

Are you clever enough?

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During the cold war in the 1960's, NASA constructed a special "space pen" in order to overcome the problem of a normal pen that would not write in space as the ink rolled backwards. It cost them hundreds of thousands of dollars in R&D. The Russians used a pencil...

Our tendency to be overconfident

Numerous experiments and studies have illustrated human overconfidence, especially when it comes to our ability to assess future outcomes.

In one experiment roughly 80% of young drivers considered themselves to be in the top 30% of their group in terms of safety. How good are your driving skills?

Another study of patients who died in ICU, compared the autopsy results with the diagnosis that the physician provided while the patient was still alive. Physicians also reported their level of confidence about the diagnosis. Physicians who were "completely certain" about their diagnosis and treatment, were wrong roughly 40% of the time – not a great statistic where a life is at stake.

The current debate

This leads us to an interesting investment topic, which has received plenty of media coverage to date. As part of our local retirement reform, passive versus active investing also caught the attention in National Treasury's discussion paper "Charges in South African retirement funds". Regulation wants to address asset managers' fees. It caused a notable reaction by the retirement fund management industry – and for good reason.

Active management can best be described as the attempt to achieve above average returns by using various techniques such as value investing (buying an asset that might be considered "cheap" compared to its intrinsic value), technical analysis, momentum investing, fundamental analysis, market timing and/or macro-economic indicators. Investment managers that are capable of employing teams of skilled researchers that support them, often use an active investment style. Investors remunerate these teams for their ability (or attempt) to outperform the market average. The individual who buys stock in a company that he thinks will do very well, is also seen as an active investor.

On the other hand passive investors invest in broad sectors of the market, called asset classes or indexes. Like the active investor, they want their capital to appreciate; however, they accept (or are happy with) the average returns of various asset classes or indexes. Essentially they do not try to "beat the market", but merely accept the return of a specific subset of the market they want to track. So why would anyone want to get *average returns* when you can achieve *above average* returns?

- **Simple arithmetic:** The sum total of all the returns of active investors would constitute the given market return. I.e. for every buyer there must be a seller. Theoretically all active investors seen together cannot beat the market, for they are the market. In other words, for every winner there must be a loser. So, what is your objective and how do you identify these so-called winners?
- **Fees:** Due to performance fee formulas, actively managed unit trusts tend to charge much higher fees than passively managed strategies; often argued as an incentive, but is it aligned with the investor's interests? In many cases performance fees have mediocre benchmarks and are relatively easy to beat. During bull markets (good times) these fees ratchet up

considerably and could affect the compound return in later years when markets are doing poorly.

- **Research:** For five years ending Dec 2014, only a handful (little over 15%) of South African general equity funds outperformed local indexes. The numbers are even worse for global equity mandates, where less than 4% did better than recognised global benchmarks.



"Leaping tall buildings in a single bound is nice, but can you outperform the S&P500 Index?"

- **Smart Beta:** Today there are alternatives to passive investing. It is possible to invest via indexes that target shares that pay higher dividends, demonstrate upward momentum or profitability.

As part of our quest to optimise our investment solutions, we have partnered with Sygnia since 2011. As a multi-manager they combine various alternatives. Together with our investment committee, Sygnia has helped us assess our options and effective strategies. In our effort to reduce fees, we have audited and picked a select skillset as part of our targeted return investment strategies. Our drive remains for evermore transparency, diversification, lower fees and ultimately better performance.

What is the way forward?

The notion is that one could efficiently combine or blend two distinct investment philosophies. We believe that passive and active management complement each other (if implemented and monitored correctly). When choosing an active fund manager in addition to using a passive index, it is important to understand the underlying investment philosophy of each manager; thus, avoiding any duplication, or amplifying a specific investment theme that may increase volatility. For example, there would be no added value in using a strategy, which invests in shares that closely resemble the very index that you are trying to outperform – you need to do something different! As such, it is interesting to note that Naspers currently constitutes a disproportionate allocation within local indexes. We believe that smaller boutique managers offer value by taking tactical positions and more meaningful stakes in companies that offer this diversification – away from the index. They seek outperformance from benchmarks due to their unique portfolio positioning where larger managers are usually unable to get part of the action. A final thought from a renowned economist John Maynard Keynes: "*The difficulty lies, not in the new ideas, but in escaping from the old ones*".

Sygnia listed on the JSE

As some of our clients may have noticed, Sygnia recently listed on the Johannesburg Stock Exchange (JSE). The listing brings exposure for Sygnia, which started out in 2003 and has roughly 140 billion rand under management. Funds under management includes multi-manager strategies, index-tracking funds and funds of hedge funds.