SOUTH AFRICAN INSTITUTIONAL INVESTMENTS

WHOSE MONEY IS IT ANYWAY?

SUMMARY & CHAPTER 1

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SUMMARY

South African workers depend heavily on the successful operation of their occupational retirement funds for their well-being in old age. Total assets in these funds have accumulated to some three-quarters of annual GDP and they form the largest set of institutional investors in the country.

This discussion document describes the operation of this part of the institutional investment market and identifies a number of areas in which, it would seem, the interests of service providers and the owners of capital are not in complete alignment.

Five themes find frequent expression throughout this paper:

- **Owners and agents.** Insufficient distinction appears to be made between the financial interests of the owners of assets – retirement funds and their members – and their agents, asset managers, investments consultants and a large number of supporting firms, all of whom are stewards of these assets.
- **Supporting the value chain.** The depth and complexity of the industry supported by retirement funds is probably not appreciated by the trustees of these funds. While market players provide an important service, a better alignment of interests would encourage them to do so more effectively.
- **The allure of the past.** Human beings are strongly inclined to seek meaning in a succession of events and often make the mistake of inferring causality where it might not exist. In the area of investment, this finds expression in an inappropriate attribution of good performance to skill, instead of recognising that at least some may be due to random factors. This in turn creates an unhealthy dependence on active asset management and on the information provided by sophisticated information intermediaries whose skills are difficult to assess objectively.
- **Conflicts of interest.** Providers of service to retirement funds have a variety of financial incentives that are not necessarily in the best interest of their customers. Conflicts of interest occur in a number of different ways, so commonly that it is not easy to find instances in which, with certainty, they do not exist.
- **Information inequity.** A large proportion of trustees are not experts in investment. They are representatives of the membership of a fund or its sponsoring employer and, to the best of their ability, seek to execute on their fiduciary responsibility to the fund and, by implication, to its members. Providers of service, on the other hand, are professionals in their fields and have the natural incentive to position themselves as well as possible, sometimes taking advantage of the information inequity in the process.

The market for institutional investments is enormously complex. This makes it easier for providers to price opaquely and to develop alternative sources of revenue, particularly with less skilled and experienced individuals serving as trustees. This also makes it difficult to provide a comprehensive analysis of the market. The discussion in this paper is therefore anecdotal in nature, asking questions in a number of areas rather than attempting to cover in detail the operation of the market.

After an initial description of the marketplace and its players and a synopsis of some of the legal principles underlying its operation, ten questions are asked. Some of these are relevant to the entire market, for example:

- Why is there such a strong emphasis on active asset management, as opposed to the index-linked alternative?
- Is the training provided to trustees independent and in the best interest of the trustees or does it tend to deepen their dependence on their service providers?
- Are fee models designed to align the interests of provider and customer?
- Is sufficient attention given to the fundamental principles underlying a socially responsibility investment approach?

A number of them are focused on particular parts of the market, for example:

- asset consultants,
- hedge funds, and
- multi-managers.

The remaining issues apply more to some parts of the market than others, but ask questions that are of relevance to trustee thinking generally.

- Do marketing activities enhance customer understanding or are they designed merely to attract a customer to a service, in aggregate moving retirement funds from one provider to another without adding significant value?
- Do performance surveys of asset managers provide a useful service and are they used responsibly?
- Are all asset managers executing all of their trades in the best interest of their customers?

The paper is aimed at retirement fund trustees. It does not name service providers, though in a small market identification by the expert is sometimes unavoidable. The express intention is not to identify business models that may be inappropriate, but to equip trustees to identify activity with which, if they understood all of its consequences, they might not be comfortable.

I hope that this work contributes to a more effective market and a better outcome for the millions of South Africans who are members of retirement funds.

Active vs Index-Linked
Skewed Representation?

In which the distinction between active management and its index-linked alternative is described and it is asked why so little retirement fund equity assets are allocated towards index-linked investments.

Since markets have existed we have asked whether it is possible to outperform, with consistency, the average. More has probably been written on this question than on any other in financial markets literature.

Those in favour believe that an inefficient market – most agree that all markets are, to some extent, inefficient – must provide opportunities for outperformance and that some market players are able to exploit them with consistency.

