INDEX INVESTING IN VOLATILE MARKETS

As the stock market maintains the excellent rate of growth that started in 2009, some investors are starting to question whether there are inherent dangers in their indexed investments. Many critics of index investing claim that it is worth paying a fund manager when the stock market is expensive as the fund manager should select assets that will not fall as much as the index in the event of a market crash. This is a topic that is very relevant to us as many of our clients have a significant exposure to indexed investments.

As always, when we attempt to understand issues like this, we rely on objective information rather than emotive arguments. We have reviewed the market crash in 2008 as a good example of how indexed investments perform in rising and falling markets. The table below shows what happened in the two years preceding the crash, the year of the crash and the following two years of recovery. This is a five year period which is the minimum period for any investment in shares, indexed or not. We compared the index performance vs. the average performance of unit trusts that invest in shares.

	Rising Market	Rising Market	Market Crash	Market Recovery	Market Recovery	Average Annual Growth
	2006	2007	2008	2009	2010	Return
All share index	41.2	19.2	-23.2	32.1	19.0	17.666
Ave equity unit trust	36.7	17.6	-22.9	27.2	18.5	15.428

It is clear that the indexed investment will fall by the same amount as the average unit trust but the index recovers more quickly than the average unit trust. This puts paid to any arguments by fund managers that index investing is somehow more “dangerous” than managed investments. It also reinforces our view that an indexed investment will beat the average over any period longer than five years. For longer periods of time, we believe that an indexed investment will actually be in the top 25% of all funds.

Some fund managers have added value to their investors over the long term. Over the last ten years, the best unit trust in SA has grown by 25% per year while the index has grown by 20% per year. This means there is scope for investors to search for fund managers that have the ability to beat the market because a handful of them have done so in the past. However one cannot simply rely on those fund managers who have performed well in the past. Very often, fund managers are unable to replicate their performance. There are numerous reasons for this; they lose motivation as their wealth rises, they retire or change industries. Their replacements are usually unable to replicate the performance of these stars. In addition, the best fund managers often achieve great results very early in their careers when they are unknown and manage small amounts of money. As they manage larger amounts, their performance declines to the detriment of their investors. Unless you have a strong conviction in your ability to predict which new fund manager will be the next great performer, it is often better to invest in the index.

INDEX OR BUST?

The large majority of our clients have a significant allocation to indexed investments and some clients are 100% invested in indexed funds. We are comfortable that they will achieve good growth over the long-term and have a high probability of being in the top 25% of all funds. Some of our clients also have money invested with fund managers in which we have a strong conviction. It is our view that these funds are more risky than indexed investments as the chance of underperformance is high. This is the price that is paid for the potential that these fund managers can outperform the market over the long term. When it comes to long term investment decisions, we constantly deal with probabilities. For investors who want as much certainty as possible, we recommend indexed investments. Investors who are willing to take more risk with less certainty, potential outperformance generated by fund managers might be attractive. In summary, there is no single strategy that is sure to succeed in all conditions, we have to tailor your investment strategy to your requirements, personality and circumstances.