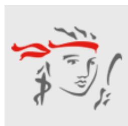

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Article 02: Passive investing: What investors need to know

Part 2 in our five-part series on Active vs Passive Investing. Passively managed funds have become a significant force in the investment world. In fact, Moody's Investor Services recently indicated that at least half the assets in the US investment-management industry will be invested passively by 2024. Read on to gain perspective and decide whether passively managed investments are for you.

What is a passive investment strategy?
Passive managers use an automated process that chooses which stocks and how many of these stocks to include in a portfolio, with the aim of exactly replicating a particular index. It could be any index, as simple as the top 40 shares (like the FTSE/JSE Top 40 Index in South Africa). Or it could follow a complicated formula or rule. The choice of which index to track depends on the client, and the passive manager has no say in which shares are chosen. So it doesn't involve stock-picking by highly-skilled and qualified portfolio managers and it doesn't require the extensive research that goes into actively-managed funds.

What is an index?
An index is a set of rules that defines how a group of investments should be combined and measured. The three main market indices for the JSE are the All Share (ALSI), the Capped All Share (CAPI),

and the Shareholder Weighted (SWIX) All Share Index. These indices have the same stocks as constituents, but the stocks' weightings differ.

There are also indices that track specific industries (such as the retail or banking sectors) and others which copy 'balanced funds' and include a wide range of asset classes for diversification.

More complicated 'Smart beta indices' have also started to flourish. Here, investors select a tailor-made index that might comprise a combination of 'green companies', 'ethical companies' or 'high dividend yield companies', for example.

What are index-tracking funds?
Index-tracking funds are pooled investments that outsource the task of capital allocation to an investment panel which determines the configuration of the index to be tracked. They then buy the shares, bonds or other underlying securities to include in the fund in the proportions defined by the index. As the index composition changes over time, in line with market movements, the tracking fund must be "re-balanced", which means buying those company shares or other instruments that have been recently included in the index, and selling those that have fallen out of the index. Re-balancings generally take place every quarter or six months.

What are Exchange-Traded Funds (ETFs)?
ETFs are like index-tracking funds in that they are groups of shares based on certain market indices. The difference is that they are listed and traded on a stock exchange and investors can buy and sell the ETFs as if buying and selling any other share on the stock exchange.

Advantages of passively managed funds
Average market returns
Passive investing aims to produce a very similar return to the chosen index return before fees are taken into account - this basically amounts to the average market return before fees. Index tracking funds and ETFs always underperform the actual index return due to the fees involved, and there will also be a return differential due to tracking error, which is a by-product of the passive process.

Low fees
ETFs and index-tracking funds generally charge lower fees than actively managed funds because there is no need for the passive managers to perform extensive research to build an investment portfolio. There is also less trading involved. As a rule of thumb this holds true for the simpler indices being tracked, but more complex "smart beta" indices do charge more. And there are also often other more opaque costs involved (for trading, taxes, etc).

Meanwhile, total costs for some actively managed funds can be lower than those for passive funds, - so when comparing fees between actively and passively-managed funds, you should check closely and also be sure you're comparing apples with apples, as fees can be defined in different ways.

Cost-efficient access to certain markets
Passive funds can provide investors with cost-efficient exposure to select markets (for example, a specific country or type of asset like high-yield bonds) that they want to include in their portfolios at a broad level. Prudential adds index-tracking solutions to some of its offshore fund exposure where it deems the assets are attractive, in combination with its own active solutions.

Low maintenance
Many investors prefer to invest in 'set and forget' funds as they can't justify the time required to keep track of actively managed funds. Some believe that broad-based market index funds make both diversification and asset allocation easy.

Avoid confirmation biases
Investors are prone to confirmation biases (seeking out information that confirms your own pre-conceived opinions) which could result in the selection of actively managed funds which have performed well in the short-term, but which aren't appropriate to your personal financial circumstances. You can avoid chasing the latest "top performers" by using passive funds instead.

Disadvantages of passively managed funds

They're not all equal
Following an 'index' is not a magical cure-all. More so when you consider that many investors have moved away from buying into

broad market indices and are now investing in sub-category index funds. This decreases diversification and goes against the founding intention of index funds which tracked the entire market in order to achieve diversification and average returns.

Index tracking in South Africa is more risky
The smaller number of companies listed in the local equity market compared to the US or Europe makes index tracking much more risky here, due to the more concentrated nature of the indices. So, while investors may think they are getting solid diversification by choosing the FTSE/JSE SWIX Top 40 Index with its 43 constituent companies (a popular index to track), what they may not realise is that one company – Naspers – makes up over 25% of the index. This adds extra volatility to a passive fund and increases the risk of permanent loss.

Lack of risk management
Another key disadvantage of passively-managed funds is the lack of risk management that is different to the above lack of diversification. Passive fund managers must buy all the shares in an index and hold them indefinitely, no matter what risks might arise over time, until they fall out of the index. Often this involves buying shares at high prices (when companies are doing well and included in a Top 40 Index, for example) and sell at low prices (when a company faces bad news), which destroys returns. They must even hold onto the shares as they fall in value, until the next re-balancing (if they fall out then). Many active portfolio managers, including Prudential, have very strict risk-conscious approaches to managing their funds. They ensure from the outset that the risk measures associated with each underlying security are appropriate to include in a fund (the long-term, strategic strategy). Then on a shorter-term basis they actively manage this risk – they can sell shares as soon as they deem them to be too risky. In this way they cushion losses in their portfolios when the bad news hits, and help mitigate the risk of permanent loss.

'Smart beta' funds can be especially risky for investors in that the selection requires them to make 'active decisions' about the index they track. Instead, these decisions should be based on the financial fundamentals of the underlying investments, rather than a

subjective set of qualitative data such as ‘how green’ the companies are.

Inefficient capital allocation
Passive investing has the potential to distort markets as the process doesn’t differentiate between ‘good and bad’ companies. The stock is bought because it’s in the index, not because of good supporting financial fundamentals.

The passive bottom-line
Passive investing can be a cost-efficient and simple solution for those investors who want to include a broad type of investment in their portfolios. The important decision comes in choosing which index to track – this is an active choice that merits careful thought. Equally, lower fees should not be the single most important factor in determining which type of fund to invest in – it is the after-fee return that matters.

Prudential has an array of actively managed funds curated by highly-regarded and experienced portfolio managers. To find out more about our funds call 0860 105 775 or email query@prudential.co.za.