PRESCIENT

INDUSTRY TRENDS

By Monei Pudumo-Roos, Head of Institutional Development and Executive Director at Prescient Investment Management

There has been an escalation in the debate about the relative merits of active and passive investing in the South African equity market.

Domestic and global research show that it is increasingly difficult for active equity managers to outperform passive market indices. For example, data from the S&P Dow Jones Indices LLC show that only 13.5% of South African equity managers outperformed their passive benchmarks over the last five years, while this number is as low as 3.5% globally.

If most of active equity managers underperform passive benchmarks, and given that they generally charge higher fees, it is tempting to conclude that employing a passive strategy should be the preferred solution for most of those looking to invest in the equity market.

We have recently seen demand for more passive funds as asset aggregators incorporate or at least consider passive solutions in their investment strategies.

There are three reasons why this should be the most logical thing to do;

- Passive strategies are transparent as the portfolio allocation is not discretionary.
- Passive solutions are inexpensive compared to active investing since there is no need to analyse securities in the index.
- Passive solutions are generally tax efficient as infrequent rebalancing is unlikely to trigger huge annual CGT bills for voluntary money.

Despite these undisputable benefits of passive over active investment styles, the major downfall of passives has tended to be overlooked by market professionals.

The major weakness of a pure passive approach to investing is that the investor is guaranteed to underperform the benchmark after investment management fees and other transaction costs are considered. Put differently, the return to a passive investor should roughly equal the benchmark return, minus the total investment cost.

In our view, both active and passive investment styles have significant drawbacks and deciding on whether to use active or passive funds is largely a matter of belief rather than hard evidence.

While Prescient Investment Management finds the passive-active debate relevant, we believe that there is another avenue that has been overlooked. Acknowledging that the debate between active and passive may never truly be settled, investors should instead sidestep the acrimony and embrace a simple approach that blends both to build a better portfolio.

In our experience, combining aspects of both investment styles results in better control of active risk, while significantly reducing total investment costs.

Our research suggests that adopting a long-term, strategic framework to blend passive (core) and active (satellite) is more efficient than trying to uncover which style works best. Each investment strategy has its merits and shortcomings (elusive alpha and high management fees for active strategies, and guaranteed underperformance after fees for passive solutions), suggesting that the most robust portfolio should be a combination of both. The allocation between the two will depend on the investor's risk tolerance and objectives.

Although the core plus satellite framework seems to resolve the debate about active and passive, there is another angle where this solution is even more compelling.

Let us suppose that for a 1% annual management fee an investor awards an equity mandate to a value manager where the investor has a 3% tracking error constraint around a given benchmark (for example, Capped Swix). Although simplistic, this example encapsulates the main features in actual active investment decision-making.

Now assume that the value manager has proven skill in selecting good value stocks that generate above market returns. However, given the 3% tracking error constraint, it is unlikely the manager will only bet on his proven skill set, opting instead to make use of an optimiser to construct the final portfolio that loads heavily on his views but that respects the investment policy guideline of the tracking error.

How different is this final portfolio from the benchmark? How much do the portfolio's holdings differ from the constituents of the benchmark index?

When a manager overweighs a stock relative to its weight in the index, there is an active long position. The summation of all the active long positions and the absolute value of the summation of all the active short positions divided by two (to avoid double counting) gives the percentage of active share of a portfolio.

Our experience shows that for such a portfolio, the active share component is generally around 25%. Alternatively, the value manager has a portfolio that mimics 75% of the benchmark while holding only 25% of shares that reflects his views.

Although the manager was paid an active fee, a sizable portion of his final holding is direct exposure to the benchmark. We believe this to be wasteful and would suggest that an astute investor should separate the core and the satellite elements to achieve a cost-effective portfolio while attaining the same tracking error of 3%.

The art of combining active and passive therefore lies in the investor's risk budget, which will inform the allocation between the active and passive investment strategies. In so doing, there is greater transparency between the investor and manager, helping to better manage the investor's expectations. The point is that the allocation must be managed in a more innovative manner, without taking excessive risk to at least return index performance after investment management fees.

The active portion should therefore be allocated to the market risk that the investor intends to gain exposure to. There are a number of well documented and proven risk premia and there are different equity investment styles such as value, momentum and market beta.

This makes it easier for the investor to hold the manager accountable. More importantly, the approach leads to significantly reduced investment management fees at a time when fees are in the spotlight in the industry.

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Monei joined Prescient in June 2010 and was appointed as a Business Development Manager at Prescient Investment Management. In her current role Monei is responsible for client service and retention as well as growing the institutional business for the company. She has over 15 years' experience in the investment management industry.

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