FUNDS ON FRIDAY
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Acknowledging passive, embracing active

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One of the stand-out success stories in global finance over the last few decades has been the exponential growth of the passive investment industry. Much has been written about the inability of active managers to outperform global indices, yet we believe there are some nuanced differences between South Africa and the rest of the world.

South African investors have long been faced with concentration risk, given the dominance of large and successful companies that make up the JSE. Whilst the industry has made strides to mitigate this risk, like introducing the Capped Swix index to down-weight very large companies, the table below highlights the significance of key companies and sectors on the JSE.

Capped Swix Weightings	Aug-18	Oct-19	Feb-20	Oct-20	Mar-21	Sep-21
Naspers & Prosus	9.7%	13.2%	15.8%	16.0%	12.8%	11.9%
Resources	12.9%	18.3%	21.0%	27.3%	31.0%	21.9%
PGM's (incl in Resources)	1.4%	4.1%	6.0%	9.6%	11.9%	7.9%

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Two of the dominant themes in South Africa over the last number of years have been the extraordinary returns that Naspers and the resources sector have delivered. Whilst both of these themes may have waned of late, the table illustrates the concentration risk that South African index investors can face. It is worth noting that the Capped Swix has a more measured approach to weightings than other investable indices – the top 15 shares make up only 51% of the Capped Swix, compared to 67% of the All Share, and 77% of the Top 40. The mathematics of an index is such that companies that have already outperformed end up with a higher weighting – we would have reservations about investing in a concentrated portfolio filled with many of yesterday's winners.

A look at the Capped Swix weightings is informative – in August 2018, the total resources weight was only 13%. A number of active managers were successful in taking a constructive view on the sector, subsequently delivering significant Alpha. By March 2021, resource weightings had increased to 31%, illustrating the spectacular outperformance of the sector. The Platinum Group Metals (PGM) sector alone, following exponential performance, had a 12% weighting by March 2021 – nearly the same as the whole resources sector in August 2018. Over the last six months, the weightings have reduced by nearly a third, following a period of brief, but significant underperformance of the sector. History has taught us that it is an exceptionally volatile sector. At the peak of the commodity euphoria in March 2021, we recall watching a market commentator choosing Sibanye as their "stock pick", the logic being that it is a defensive company, given that it mines both gold and PGM's! Whilst their view may be proved correct, there are precious few defensive resources companies, in good times or bad.

As shown in the table, the combination of Naspers, Prosus and the resources sector contributed over 40% of the Capped Swix between October 2020 and March 2021. From a concentration risk standpoint, the combination has now moderated to "only" 34% by September 2021.

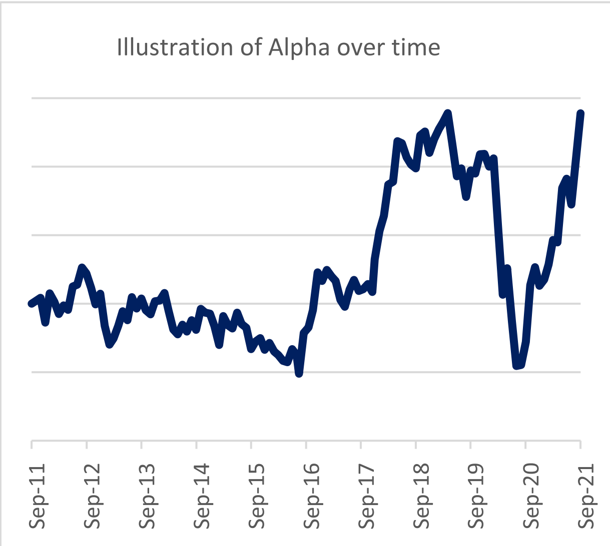
In the past, we have embraced the cyclicality of the resources sector, when the earnings backdrop was more favourable. Given concerns around peak earnings in resources and potential valuation concerns in global technology companies, we have some concern around the relative unpredictability of the prospective returns from these particular companies. This has resulted in us currently holding more modest weightings to mitigate against potential risk – index investors currently don't have that luxury.