Those against argue that, even if markets are broadly inefficient, it is not possible for any market players to sustain an advantage over their competitors sufficient to produce consistent performance and that apparent outperformance is often attributable to luck – random movements in an enormously complex set of factors – rather than skill. To this they add the reminder that it is not sufficient merely to obtain excess returns, but that outperformance needs to exceed the additional fees charged by these managers. Success, in other words, must benefit the asset owner, not just the manager.[1]

Why is the issue important? The answer to this question is simple, its ramifications complex. The very existence of most investment managers depends on their continued ability to project themselves as better (1) than their peers, and (2) than the market as a whole. Nearly all asset managers fall into this category, certainly to a man and woman those who are committed to trading securities in an effort to outperform the market. More than that, they believe that they have the skill to do so and honestly expect to.[2]

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[1] *The discussion is limited to equity assets, acknowledging that, while index-tracking is not simple for this class of assets, it is considerably more complex for others, like debt securities.*

[2] *"Individuals systematically overestimate their own individual ability: even professionals who believe in the efficient markets hypothesis also believe that they will (uniquely) be able to beat the market." (Cannon & Tonks, 2006:106).*

We find ourselves in an interesting situation, perverse even, because…

> *… A man is incapable of comprehending any argument that interferes with his revenue. (Descartes, quoted in Bogle, 2005a:144)*

Now if it were only the asset managers – those who firmly believe themselves able to pick winning stocks – whose interests were best served by perpetuating the confidence in stock-picking, we might not have a problem. But other parties, who should be concerned solely with the best interest of the client, appear also to have a strong motivation to cultivate the faith in active management.

This section does not attempt to answer the question of whether it is possible for an investment manager consistently to outperform an unbiased benchmark, after charges. It asks why, in the absence of clear evidence that this outperformance is possible, so little institutional investment money is directed to cheaper index-linked alternatives.

Active management versus index-tracking in a nutshell

Most asset managers in this country do more than look after the assets of their clients. They are granted the mandate, usually with limitations, to seek to improve the financial return on the assets, by buying and selling securities. They seek to use their information and skill to buy low and sell high, aiming to outperform their peers and the market average. These are *active managers*, distinguishing them from the *index-trackers* or *index-linked managers* discussed below.

It is credible that market experts have access to better-than-average sources of information and have developed better-than-average skills at interpreting this information. It is therefore tempting to believe that these experts are best able to turn these advantages into better-than-average performance.

The problem, the counter-argument runs, is that the market is dominated by experts, managing large volumes of institutional investments, with only a very small proportion of trade attributable to amateurs. It is simply not possible for all of them to consistently buy low and sell high because every trade has two parties, one buying and the other selling. Consequently, on average, active managers achieve performance no better than that of the average for the whole market. Furthermore, since active management is not a zero-cost activity, on average after costs, active managers must under-perform the market.[3],[4]

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[3] *The evidence for this statement is mixed. Richard Grinold & Ronald Kahn elaborate: "The initial studies of mutual funds showed that the average manager underperformed the benchmark, in proportion to fund expenses, and that performance did not persist from period to period. Some recent studies have shown that the average manager matches the benchmark net of fees, that top managers do have statistically significant skill, and that positive performance may persist. Other studies have found no evidence for persistence of performance." (Grinold & Kahn, 2000:481)*

How do active managers survive? The investing public and their institutional counterparts believe that some of them do outperform the market, that they can do so with consistency and that they can be identified with reliability. Systematic evidence to the contrary is very difficult to put together and the sheer weight of marketing material and carefully presented data[5] leaves customers conviced that there must be some merit in selecting an active manager.

The alternative to an active manager is an index-tracker, a company that does not attempt to buy low and sell high but puts its resources into investing assets into a mix that, as closely as possible, matches the corresponding mix of the securities exchange index. These products are cheaper than their active management counterparts because they do not require the investment in information and skill. And they are expected to produce performance that, while sacrificing the potential for a strong upside, at least also avoids the corresponding potential for a nasty surprise on the downside.

