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INSIGHTS & ANSWERS: Blending active & passive allocations in a portfolio

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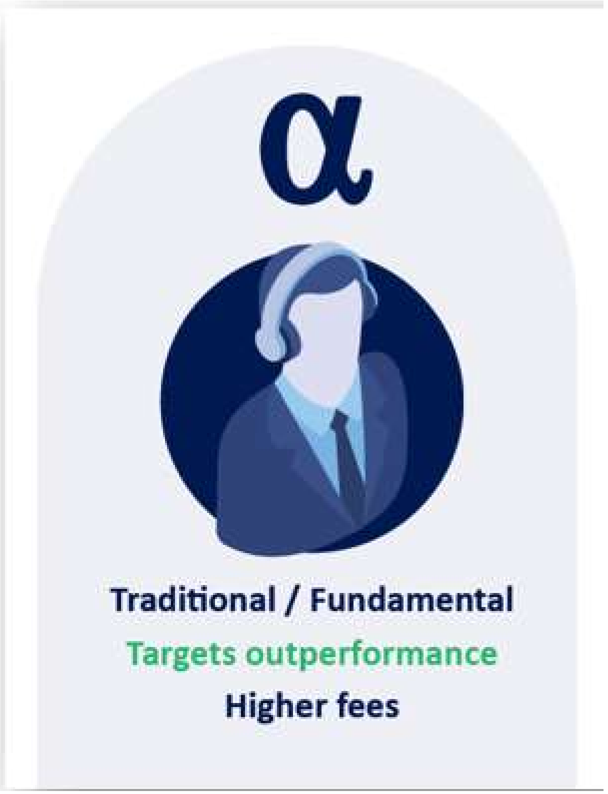
Overview

- Definitions
- Explanations
  - What it is
  - Different markets and different approaches
- Global and local trends
- Applicability in Portfolio Construction
- Some actual examples
- An Optimal Investment strategy

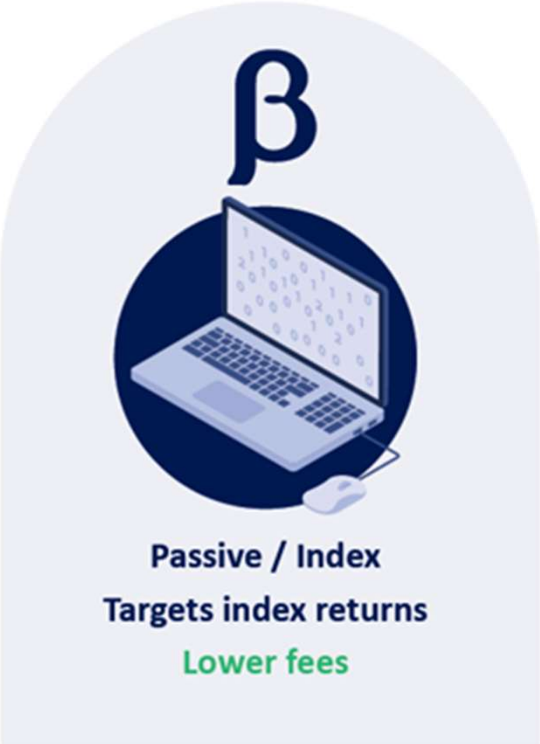
Active versus Passive



Alpha = outperformance / excess return

- **Active refers to taking positions relative to a benchmark**
- **Skilled managers can add alpha relative to a benchmark**
- **Typically 1% to 2% p.a.**
- **Not always the same managers**
- **Charge active fees**

Active versus Passive

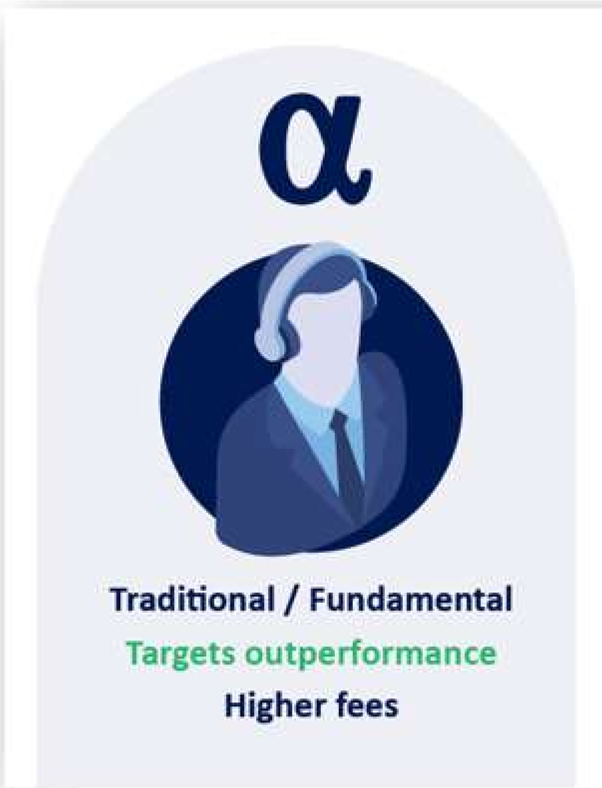


Beta = measures the movement of the market as a whole

- **Passive = opposite of active**
- **Positioning equivalent to a BM**
- **Defining what you are measuring is important**
- **What is the appropriate index?**
- **How well is the index replicated?**

Active versus Passive

Not mutually exclusive



- They are not mutually exclusive
- Some asset classes or markets lend themselves towards one or another
- Choosing to go passive, is an ACTIVE decision

And then there is Smart Beta

The best of both worlds

α

Traditional / Fundamental

Targets outperformance

Higher fees

Smart Beta

Factor / Active Quant

Targets outperformance

Lower fees

β

Passive / Index

Targets index returns

Lower fees

What is Smart Beta Investing?

