By Johan Fourie

ASSET ALLOCATION

The battle between active and passive

Some considerations in the decade-old debate remain important.

The Index Card is a popular personal finance book, first published in 2017. Its thesis is simple: Buy an index fund – like the ALSI Top 40 – rather than paying the fees of asset managers, who in the long run rarely outperform the market. I asked Nico Katzke, head of portfolio solutions at Satrix, why we should not all follow *The Index Card*'s advice and go for passive rather than active investing.

"The debate has often been framed, wrongly in my opinion, as either active or passive. In reality, both have their place. Active managers have an important price discovery role to play and preserve the ability to outperform indexes. Index-tracking funds, often referred to as passive funds, provide investors with a low-cost alternative, while tracking indices that have proven to be very hard to outperform consistently."

But even passive investing is not that simple. "In reference to index funds, passive is a bit of a misnomer. Our research shows that the tracking error between two widely tracked indices, the Capped SWIX and the ALSI Top 40, is in line with that of the median active manager to the Capped SWIX. This suggests that your choice of index to track is a very active decision, and not all indices are created equally."

The main advantage of indices, though, is the fee structure. The "tyranny of fees", as the *The Index Card* makes clear, can be devastating for future returns. Is that true in the South African context too?

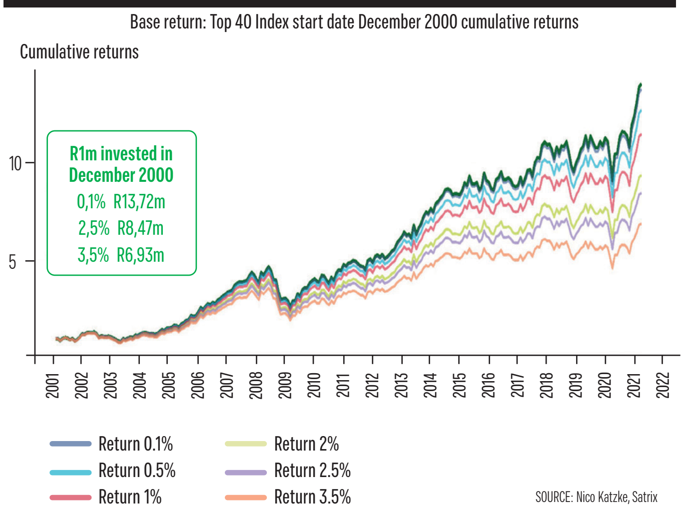
"Increasingly, the argument for index-tracking investing can be made from both a performance as well as cost perspective. The two cannot easily be separated though, considering the erosive impact of fees. Indeed, the surprisingly large impact that compounded fees have on investment returns can be summarised in the graph. It shows that if you invested R1m at the inception of SA's first index tracker, the Top 40 Index, what your return profile would've been had you been paying different fees. Because it is incredibly hard for active managers to consistently outperform low-cost indices sufficiently to mitigate the impact of their fees, it is therefore no surprise that such a large cohort fail to outperform index trackers."

It is time to have active asset managers defend their craft. I asked Paul Theron, founder and CEO of Vestact, whether active management still has value.

"Most people are better off buying and holding an index fund like the S&P 500 than investing by themselves. Owning an index tracker is better than trying to day trade penny stocks or time the market. Our fee is 1% per annum, and we've beaten the S&P 500 handily over 15, 10 and 5 years by being more focused on some sectors (like tech) and less on others (like basic materials, oil and gas). Our services also appeal to those who enjoy owning actual shares. Some of our success is due to stock picking, but it could be that encouraging clients to hold on to their shares in tough times is just as important."

Mia Kruger, director at Kruger International, stresses the diversification that comes with active management. "At Kruger, we combine indexing strategies with investments into assets like renewable energy and infrastructure projects. Renewable energy and infrastructure projects have not been available to retail investors in SA up until last year when we brought the first investment into a windfarm to our clients. Buying an exchange-traded fund (ETF) will rarely fulfil all your investment needs. Besides, it is not that easy to pick the right ETF as there are so many and they don't all charge the same low fees."

FEE IMPACT ON CUMULATED WEALTH



SOURCE: Nico Katzke, Satrix

From the two responses, two things stand out: The need to manage investors' own "animal spirits" and the need for diversification. Retail investing is becoming increasingly popular, as the valuation of Robinhood Markets, an American online trading platform, suggests. Is it not likely that investors will simply manage their own active portfolios, and leave the rest to index funds?

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"New-generation investors are more astute," says Katzke, "asking difficult questions around value added by active managers in relation to fees. Index providers are also coming to the party by providing new-generation investors with the tools to manage their own investments. Platforms like EasyEquities make investing in single-stock names easy to do, while SatrixNOW similarly makes investing in a wide range of well-diversified index-tracking funds simple."

But both Kruger and Theron warn against retail trading. Says Kruger: "There is a big difference between speculating and investing. The majority of Robinhood's clients are traders, not investors." Adds Theron: "And most traders lose money. My clients like to have a sensible adviser to talk to."

For both active and passive asset managers, guiding investor behaviour and diversifying their offering will be key. New technologies that give investors more information will bring more competition and more choice, pushing down prices. That can only be a good thing for investors worried about their future earnings. ■

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