

Does Smart Beta have a role in South African portfolios?

Recently we have been looking at the emergence of 'smart beta' and the role it can play in client portfolios. Smart beta goes by many names – 'factor investing', 'quants' or 'enhanced indexation' are all similar terms used to describe an emerging form of fund management set to try and take a slice of active fund managers market share.

Simply put, smart beta aims to try and capture a large portion of the outperformance which active managers offer, by following a low cost, quantitative approach.

Examples of these methodologies include choosing stocks with 'quality' attributes (high ROE, strong balance sheets, earnings stability), stocks with 'value' attributes (high dividend yield, low price to book, etc), and stocks with 'momentum' attributes (positive price and earnings momentum). Each of these methods puts forward a case for outperformance of the All Share. Does this form of investing warrant consideration?

Active managers have left the door open to lower cost alternatives such as smart beta. The success rates within active management vary, and many tend to sit quite near to the benchmark which in itself makes a case for looking at more efficient ways to access returns. The logic follows that if you can implement a similar outcome to active managers using smart beta, then why not do so at lower cost?

The life cycle of this form of investing is still in relative infancy. Chart 1 shows its progression:

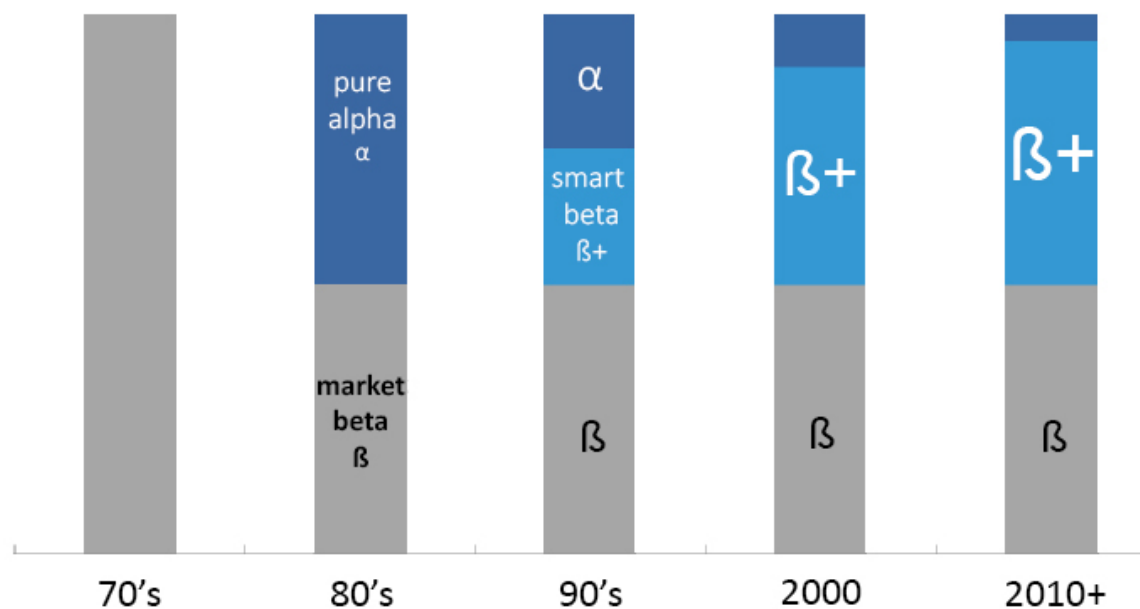


Chart 1: evolution of smart beta investing (source: Satrix)

This separation of *alpha* (outperformance generated by active managers) and *beta* (the market return, which can be accessed cheaply using passive funds) has started to take place in the institutional market in SA, and is already commonplace offshore. The question for the advice industry is: "does smart beta present a viable alternative to active or passive investment options?".

