FUNDS ON FRIDAY
by Glacier Research

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10 June 2016
Volume 865

Market Matters

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When we talk about markets

The world's first stock market index was created in 1896, exactly 120 years ago. The Dow Jones Industrial Average was created to give the investing public some indication of what the US stock market returned over a specific time period. Today when you listen to the news in South Africa, you will notice that reporters talk about the market being up or down a certain amount brought about by accumulating performances from various sectors. The market is generally a broad index representing most listed entities and in our case we refer to the JSE All Share Index Total Return (J203T) as calculated by FTSE / JSE: a joint venture between the Johannesburg Stock Exchange (JSE) and the FTSE Group (FTSE), a world leader in the creation and management of indices. There is also the S&P South Africa Composite Index which by definition is constructed in a very similar way, but for simplicity sake we will only refer to the J203T during the course of this article.

So what...I knew that!

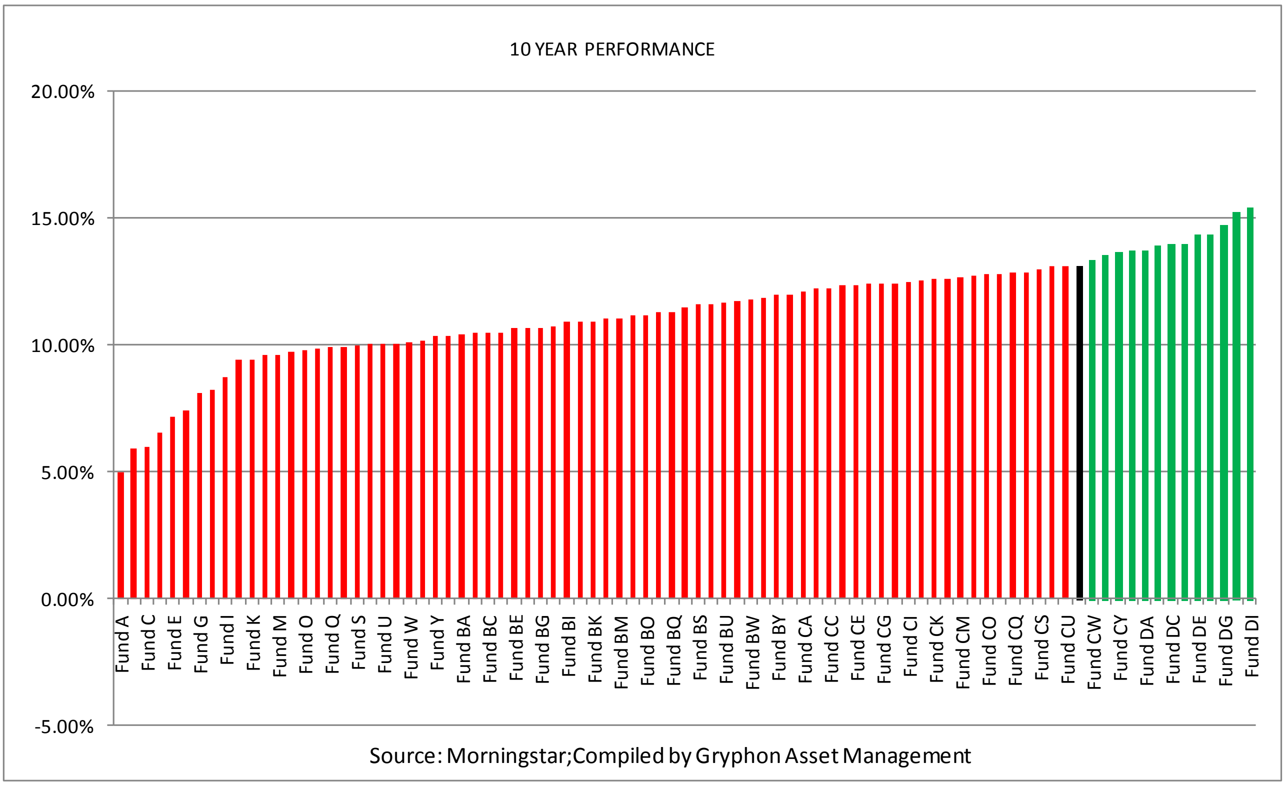
The JSE All Share Index (J203T) is the preferred benchmark when referring to the market due to pure logic and is backed up by studies of it being the most representative index of the total market and therefore indicator of performance. When investors decide to participate in the JSE they have 268 shares from which they can choose to invest in (March 2016 index review). However, share listings need to comply with certain criteria in order to be included in the All Share Index. The result is that small and illiquid counters are excluded to give a true reflection of what can be considered a reliable and realistic reflection of the market. Currently a total of 164 companies are included in the J203T (March 2016 index review).

