

The Great Debate – Which Index Should Pension Funds Use....Continued

The Benchmark Debate Redux

Last quarter, we spoke at length about the problems associated with correctly interpreting fund manager performances. The crux of the discussion was our point that, because there is still considerable disagreement as to which benchmarks are best suited for prudent investing, (the new JSE/FTSE Free Float Index or some alternative benchmark that down-weighted investors' exposures to mega-cap shares such as Anglos or the resource sector in general), performance differentials are now reflecting this lack of consensus. Carrying this debate through to the current quarter, we can begin to see the performance gap widening. Year-to-date, for example, the official JSE/FTSE Free Float Index is off –7.05%. By contrast, the Dual-Listed Adjusted Index (not yet official), that coincidentally looks markedly similar to the current weightings of the average asset manager, is off only –3.56%. Notably, the return on the average general equity portfolio was –3.11%, suggesting that indeed, the bulk of asset managers are probably opting towards this down-weighted benchmark. More remarkable, though, is the fact that the three index funds listed in the general equity sector of unit trusts had as much as a 7% differential in performance between them over that same period, so its anyone's guess what possible indices those three index funds must have been using.

Just where is this benchmark debate now going?

To placate the range of differing views on the matter, the JSE has put on the table a proposal to offer no fewer than three different options for a general equity benchmark. The three options being proposed by the JSE – and a brief statement on their advantages/limitations are as follows:

- **The full JSE/FTSE Free Float Index** - (currently in existence)
Pro: By eliminating strategic shareholdings and shares with low liquidity, this new index captures a more truly investable universe of shares. Minimal turnover.
Con: Suffers from the fact that a share such as Anglos could easily come to represent more than 20% of the Index).
- **A Dual-Listing Adjusted Index** - (still on the drawing boards)
Pro: Alleviates the mega-cap problem to some extent by excluding those shareholdings in dual-listed shares that are deemed to be foreign-held, on the grounds that these shares lead to a double counting of the actual investable universe of a dual-listed share in our index.
Con: By reducing the exposure to dual listed shares such as Anglos and Billiton etc to nearly half of their current index weighting, this raises the question as to whether this index is truly representative of the South African economy. Also could lead to higher and purely arbitrary turnover in share composition.
- **A Capped Index** – (still to determine % cap – current proposal is 8% cap to any one share.
Pro: Removes any question of regulatory compliance by limiting investors' exposure to any one share to a fixed percentage regardless of who holds the underlying shares.
Con: Again, distorts the economic reality of South African equity market. While it reduces exposure to mega-cap shares, it will increase weightings to higher risk, less liquid shares. Will also lead to higher turnover although changes in index composition can be anticipated. Finally, the 8% cap appears to bear no resemblance to any current or proposed regulatory limit.

What's our verdict on the options? With all due respect to the considerable efforts of the JSE and the industry as a whole to come up with a meaningful solution, we still believe that all of the proposed options are sub-optimal.

What makes this debate so difficult to resolve?

One source of confusion clearly centers on understanding the difference between an index and a benchmark. In a sense, the two words speak for themselves.

An index provides an indication of the investable universe of the segment being captured, whether it be equities, bonds or the resource sector etc. It's "everything you can invest in and nothing you can't" in that sector, to quote a phrase we saw in a Peregrine Quant publication. What makes the new JSE/FTSE Free Float a better index than its predecessor, the JSE All-Share Index, is the fact that it employs a screen that removes those shares that are either closely held or illiquid, effectively those shares you *can't* invest in.

A benchmark, on the other hand, is something against which to mark or gauge your performance. As such, its fundamental requirements must be that it captures a universe of investments that would not be dissimilar to the universe invested in by the fund or manager being measured, that it would be known in advance, that it be fully transparent, and ...that it be fully investable.

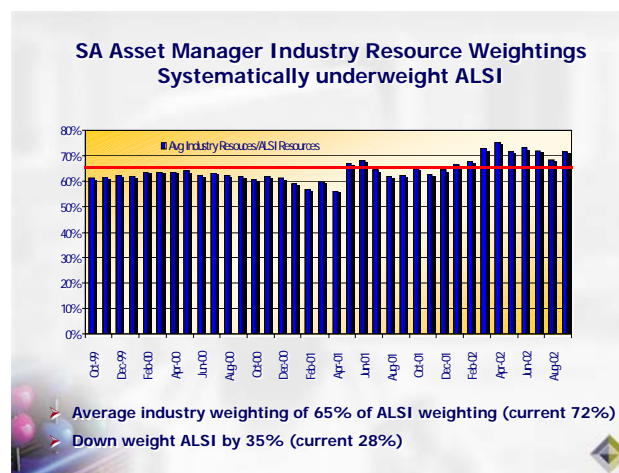
So while the debate *should* be about optimal indices – something the FTSE knows a thing or two about and can competently address - it has shifted, rather, to what is an optimal benchmark for South African managers, something that requires more of an insight into the behavioural biases of South African managers than it has anything to do with identifying the truly investable universe of equities. Let's understand those behavioural biases in a bit more depth.