It is technically not possible to track an index with perfection, so there is always the possibility of some loss or gain relative to the index, but, by and large, at a much lower fee, customers get what they aimed for, the index.[6]

> *According to most international, independent, sources ... two factors have fuelled the recent growth in passive management.[7] Firstly, mounting research is showing the dramatic impact compounding fees and costs have on long-term performance. Secondly, the claim by every active fund manager that they have ... outperformed or have above-average performance in what is clearly a zero-sum game has tarnished their reputation. It is the second reason, more so than the first, that is most damaging. As William Sharp convincingly proves in his paper "The Arithmetic of Active Management", if the majority of active fund managers consistently outperform, there must be a group of equal size that consistently underperform (sic) yet*

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[4] I have heard the argument that the South African market has local and international investors, with different objectives, both of which groups could outperform their benchmarks because they could, where the objectives do not overlap, profitably trade with one another. I think we would find the opportunity for consistent outperformance to be very small as the overlap in benchmarks is very large.

[5] Though data is sometimes presented selectively, it often doesn't need to be, since a number of managers can be expected to outperform a market-average benchmark at least some of the time, even if their stock-selection is merely random.

[6] This description would be incomplete without the acknowledgement that there are a number of investment products that are neither index-trackers nor traditionally active in nature. The so-called absolute return product is designed to produce the best of both worlds, an upside in line with the markets with protection against the potential for very poor performance. These products differ from the traditional active management alternatives, however, in that they seldom aim to beat a market-related benchmark, but an inflation-linked alternative. Refer to the appendix for two articles commenting on this investment form and to section 4 on some of the concerns around the fee models used under these products.

[7] This is another term for index-linking. Such growth has not been seen in South Africa except in isolated pockets. A few pension funds – very few – have a clear commitment to investing more than a trivial proportion of their assets in index-tracking instruments.

> *nobody can identify this mysterious losing group. (Rousseau & Tayob, 2006:33, paragraph breaks removed)*

Note that the central thesis of this section is not that outperformance due to active management is impossible or even that it is not possible on a sustained basis by some managers. In fact, there is emerging evidence that South Africa provides better opportunities than most countries for active management outperformance (see later).

Nevertheless, to state the obvious, active management outperformance is simply not possible by all managers over any time span, unless by fabrication or distortion. After fees, the average of all active managers is very likely to trail or lag behind the average index-tracker, even allowing for imperfect tracking and greater-than-zero costs on the part of the latter. The core of the message here is that the safer and cheaper alternative, unexciting as it may be, is under-represented in the marketing of managers and advice of consultants, and under-utilised by the trustees who must always consider the best interests of their members.

Why does the story sell?

If active management is a zero-sum game, before charges, how could it possibly be that so many believe that it provides a legitimate approach to the investment of equity assets, more likely to lead to success than failure?

Nicholas Taleb's brilliant description of systematic error in the assessment of probability, *Fooled by Randomness* (Taleb, 2007a)[8] sets out a number of possibilities. These are flaws common to all of us, including the investment expert.

- **Causality**. We are strongly prone to connect events erroneously, rather than acknowledge that there may be no link between them. In other words, we claim causality where none exists. Journalists do this all the time. Every movement in the markets is accompanied by a reason, frequently without acknowledgement that there may be another, or that cause is simply unknown. [9] The sheer volume of information makes it difficult to postpone an attempt to link individual items or to acknowledge that such connections are not possible in the midst of the complexity.[10]

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[8] If you enjoy it, I recommend his follow up, The Black Swan (Taleb, 2007b) that makes it clear that we cannot understand a system until we understand the extreme events that it can and does – but only rarely – produce. The discussion in this section is drawn from both of these books.

[9] Taleb cites the following "Dow up 1.03 on lower interest rates" on his Bloomberg screen and goes on to point out that such a movement, 0.01% of value, does not need an explanation, certainly not one as straightforward as this one. "Perfect noise", Taleb calls it (2007a:214), part of the randomness around us all the time.