- Different names provide insight

  - Active Quant Investing
    - Active versus passive index tracking
    - Quantitative data and techniques (e.g. risk management)

  - Factor Investing
    - Investors get rewarded for being exposed to factors
    - Factors backed by a huge and growing body of academic research
      - Why it works
      - Evidence – supported by empirical analysis over many markets

  - Smart Beta investing
    - Initially => returns driven mainly by Beta exposure to the market
    - New thinking: styles also explain some of the returns (Beta exposure to styles as well)

What is Smart Beta Investing?

- Main Qualities

  - Positioned between trackers and traditional funds

  - Inputs => objective data rather than subjective fundamental information
    - Objective data Figures from financial statements
    - Subjective information Outlook based on macro economic forecasts

  - Decisions => Rules based rather than subjective
    - The figures tell a good story v.
    - Management did a great presentation

  - Exploit investment styles e.g. Value, Momentum, Quality, etc.

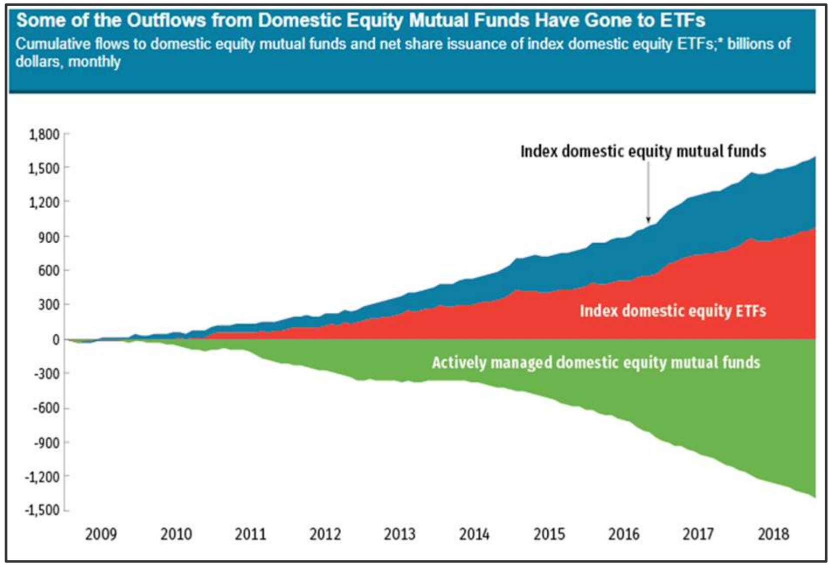
Differences Between Approaches

- Single factor or multi factor portfolios
  - Trending, Value or Quality – a single factors
  - Multi factor
    - Bottom up – each share is individually viewed through multiple style lenses
    - Top down – blending of various single style portfolios

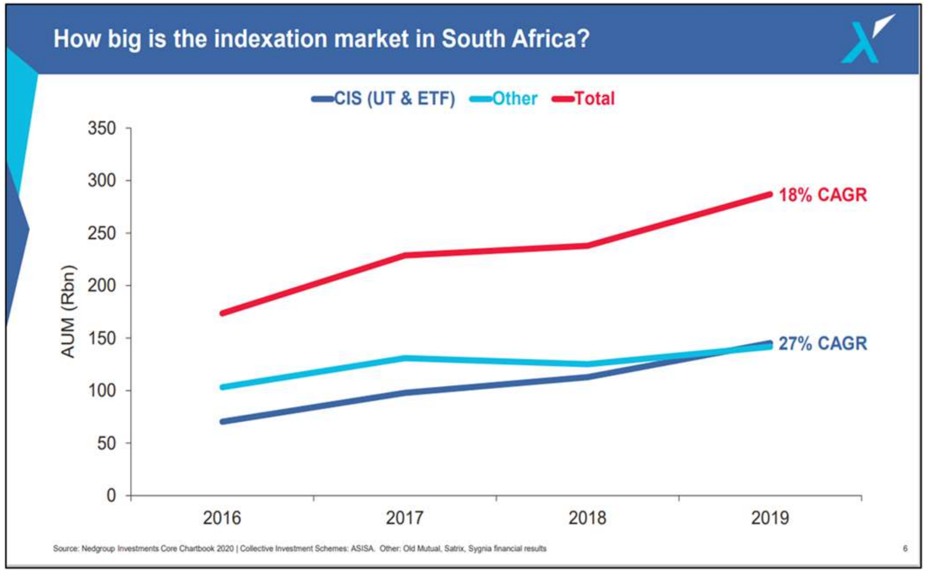
- Tracking a smart beta **benchmark** versus an **active** hands on approach
  - Benchmark tracking
    - Smart Beta index designed upfront
    - Followed by a "set and forget" index tracking approach
    - Fixed rebalancing dates
  - Active approach
    - Consider input data on a daily basis
    - Hands on decision making
    - Rebalance daily

Global and SA trackers in powerful growth trend

- USA Mutual Fund & ETF cumulative flows – massive switch from active to passive
- SA total tracker industry growing at 18% p.a.
  - CIS market (UTs & ETFs) growing at 27% p.a.



