FUNDS ON FRIDAY

by Glacier Research

glacier by Sanlam

26 October 2018
Volume 981

Ignore one-year performances

Written by: Casparus Treurnicht, Portfolio Manager at Gryphon Asset Management

Investors are obsessed with short-term gains and, in this desperate pursuit, often make decisions that rarely turn out to be good ones over the longer term. In financial markets these decisions can result in individual stocks or funds that underperform the market index or worse; deliver negative returns or 100% capital losses. If we consider the effort and related stress involved in making these decisions, very often it becomes apparent with hindsight that earning a return close to the market would have been the prudent choice in building long-term wealth.

What do the numbers say?

According to a series of research studies conducted by Standard and Poor's, the majority of equity funds consistently underperform their respective market indices. The table below illustrates this point in that 76.60% and 88.65% of all RSA- based equity funds underperformed the capped or uncapped indexes of the South African equity market over the five-year period ending 30 September 2018. This is also a global phenomenon in that 96.55% of global equity funds underperformed the S&P Global 1200 Index over the same period:

FUND CATEGORY	COMPARISON INDEX	ONE-YEAR (%)	THREE-YEAR (%)	FIVE-YEAR (%)
South African Equity	S&P South Africa DSW Capped Index	51.49	60.59	76.60
	S&P South Africa DSW Index	84.16	86.47	88.65
Global Equity	S&P Global 1200	82.26	87.18	96.55

Source: https://africa.spindices.com

How do I get equity market performance?

For the period 30 June 2002 to 30 September 2018 the market returned 14.05% per annum, considerably more than any other asset class bar property (which is a sub-index of the stock market that has now turned the corner and faces all types of headwinds). So how could one get the 14.05% delivered by the market? Short answer: You can't! The reason being that a market index is not investable, it is not a product you can buy directly. You can only buy products based on the index; they own the stocks that comprise the index and, in so doing, attempt to replicate the index's return.

Which index fund should I choose?

The best way to approach this dilemma is to use an index fund that has the lowest Total Investment Charge (TIC) and has also proven to be successful in tracking the overall equity market.

Looking at the TIC, its components are predominantly:

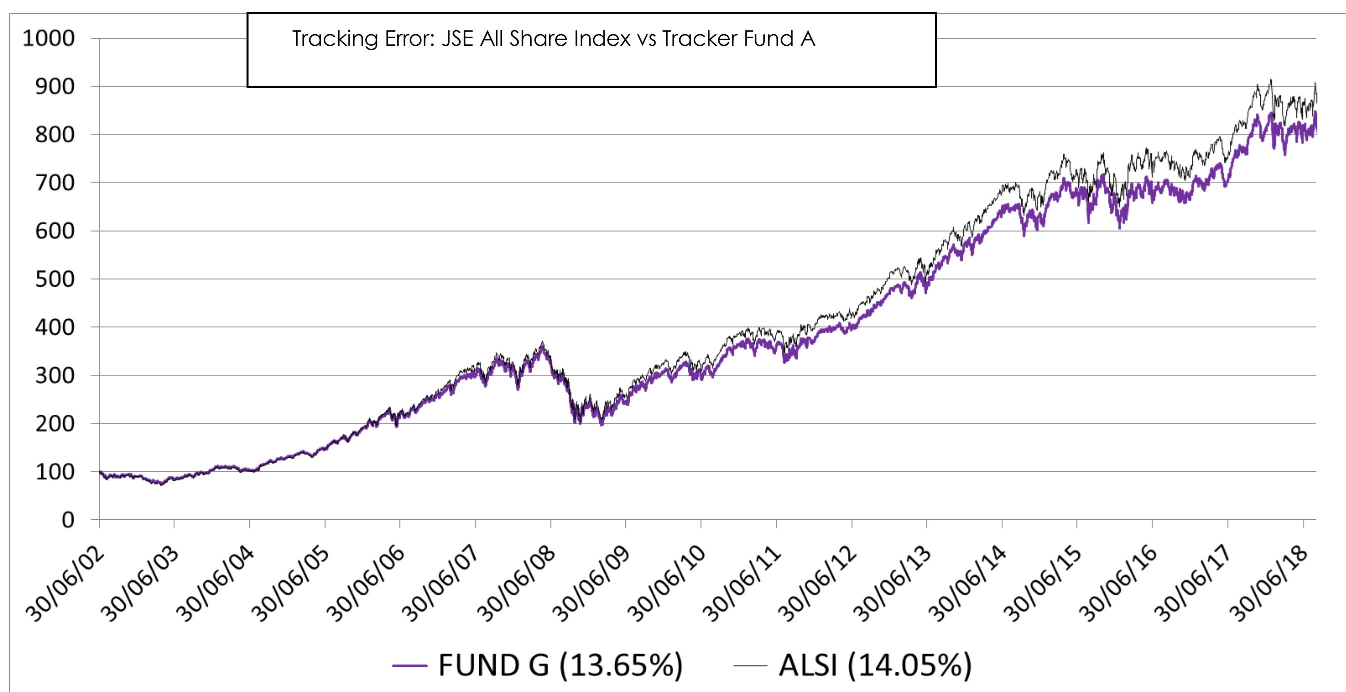
1) Trustee fees which ensure your assets are held safely;
2) Trading fees to obtain exposure to the market index;
3) A portfolio management fee;
4) Bank charges.