[10] "We believe especially in near-term causes: a snake bites your friend, he screams with pain, and he dies. The snakebite, you conclude, must have killed him. Most of the time, such reckoning is correct. But when it comes to cause and effect there is often a trap in such open-and-shut thinking. We smirk

- **Conjectures**. Despite the modern view that truth has no absolute, we are inundated with conjectures posing as truth. This has become so much a part of modern life that we lose the ability or willingness to criticise these conjectures. It is not surprising that, in the enormous complexity of relationships that constitute the financial markets, the same takes place there. In our mental effort to understand, we develop models – heuristics – that attempt to link everything and frequently build erroneous relationships.
- **Induction**. Flowing from the error of causality – Taleb describes us as hard-wired to find links – we build patterns that don't exist. A caused B last time, so A will cause B again.

  > *What is induction? Induction is going from plenty of particulars to the general. It is very handy, as the general takes much less room in one's memory than a collection of particulars. The effect of such compression is the reduction in the degree of detected randomness. (Taleb, 2007a:130)*

- **Inference** is a variation on induction. Given our tendency to build causality and induce a future based on insufficient evidence of a system in the past, it is perhaps not surprising that we are prone to errors of inference, making predictions based on very weak data.[11] The past is deterministic – there is only one outcome in evidence – the future is not.[12] To this we add the tendency to attribute successes to skills, but failures to randomness.[13]
- **We do not have all of the evidence**. Today's portfolios, and their associated performance information, are but a sub-set of those that existed in the past. Survivorship bias is discussed more narrowly in the section that follows, but we should

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*now when we think of ancient cultures that embraced faulty cause – the warriors who believed, for instance, that it was their raping of a virgin that brought them victory on the battlefield. But we too embrace faulty causes, **usually at the urging of an expert proclaiming a truth in which he has a vested interest**." (Levitt & Dubner, 2006:128, emphasis mine)*

[11] *If an infinite number of monkeys were to type away – I borrow again from a Taleb illustration – we can be sure that one of them would produce Homer's Iliad. Now, what are the odds of the same monkey going on to type out the Odyssey, follow-on opus of the same author? The point is this: past performance in an environment of randomness has no bearing on future. They key is to understand what determines the performance rather than falling into the trap of making inferences on the performance alone.*

[12] *Since there is so much data available, it is easy to find the evidence that matches the theory, particularly in the markets… "…successions of anecdotes selected to fit a story do not constitute evidence. Anyone looking for confirmation will find enough of it to deceive himself… " (Taleb, 2007b,xxvii)*

[13] *Refer to Taleb (2007a:243). Unfortunately, this affects experts particularly badly. Taleb continues: "We have known about this wedge between performance and self-assessment since 1954, with Meehl's study of experts comparing their perceived abilities to their statistical ones. It shows a substantial discrepancy between the objective record of people's success in prediction tasks and the sincere beliefs of these people about the quality of their performance." (Taleb, 2007a:244)*

be aware that it distorts all of our thinking.[14] Any complete study of track records must consider the records of those who perished along the way, not just those who succeeded.

These are just a few examples of the demonstrated set of biases that affect behaviour.[15] They help us to build some understanding of our emotional belief that we would do better to entrust our wealth to an expert with a good track record rather than take the market average. Startlingly, research shows that the expert is even more prone to such biases than we are. He or she is just as exposed to emotion as we are, but has everything riding on their success. We should not be surprised that causality and induction, leading frequently to errors, strongly characterise all those who have much to gain from a continuation of existing beliefs.

> *"Nothing is easier than self-deceit. For what each man wishes, that he also believes to be true." (Demosthenes, quoted in Bogle, 2005a:144)*

Taleb puts all of these flaws together in simple argument that surely rings true with all fiduciaries. He describes two Wall Street traders who, following a period of remarkable success, bankrupted themselves and lost their jobs on the back of their overconfidence.[16]

He closes his narrative as follows:

> *How could traders who made every single mistake in the book become so successful? Because of a simple principle concerning randomness... we tend to think that traders were successful* ***because*** *they are good. Perhaps we have turned causality on its head; we consider them good just because they make money. One can make money in the financial markets totally out of randomness. (Taleb, 2007a:93)*

This discussion summarises some of the flaws in the thinking of all of those who have an interest in the markets. The next section focuses a little more narrowly on the issue of active management versus index-tracking.