Source: Investment Company Institute website



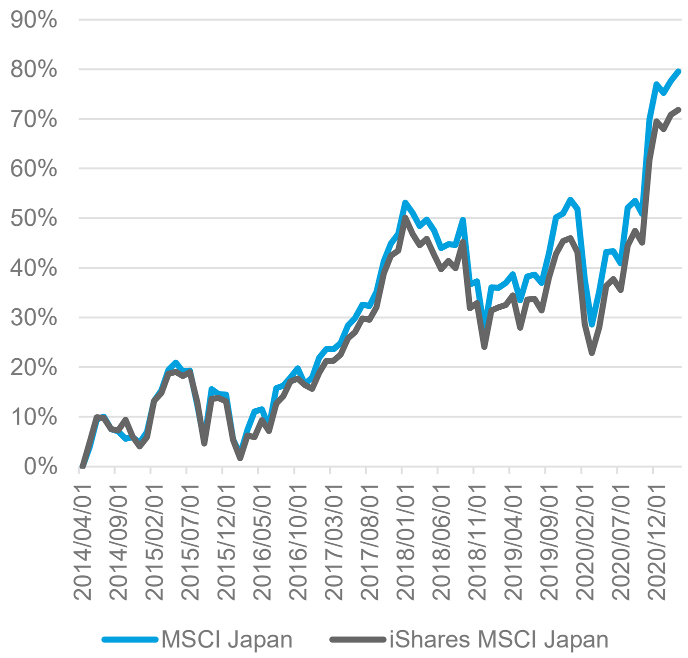
Source: Satrix estimates, meet the manager presentation, Mar 21

Equity strategies spectrum

	Passive	Smart Beta	Systematic	Active
Objective	Match market returns	Beat risk-adjusted market return	Beat risk-adjusted market return	Beat risk-adjusted market return
Cost	0-30 bps	0-60 bps	0-100 bps	0-150 bps
Active risk	~0%	~5-10%	~5-20%	~5-20%
Turnover	~5%	~30-60%	~30-150%	~20-60%
Holdings	As index	~100-200	~100-500	~20-60
Diversification	As index	Average	High	Low

Passive

iShares MSCI Japan



You want passive when:

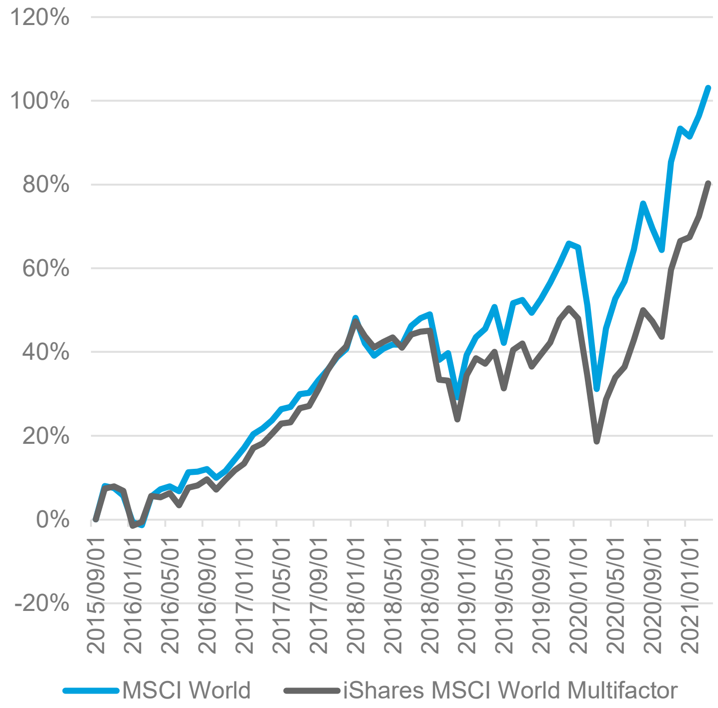
- You want exposure to a certain region, sector or industry
- You don't want any surprises
- You don't think there is any active opportunity in the market
- You want to pay very low fees

You don't want it when:

- You want to outperform the market
- You want active stock selection

Smart beta

iShares MSCI World Multifactor



You want smart beta when:

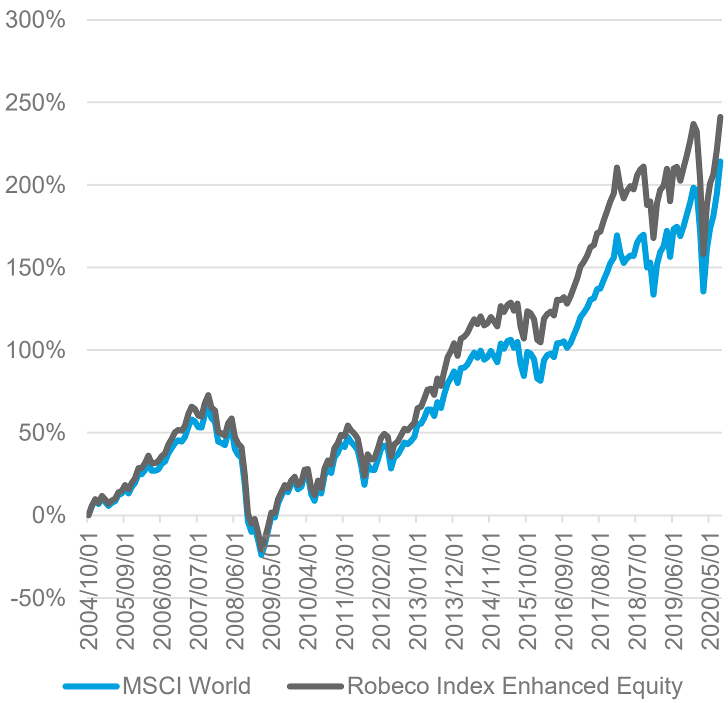
- You want a diversified exposure to rewarded factors, with little stock-specific risk
- You want to outperform over the long run
- You want transparency
- You want a specific factor or thematic exposure

