OCKHAM’S RAZOR AND INDEX INVESTING – THE SIMPLEST INVESTMENT SOLUTIONS ARE OFTEN THE WISEST.

William of Ockham, the 14th century logician, philosopher and Franciscan friar, if he could, would have been an index investor. He was best known for Ockham’s razor or the law of parsimony, a principle for decision-making that stems from logic. In philosophy a razor is a principle or rule of thumb that allows one to eliminate or “shave off” unlikely explanations or phenomenon. The principle states that among competing hypotheses leading to the same outcome, the one that is simplest should be selected. It is a heuristic problem-solving technique that has applications in fields as diverse as medicine, religion, crime and literature. For example, scientists with their preference for parsimony use the simplest means for arriving at their results and exclude what is not necessary. This can be applied as well to the field of savings and investments, where the preference for simplicity is a positive development for the growth of index investing. Index investing is the simplest, cheapest and most efficient strategy that can be used to reach your financial goals.

The hard facts

Investment managers in South Africa have been increasingly criticized in recent years for failing to significantly outperform the market index. They have on average underperformed both the FTSE/JSE Africa All Share and Shareholder Weighted indices, the country’s equity benchmarks, after fees. As a result, many investors are now indexing a portion of their equity allocation.

Index investing is called “passive investing” as the managers of index funds do not have to do much. They simply buy exposure to the stocks in the market index, a diversified basket of stocks with the largest companies receiving the largest weighting. Active managers do not want to buy all the stocks in the market or weight stocks in this way. Instead they do research on companies and try to untangle the web weaved by accountants and corporations, trying to predict the future value of investments. They gather their best ideas and buy what they find attractive. They are called “active” because as information and market prices change, their best ideas change, and this involves frequent buying and selling. Yet history has shown us that these best ideas have not significantly outperformed the market.

Analyzing the returns over the last ten years to July 2016, managers in the Alexander Forbes SA Equity Manager Watch Survey on average earned an annual alpha (return in excess of the market index return or benchmark) of only 0.38% before fees. We see this pattern for several shorter periods too, including five year and three year periods where the average annual alpha was negative at -0.98% and -1.01%. Those that have outperformed have provided excess
returns not significantly larger than zero after fee charges. The activities of active managers are expensive. Their costs are at least 1% higher than passive funds. Yet in South Africa most money is run by active managers. With active managers persistently failing to beat the market, investors need to know more about indices and the investment options available.

**A simple way to beat the average investor**

Index investing provides a simple way for you to beat the average investor. This was highlighted by American economist and Nobel Prize winner William F Sharpe in the early 1990s. He said that in any given time period, the average actively managed dollar and the average passively managed dollar will get the same return before costs.[3] This follows not from using any higher level mathematical or finance theory but by using very simple arithmetic. The market return is the weighted average of the returns of the stocks within the market. This means that the market return must also equal the weighted average of the returns of active and passive managers in the market. We know that before costs, passive managers will provide market returns. It follows by the arithmetic of averages that active managers will get the same return as passive managers before costs. Since actively managed funds have higher costs, on average they will provide lower returns after costs. What this means is that a person saving for retirement is better off choosing low-cost investments instead of higher cost ones. While a few managers will beat the market after costs, it is difficult to identify the winners in advance, as past performance is not an indication of future performance. This is due to the fact that many investors who were past winners were simply lucky. Adding to this, competition and arbitrage between investors results in prices adjusting with previous winners fast becoming losers and vice versa. So investing with winners after a streak of good performance may not be the wisest decision. To minimize costs as well as the risk of selecting the losers, many investors share their allocation between active managers they believe will outperform the market and index managers that have proven their skill in delivering market returns.

Another strategy we see more often now is investors allocating between different types of index funds. With the growth of indexation, indices no longer just reflect the markets, but offer solutions that may outperform the market. These are weighted using factors like value, momentum, quality, size, growth and volatility as alternatives to a market cap weighted index. They have the potential to outperform markets over the long term at considerably lower costs than traditional active management.

**Prescient offers indexation as a low risk solution**

Prescient manages index or enhanced index funds on any replicable benchmark with reasonable liquidity. Our dedicated investment team has over time proven its skills in indexation. We provide efficient and cost effective exposure to a market index, factor/style index or any customized client index. Portfolios are structured to match the performance of a
benchmark, and low risk enhancements, appropriate to the client’s specific risk tolerance are then made, delivering modest returns that offset both management and trading costs. Targeting index returns after costs gives Prescient an advantage over traditional index trackers, as keeping the costs of implementation and services lower results in more value passed on to investors.

Ends

References


For media interviews:
Monique Martheze
PR/ Media
Email: monique.martheze@prescient.co.za
+ 27 (0) 21 700 3663

About Prescient

- Prescient’s subsidiaries include: Prescient Investment Management (SA), Prescient Securities, Prescient Management Company, Prescient Life, Prescient Fund Services, Prescient Fund Services (Ireland) Prescient Wealth Management, Prescient Profile, and EMHPrescient Investment Management.
- Prescient Investment Management is a signatory to the United Nations Principles of Responsible Investing (UN PRI) and pledged to the Codes for Responsible Investing in South Africa (CRISA).
- The Prescient Global Income Fund, now known as the Prescient Global Income Provider Fund, was ranked by Morningstar as the 7th top performing fund for 2015.
• More recently, the Prescient Income Provider Fund won the Raging Bull Award for the Best South African Multi-Asset Income Fund, Best South African Interest-Bearing Fund as well as a certificate for the Best South African Multi-Asset Income Fund on a risk – adjusted basis over five years to December 31, 2016.

• Morningstar data also confirmed that The Prescient China Balanced Feeder Fund has been the top performing South African domiciled fund for the second year in a row.

• Prescient Investment Management was the first institution in Africa to be granted a Qualified Foreign Institutional Investor (QFII) licence by the China Securities Regulatory Commission (CSRC).

• Prescient Investment Management was named Overall Investments/Asset Manager of the Year at the Imbasa Yegolide Awards 2011, Absolute Return Manager of the Year in 2013 and Bond Manager of the Year and Responsible Service Provider of the Year in 2015.

• The full details and basis of the award can be obtained from the fund manager.

• For any additional information such as fund prices, brochures and application forms, email info@prescient.co.za or visit www.prescient.co.za

• Prescient Investment Management Ltd, is an authorised financial services provider (FSP 612). Collective Investment Schemes in Securities (CIS) should be considered as medium to long-term investments. The value may go up as well as down and past performance is not necessarily a guide to future performance. CIS’s are traded at the ruling price and can engage in scrip lending and borrowing. Performance has been calculated using net NAV to NAV numbers with income reinvested. There is no guarantee in respect of capital or returns in a portfolio. Prescient Management Company (RF) (Pty) Ltd is registered and approved under the Collective Investment Schemes Control Act (No.45 of 2002). For any additional information such as fund prices, fees, brochures, minimum disclosure documents and application forms please go to www.prescient.co.za