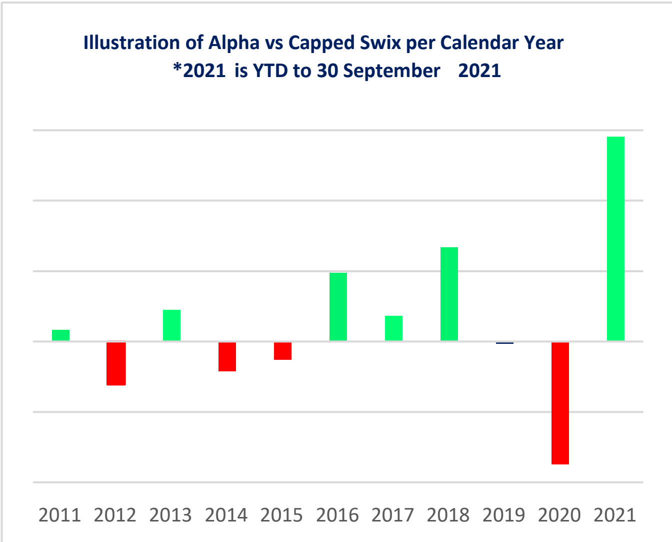
Alpha generation

All investors strive for alpha. Few, if any, have the magic formula to generate it consistently. We believe a few fundamentals need to exist to give yourself a chance. Firstly, as Sir John Templeton said: "It is impossible to produce superior performance unless you do something different from the majority." You can't hope to outperform an index if you are not prepared to diverge materially from it. Secondly, we believe that focused portfolios of well-researched, high-conviction ideas amplify the ability to produce alpha. In a study a few years back by Anton, Cohen and Palk, they draw the conclusion that the "Poor performance of US mutual fund managers is not due to lack of stock picking ability, but rather to institutional factors that encourage them to over-diversify." A third requirement would be patience, an ability to wait for the investment case to play out.

Smaller asset managers frequently refer to a structural advantage over larger managers given their breadth of opportunity set across the market cap spectrum. This ability firstly to identify and then most importantly to invest in underexplored and less liquid opportunities, provides smaller managers with an edge over their larger peers. Market cycles dictate that this advantage can be both a blessing and a curse. In times of crises, like COVID-19 in March 2020, the immediacy of the need for liquidity to fund redemptions, margin calls and general expenses, can contribute to share prices of less liquid companies falling precipitously into a void of liquidity, and investors being permanently jaundiced against relatively illiquid companies. For good, attractively valued companies, these selloffs are typically short-lived, but nonetheless painful. Portfolio managers often trade off liquidity against valuation, given the perceived career risk in illiquidity, resulting in the market often over-pricing liquidity, with the converse being equally true.

The charts below are an illustration of alpha generated by our South African-only equity fund, investing in differentiated holdings, and a limited number of portfolio companies. Whilst the end-result is indeed the generation of alpha over the Capped Swix over all periods, the alpha profile has not been smooth. The reality is that good managers aim to produce alpha, in time, over time, but given the differentiated make-up of the portfolios, alpha perhaps is not possible all of the time. The objective is to have a chart that moves upwards to the right, as depicted below.





We acknowledge that the passive industry in South Africa is likely to continue to grow. For active managers to survive and ultimately thrive, our view is that we need to be able to offer a differentiated product that blends well with passive solutions and naturally needs to demonstrate an ability to generate alpha over time. Our South African Equity Fund is already a focused fund with a limited number of portfolio holdings, yet we have seen growing interest from professional investors for an even more focused and highly active offering.

Our hope for all investors is that the index returns are strong. We believe that truly active funds offer blending benefits to client portfolios and have a role to play in the diversification of risk, and the generation of superior returns.

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

Andrew Vintcent

Portfolio Manager

ClucasGray

Andrew Vintcent has worked in the asset management industry for over 21 years, the first 16 of which were spent at two large institutions, RMB Asset Management and Stanlib. His roles spanned research, portfolio management and leadership, with significant portfolio management experience gained in managing both South African equity and asset allocation funds. In 2015, Andrew partnered with ClucasGray as an equity investor in and manager of the asset management business. Andrew, along with co-portfolio manager Grant Morris, has managed the ClucasGray Equity Prescient Fund, the ClucasGray Equilibrium Fund and mirror institutional mandates of those funds since 2015.