Exchange Traded Funds and the Retirement Industry

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Batseta
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Nerina Visser, CFA

- Consulting & Advisory Work
  - World Bank / IFC
  - Financial Services Board (FSB)
  - Johannesburg Stock Exchange (JSE)
  - OUTvest (Outsurance)
  - Satrix Managers
  - Momentum SP Reid
  - Cloud Atlas Investing
  - Rwanda Stock Exchange
  - S&P Dow Jones
  - Nigerian Stock Exchange
  - Nedbank CIB & Private Wealth
- Academic & other Qualifications
  - BSc Applied Mathematics & Mathematical Statistics
  - MBA (Financial Management specialisation)
  - CFA Charter holder
  - FAIS Key Individual
- Training and Education Initiatives
  - ASISA Academy: CIS Short Course
  - ASISA Academy and University of Johannesburg: CIS@UJ
  - Financial Services Board (FSB): Exchange Traded Products (ETPs) training workshop
  - Passive Investment Management Mastery School (PIMMS): online course
  - Journalist Training Academy (JTA) for FinWrite – Wits Journalism
  - Nigerian Stock Exchange (NSE): ETF Workshop
- Industry Volunteer Involvement
  - CFA Society South Africa – President
  - CFA Institute Society MarComm Council – member
  - ASISA Investments Board Committee – ETF Standing Committee – chairperson
  - JSE Issuer Regulation Advisory Committee – member
  - JSE Product Advisory Committee – member
  - SWIFT African Advisory Group – member
  - Collective Insight publication Editorial Advisory Committee – member
  - NSE – ETF Product Advisory Committee – member

Part I

What are we talking about?

What’s in a name?

alpha and omega

index-tracking

beta

passive

investment strategy

average

ETF

CIS

derivative

index

the market

unit trust

asset class

Passive investment = Index tracking

- "Index tracking" means "following a recipe"
- To bake a cake, your recipe specifies the ingredients and quantities

Index measures "average" performance

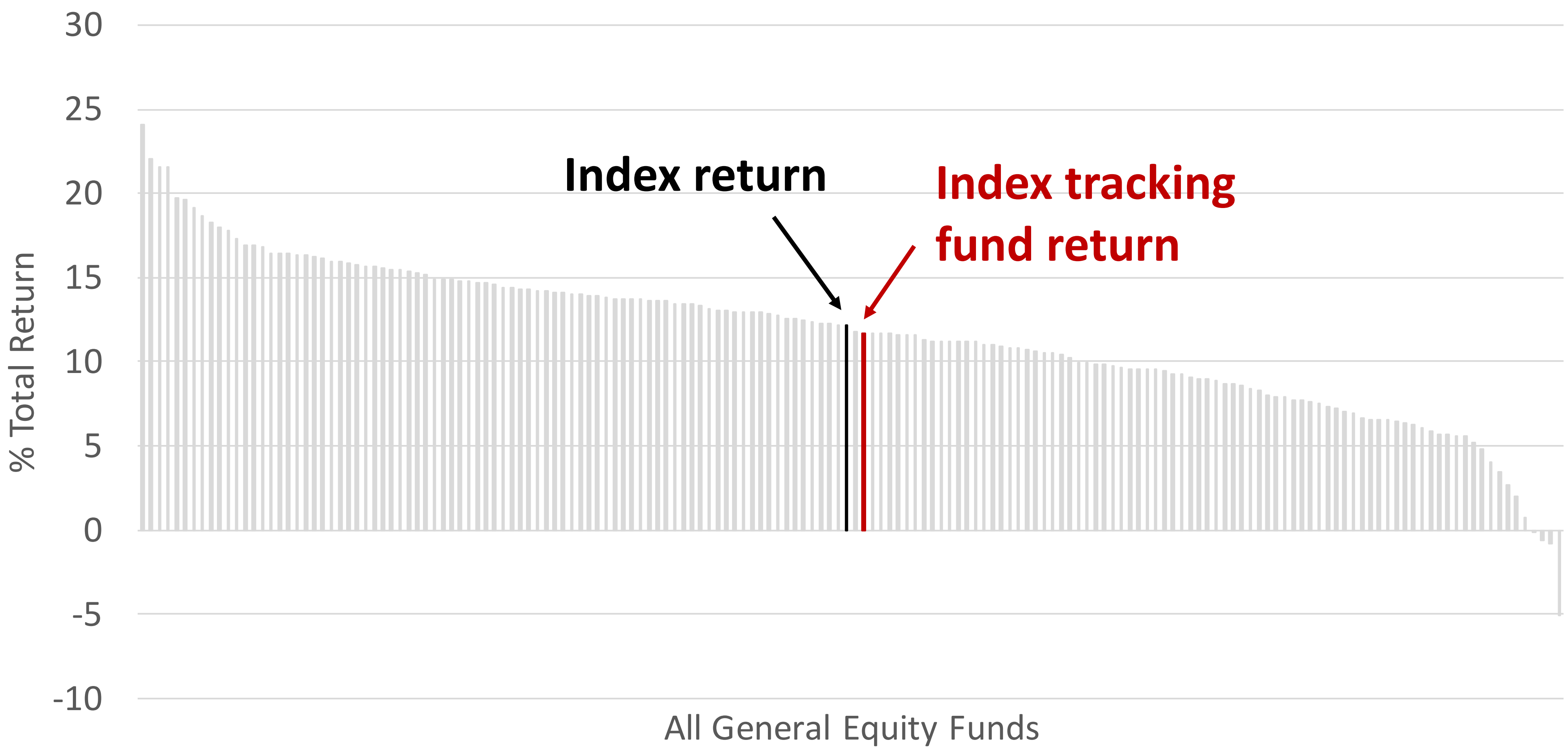
- An index reflects the aggregate performance (capital growth and dividends) of a basket of securities, e.g.
  - SA equity market as a whole (FTSE/JSE All Share or Top 40)
  - Component of the equity market (Financial or Industrial)
  - Global equity market (MSCI World, FTSE All World)
- Can measure different types of assets:
  - Equities
  - Bonds
  - Listed Property
  - Commodities
  - Currencies
  - Cash (money market)