You don't want it when:

- You don't want to risk lagging the benchmark
- You do not want to spend time analysing the portfolio construction rules

Systematic

Robeco Enhanced Index Equity



You want systematic when:

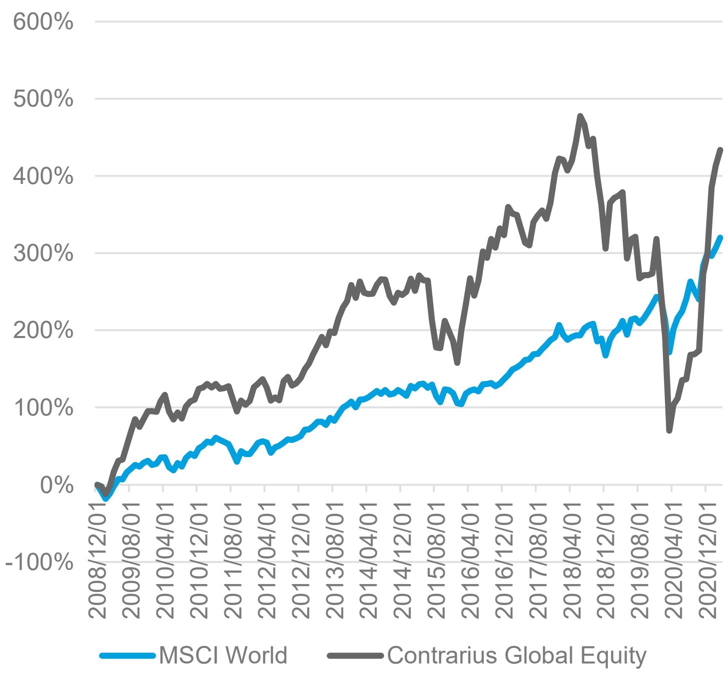
- You want a diversified exposure to rewarded factors with little stock-specific risk
- You want to outperform over the long run
- You want to complement stock-picking strategies
- You want a specific factor exposure

You don't want it when:

- You do not have a very good manager running it
- You want stock selection risk

Active

Contrarius Global Equity



You want active when:

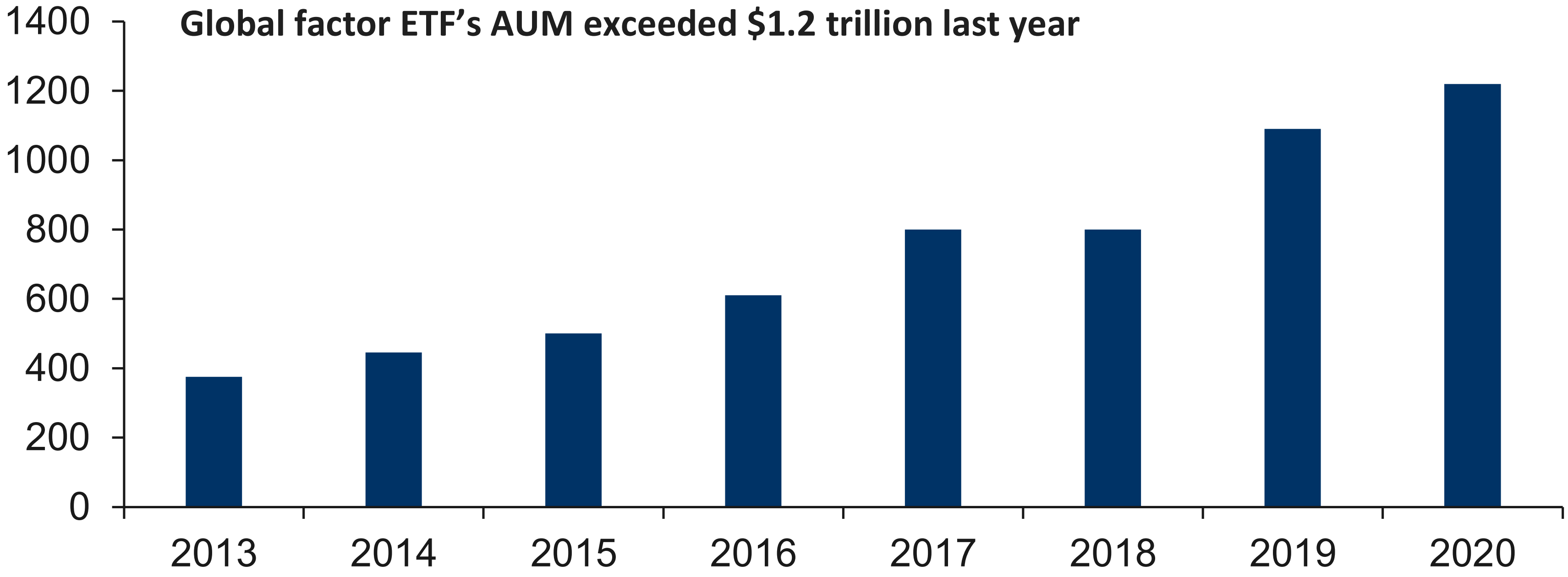
- You believe there are hidden opportunities in the market
- You find a good manager to do so
- You want stock selection risk
- You want to complement systematic strategies

You don't want it when:

- You are mindful about diversification
- You want to pay very low fees
- You cannot bear periods of underperformance

Global smart beta – phenomenal growth

Massive growth of around attractive 20% p.a. in the last 7 years, other sources estimate even higher figures