It is also important to consider how closely the fund manager is able to track the equity market/index. This is known as the tracking error and investors should look for consistent, close alignment between the fund- and index- performance. Studying market data and fund fact sheets will provide the necessary information and insight in order to establish the best product providers from the perspective of a low TIC and tracking error.

What kind of performance can I expect?

Firstly, it all depends on what the stock market is going to do next. This has proven to be extremely difficult to forecast and market predictors rarely get it right. What we do know, is that the stock market is the best-performing asset class over the longer term. Consistently contributing to a market-based product (index fund) has proven to be the simplest solution to creating long-term wealth.

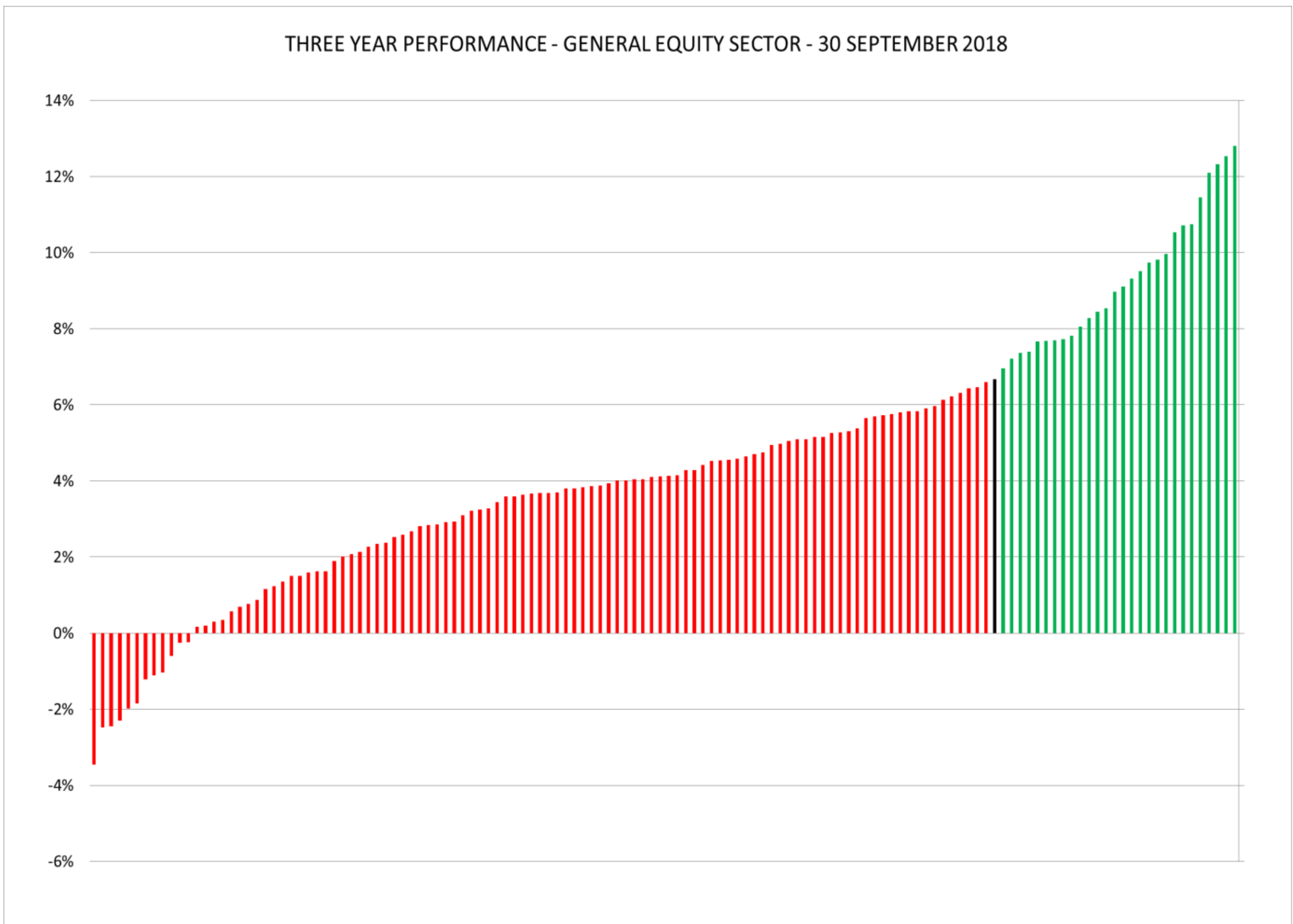
The diagram below illustrates two performances; the JSE All Share Index total return (grey) and a fund (purple) that tracks the performance of this market index. The difference in returns since inception (14.05% - 13.65% = 0.40%) is what investors should pay attention to when considering investing in these products – this difference should not be greater than the cost of managing the fund (TIC). Where the difference in returns is higher than can be justified by the TIC, the fund manager is not doing a good job of tracking the market index:



Source: Gryphon data
Date: September 2018

Long-term returns are the consequence of a series of short-term returns. Let's look at shorter-term stats and how value can be destroyed. Some investors will claim to be able to select the fund that will outperform over any period! Caveat emptor!

