-to-earnings ratios, low price-to-cash-flow ratios and many more. Various combinations of factors are also offered by asset managers, typically as a response to the low predictive power of single ratio definitions. Some managers also try to time which factors will outperform in various periods, often with limited success. There are many construction methodologies applied around the globe and in South Africa and all of these decisions will result in differences in performance.

An investor needs to decide which methodology he wants to invest in, hardly a passive decision, and sometimes a more active decision than giving your money to a good equity manager and letting them make their choices.

Similar to passive investing, an investor will incur various costs when buying Smart Beta products. These costs include transaction fees as well as asset management fees. Smart Beta products may have much higher turnover compared to both passive and the average active equity fund, resulting in higher transaction fees, which can impact returns significantly.

Conclusion

In conclusion, various decisions are required by an investor when investing in either passive or Smart Beta products. The wrong decision could result in an investor not meeting his investment objectives or expectations. Investing in unintended bets can also be the trap of these strategies, as we illustrated with the 17% exposure to Naspers in the SWIX. Although Naspers is a well-diversified global company, few investors have the risk appetite to invest such a large percentage in one share. The return dispersion between Smart Beta products is even bigger and certain factors have shown to have much larger drawdown than a broad equity index, which might not be suitable for all investors.

We reject the traditional approaches of believing that one approach is better than another, and take the challenge of doing the hard work of researching all available options, head on.

At STANLIB Multi-Manager, we believe in combining the strengths of active managers with carefully selected passive and Smart Beta strategies to create the optimal risk-adjusted return portfolio at competitive fee structures, which we think is the winning strategy to achieve an investor’s long-term investment objective.
Active vs passive - it is both and... not either or

By Kent Grobbelaar, Head of Portfolio Management (Offshore), STANLIB Multi-Manager

“My advice to the trustee couldn’t be more simple: Invest in a low cost index fund. I believe the long-term results will be superior to those attained by most investors – whether pension funds, institutions or individuals – who employ high fee managers”.

Warren Buffett

Doesn’t this quote from the 2013 Berkshire Hathaway report make you think of the song; “Isn’t it ironic”? If Alanis Morissette released her chart topping single 15 years later, there is a chance the lyrics would not start off with a 98-year-old man winning the lottery and dying the next day. Instead it might be about an 83 year old endorsing an Exchange Traded Fund despite being the most successful active manager of all time. The objective of this article is to provide insight into the inclusion of both passive and active investments within global portfolios.

Background

While the advent of a stock market index such as the Dow Jones Industrial Average can be traced back to 1896, it wasn’t until the 1950’s when Markowitz introduced the world to Modern Portfolio Theory, and Fama in the 70’s who presented us with the notion of the Efficient Market Hypothesis, that the basis for investing in a style that today is commonly referred to as passive was born. Subsequently Malkiel and Ellis both put forward the case for investing in indices calculated on a market cap basis as an alternative to an active manager.

There are an infinite number of ways in which one could specify the constituent weights in an index so despite the debate around what constitutes passive, we subscribe to what the finance industry means by beta. In this regard we assume it is the risk one takes when investing in an index tracking fund where the constituents are weighted according to their market capitalisation. There is also sufficient academic evidence to support an alternative source of return where risk premia can be harvested systematically. We have lumped all of these factors together into a separate bucket called alternative beta.

The decision tree for investors therefore looks something like the diagram below:
A swing and a miss

Let us try understand why the Sage of Omaha (Warren Buffet) may have made the aforementioned comment. To do this we look at SMMIS - GE (STANLIB Multi-Manager Indicator of Success – Global Equity). In the table below SMMIS compares global equity portfolios in the Morningstar database and highlights the number of funds in the universe, the average relative performance and the percentage of funds that beat the benchmark.

<table>
<thead>
<tr>
<th>Year</th>
<th>% of funds beating the benchmark</th>
<th>Number of funds</th>
<th>Average relative performance</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>14.8</td>
<td>2534</td>
<td>-5.4%</td>
</tr>
<tr>
<td>2012</td>
<td>30.9</td>
<td>2612</td>
<td>-2.0%</td>
</tr>
<tr>
<td>2013</td>
<td>23.4</td>
<td>2598</td>
<td>-5.0%</td>
</tr>
<tr>
<td>2014</td>
<td>15.8</td>
<td>2376</td>
<td>-4.9%</td>
</tr>
<tr>
<td>2015</td>
<td>31.1</td>
<td>2466</td>
<td>-2.1%</td>
</tr>
</tbody>
</table>

Benchmark: MSCI AC World NR, Vendor: Morningstar, Universe: Global Equity, Source: FundQuest

From this it is clear why Buffet could have made the statement. Take 2011 as an example - only 14.8% of the 2534 funds beat the MSCI AC World Index after fees. On average they underperformed by 5.4%.

Similar results which back up our analysis can be found in the S&P SPIVA scorecards. The US (which represents half of the world’s stock markets) highlights 84.2% of mutual funds underperformed the S&P 500 over the last 5 years.

To be clear this does not mean active managers cannot add value - not all managers are average (see example below) and it only takes into account the most recent cycle whereas we prefer looking at five or six cycles going back to the 70’s.

Also note 100% of cap weighted passive managers would under-perform after fees, spread costs, index rebalancing charges, withholding taxes and admin expenses as well as trailer commission.