Back to the active managers: the fact that our share market is relatively small and concentrated presents both an opportunity and a challenge. This concentration means that the drivers of investment returns can and do change with a great degree of frequency and magnitude, making it difficult for any particular investment style to succeed on a consistent basis. By way of comparison, the MSCI World Index has over 1600 constituents, while the All Share has only 160, with a significant size bias (>85% in large caps). For evidence of this reflect back to the time (within the last 10 years) when the All Share was almost 50% resources (now +10%), the flight to quality post the 2008 GFC, the midcap value run in the mid-2000's, and more recently the

momentum led bull market headed up by Naspers. If your investment process had any of these traits you would have experienced at least one good patch of strong performance, surrounded by patches of mediocrity and underperformance. Through the cycle the case put forward by the active management supporters is that patience is rewarded, and the net result is positive for investors. For a long period now a large segment of the industry has been underperforming as we've been riding a 'quality' wave which turned into a 'momentum' wave post the GFC and in a world of cheap money. Few managers exhibit these traits. In SA the predominant investment approach is 'value' – and this has been out of favour (see Chart 2) since 2012.

Do the smart beta's enhance our odds? Well, not on the face of it. Selecting and producing a smart beta fund is in itself an active decision, so they should be seen as active alternatives, not passives. Does the benefit of avoiding active management behavioral errors get outweighed by the additional insight a human manager provides? We're not sure. The chart below shows the relative performance of various available 'smart beta' unit trusts (typical fees are around 0.35%):