79% of all funds in the General Equity Sector underperformed the market (FTSE/JSE All Share Index total return) over the three-year period to 30 September 2018. The average return of these funds was 4.39% per annum compared to the market return of 6.67% per annum, a massive underperformance of 2.28% per annum. Due to high aspirations and poor fund selection, investors in some of these funds ended up suffering massive underperformance and, in some cases, negative returns. This is primarily due to excessive fees and problematic stock selection. One fund had a negative return of -3.45% per year! The graph below illustrates the performance ranking of these funds:



Data Source: Profile Media
Red bars: Underperforming funds
Green bars: Outperforming funds
Black bar: Market return

Ultimately, what we are saying, is that in order to grow wealth over the longer term, investors need to ensure that they capture a substantial part of market performance. Consistently protecting yourself against underperformance means consistently earning a return close to the market.

How does one do this? Simply make use of an index fund that effectively tracks market performance over the longer term at the lowest Total Investment Charge.

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

Casparus Treurnicht – CFA, *Bcom Hons (Financial Analysis)*

Cassie is a Chartered Financial Analyst charter holder and fulfils the role of Research Analyst and Portfolio Manager. Cassie joined Gryphon in 2011 bringing a strong quantitative background which made him a natural fit for maintaining and developing their proprietary valuation models and conducting equity research.