What is "average"?

- Index performance
  - (Weighted) average performance of all shares
  - Mathematical calculation – costless
- Fund / portfolio performance
  - Rand value of all investment holdings + cash distributions compared to initial investment amount

    after all costs incurred to make those investments
    - Transaction costs
    - Administration costs
    - Management costs
    - Tax implications

Perception of "average"



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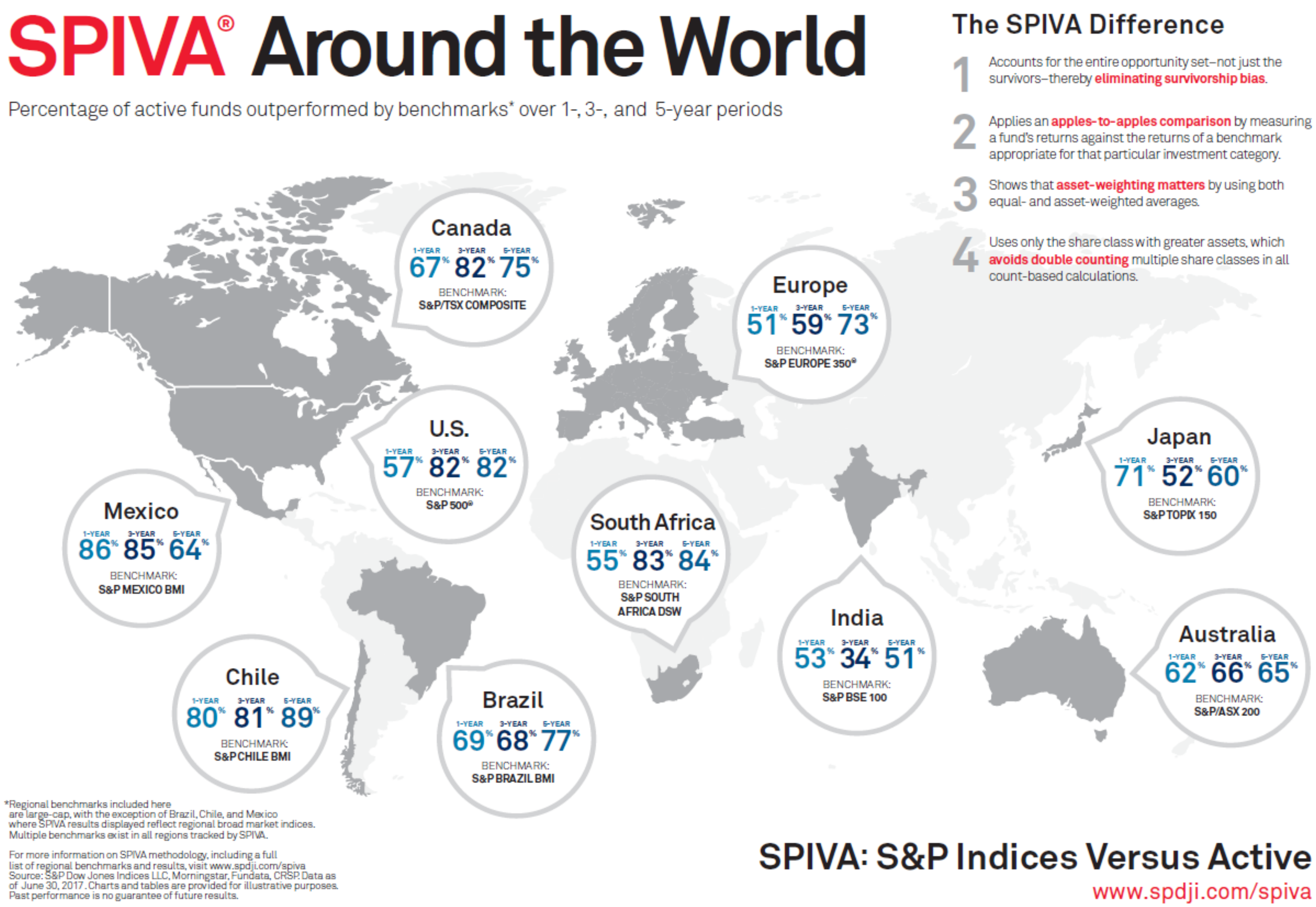
What we know to be true



