

The right active manager will deliver the goods

The cases for investing in a lower-cost index-tracking investment as opposed to paying more for an active manager who can earn more for you than you would get from a market-linked passive investment were argued at a recent acsis/Personal Finance Financial Planning Club meeting. **Laura du Preez** reports on the case made by Karl Leinberger, the chief investment officer of Coronation Fund Managers, for active investing. **Neesa Moodley-Isaacs** reports on the arguments put forward by Roland Rousseau, a consultant to the index investment company, Satrix.

The fact that many investors' portfolios under-perform their benchmark index is not a good reason to abandon active investing, Karl Leinberger says.

He says you cannot argue that active investing is flawed because some active fund managers achieve returns that are lower than the benchmark index for their fund or portfolio.

Every man's gain is another man's loss, Leinberger says, and in order for certain active fund managers to out-perform the market average, as represented by an index, there need to be managers or other investors who under-perform.

He says the issue you should consider is not whether to invest with an active manager or in a passive index-tracking investment but how to pick an active manager who can earn a return that is higher than the market can deliver.

Leinberger says for all the fund managers who beat a market index, there are managers who lose against the index to the same extent, resulting in average performance equal to that of the market index. This means that after their fees have been deducted, fund managers must, on average, under-perform the market index.

As proof of this, Leinberger says, over the five-year period to the end of August the average return of domestic equity general unit trust

funds was 18.4 percent a year, whereas the benchmark index, the All Share index (Alsi), returned 20.3 percent. The average fund therefore under-performed the index by more than two percentage points.



Karl Leinberger

But while in aggregate fund managers under-perform their benchmark indices, there are some good fund managers who consistently deliver market-beating returns over the long term, Leinberger says.

You must, he says, choose a manager based on long-term returns – at least five years – because short-term performance is “incontroversibly random”.

Leinberger says the value that active managers can add over time is illustrated by the returns earned by four top domestic equity fund managers over the eight and a half years to the end of March this year.

An amount of R100 000 invested in the Alsi over this period would have been worth R338 613 at the end of the period. An investment of R100 000 with the worst-performing of the four top active fund managers would have been worth R623 587 after costs, while the best-performing active fund manager would have returned R956 096.

Leinberger says if you choose a manager rationally and for the right reasons, you will receive great out-performance. This, he says, is true around the world.

While short-term performance may be lumpy, with both positive and negative returns, a good manager should be able to produce positive returns over each five-year period on an ongoing basis – that is, on a rolling five-year basis, Leinberger says.

WILL GOOD RETURNS ENDURE?

Leinberger says you may wonder whether top fund managers will continue to deliver good returns in a competitive market.

“We think they will keep delivering, because markets always provide the rational long-term investor with opportunities.”

Leinberger says there are three reasons why there will always be “enormous opportunities for bold, courageous investors”.

The first is that investors continue to invest in line with their emotions – particularly fear and greed – and this makes them pull out of falling markets and invest again when markets are rising.

Good fund managers can see the opportunity in going against this trend: buying cheap the share that others are selling and selling when markets are rising and other investors are buying.

The second reason is that many smart investors, including fund managers, make investment decisions based on short time horizons, because they are under pressure to show good performance for the year, he says.

And third, many fund managers hug the benchmark, because they

Top four active equity fund managers out-perform Alsi



Performance of domestic equity general funds to the end of August 2009*

	1 year	3 years	5 years	7 years	10 years	15 years
All Share index:	-6.8%	7.4%	20.8%	18.0%	17.6%	14.1%
Median fund:	-4.0%	6.9%	19.2%	16.4%	16.5%	13.5%
Out-performed:	67.0%	43.0%	27.0%	60.0%	41.0%	29.0%
Under-performed:	33.0%	57.0%	73.0%	40.0%	59.0%	71.0%
Number of funds:	296	176	95	69	37	14

*Annualised returns inclusive of fees except for index.

SOURCE: ACSIS

are afraid to look bad in the short term. This forces them to buy certain stocks when their prices are high and to sell them when their prices are low, Leinberger says.

INDEX INVESTORS BUY HIGH

Leinberger used three examples to illustrate how investing in line with an index makes you buy when prices are high and sell when prices are low.

The first example was the last big oil price boom in the 1980s.

At that time, 14 of the 20 largest global shares, which would therefore have been large shares in any

global equity market index, were companies in the oil industry. When these shares became large enough to be included in the indices, the price of the shares was already high.

These companies under-performed global stock market returns massively over the next 20 years, Leinberger says.

In the second example, in 1990, 12 Japanese shares were among the world's 20 largest shares, whereas only two oil companies were among the 20 largest. Japanese shares were then very expensive and a rational long-term investor would have bought none of them, he says.

WHAT THE TERMS MEAN

AN INDEX: An investment market index gives an indication of the performance of a market, as it is compiled by including shares or other securities in a particular market or market sector in accordance with each share's weighting in the market or its market capitalisation. For example, if a company's shares are worth R20 billion and all the shares on the stock exchange on which it is listed are together worth R200 billion, that share would be given a weighting of 10 percent in an index that tracks that stock exchange. An index can track a number of markets (the Morgan Stanley Capital World Index, for example, tracks 1 500 shares on the equity markets of 23 developed countries), a single market (the All Share index tracks the JSE) or a market sector (the Alsi 40 tracks the 40 biggest shares on the JSE).

PASSIVE, OR INDEX, INVESTING: The strategy of investing in line with, or tracking, an index to produce a return in line with that of the market. This investment strategy does not require investment analysts and research by expert fund managers and hence the costs are usually a lot lower than they are for actively managed investments.

ACTIVE ASSET MANAGEMENT: An investment strategy that involves asset managers choosing investments based on research into asset classes and the securities within those asset classes. Active managers seek to out-perform the market, but they are not always successful and sometimes take greater risks to achieve out-performance than do managers who invest in line with a benchmark.

The Nikkei, the benchmark for the Japanese equity market, fell from a high of 38 915 in December 1989 to a low of 7 699 in April 2003, and has subsequently recovered to only about 10 100.

In the third example, in March 2000, the 16 biggest shares among the 20 largest globally were technology, media and telecommunications (TMT) stocks.

The TMT bubble burst shortly thereafter, with the Nasdaq, the United States stock market where most TMT stocks are listed, peaking at 5 048 before falling spectacularly to a low of 1 139 by October 2002.

Leinberger says last year the

world experienced the biggest commodity boom in history, and nine of the 20 largest stocks globally were shares in the resources sector.

The rational investor, he says, should then have been selling these shares rather than holding or acquiring them. Now, many commodity shares are worth half of what they were a year ago, he says.

A good fund manager can beat an index by not buying shares when they are expensive and are about to fall from their peak. But if you are invested in an index, you will be caught in the rise and the fall of the big shares as they enter and drop out of the index.