It's a Fact: Managers Avoid Resources

The historic aversion of fund managers to the Resource sector can be explained from any number of perspectives:

- The resource sector should be avoided because it is excessively volatile and its earnings are particularly difficult to accurately predict.
- The resource sector's representation in the All-Share (currently around 50%) exceeds its proportional % of GDP (approximately 20%) and therefore should be down-weighted.
- If resources aren't down-weighted, this results in excessive concentration of the portfolio into a handful of shares.

Whether these are acceptable excuses for avoiding resources is not really the issue here. The fact of the matter is that managers *do* persistently down-weight the sector in their portfolio, as the graph below from Futuregrowth highlights:



Keeping in mind that one of the most important concerns of fund managers is that they are not seen to be under-performing other fund managers, is it any wonder that there is strong lobbying for an index (in fact a benchmark) that provides a de facto reduction of this resource sector by either overt or covert means?

Anything But the Current Free Float Will Do (?)

The Futuregrowth chart below is particularly illuminating in this regard. In the right hand column is the average fund manager weighting to each sector, which is not significantly different from the historical bias of these managers. Notable is the fact that both the JSE Dual-Listed Adjusted and the traditional resource down-weighted benchmark favoured by fund managers both reflect remarkably similar weightings to the fund manager industry weightings .

	FTSE ALSI	JSE DL PROP	JSE 10% CAP	80% RESOURCES	INDUSTRY
RESOURCES	47.5	36.6	42.5	38.0	37.0
(RES. INCL. BASIC IND)	(53.3)	(43.7)	(48.9)	(42.7)	
FINANCIALS	22.4	31.6	24.6	26.5	28.0
INDUSTRIALS	30.1	31.8	32.9	35.5	35.0
	100	100	100	100	100

What this chart doesn't capture is the fact that the Capped Benchmark currently under consideration by the JSE is for a cap of 8% and not 10% as shown above. What does that subtle difference do to the numbers? Surprise, surprise – it moves the Cap Index numbers into alignment with the fund manager industry as well.

Should we care?

We believe that consultants and trustees of pension funds certainly should care about this debate. We are beginning to feel as if this whole issue isn't pushing managers and investors further and further away from the whole rationale of investing in equities as an asset class in the first place. There is an interesting debate emerging among academics and trustees of pension funds around the world that maybe we're getting our priorities all wrong.

Consider the primary objective of retirement funds – whether they are defined benefit or defined contribution. Basically their *raison d'être* is to identify that blend of assets that will best fund their members' retirement after a given time frame and within a given risk parameter. It's all about keeping pace with Cost of Living adjustments over time. **But when an asset manager looks at risk/return maximization in an investment context, the risk reduction exercise concentrates on reducing volatility in returns, not determining whether the returns are likely to match future liabilities (i.e. keep pace with economic and cost of living growth.)**

Cast in this light, the more important question trustees and their consultants should be asking is: If we significantly downweight the resource or rand-hedge shares in the equity component of our asset mix, will we still have a complete reflection of South African growth? Will our exposure be robust enough to provide our funds with adequate protection during swings in global economic cycles or further rand depreciation?

Surely these considerations represent more of an imperative to retirement fund members than whether their fund manager is performing reasonably well against other fund managers.

Unfortunately....that's not the only consideration

It would be nice if we could just end this debate right here, flush with the confidence that we have just seized the moral high ground. But it's not that simple. The reality is that the one index that does capture the full breadth of the South African economy, the JSE/FTSE Free Float, also runs the risk of exposing investors to weightings in mega-cap shares such as Anglos of as much as 20% of the equity portion.

Consultants would be remiss if they weren't encouraging trustees to consider whether it was prudent to have such a large exposure to any one share. And so the debate continues to drag on – as consultants side with the investment community in their preference for any index other than the JSE/FTSE Free Float. Frankly, it's getting a bit lonely on our side of the fence.

So how have we, m Cubed Asset Management concluded we should go forward?

Allow the debate to continue. Ensure that everyone understands what they get and what they give up in each of the index choices. Make sure the final decision is made in full cognizance of the issues we've set out here. And then make sure that, whatever decision is made, m Cubed can accommodate whatever makes the most sense for the Fund's specific requirements. Watch this space. We are not going to let this discussion die.