±80% of active managers under-perform the general equity index

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How Well Do Actively Managed Funds Perform?

% of active managers who failed to outperform their benchmarks (broad-based market index)

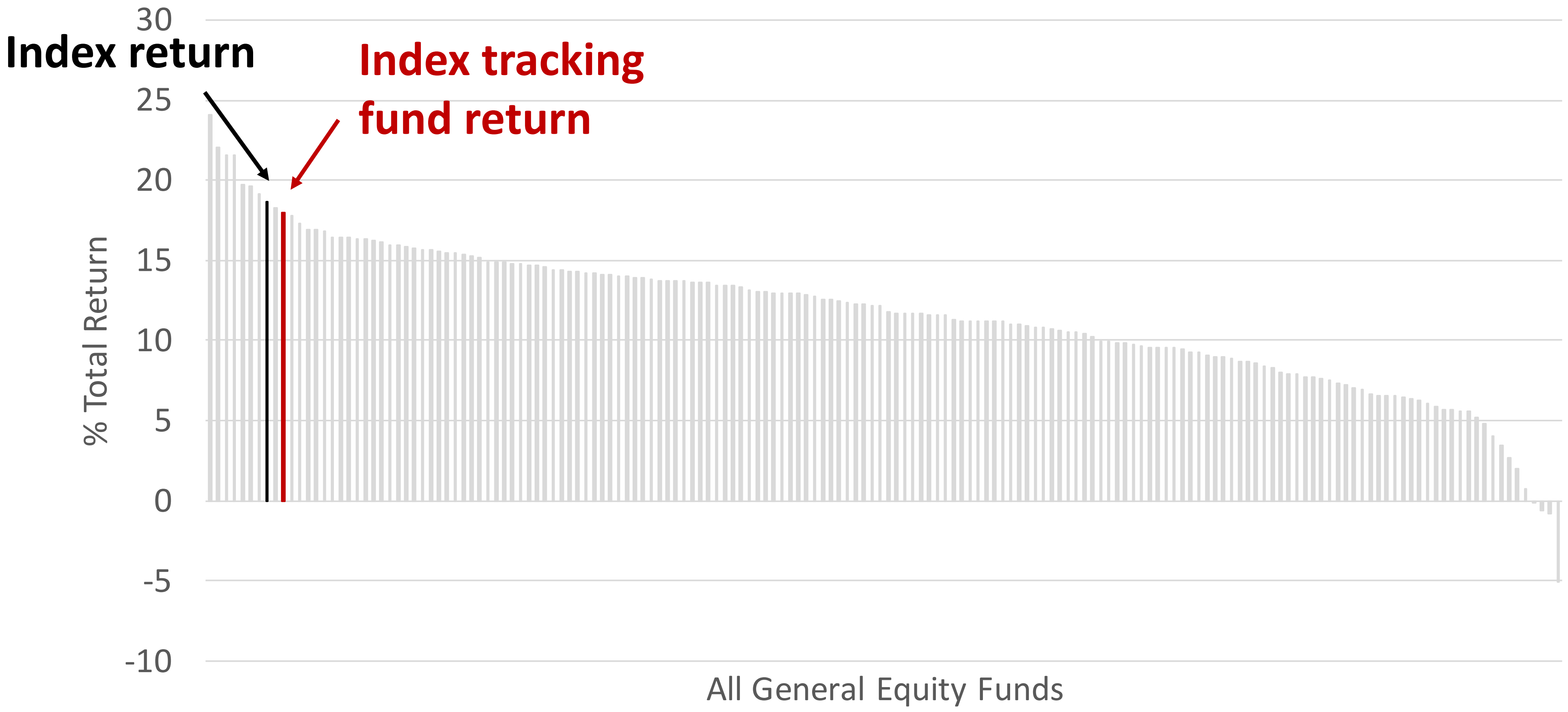
	1 year	3 years	5 years
USA	57%	82%	82%
Europe	51%	59%	73%
South Africa	55%	83%	84%

