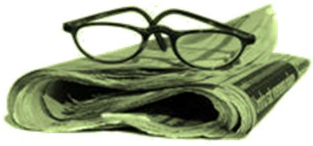
Investment Update

2018.03



PASSIVE INVESTMENT STRATEGY:
THE ANSWER FOR A 'SAFE' RETIREMENT?

Introduction

The fierceness of the debate between proponents of passive investment management principles and active investment management principles on whose approach is better suited for retirement savings has been heating up gradually over the past two decades.

Events over the past year has again focused the spotlights on this debate.

Before we dive into the merits of the respective arguments, let's recap what exactly these two investment management principles are.

Simplistically put, active investment management focuses on <u>outperforming</u> the market compared to a specific benchmark, while passive investment management aims to <u>mimic</u> the performance of a particular index.

However, both concepts are far more complex that this basic explanation suggests.

The illustration by Colin Daniel in Personal Finance on 14 November 2017 offers a humoristic view of the common perception of Active vs Passive Investment Management styles:

Active Investment Management

This approach is often regarded as the domain of hubristic stock pickers who believe that they have superior foresight than most when it comes to selecting stocks that will outperform over a given period of time.

Such foresight is usually (hopefully?) the result of comprehensive (and often expensive) research and should lead to performance in excess of whatever benchmark was agreed upon.

When this does not happen, the investor is usually provided with a comprehensive (or should I say complicated?) explanation as to why the active manager did not achieve the result it was paid for.

Research conducted by S&P Dow Jones Indices in 2016 proved that only 10% of active stock managers in the US managed to achieve the benchmark return over one-, five- and ten-year periods. The same research found that one of the leading causes was the relatively high fees charged by the active stock managers sampled.

So, it would appear that while all the asset managers were paid what was agreed, a staggering 90% of them did not deliver to their clients what they were supposed to.

If you are a client of the 10% of active managers that achieved or outperformed its benchmark, it would not be surprising if you ascribed it to your own foresight in selecting one of the better active managers, and would suggest the argument for passive investment is irrelevant.

For the clients of the remaining 90% that are die-hard proponents of active investment management, the most obvious remedy would undoubtedly be to terminate the services of the underperforming asset manager and move to another in the hope that the new appointee would achieve the benchmark in the future.

This investor behaviour of selecting the active investment manager with the best performance in the most recent surveys to replace the non-performing incumbent is unfortunately often as destructive as the underperformance of the incumbent.

This is a sad indictment of the inability of many investors (and investment advisors alike) to consistently select the best active managers for the right reasons.

So, in defence of active investment management, it is fair to say that fees and investor behaviour are probably the two factors that have played the leading roles in giving active management such bad reputation over the years.

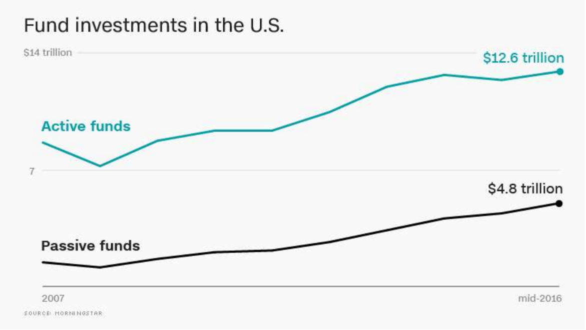
Furthermore, one of the arguments prove that active investment management has become irrelevant. It remains our view that there is still a significant role for active investment managers in the retirement savings industry.

Passive Investment Management

Passive investment management is often seen as the "less risky" or "boring opposite" of active investment management. It is however not necessarily the case.

The last 3 decades has seen the passive investment industry evolve into a very sophisticated market that offers a plethora of different avenues and methodologies through which some form of passive investments can be facilitated.

Unsurprisingly, the amount of investment flows into passive investment products now exceeds the inflows into the traditional active investment products.



The principle underpinning passive investments or index tracking investments is to invest in something and to then hold it for the duration of the investment horizon.

It is, however, important to differentiate between the principle of passive investment management and that of passive investment products (index tracking products).

Many self-titled passive investment managers use passive index tracking products as the building blocks of their investment offering, but by making regular changes to the proportions of each index tracking product that they invest in (referred to as tactical asset allocation), they are in effect behaving like active managers.

Experience has shown that these managers' investment products often end up achieving the same risk and return characteristics as that of the active managers, albeit at the lower costs usually associated with passive investment management.

It is our view that it is inaccurate to refer to such products as passive investment products.

To be regarded as truly passive, the investment product must set and maintain a long-term strategic asset allocation based on the required risk vs return characteristics and should not engage in constant tactical manoeuvring of the allocations to the asset classes. In other words, it should not try to time market movements.

This requires a buy-and-hold mentality. That means resisting the temptation to react or anticipate the stock market's every next move.

It also means that the investor using a truly passive investment product should be satisfied with earning only the return of the index (or basket of indices) that the product is tracking, as the product's aim is not to generate any return in excess of that index.

The benefits to the investor are returns that are aligned with the index and costs that should be significantly lower than that of the actively managed portfolios.

In other words, the volatility of returns of a passively managed investment product relative to "the market" should be much lower than that of an actively managed portfolio.

There are, however, a few health warnings when it comes to passive investment products that investors need to look out for:

1. Interrogate the fee structure thoroughly - including the hidden transactional and holding costs that are often only disclosed in the fine print.

2. Ensure that you understand whether the product is fully passive or whether the investment manager has tactical asset allocation discretion. Any such discretion may significantly alter the risk profile of the investment product.