Okay so where are we heading?

A small investor (Mr. X) should not find it very difficult to acquire shares in a small-cap stock (Company ABC) that is listed on the JSE in the 160th position. Company ABC is small, but so is Mr. X's investment portfolio. Ten years later Mr. X's wealth accumulated to R1bn and he is finding it harder and harder to maintain his exposure to Company ABC as he will eventually own a disproportionate amount. Also, the liquidity (or volumes) offered against Company ABC on the JSE is insufficient in order to allow Mr. X to meaningfully accumulate more shares given the size of his investment portfolio. Indexation, or passive investing, through the JSE All Share Index neutralises the issues that Mr. X and much bigger investors can experience. Surely Mr. X will diversify his portfolio into a greater number of counters but eventually all big investors such as major pension funds and institutional investors will be exposed to a broader proportion of the overall market.

1. **Passive Investing or Indexation is the process of acquiring diversified exposure to a broad market index at a low cost.**
2. **A growing number of portfolio managers concede that most investment managers fail to provide returns superior to funds that track a broad market index**.

The following graph arranges all South African Equity Unit Trust Funds from lowest to highest performance over the past ten years with the black line indicating the J203T return:

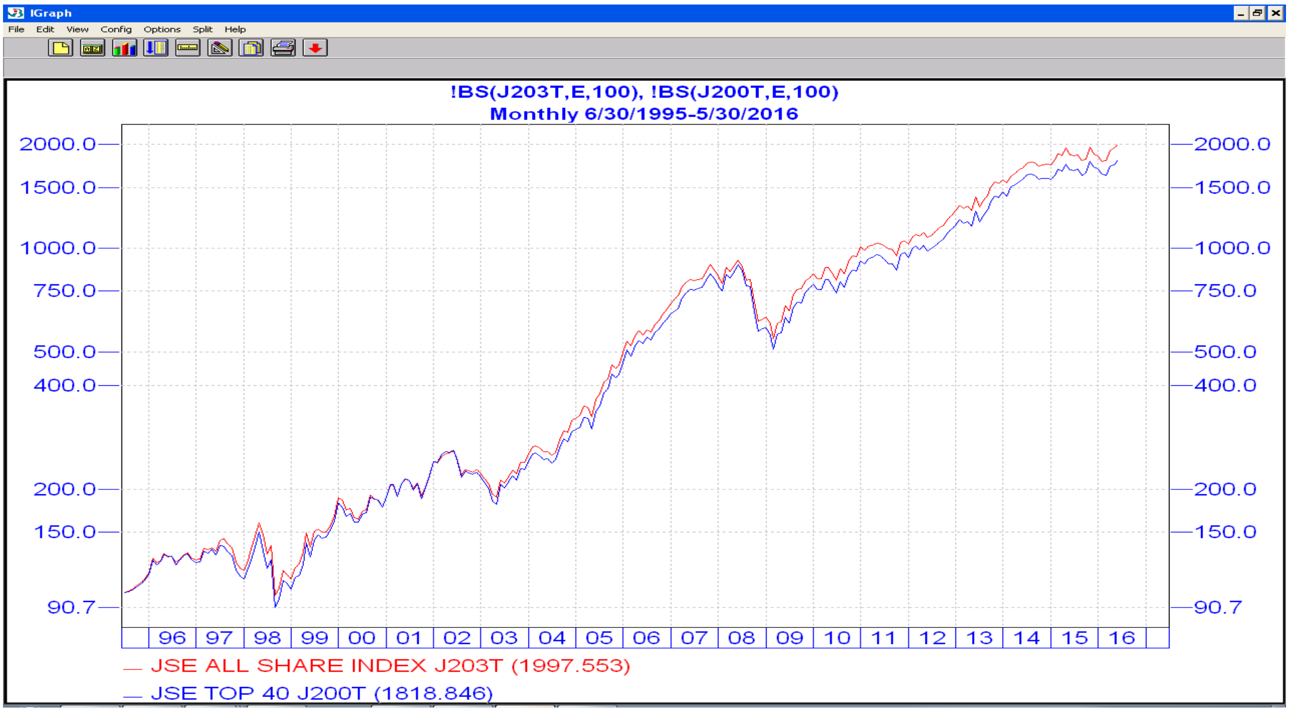


Surely there will always be managers that outperform the broad equity market over extended periods, the ones that truly possess some skill, but identifying them in advance proves to be one of the most difficult tasks us humans could ever accomplish. 85% of equity fund managers underperformed the JSE All Share Index (J203T) over a ten year period and this figure does not include underperforming funds that closed down due to underperformance (survivorship bias). Also note that potential underperformance is much greater than the potential outperformance relative to the index. Surely the prudent thing, especially so for financial advisors and investment consultants, is to allocate wealth to indexation.

Indexation implies that an investor will own the percentage exposure to counters as listed on that index. In our case big counters such as Naspers will make up 13.28% of a passive investors' holding as that is the weight of Naspers in the JSE All Share Index (as at 31 May 2016). The liquidity aspect also plays a role here as one can argue that on average 13.28% of all flows that happen on the JSE will be related to Naspers (over a longer period).

But there are alternative indexes?

The JSE All Share Top 40 Index (J200T) is similar to the J203T in all respects except that it includes only the top 40 counters by size screened from the same investable universe as the JSE All Share Index. From the March 2016 index review, 43 counters were approved which is normal in order to prevent too many counters being reshuffled in and out of the index on a rolling basis. Obviously this index is biased towards more mature companies and does not capture the performance of smaller growth (and/or more efficient) companies from an earlier date.