Source: S&P Dow Jones Indices (SPIVA Scorecard) (June 2017)

What causes this underperformance? (other than costs)

- Size matters!
- Investable share universe decreases as fund size increases
- If you invest 5% of your fund in 1 company and do not want that own more than 5% of that company:
  - Fund size R 100 m – 170+ shares to choose from
  - Fund size R 1 bn – <160 shares to choose from
  - Fund size R 10 bn – 80 shares to choose from
  - Fund size R 40 bn – 35 shares to choose from

Reality of “average”



Exchange Traded Fund (ETF) Defined

- Listed (necessarily) index-tracking (usually) collective investment scheme (sometimes)

- Listed: trades like any other share on the stock exchange
- Index-tracking: fund replicates the make up of the reference index
- Collective Investment Scheme (CIS): regulated unit trust (mutual fund)

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What does an ETF represent?

- Open-ended investment fund backed by a basket of physical securities
- Offers investment exposure to different underlying assets: equity, fixed income, property, commodities via a single listed share / unit
- Most ETFs are registered as CISs (unit trusts)
  - But not all ETFs are CISs (and there are also ETNs)
- A market maker ensures that there is always a buyer and seller in the market at the live fair value (NAV) of the ETF (underlying fund)

ETFs vs. ETNs

- Exchange traded note (ETN) sounds a lot like an Exchange traded fund (ETF), but it's a very different type of investment
  - Only thing they have in common is that they are both listed on an exchange
- An ETN carries the credit risk of the issuer, and is not necessarily backed by physical assets
  - The issuer promises the investor to pay him the return of the reference asset, but the investor runs the risk that the issuer won't be able to fulfil this promise
  - The issuer may choose to hedge his own risk by holding physical assets, but is not obliged to do so
- Examples of ETNs on the JSE:
  - International index-tracking equity funds (i.e. very similar to ETFs)
  - Commodities; Currencies

"ETFs are Low Risk Investments"

