INDEX INVESTING IS EVOLVING

The flow of money into index tracking investments around the world shows that investors have realised the merits of this form of investing. Personally, I think it is a waste of time to debate whether index investing is better than other forms of money management. The benefits of low cost, index investments and the relatively poor performance of most fund managers has been proven many times over. However the world of investments is so complex that you simply cannot invest your money with 100% conviction that you have all the answers – history teaches us that this is a great way to lose money. I believe the most sensible way to invest is to use index tracking investments as the core part of any portfolio and to use a fund manager to compliment the index portfolio.

There are a handful of fund managers who have beaten the index over long periods of time and their performance has been good enough to merit consideration – the difficulty remains in determining who the next great performer will be. Historically, you only have a 20% chance of choosing the right manager and a mistake could be very costly.

EVOLUTION

It was only a matter of time before a larger number of product providers started offering their own index trackers. In South Africa, the index market was developed mainly by Exchange Traded Funds (ETF). At the time, they were revolutionary due to their low costs and simplicity. Unfortunately, ETF's proved very difficult for investment platforms to administer so we were not spoilt for choice with investment platforms. Often the best option was to open a stock broking account to buy your ETF's directly. Personally, I have always preferred a stock broking account because the annual fees are a fixed monthly amount rather than a percentage of the value of your investments. Fortunately, the banks also realised that they could gain market share by embracing ETF's and so they starting offering very low cost trading options via their own stock brokers. For a time, this was the best way to access indexed investments.

UNIT TRUSTS GET IN ON THE ACTION…FINALLY

It took quite a long time for the unit trust industry to wake up to the benefits of index investing but they are now entering this market segment with vigour. Some providers have also realised that they need to price these investments properly and we now have highly diversified, index unit trusts with a Total Expense Ratio (TER) of 0.47% per year. In the context of the South African market this is a remarkably low cost and should put some fund managers out of business unless they change their business models. In the USA, you can invest in index trackers with TER's of 0.01% but our market is too small to achieve those economies of scale. I believe TER's of most unit trusts in SA are too high – the maximum should be 1.25% per year and all index trackers should be below 0.5%. Unfortunately unit trust TER's of 3% and higher are still common in SA, which is not beneficial to investors. If you consider that the stock market gave us 11% last year, a fund with a TER of 3% would have eroded nearly 30% of your growth. This is when low costs really matter, a difference of 1.5% in costs per year could determine whether your investments beat inflation or not.

Now that range of low cost index tracking unit trusts in SA is increasing rapidly, it is becoming difficult to determine the most appropriate type of index investment to use – an increasing range of options creates new problems. I prefer highly diversified indexed investments, for example a fund or combination of funds that provide exposure to the JSE, listed properties, bonds, cash and international markets. Fund managers correctly raise the objection that some index trackers cannot protect you against overvalued shares. The best antidote to overvalued shares is to have a broad exposure to a range of shares or to invest equally across a fixed number of shares. I like the equally weighted index investments where you allocate the same amount of money to a fixed number of shares. There are also index trackers that limit your maximum allocation to any single share. As an example, if Naspers accounts 15% of the value of the Top 40 index, some trackers will limit your Naspers allocation to 5% of the index value so that you are not overinvested in one company that might be very overvalued.

If you prefer to invest in ETF's, then it might be an idea to combine a Top 40 tracker with a Rafi tracker or something similar where you can get diversification and a different form of protection against overvalued shares.

CONCLUSION

As the range of indexed investments increases, you should not be tempted to invest in too many different products because you will eventually over-diversify your money. You should also have a real focus on costs and should not overpay for index trackers. Finally, there probably is a real benefit to be gained by combining an index tracker with a fund that is managed by a fund manager but there are real dangers in selecting a fund manager. History proves that you have a better chance of choosing a losing manager than one of the very few who will actually beat the market. Unless you are prepared to do the research on fund managers, rather invest in an index tracker.