A STEP AHEAD OF ENHANCED INDEXATION.

Rupert Hare, Quantitative Analyst at Prescient Investment Management, says savers don't need to choose between taking the escalator or the stairs to reach investment nirvana.

Conventional wisdom holds that passive funds are the answer to the problems of high costs and modest returns that plague many active asset managers. The result has been a profound change in the investment landscape, in South Africa and internationally, with large fund flows diverting to passive vehicles – especially exchange traded funds.

Exchange-traded funds that track an underlying index have experienced exponential growth in popularity because they offer diversity at lower cost, and with minimal effort.

What we've found, however, is that by approaching the problem from a different angle, it's possible to combine the best of active and passive investing to create portfolios designed to marginally - but consistently - outperform pure passive investment strategies over time.

Prescient Investment Management's approach involves combining the strengths of passive investments – low fees, low transaction costs and a low tracking error – with those of active strategies. The latter having the potential to deliver additional alpha, representing out-performance of the portfolio relative to its benchmark, while facilitating efficient allocation of capital and capturing market dislocations.

The result of combining the attributes of passive and active management in this way is a portfolio with highly efficient market exposure and that's cheaper than both active and passive but with a consistent performance sweetener.

The multi-asset high equity environment is very competitive with some 250 funds vying for attention. In terms of setting ourselves apart in this environment, we start by building a solid foundation in our portfolios using robust longer-term strategic asset allocations to asset classes.

Strategic asset allocation starts by considering the expected long-term returns from various macro asset classes, including equities, bonds and cash, but no single stock bets. Long term return expectations are built using a risk premia approach, which operates on the premise that investors demand a return premium for additional levels of risk in different asset classes. For example, an investor would not invest in higher risk emerging market equities in preference to a money market investment if the emerging market equities did not have a higher level of expected return in the long run.

In terms of enhancements over pure passive via active tactical asset allocations, Prescient's process is run via a systematic process that scores asset classes based on over 400 different metrics to produce signals of *significant* market dislocations. These tilts are only taken when the signals all align for an asset class - for example, in the past year the Prescient Balanced Fund has taken only 6 tilts based on high conviction signals, and those tilts are only marginal shifts away from the portfolio's foundation. This reduces trading costs significantly - amongst the 250-odd funds that make up the Association for Savings and Investment South Africa (ASISA) multi-asset high equity category, Prescient's fund - with a target of CPI plus 6% - is the fourth most cost-effective based on Total Investment Charges (TIC).

Achieving a "best of both" outcome requires delivering enhanced alpha through the effective allocation of capital, in conjunction with shorter-term market dislocation trades. Prescient's approach is the idea of 'portable alpha', alpha being the additional return achieved, either positive or negative, relative to the benchmark index.

Some asset classes are notoriously difficult when it comes to generating alpha. For example, more than 75% of active equity managers have underperformed in the South African market over the last ten years. In the income fund space, however, the majority of fund managers can outperform the prevailing money market rate. This is key to our process is that we leverage off of our well known in-house fixed income capabilities to generate excess returns and 'port' it on top of equity returns. This involves investing the capital amount in the income fund and obtaining the equity exposure synthetically by purchasing an equity index futures position on the benchmark index.

The structure, although simple and reliable, requires considerable knowledge and oversight with an asset manager who has specific capability in both derivatives and fixed income. On the upside, the process can lead to much more consistent outperformance relative to active management investment in the equity space.

Prescient differs from peers in that many equity houses have built their multi-asset process on top of an existing equity process, taking their existing equity portfolios and adding other assets on the fringes. We believe that our approach is more efficient with insignificant single stock exposures to the likes of Steinhoff, while delivering added alpha over the index. Importantly, the portable alpha component has also delivered more than fees in a consistent fashion – implying the fund earns you back your fees and then some.

With a five-year track record and top decile performance in the Prescient Balanced Fund, Prescient employs this approach across its multi-asset range. It adopts a conservative approach aiming for performance that's consistently a bit better than average. IFAs, answerable to clients, have found this approach reassuring and much more efficient than swinging the bat and sometimes missing the ball altogether.

The Prescient Multi-Asset process's consistently superior investment performance over the longer term, together with low costs, deliver on the challenge of how to enhance traditional passive strategies. In this regard, Prescient has remained true to its quantitative and systematic approach that excludes discretionary processes like ad hoc trades and punts on specific stocks.

Ends

For any additional information such as fund prices, brochures and application forms please go to www.prescient.co.za.