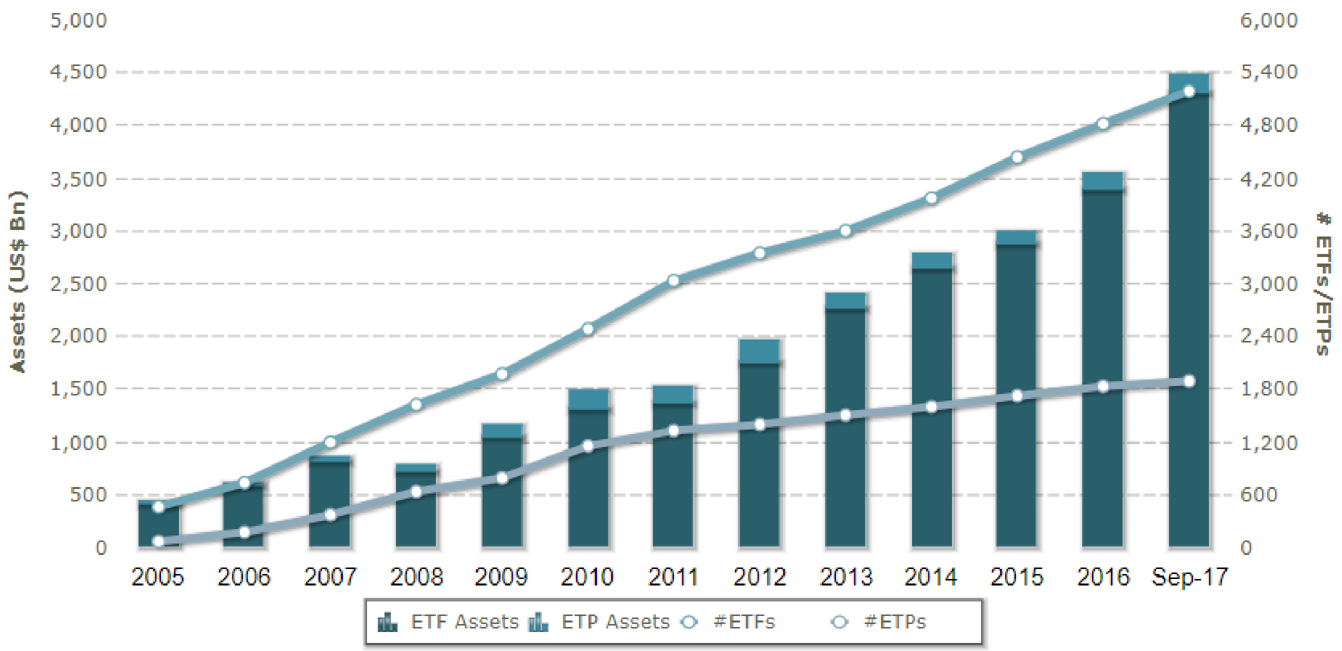
- Absolute Risk
  - An ETF carries just as much *absolute* risk as its underlying investments – can be very high, or very low
  - It's the same as a unit trust in the same category
- Relative Risk
  - An ETF has negligible *relative* risk – SA regulations require full physical backing
  - The level of underperformance ≡ cost to manage the fund (TER)
- Regulatory Risk
  - An ETF has the lowest *regulatory* risk – governed by FSB & JSE
  - An ETN has additional credit risk

Part II

How did we get to where we are?

Global history

- ETFs first launched in Canada in 1990 – US followed in 1993
- Net flows into ETFs surpassed those of mutual funds (unit trusts) for first time in 2008
- Global assets of over $1 trillion in 2009 (20 years)



- Currently more than $4.5 trillion
- Global ETP industry is now bigger than hedge fund industry

