PRUDENTIAL **INSIGHTS**

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INVESTMENT MANAGERS

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Resilient in the Top 40 Index: Thoughtless indexation

Because larger companies virtually assure executive management of higher compensation, there exists a perverse incentive for management to grow the absolute size (i.e. the market capitalisation) of their companies, even if this comes at the expense of lower return for shareholders. With the growth in passive investing, which tends to invest in the largest and most liquid companies, there is now an additional – yet still unwarranted – incentive for management to grow the "free-float" market capitalisation, as most tradeable JSE indices use the shares actually available for investment to determine size.

The JSE Index Committee is responsible for determining the free-float of each company at the quarterly index rebalancing. One potential problem is that the JSE relies on annual public disclosure by the companies themselves to determine their free-float (despite the fact that JSE owns STRATE and could use the shareholder register to verify and update company disclosure). A second potential problem is that the passive providers appear not to verify the JSE calculations despite pouring billions of their clients' money to track these indices.

The Resilient group of companies is an example of how corporate managers can arbitrage certain indexation rules to obfuscate reality to the detriment of investors. In addition to the cross-shareholding between Resilient and Fortress (that the companies have now agreed to unwind), the Resilient group may have potentially used the structure of its BEE trusts to inflate the free float of certain group companies. This – incorrectly in our opinion – allowed Resilient to be included in the FTSE/JSE Top 40 Index late last year, with significant consequences for passive investors.

Resilient entered the Top 40 Index at around R145 per share, which would have required passive managers to **actively** buy the shares. After its share price lost more than half of its value, Resilient exited the Top 40 Index at around R65 per share in the March rebalancing. This would have required passive managers to **actively** sell the shares. The net impact at an index level of this **active** buying and selling by the **passive** managers was in excess of 0.40% of performance. Passive investors should add this loss of index return to their management fee to determine the "true" costs of passive management.

And what other difference could it make if the BEE shares are not excluded from the free-float? Essentially, passive as well as active managers managing against a free-float benchmark will structurally struggle to find Resilient stock, as at least 13% of Resilient's weight is tied up in the BEE Trusts but not removed from the free-float. This creates latent demand for Resilient, which is great news if you are a serial equity issuer – and your share price continues to rise. This demand is exacerbated during equity placements, particularly if (as has been alleged by some) the allocation of shares in equity placements by the Resilient Group of companies has unfairly advantaged related entities.

We believe investors in passive products should be asking passive providers whether, as a matter of course, they independently check the validity and integrity of the indices they are tracking, including the calculation of each company's free float. As an aside, the correct calculation of the free-float appears to be child's play in comparison to the detection of fraud the active management community is expected to police. The answer that "we rely on the

JSE” would be tantamount to active managers arguing that “we rely on the auditors” to detect fraud.