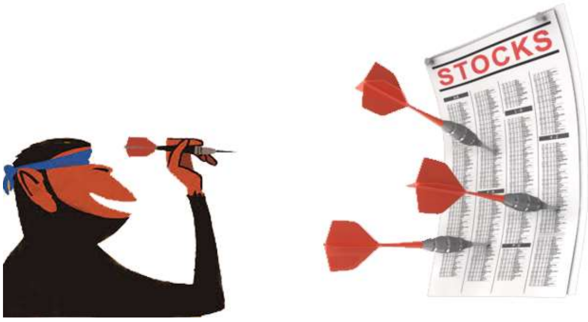
3. Make sure that you are tracking the correct index. Investors in passive investment products often misinterpret the risk profile of the index their selected product is tracking. The proliferation of indices requires active thought by the investor to ensure that he / she understand the true underlying risk profile of their selected product.

4. Appreciate that you will have to ride the depths of the market throughs as well as the highs of its peaks peaks during times of volatility.

5. Appreciate that you will be exposed to the full basket of the index(es) that you are attempting to track. If any component thereof implodes (for example Steinhoff in December 2017), you will be exposed to the associated losses.

The Rise and Rise of Passive Investment Management

In 1973, a Princeton Professor in Economics made the wild suggestion that "*a blindfolded monkey throwing darts at the stock listings*" could do as well as a professional investment manager when it comes to stock picking.



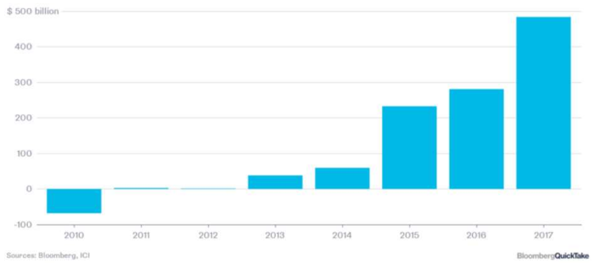
His argument did not suggest that no manager would outperform the group, but rather that as a group, they would achieve the same results as the market, minus the fees they charge.

As alluded to earlier, many studies over the last 30 years have proven that only a very small proportion of actively managed portfolios consistently outperform the indices or basket of indices they use as benchmarks.

This argument lead to the development of the first index-tracking fund in the 1970's, followed later by Exchange Traded Funds (ETF's).

With technological advances the variety and complexity of the passive investment management industry has seen a massive tide away from traditional actively managed portfolios to products marketed as passive investment products.

According to Bloomberg, the flows out of active and into passively managed portfolios reached nearly $500 billion in the first six months of 2017.



By December 2017, more than a third of all assets in the U.S. were invested in passively managed investment products, up from about a fifth a decade ago

In Europe, passive investing's market share has doubled over the past decade, but to only 15%, with the rise primarily driven by institutional investors, according to Morningstar Inc.

In South Africa we have over 100 collective investment schemes that regard themselves to be "passive", but it has not yet garnered as much inflows as their US and European counterparts.

So, which is best – Active or Passive Investment Management?

In investment jargon, the performance of "the markets" is known as "beta". Any performance above "beta" that can be attributed to the skills of a fund manager is known as "alpha".

In his 1991 book, The Arithmetic of Active Management, William Sharpe eloquently (and very logically) explained the two types of investors:

- Passive investors that earned beta; and
- Active investors that, on average, also earned beta.

He explained that active investors on average had zero-sum returns because for every winning holding there would be a loser to offset it. And since active investment comes with management fees, active offerings would therefore underperform their passive rivals.

This argument was however based on the theory that "the market" (the basket of stocks than make up and index) will remain constant over time. This is, however, not the case.

Furthermore, whilst passive investment management requires less active buying and selling of stocks, it will never fully eliminate the need for the investor to make decisions relating to things such as their financial goals, retirement contributions, diversification, asset allocation, investment options and benchmark selection.

Whilst few domestic actively managed portfolios can claim to consistently achieve alpha, there is a handful in the South African asset management industry that have consistently done so.

There are however far more that have not, and this is without counting those that have ceased to exist due to attrition over time.

Therein lies the difficulty for the investor – how do you ensure that you select the active manager that is able to provide alpha in the future (as opposed to selecting the one that has done it in the past)?

Retirement fund trustees must seek proper advice to help them navigate the investment decision-making processes.

The chart below (sourced from Hartford Funds' research paper entitled "The Cyclical Nature of Active & Passive Investing") provides sufficient evidence that the relative performance of active vs passive investment management is cyclical in nature.

12/31/1985 to 12/31/2017 Rolling Monthly 3-Year Periods

Data Sources: Morningstar, 12/31/17

Ensimini's House View

Based on our extensive research on this topic, it is our view that neither of the strategies are superior to the other. The question should not be a case of which strategy to select, but rather what the appropriate combination of the two strategies should be in a client's portfolio.

Ensimini's house view is based on selecting the appropriate combination of actively and passively managed structures for each asset class in a client's portfolio.

The result of this combination has been able to consistently deliver returns in excess of the benchmark at lower risk than actively managed portfolios (and in fact also lower risk than a few passive-only managed portfolios).

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Our team of experienced investment professionals have succeeded in developing robust investment policies and strategies that have consistently achieved the risk and return objectives of our clients.

We are advisors to retirement funds with a total combined asset base in excess of R2.5 billion.

Feel free to contact our investment consulting team to discuss your needs or if you require more information.

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Prepared by:
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