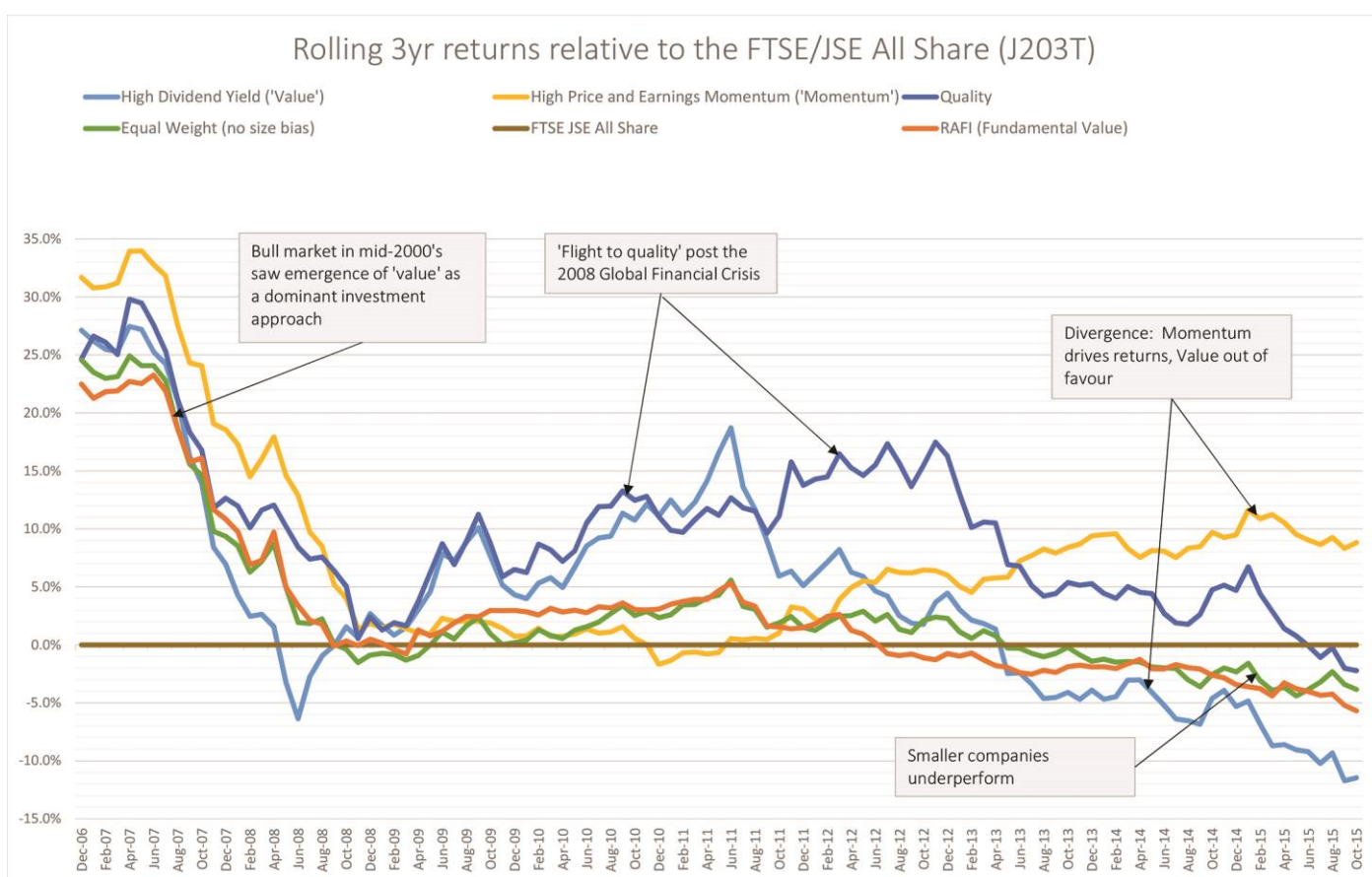


Chart 2: Rolling 3yr returns relative to FTSE/JSE All Share (source: INET, FE Analytics, Satrix)

The All Share for its part is an index of many faces, at all times containing the attributes of all of the styles. It is therefore an evolving style, which makes it so difficult to beat as active managers tend to be more resolute in their approach and adhere to a fixed investment philosophy. In a concentrated market such as ours with evolving performance drivers (styles), a fixed investment process means you are likely to go through deep patches of underperformance.

During this recent period post GFC, managers who have been flexible and changed their stripes have stayed in touch and generally performed better. Interestingly, it's the newer breed of active managers who did not grow up in the Value bull market of the mid-2000's who currently find themselves performing well. These managers are quite comfortable living in a momentum driven world. (also note: value managers only emerged in the last 10 years as an industry norm in SA. Globally they are more of an outlier which says something about how our market concentration problem could be driving investment process). We're also seeing style drift, particularly in the value oriented managers, as they start weaving in the term 'quality' to how they manage money (which, by some accounts, is now too late). Very few have been brave enough to weave in 'momentum' (Investec Equity is an example) due to the negative connotation it tends to have in investment circles.

Ironically, the managers who have some form of index relative approach (eg Prudential) have fared well, as their process automatically links them to the changing face of the All Share and reduces the 'style risk'. Investec Value is on the other end of the spectrum, and it's no surprise its return profile closely mirrors the value oriented 'smart beta's' shown above.

What can we take out from this? Smart beta funds are unlikely to be the holy grail of investing, but they seem increasingly positioned to be competitive relative to active peers. In SA the reality is that we need more evidence and more comprehensive evaluation of the potential drivers of return, not just what we have seen in the past 10 years (how many were calling for the 'Quality' style in 2004?). As always there are no finite answers in investing, and going forward we would expect the worlds of active, passive and smart beta to co-exist in investor portfolios.