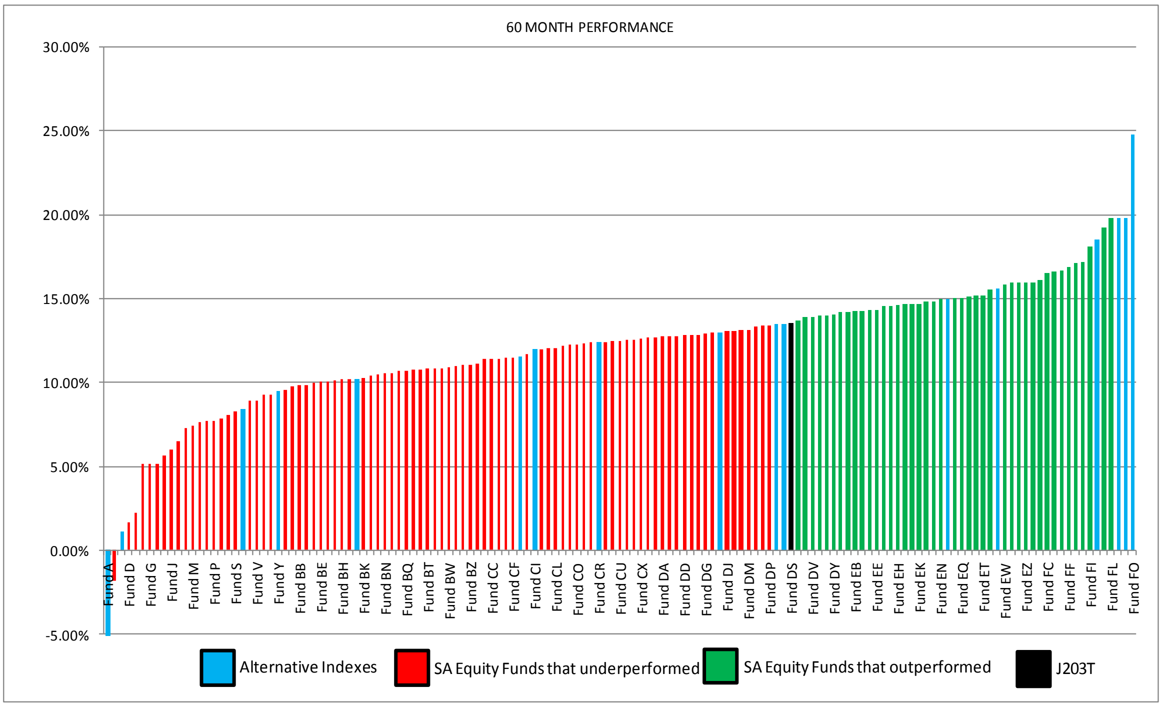


Source: INET BFA

Breaking down the JSE All Share Index will also give you each and every sector and its sector benchmark / index. For example, you will find that the Banking sector (J835T) includes the following counters: Barclays Capital, Capitec, Finbond, Firstrand, Nedbank, RMB Holdings and Standard Bank. Similarly if you roll up most financial institutions you will end up with the JSE Financial Index (J212T). There are numerous financial institutions providing investment products that track the performance of these underlying sectors.

You also get the Shareholder Weighted All Share Total Return Index (J403T). This index contains exactly the same counters as the J203T, but with weights adjusted to reflect only local shareholdings. For example if counter number two is dual listed on the London Stock Exchange and held by a majority of local investors then it means that it can carry a higher weight than counter number one which might also be dual listed but held by a majority of offshore investors. There is considerable debate whether this index is more relevant; some argue that this index is not a true reflection of our market as foreign share dealings (and arbitrage) are a major component and a determinant of share price performance.

Weighting schemes that adjust individual share proportions of an index in ways so that they deviate from the All Share Index will naturally result in different performance. Smart Beta, Enhanced Indexing, Dividend-, Momentum- or Value enhancing indexes, Fundamental Value ranked indexes etc. are all examples. Service providers offer products trying to replicate these methodologies thereby tilting fund exposures in ways that is similar to what active equity fund managers do. Ranking these funds together with South African Equity Unit Trust Funds over a 5 year period gives us a very similar result:



Source: Morningstar; Compiled by Gryphon Asset Management

Again, outperformance is likely but predictability is key. Should one have the skill to identify these trends in advance the outcome can be very lucrative and vice versa.

Conclusion

So now that we understand indexes and why they exist we can perceive the market with a better understanding and what makes them move. Eight counters, namely Naspers, SABMiller, BHP Billiton, Compagnie Financiere Richemont, Sasol, Steinhoff International Holdings, British American Tobacco, and MTN make up more than 50% of our index and are major determinants of where we are going. We also know that trying to produce outperformance is a horrendous task but also possible. So where does this leave us? Consensus suggests that the answer lies somewhere in the middle with a core passive holding supplemented by satellites of active management should the need / skill exist...with the overall equity exposure calibrated to suit an individual's profile.

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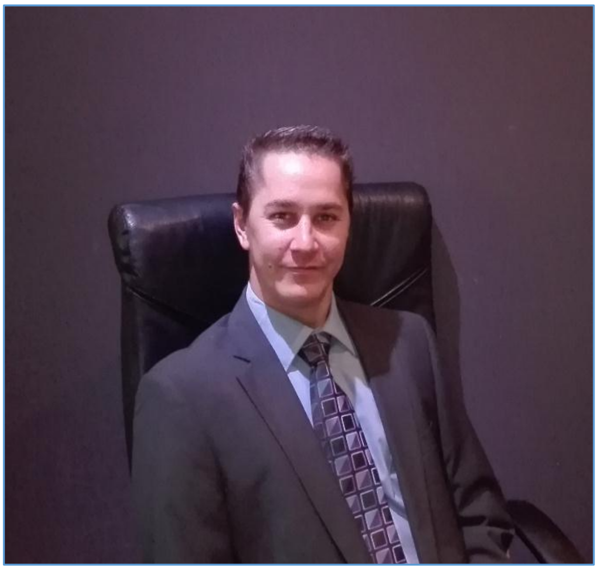
Glacier Research would like to thank Casparus Treurnicht for his contribution to this week's Funds on Friday.



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He joined Gryphon in 2011 as a Research Analyst, specialising in equities. Besides managing the Fund and assisting in formulating Gryphon's house view, he enjoys educating the public about investments. His work experience includes being a front Office Business Analyst and Team Leader at MFS (2007 – 2011), Research analyst at Gryphon Asset Management, (2011 – 2013) and Portfolio manager and Research analyst at Gryphon Asset Management (2013 – current).