Portfolio construction

We believe the magic lies in how you pull the opportunity set together into a solution for clients. Let us start with the passive decision, should you go with a market cap or alternatively weighted vehicle? We think the latter. Take the value premium as an example, a patient investor would have been rewarded over the long-term by investing in value stocks passively. The graph below indicates that value has outperformed.

The problem is the risk of relative drawdowns is material. After all, academic theory suggests a premium usually exists as a result of a risk. So while alternative beta indices have the potential to provide outperformance, we need to carefully analyse and manage risks. Index providers spend a lot of time comparing their indices’ performance against cap-weighted counterparts but rarely take into account tracking error risk budgets.

In this regard if one looks at the graph below, you will see that the magnitude of the downturn in value, on a rolling 10 year basis, was around 30% when the Tech bubble burst in 2000 and post the financial crisis in 2007.

An additional challenge is that due to the poor performance of active management, there has been a flood of money into Smart Beta funds. In fact new product launches have dwarfed almost every other fad.
Maybe it is too early to call, but our sense is there is a risk of a bubble brewing in this space. Consequently, valuation levels of certain factors are elevated, which in turn could reduce future return potential or increase risk if we see mean reversion. Of all the recognised premia, only value stands out as cheap – see below.

A word of caution therefore is to consider the herd mentality as many factors have rerated.

Our approach would be to target a factor, which is robust over numerous decades, supported by academic research, applicable across regions and importantly, cheap/ripe for harvesting. Take a look at Richo’s article where he elaborates on how to choose its own history. The line endpoints indicate historical minima and maxima.

The other side of the equation is how to blend the passive component of your portfolio with active managers. We think it should ideally compliment what your stock pickers are doing. As an example we have taken one of our managers (Capital) which has a similar, albeit better, long term track record to the aforementioned premia value index.

At the moment, Capital has a structural overweight to Technology companies and is underweight more cyclical areas of the market such as Materials. You will see from the portfolio skyline below, the blue bars show their anti-value orientation while the green bars confirm the growth bias. If one drills down further though, there are a few other factors to consider such as a small cap (orange), momentum (black) and quality bias (debt to equity in yellow).

If in the above example we blended this active manager with a value weighted passive mandate, the diversification benefits become even more apparent if one looks at the matrix below showing the negative correlation of value to the aforementioned exposures of momentum and quality.

<table>
<thead>
<tr>
<th>Portfolio style skyline</th>
<th>Minimum volatility</th>
<th>Value weighted</th>
<th>Quality</th>
<th>Momentum</th>
<th>Risk weighted</th>
<th>High dividend yield</th>
<th>Equal weighted</th>
<th>Quality mix</th>
<th>High dividend yield</th>
<th>Risk weighted</th>
<th>Equal weighted</th>
<th>Quality mix</th>
<th>Value weighted</th>
<th>Momentum</th>
<th>Risk weighted</th>
<th>High dividend yield</th>
<th>Equal weighted</th>
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</thead>
<tbody>
<tr>
<td>Minimum volatility</td>
<td>100</td>
<td></td>
<td></td>
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<tr>
<td>Value weighted</td>
<td>-0.42</td>
<td>1.00</td>
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<tr>
<td>Quality</td>
<td>0.52</td>
<td>-0.71</td>
<td>1.00</td>
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</tr>
<tr>
<td>Momentum</td>
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<td>-0.46</td>
<td>0.36</td>
<td>100</td>
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<td>0.26</td>
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</tr>
<tr>
<td>High dividend yield</td>
<td>0.51</td>
<td>0.41</td>
<td>-0.07</td>
<td>0.18</td>
<td>0.42</td>
<td>1.00</td>
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<tr>
<td>Quality mix</td>
<td>0.36</td>
<td>-0.37</td>
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<td>0.30</td>
<td>0.32</td>
<td>0.35</td>
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<tr>
<td>Equal weighted</td>
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<td>0.01</td>
<td>0.62</td>
<td>0.12</td>
<td>0.23</td>
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</table>

One final thought on portfolio construction; debates have centered on whether active is better than passive but maybe the focus needs to be on periods when active managers are more likely to outperform. The outcome for active managers is after all partly dependent on the available opportunity set and there is evidence they can generate outperformance when cross sectional volatility rises. We have tried to take advantage of this by dialing up our active exposure.
Conclusion

“The stock market is designed to transfer money from the active to the patient.” - Warren Buffett

Note Buffet’s quip is not about transferring money from the active to the passive. It is about being patient. We believe combining the right passive (if you want to define it loosely) whereby you implement rules based, transparent and low cost exposure, with proven active managers is a winning strategy. The caveat being one must adopt a holistic approach and portfolio construction is vital.

Before implementing alternative beta solutions, one needs to consider the change in the value chain. Instead of sub-delegating to a manager, the responsibility shifts up a level to the investor and you need to be aware of the risks. On a relative basis it is possible that investors are overpaying for exposure to certain factors and are leaving opportunities on the table.

Utopia in implementation would be a completion portfolio which decreases risk while enhancing return.

We believe it is possible to combine active and passive smartly but think the process needs to evolve whereby you should swing the guns in favour of a particular style depending on the opportunity set.
STANLIB Multi-Manager

Diversification beyond asset classes