Sources: Morningstar and S&P DJI

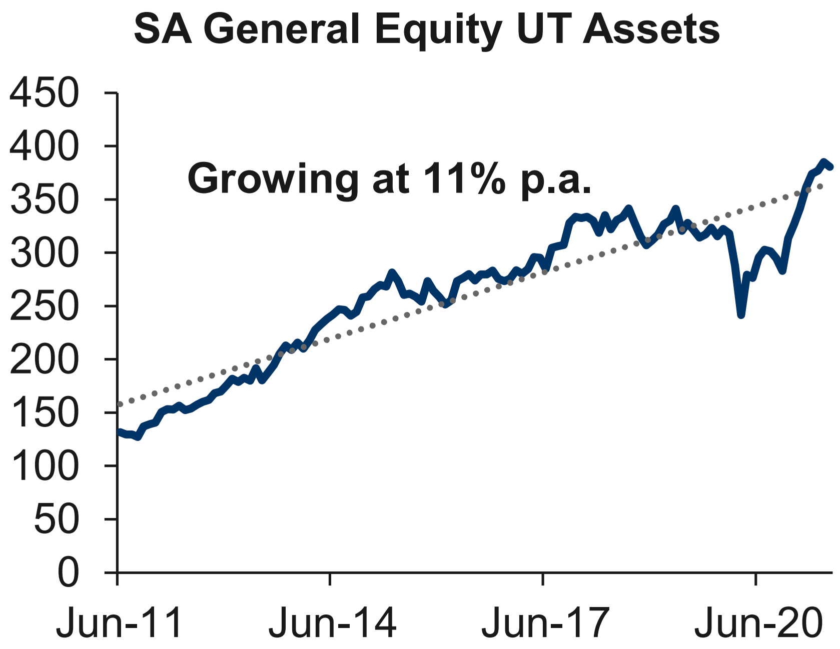
Differences Between Markets

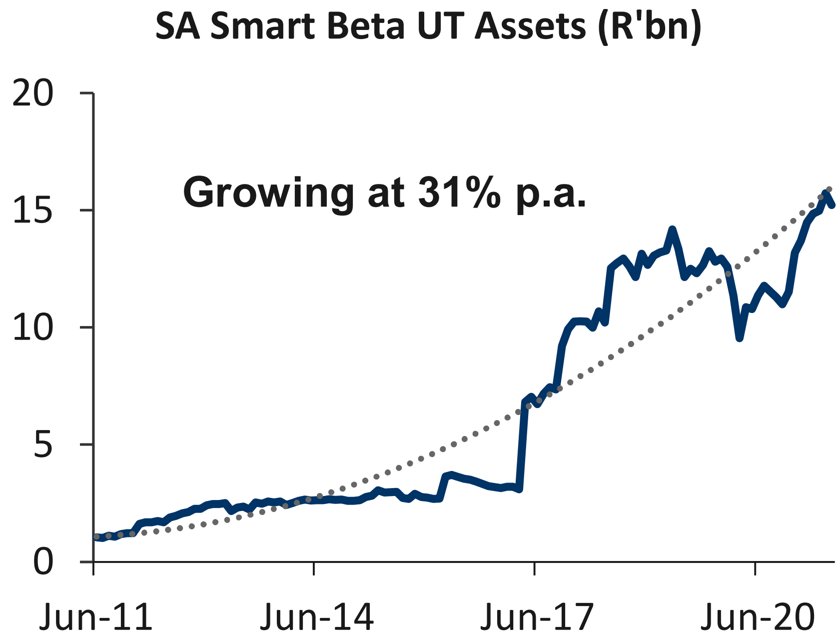
- Global v. Local
  - Globally thousands of shares to choose from, in SA less then 100 liquid stocks
  - Local portfolios hold smaller numbers of shares
  - More weight per individual counter => more skill required
    - Risk management
    - Data scrubbing
    - Basic understanding of fundamentals

- Equities v. Fixed Income
  - Fixed Income lags equity AUM
  - Less data, less academic research, less investor familiarity
  - More bond managers outperform their benchmarks, less urgency to rethink
  - Perhaps already doing Smart Beta investing (liquidity, credit risk premia), just by another name…

South African smart beta CIS growth

AUM now at R15bn compared to R380bn of sector, number of funds grew from 5 to 25





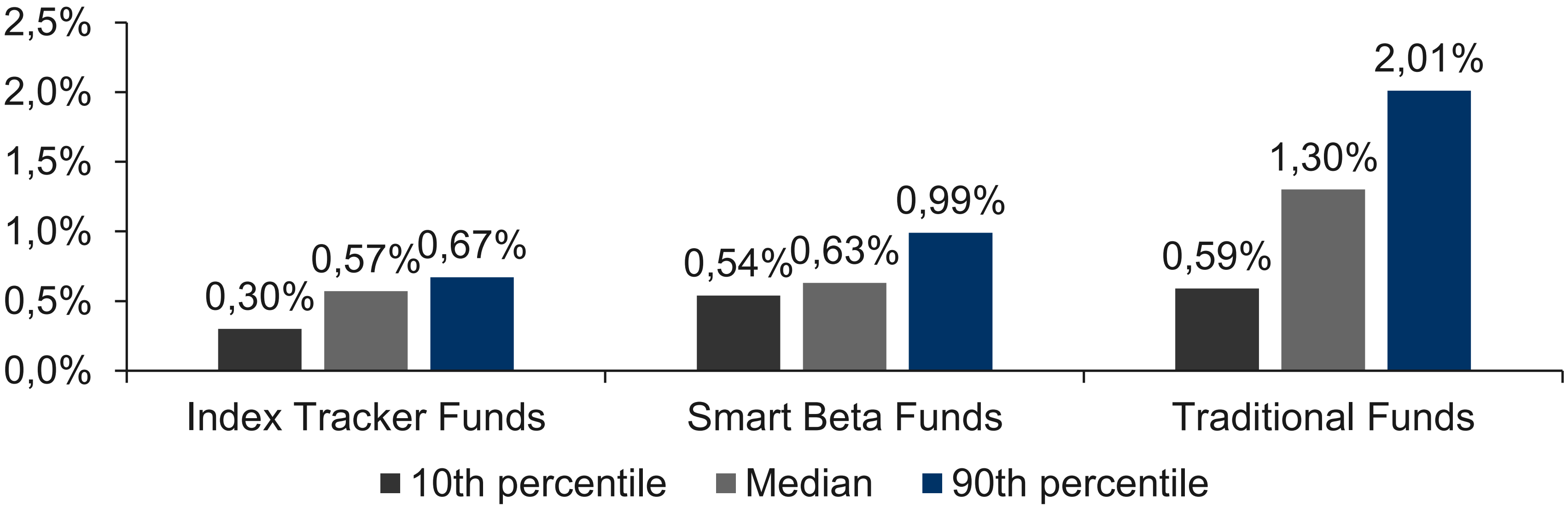
Sources: Morningstar, Momentum Investments