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[14] Do not read a book describing the attributes of successful millionaires if it does not also consider the corresponding attributes of those who set out to succeed but failed. Perhaps the honest writer would find that many of these attributes exist among the failures as well, suggesting that luck plays a greater part than otherwise acknowledged.

[15] There are more. We feel the pain of failure more than we appreciate the euphoria of success, for example.

[16] He lists some of their failures, overestimating the accuracy of their beliefs in some measure, a tendency to wed themselves to their investment positions, no predetermined game plan in the event of losses, an absence of critical thinking, and, when things went awry, denial. These should provide some interesting questions for trustees to pose to their asset managers.

Some more of the complicating issues

Three important issues are worth addressing because they have an impact on trustees' decisions between active management and index-tracking. The first tends to favour active management, the second index-tracking and the third shows that, while there is opportunity for active outperformance, managers could do better to capture it.

- **Emerging markets.** Proponents of the market inefficiency theory for South Africa, generally those of the view that active management can produce sustained outperformance, point to the evidence that smaller markets are more likely to have information inefficiencies than their larger counterparts. This rests on the assumption that fewer players results in a less efficient dissemination of information, allowing those who hold such information longer to execute profitable trades as a result.

  The counter-argument to this is that inefficiency should be reducing over time as information is more rapidly transmitted, through advances in technology, and that the concomitant opportunity for consistent outperformance should be correspondingly reducing. The jury is out.

- **Survivorship bias.** Investment funds sometimes close. It should not surprise us that funds more likely to close are those with poor investment performance. This is very important, because it means that analysis of the performance of today's funds is prone to overstatement of average active manager performance unless it allows for those funds that are no longer part of the dataset.

  Pawley (2002) shows that nearly half of all unit trust funds did not survive a period of 20 years, over the study period 1976-2001. If nearly half of the funds are closed, by how much is the performance of the surviving funds an upwardly biased estimate of the true average performance of all of the funds? A later study (Pawley, undated) estimates the impact on reported annual performance, over 20-year measurement periods, as 1.05%.[17]

  Hogan (2005) demonstrates the impact of survivorship bias on the published performance data of United States mutual funds.[18] He shows the upward bias in 5-year

[17] Some might suggest that such bias is unlikely to affect the market for institutional investments. I would treat such a position with skepticism. Firstly, there is little reason to expect the institutional investment portfolios of a particular asset management house to systematically outperform the corresponding retail portfolios. Why would the manager give up retail performance to achieve this? Secondly, since portfolios are routinely constructed specifically for institutional clients, there is less standardization of portfolios in the institutional space than in the retail space and more opportunity for this type of distortion in aggregate data.

[18] He shows the difference between the median performance of managers for each calendar year from 1999 to 2004 ***for those portfolios in existence at the end of that year*** *and the corresponding median performance for each calendar year* ***for those portfolios in existence at the end of the period of analysis****. The difference is important because performance histories cover a period of years and include only those portfolios present throughout the period. For example, large cap value funds included in the Lipper survey and in existence at the end of 2000 returned 1.1% for that year, but*

performance figures at the end of 2004 attributable to the removal of poor performers form the sample. Calculated separately for different types of funds, his figures range from 0.41% for small cap growth to 1.83% for large cap value portfolios. These are annual return errors, easily sufficient to present the appearance of success where it may not exist.

Survivorship bias is not just an important academic consideration. Fund managers presenting the performance of their portfolios, even if they include all of them, are likely to omit the performance of those no longer in existence.[19]

- **Alpha capture efficiency.** Peregrine Securities analysis (Polakow & De Araújo, 2005) reveals that the performance of around two-thirds of all domestic equity general unit trusts demonstrates no more than randomness and only one-third demonstrates skill (see summary in box 2). The authors of that paper suggest that this is not due so much to the absence of skill at the valuation stage, but rather the absence of clean and efficient transfer of analyst findings and judgments into active weights in the portfolios. They further note that this lack of transfer is often less a fault of the managers and more a consequence of regulatory constraints.

Box 2

Translating analysis into performance

In a research report (Polakow and De Araújo, 2005) focussing on the degree to which active fund managers in South Africa exhibit skill at stock-picking (or the lack thereof), Peregrine Securities transposed the problem from one of skill versus non-skill (or flair versus fluke) into a neat and coherent approach of using a simple statistical interpretation: non-randomness and randomness.