NOV INVESTMENT 2015 REVIEW

30 November 2015

Sector		1m	3m	6m	YTD	1yr	3yr pa	5yr pa	10yr pa	10yr Vol
LOCAL MARKET INDICES (In Rands)										
FTSE/JSE All Share Index (ALSI)	ZAR	-3.9%	4.4%	0.5%	7.0%	6.8%	14.1%	14.7%	15.2%	15.6%
FTSE/JSE SA Listed Property	ZAR	-0.5%	2.4%	7.5%	15.0%	16.3%	16.6%	19.0%	19.5%	17.0%
SA All Bond Index (ALBI)	ZAR	-1.0%	0.2%	1.2%	2.9%	1.4%	5.3%	7.9%	8.0%	7.0%
SA Cash Index (SteFI)	ZAR	0.5%	1.6%	3.2%	5.9%	6.5%	5.8%	5.8%	7.3%	0.6%
Balanced Benchmark ²	ZAR	-1.5%	4.8%	4.1%	10.1%	10.6%	14.5%	15.0%	14.1%	6.9%
SA Inflation (1 month lag)	ZAR	0.3%	0.3%	2.0%	4.9%	4.7%	5.4%	5.5%	6.1%	1.4%
GLOBAL MARKET INDICES (in USD)										
Global Equity (MSCI World)	USD	-0.7%	3.0%	-4.8%	-0.9%	-2.6%	8.8%	7.3%	3.2%	16.4%
Emerging Markets Equity (FTSE EM)	USD	-3.7%	-1.3%	-18.5%	-13.4%	-17.5%	-3.7%	-2.8%	5.2%	23.6%
Global Bonds (Barclays Global Bond Index)	USD	-1.7%	-0.9%	-1.0%	-3.7%	-4.3%	-2.0%	1.1%	3.8%	5.6%
Global Cash	USD	0.0%	0.0%	0.1%	0.1%	0.2%	0.1%	0.2%	1.6%	0.6%
MAJOR INDICES BASED TO RANDS										
FTSE/JSE All Share Index (ALSI)	ZAR	-3.9%	4.4%	0.5%	7.0%	6.8%	14.1%	14.7%	15.2%	15.6%
Global Equity (MSCI World)	ZAR	3.7%	11.9%	12.9%	23.5%	27.2%	27.9%	23.6%	11.9%	13.3%
Emerging Markets Equity (FTSE EM)	ZAR	0.6%	7.3%	-3.5%	8.0%	7.7%	13.2%	12.1%	14.0%	15.4%
COMMODITIES										
Gold (US Dollars)	USD	-8.4%	-5.9%	-10.9%	-11.8%	-10.4%	-15.1%	-5.1%	7.9%	19.4%
Gold (Rands)	ZAR	-4.3%	2.3%	5.6%	9.9%	17.0%	-0.2%	9.3%	16.9%	21.5%
Currencies (positive return = Rand weakening)										
Rand / Dollar	ZAR	4.4%	8.7%	18.5%	24.6%	30.5%	17.5%	15.2%	8.4%	16.1%
Rand / GBP Pound	ZAR	1.8%	6.4%	16.9%	20.3%	25.5%	15.1%	14.5%	6.9%	14.3%
Rand / Euro	ZAR	-0.1%	2.5%	14.2%	8.8%	10.6%	9.7%	10.5%	7.2%	13.5%

Spot Rates

30-Nov-15		7-Dec-15	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
Rand/US\$	Rand	14.51	13.82	11.28	6.96	6.33	3.65
Rand/GBP	Rand	21.83	20.93	18.28	10.92	11.20	5.76
Rand/EUR	Rand	15.61	15.46	14.24	9.47	7.66	4.34
Rand/Aus \$	Rand	10.52	9.68	9.86	6.71	4.85	2.76
Libor 6m \$	US\$	0.71	0.53	0.33	0.46	4.23	N/a
Prime	Rand	9.75	9.50	9.25	9.50	10.50	18.50
Repo Rate	Rand	6.25	6.00	5.75	6.00	7.00	N/a
All Bond Index Yield	Rand	8.77	8.54	8.42	8.51	9.67	13.77
Gold (\$/oz)	US\$	1,072.15	1,115.05	1,208.83	1,309.34	469.20	383.55
Palladium	US\$	557.00	661.00	775.00	573.00	194.00	142.25
Platinum	US\$	853.50	906.50	1,301.50	1,655.00	929.00	423.00
Oil (Brent Crude) \$	US\$	40.72	48.54	94.74	81.25	63.77	16.30
SA Inflation	Rand	4.70	4.60	5.90	3.20	4.40	6.40

data provided by Profile Data Analytics and INET BFA