What is behind this fast growth?

- Low fees – especially when ***returns are low***
- Lower risk – especially in a ***volatile times***
- Great performance relative to the ***average*** peer
- Robust portfolio construction tool - using trackers ***alongside active funds***

FY1

Drivers of growth – attractive fees



Sources: Morningstar, Momentum Investments

Slide 20

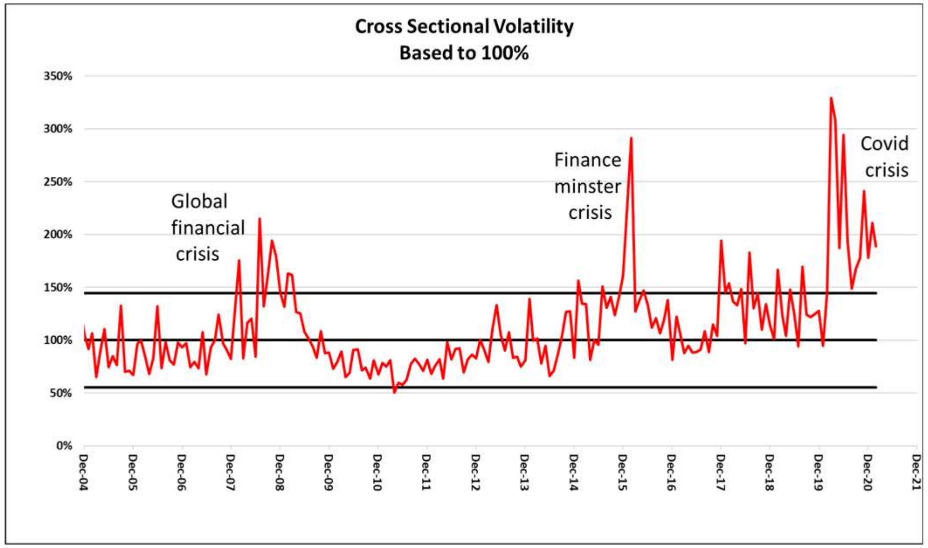
FY1 Florbela Yates, 2021/10/11

Lower risk in volatile times

- Two types of equity market risks:
  - Common factor (e.g. market risk)
    - Known unknowns
  - Specific (stock selection risk)
    - Unknown unknowns

- Traditional "active" funds exposed to both risks
  - Trackers take zero specific risk

- Tough markets – high cross-sectional volatility an indicator of specific risk during covid crisis
  - huge dispersion of fund returns, investing a component of a product in a tracker would reduce impact of unknown unknowns
  - GE UT Return dispersion year Jan to Dec 2020
    - Best 19,8%
    - Worst -24,1%



Drivers of growth – pleasing returns

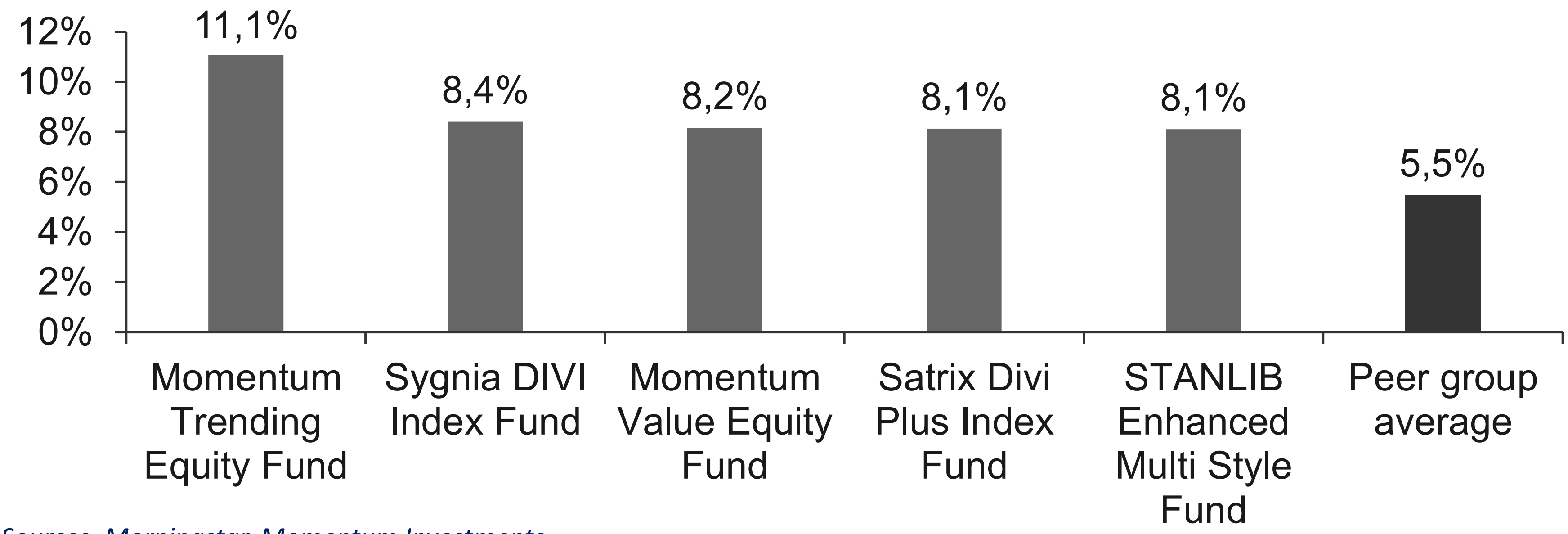
General Equity UT sector versus the ALSI