Empirical returns on a liquid universe of common domestically traded stocks were used, together with the typical regulatory constraints and risk-mandates that long-only fund-managers are faced with in South Africa, with one important difference: the stocks are picked entirely at random. Fees are charged at typical values.

For defined mandates, the simulation delimits (for a specific reference period of history) a 'frontier-of-no-skill', above which defines 'non-random' stock picking and below which signifies noise (or essentially 'random' stock picking ability).

A history from a broad universe of general-equity funds trading the same universe are then overlaid with the finding that some two thirds of actively-managed funds (after costs) exhibit noise and only one third exhibit non-randomness. These findings for the South African general-equity portfolios closely resemble the findings from similar international studies.

It is important to note that Polakow and De Araújo's intentions were not to name-and-shame, but rather to understand any fundamental differences between what characterises actual funds above and below the frontier.

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many of them closed in the next few years, so the year 2000 median performance for funds still in existence at the end of 2004 was reported as 7.9%.

[19] *The portfolio need not necessarily have been closed. It could have been absorbed by a more successful counterpart. In this instance, the history of poor performance might be permitted to disappear because the portfolio no longer exists.*

The results are insightful and point to the benefits of i) covering relatively fewer stocks better and ii) having a more rigorous process whereby views are better translated into active bets. The authors infer that far more of the same funds would move into the 'non-random' realm if investment process(es) facilitated a stronger correspondence between analyst calls and the active views that are implemented in such portfolios. By placing more overt bets into portfolios, the ability to garner alpha from one's skill-set are enhanced and the facility for closet-tracking (or hiding beneath the radar) are substantially reduced.

More recent research (Polakow *et al*, 2007) suggests that the degree of market outperformance opportunity in South Africa, as measured by the dispersion in returns of equity stocks, or cross-sectional volatility, is actually higher than in the developed world, and exceeds the corresponding outperformance opportunity of other emerging markets on average.[20]

Active management is a complex process. This example shows that it is more than analysing the options and making the right calls: these need to be translated efficiency into trading decisions.

The bottom line on active versus index-tracking is that

- active management is almost always more expensive,
- active market participants cannot, on average, outperform their passive counterparts, so success depends not only on choosing active management but on choosing the right manager or managers, and
- active managers have a strong incentive to demonstrate the value that they provide to customers, and may do so in a manner that is not completely transparent.

In addition to all of the arguments put forward so far, some hold to the view that large actively-managed investment funds are constrained by their size, because their trades are so substantial that the price tends to move against them during the course of execution. This suggests that such managers must hold a proportion of their assets in index-linked classes and attempt to gain outperformance using the balance of their assets. This view appears to be supported by the majority of South Africa's asset management community, judging by the move towards breaking large houses into boutiques, but it is not translated into a larger holding in passive asset classes, or, if it does, this is not disclosed.

Active management prevalence: the business case

Despite a theoretically compelling rationale, index-tracking forms a very small part of the South African institutional investments market. Industry players estimate total assets in

[20] *Please note the point that this is making. The research is not claiming that, on average, active manager performance could exceed that of the market. This is not possible. It is suggesting that the opportunity for individual managers to return performance that exceeds the market is better than in many other markets.*

privately managed index trackers, including the Satrix exchange-traded fund[21] at around R40bn, ignoring any GEPF assets in similar vehicles. This is a very tiny proportion of total pension fund assets.[22] At the very least, we would expect rational trustees to recognize that this is probably not an either-or decision and to consider allocating not all of the assets of the fund, but at least a significant proportion, to index-tracking alternatives.