Source: www.ETFGI.com

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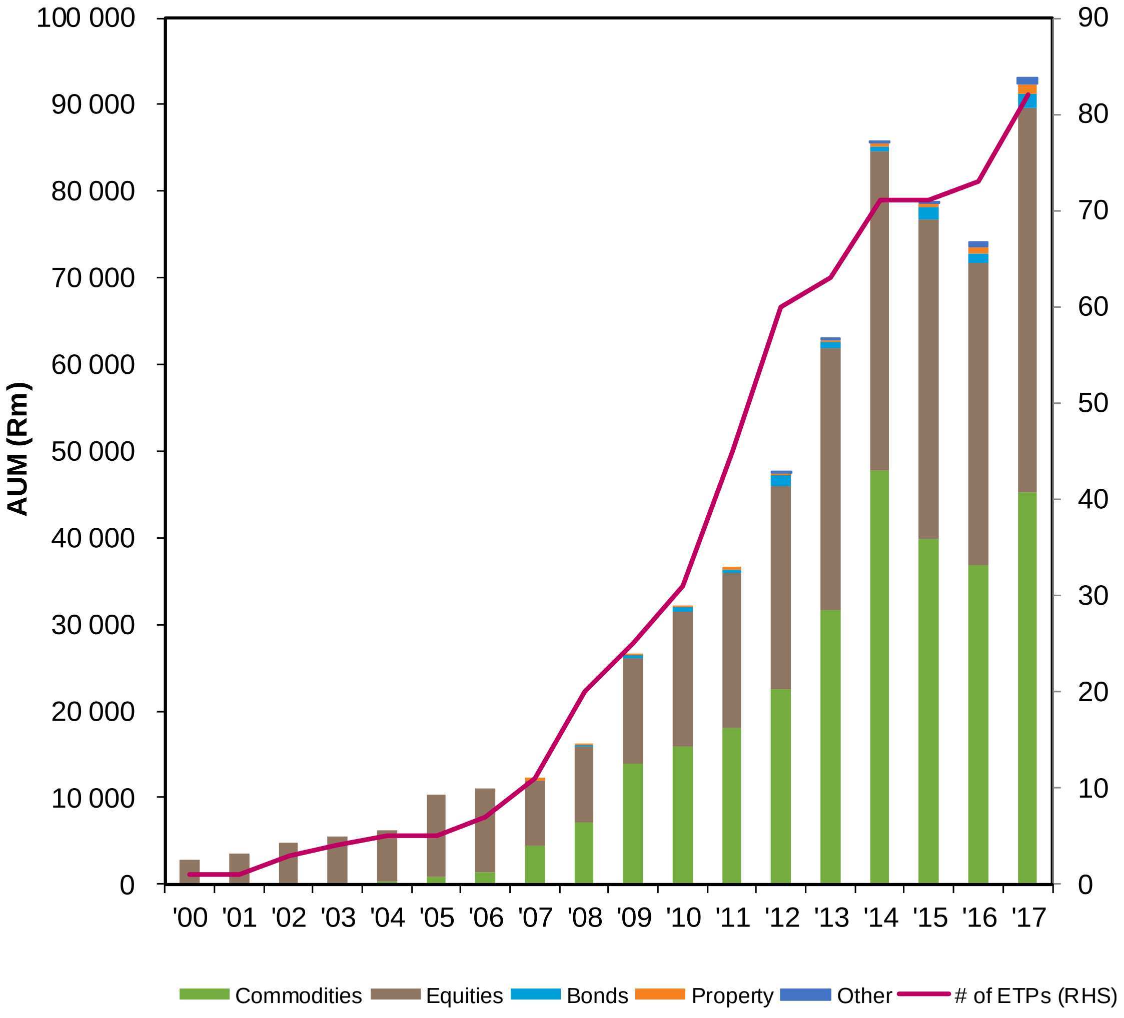
SA history



- ETFs launched in SA in 2000 (Satrix40); currently 82 ETPs listed on JSE
- Assets of ±R93 billion, growth of >25% year-to-date
- National Treasury has identified ETFs as key in achieving reduction in costs and increase in transparency in their quest to reform the retirement and savings industry*