Time Period	1 Year	3 Years	5 Years	10 Years
ALSI Return (annualised)	33.20%	7.57%	9.21%	10.73%
Number of Funds in GE category	164	147	114	62
Number of Funds that outperformed (% outperforming)	11 **(7%)**	20 **(14%)**	12 **(11%)**	8 **(13%)**
Number of funds that underperformed ALSI (% undperforming)	153 **(93%)**	127 **(86%)**	102 **(89%)**	54 **(87%)**

Sources: Morningstar, Momentum Investments

Drivers of growth – pleasing returns

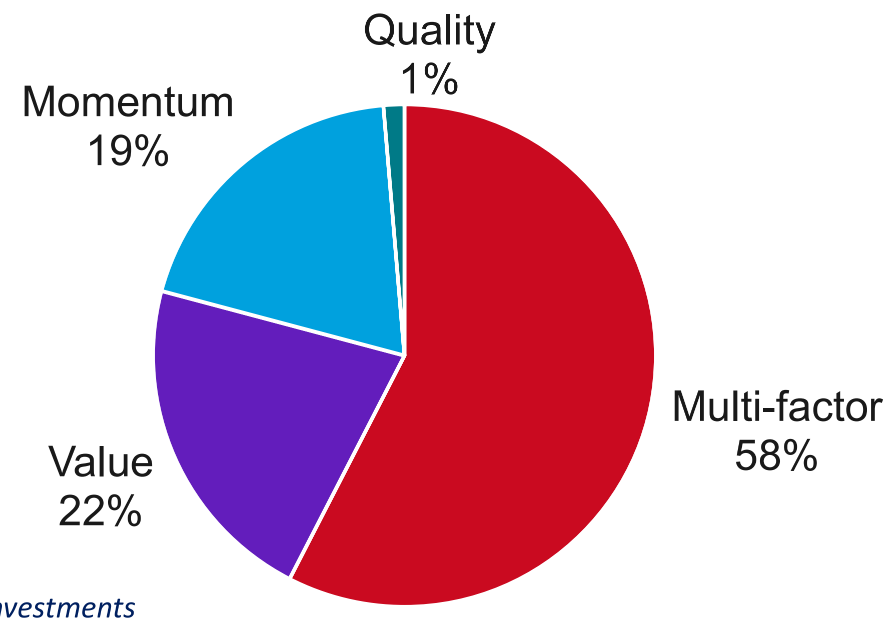
Five top-quartile smart beta funds over three years to June 2021



Sources: Morningstar, Momentum Investments

Drivers of growth – risk reduction

Opportunities for diversification



Sources: Morningstar, Momentum Investments

Applicability in OBI portfolio construction

Constructing our Local Equity Building Block

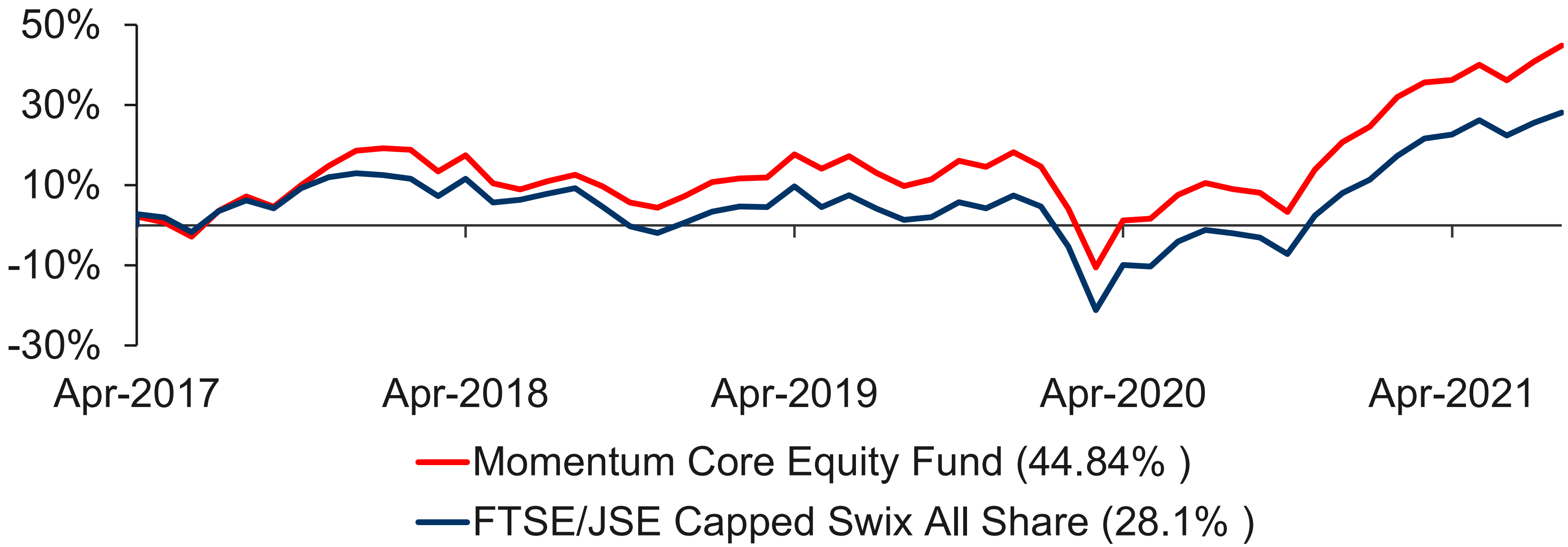
- Choosing an appropriate benchmark
  - Capped SWIX Index
- Investment time horizon
  - From an advice perspective: Long-term (7 years +)
  - From a performance perspective: Rolling 3 years
- Performance Target
  - Capped SWIX +1% (net of investment fees) over 3 years
- Risk Management
  - Not to underperform the Capped SWIX by more than 5% over any 12 months