> *Global best practice currently seems in agreement that an allocation to both active and passive investments provides opportunity for both outperformance… and cheap market or benchmark exposure… resulting in higher satisfaction than a full exposure to either passive or active investments. (Rousseau 2007:4)*

If the theoretical argument in favour of active management, particularly after costs are taken into account, is tenuous, why is this approach so strongly supported by retirement fund trustees? The answers appear to be self-evident:

- **Asset managers** operate on higher profit margins from active management than from index-linked management,[23] so have a very strong preference for active mandates over their passive counterparts. This alone would not be sufficient to sustain the predominance of active management, since other parties would balance this incentive, so we need to look a little further into the dynamics of the institutional investments environment.[24]
- **Multi-managers** have a strong incentive to sustain the view that active management yields positive after-fees returns, that successful managers can be identified in advance, and that the skill required to do so deserves significant remuneration. A higher market allocation to index-linked alternatives translates directly into reduced fees to multi-managers.

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[21] This is an index-tracking fund that, for contractual reasons linked to the reason for its existence, must match the index with higher levels of precision than is commonly achieved by its competitors. It has struggled to attract institutional assets despite its reliable performance and very low charges.

[22] Feedback from trustees at the October 2007 seminar of the South African Pension Fund Investment Forum (SAPFIF, part of the Europe-based network, EPFIF, www.epfif.com) suggested that the incidence of index-tracking is probably higher than this. The commentator continued that passive management is often carried out by active managers with charges closer to the rates common for active management.

[23] "The continuing trend among pension funds towards separating index-tracking from absolute returns is a challenge for some active managers, the UK's Investment Management Association (IMA) found. … 'You have a whole slug of assets that goes to indexation, and the part that goes to active management has shrunk,' an asset manager commented in the IMA's 2006 Asset Manager survey. 'Everyone says that the fees are a bit higher, but if your assets under management have gone down, it's not a great help. What we are seeing is a collapse of the institutional fee cake.'" (Investment & Pensions Europe, 1 August 2007, www.ipe.com)

[24] I would argue that the preference for active mandates among asset managers is not just a pragmatic position. Active managers must believe that they are able to generate consistent outperformance: this belief allows them to sleep better at night! "It's amazing how difficult it is for a man to understand something if he's paid a small fortune not to understand it." (Upton Sinclair, quoted in Bogle, 2005b:22)

- **Brokers and other investment professionals** have a strong interest in prolonging the view that active management generates higher performance. The so-called *deal flow*, primary source of income for these market traders, depends on a high level of confidence in active management.[25]
- **Investment consultants** also have a vested interest in the position that active management has a high probability of producing better results. This belief sustains a significant proportion of their business, since manager selection is an important part of their work. The investment consultant who subscribes to Rousseau's view that just under one-third of the assets of a portfolio should be index-tracking vehicles[26] may earn just as much revenue as under the current scenario in which all assets are held in actively-managed portfolios, but it would probably be hard to convince the trustees that the fees are justified.[27]
- **Trustees** ultimately sustain the existing allocation to actively managed portfolios, despite the uncertainty that this is the optimal approach. During a time in which the global trend is to allocate less to active strategies and more to index-linking, the large majority of South African retirement funds seem to be standing still, retaining a tiny proportion of total assets in index-linked strategies.

Perhaps the most instructive statistic illuminating this puzzle is the Satrix exchange-traded funds have succeeded in attracting some money from the retail sector, but virtually nothing from the institutional investments sector. This suggests a systematic resistance to index-tracking investments that has more to do with the trustees and the investment consultants than the asset managers and brokers. It would seem that individuals, given the freedom to choose – trustees and investment consultants are not present in the retail space – allocate a greater proportion of their assets to index-linked funds than do pension funds.

Concluding thoughts: what should trustees be doing?

It is not for me to call for a higher allocation to index-tracking investments. Perhaps there are reasons to believe that some managers systematically and consistently outperform the market, after fees, after adjusting for survivorship bias and any other forms of possible misrepresentation of information, and that it is possible to identify them.