Source: JSE, ProfileMedia

** Strengthening retirement savings – National Treasury 14-May-12*

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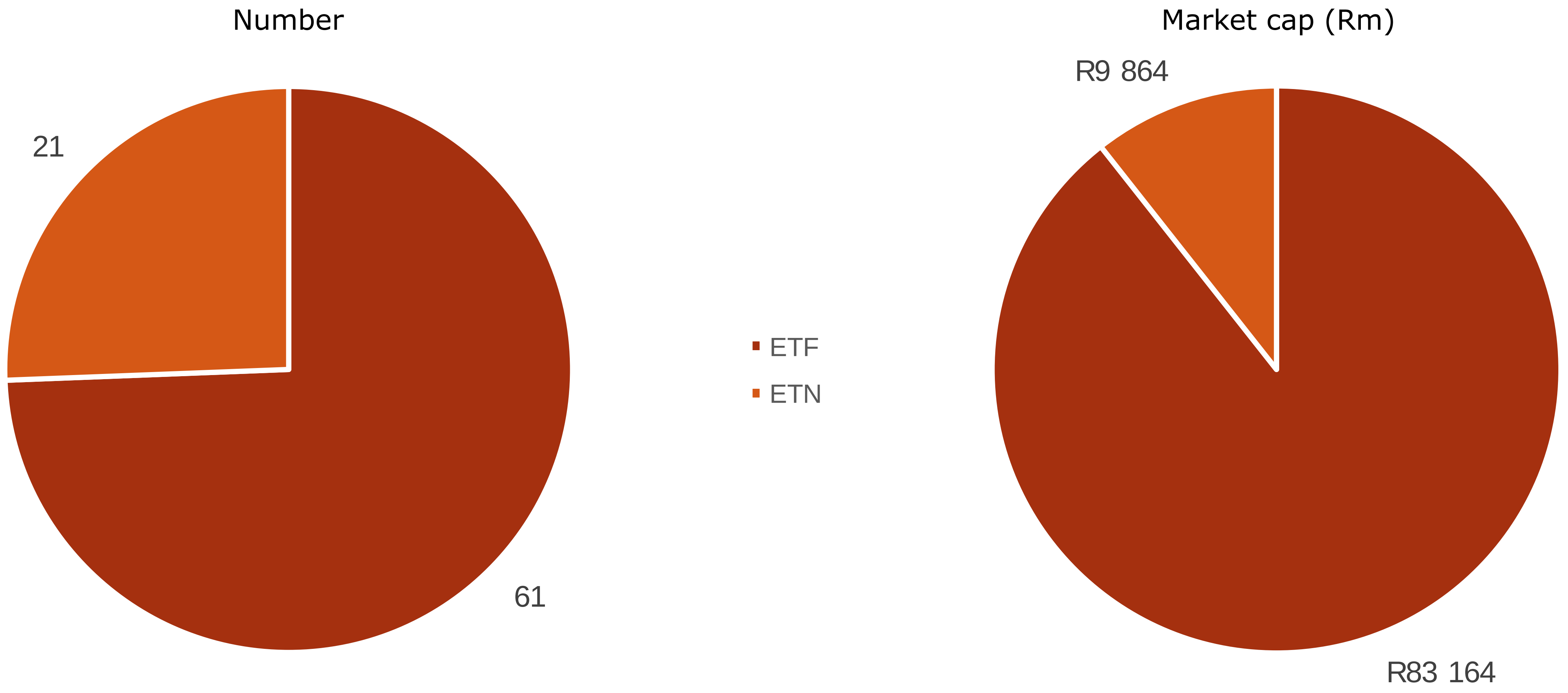
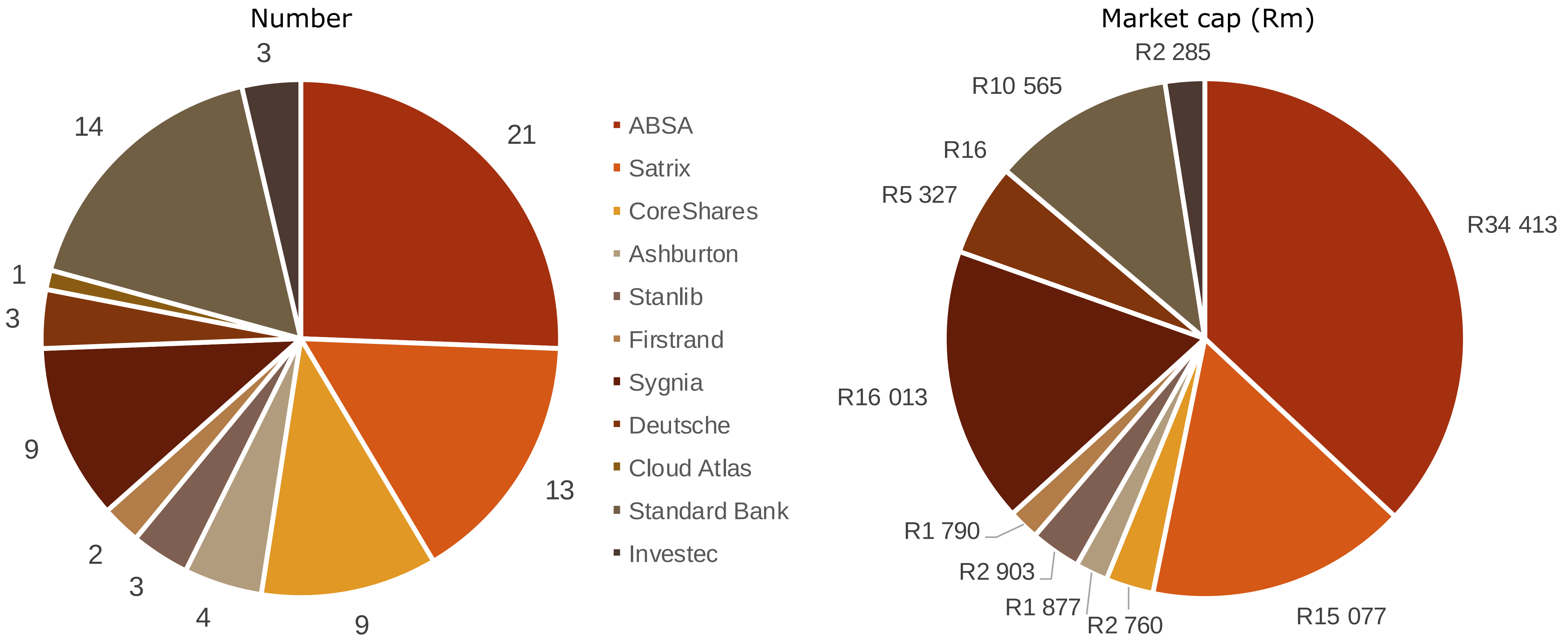
Make-up of SA industry
ETF vs. ETN



