# ACTIVE INVESTING OR INDEXATION

Any private investor who is new to the world of share investing has a range of investment options that can be a little intimidating. As a starting point, an investor can choose individual shares or ETF's which consist of a number of different underlying shares. The question for a private investor is, which is the best way to start?

## *ACTIVE INVESTING*

There is some jargon to decipher before one can make sense of the debate around this issue. The term "active investing" refers to managers who try to choose individual investments that will beat a specific benchmark. An active equity investor will select a number of different shares in an attempt to generate better growth than the stock market. An index investor simply tries to replicate the index's performance i.e. tries not to take more or less risk than the stock market – this is described as passive investing.

## *COSTS AND TURNOVER MAKE A BIG DIFFERENCE*

One of the big advantages of index investing is the benefits of lower costs. If you buy an ETF (e.g. Satrix Rafi) you are actually buying 40 different companies at once. That means your brokerage is much lower than if you were to buy all 40 different companies individually. This makes the ETF very cost effective for a smaller investor who will be making regular monthly investments.

John Bogle (the father of index investing) found that the average active fund investor in the USA, only received 47% of the cumulative returns generated by the active fund due to the turnover costs. By comparison, an index fund investor received 87% of the cumulative return. This means that an investor who placed $10,000 in an average active fund for 16 years would have earned $49,000 whilst the index investor would have earned $90,000. If the same study were done in SA, I am convinced that the statistics would be very similar. On the issue of costs, there is a clear argument in favour of index funds. Active investors would argue that their performance would be better even with the higher fees.

## *WHICH IS BETTER?*

Some active managers do beat the market very handsomely over extended periods of time which means it is possible to beat the market. Unfortunately the number of managers who can sustain this outperformance is very small. To complicate this issue further, some of the great managers cannot replicate their performance from one economic cycle to the next. According to MotleyFool.Com, only 20% of large unit trust funds actually manage to beat the US stock market (S&P 500) over longer periods of time. For a private investor, the odds are certainly against you! However if you get it right you can benefit from fantastic returns. According to the local Morningstar unit trust figures to the end of July, the best local General Equity unit trust generated a return of 23.31% per year for the last 10 years. This is almost double the return of the All Share Index which grew by 13.07% per year for the last 10 years. Even with the additional management fees and turnover costs, the top unit trust was a great investment.

## *SOME ALTERNATIVES*

Many of the large pension funds in the USA use a combination of index investing and active investing. For example, the largest pension fund in the USA, the CalPERS Fund has 69% of its domestic share exposure invested in indexes. The balance is invested with active managers who attempt to beat the market. South African investors can adopt this approach - called core and satellite - if they buy index ETF's via a stock broker and select individual shares. The philosophy behind this approach is that you might be able to select certain shares that are obviously undervalued whilst still getting the broader stock market exposure via the ETF.

Another alternative is to select your own portfolio of shares in an attempt to beat the market. As a private investor you have some advantages over institutional investors.

- You don't have to report your performance to clients (or the press) on a monthly basis. This allows you to take long term views on great, undervalued companies where you give them the time to unlock their real value.
- You can also buy some of the smaller companies on the JSE that are not accessible to large institutional funds. If a large fund of R17bn buys a listed company, it will need to account for at least 1% of the portfolio in order to add to performance of the fund. If the company only accounts for 0.2% of the fund and it doubles in value it will only add 0.2% to the fund! This means the fund needs to allocate a minimum of R170m to each company. Unfortunately many of the smaller companies on the JSE are worth less than R170m in total! This gives the private investor a great advantage as some of these smaller companies are great businesses and are trading at massive discounts to their net asset value.
- You can create a more concentrated portfolio than a unit trust manager can. This means you can invest in only five shares rather than the 17 – 40 that most unit trusts have. If two or three of your shares do really well, it will have a massive impact on your portfolio. Conversely, if 2 or 3 shares do really badly, you could lose most of your money.

Personally, I really like the core and satellite approach where the index forms the largest proportion of your portfolio and selected shares make up the balance.