Constructing our Local Equity Building Block

Fund	TIC
Momentum Core Equity Fund	0.78%
Aylett Equity Prescient Fund	1.33%
BlueAlpha BCI Equity Fund	1.09%
Fairtree Equity Prescient Fund	1.40%
Foord Equity Fund	0.26%

Momentum Core Equity Fund

Investment returns to August 2021 since launch on 4 April 2017, ranked 26th out of 124 general equity CISs



Sources: Morningstar, Momentum Investments

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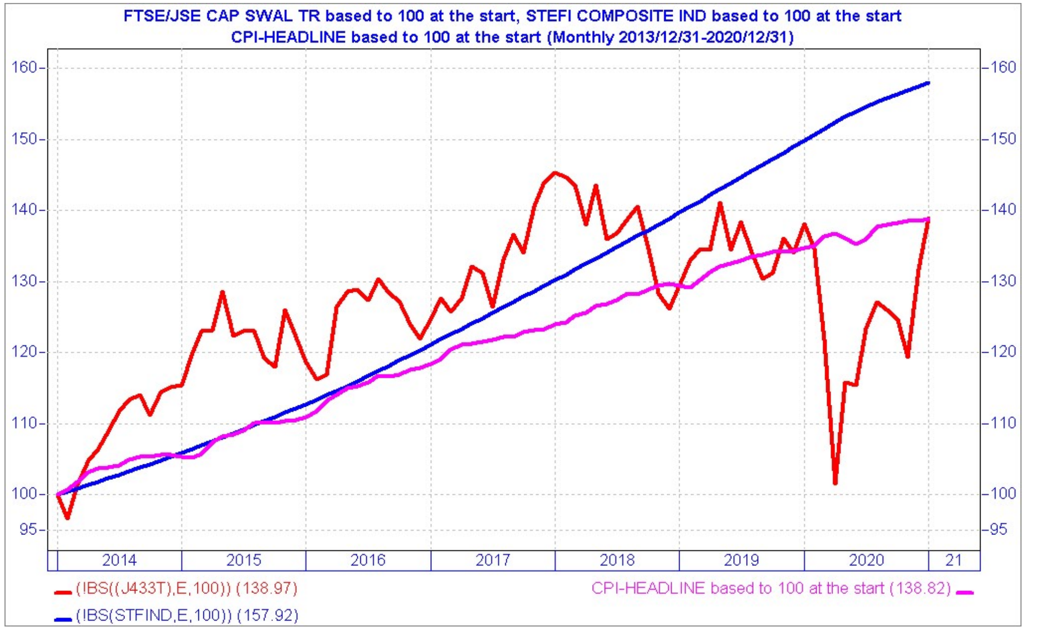
Low fees attractive when returns are low

- From Dec 2013 to Dec 2020 (7 years)
  - Equities 4,8% p.a.
  - Inflation 4,8% p.a.
  - Cash 6,8% p.a.

- General Equity UT management fees
  - Mom Cap Swix Tracker 46 bps p.a.
  - Median peer 115 bps p.a.

- Compounding effect of lower fees over many years has a material impact on eventual outcome



Multi-factor

After diversification: Alpha still >4% with less than HALF the risk!

Parameter	Trending	Value	Quality	Multi factor
Average alpha p.a.	5.8%	5.2%	6.0%	4.2%
Tracking error	7.0%	7.4%	7.9%	3.8%
Information ratio	83%	70%	77%	111%
Worst 12 months lag	-12%	-17%	-11%	-5%

Source: Momentum Investments, blend of back tested and actual data

Constructing our Offshore Equity Building Block

Fund	TIC
Coreshares MSCI ACWI FoFs	0.49%
Satrix MSCI World Equity FF	0.44%
Coronation Global EM Flexible Fund	1.38%

In Summary

- Fees alone aren’t a reason for using passive
- It needs to make sense in terms of what you are trying to achieve
    - From a performance objective
    - Relative to your chosen benchmark
    - Should increase predictability
    - Add to diversification
    - And contribute to risk management process
- There’s a place for passives, smart-beta AND active funds
    - But it differs across regions, asset classes and strategies
- You need to consider the effects at total portfolio level and not in isolation

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Sources: Momentum Investments, Morningstar