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[25] *As is pointed out in section 8, this belief does not produce optimal results. A significant proportion of trading ordered by asset managers and executed by brokers is wasteful.*

[26] *"Our own research in recently quantitative reports shows that all investors (including active investors) should have about 30% of their money in passive, low-cost investments to maximise their opportunity/cost ratio with a ±4% tracking error." (Rousseau & Tayob, 2006:33)*

[27] *More is written on the commitment of consultants to industry improvement in section 3 and on consultant fee models in section 4.*

But when it comes to the active-passive debate, it seems that trustees are putting all of the eggs into one basket and hoping that it works. They should seek instead to

- understand the nature of the trustee responsibility and consider carefully whether the assets of members should all be committed to the belief that good active managers can be accurately selected;
- understand the vested interests of all parties involved in the fund, asking whether these interests may be clouding their judgment;
- understand the costs of active management and weigh them up against the likelihood of outperformance and the corresponding costs of index-linked alternatives;
- consider the reports of asset managers, and the intermediaries, with appropriate care and ensure and that they do not present information selectively, asking them, for example, about the treatment of closed portfolios and whether all numbers are compliant with GIPS and, if not, why not;[28] and,
- require better analysis of performance figures from asset managers and consultants. A good rule of thumb is *if it looks too good to be true it probably is*.

Analysis of performance is important.[29] Both asset managers and investment consultants should provide a clear attribution of performance between the so-called *stock* and *style* impacts, showing precisely how much of the apparently miraculous outperformance is attributable to the allocation to resource counters, for example, and how much, positive or negative, to successful stock selection. Trustees should ensure that they understand this analysis, requesting reports to be redrafted if they are not written in a way that is sufficiently clear to them.

Decent, intelligent, unbiased analysis, breaking down the portfolio into its component parts and providing a complete picture of historical manager performance, should be the minimum expectation of trustees.

Final word to an asset manager:

> *Remember that most new funds are launched to give the marketers something to sell. Your long-term needs as the investor do not feature highly in that whole process. If you struggle to understand what your fund manager does, a low-cost indexation strategy makes a lot of sense. (Peter Foster, Regarding Capital Management, Business Report, 15 March 2007, full article in section 6.)*

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[28] *These are Global Investment Performance Standards, ethical and professional standards for the presentation of investment information and advice.*

[29] *A high proportion of annual outperformance figures in recent years can be attributed to systematic differences between the portfolio allocation of asset managers and the corresponding allocation of the indices, often due to a substantial over- or under-allocation to resources stocks. The somewhat arbitrary construction of benchmark indices over the last decade or so is discussed in more detail in section 3.*

EPILOGUE

Ernest Hemingway tells the story of an old man who fishes the warm waters of the Gulf Stream from a skiff with nothing but a set of fishing lines and a harpoon.[1] *At home he sleeps on newspaper on the springs of an old bedstead and eats whatever he can find.*

One morning, after eighty-four days without taking a fish, he hooks a marlin longer than his boat. For two days the fish drags him and his boat out to sea. For two days, his line tight over his shoulders and his hands raw, the old man fights the beautiful giant, at the same time catching and eating what small fish he can to keep up his strength.

On the morning of the third the fish, finally showing signs of weakening, begins to circle the boat and eventually comes close enough to take the fisherman's harpoon. The old man kills the enormous marlin.

"He started to pull the fish in to have him alongside so that he could pass a line through his gills and out his mouth and make his head fast alongside the bow. I want to see him, he thought, and to touch and to feel him. He is my fortune, he thought. But that is not why I wish to feel him. I think I felt his heart, he thought." (p 89)

He lashes the fish to the boat, hoists his mast, trims the sail and begins the long journey home. "It was an hour before the first shark hit him. The shark was not an accident. He had come up from deep down in the water as the dark cloud of blood had settled and dispersed in the mile-deep sea." (p 92)

Bravely, the exhausted old man fights off shark after shark until he can do no more. "He was a fish to keep a man all winter, he thought. Don't think of that. Just rest and try to get your hands in shape to defend what is left of him." (p 103) But each takes another chunk out of the fish until "in the night sharks hit the carcass as someone might pick up crumbs from the table". (p 110)

Finally he lands.

"He unstepped the mast and furled the sail and tied it. Then he shouldered the mast and started to climb. It was then that he knew the depths of his tiredness. He stopped for a moment and looked back and saw in the reflection of the street light the great tail of the fish standing up well behind the skiff's stern. He saw the white naked line of his backbone and the dark mass of the head with the projecting bill and all the nakedness between." (p 111)

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[1] *Hemingway, E (1952) The Old Man and the Sea, quotations from the 1953 edition by The Reprint Society,* ***London***

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