Source: JSE via ProfileMedia, etfSA calculations, as at 30-Oct-17

Make-up of SA industry Issuers

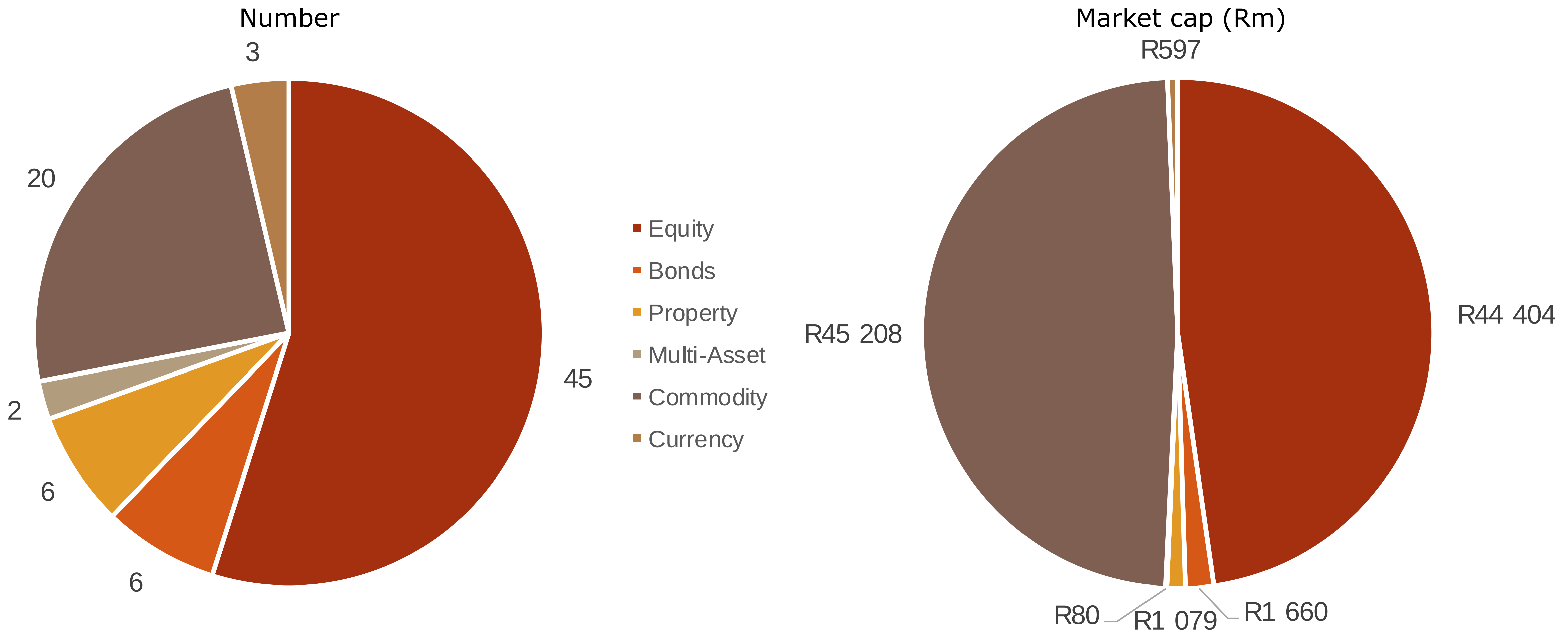


Source: JSE via ProfileMedia, etfSA calculations, as at 30-Oct-17

Evolution of “passive” investment strategies

- Exposure to broad-based equity market indices
  - Traditional “passive” investing
  - Efficient exposure to (market) beta
  - *Benefit*: low cost, transparency, operational and tax efficiency
- Expansion of “passive” to other asset classes
  - Application of indexation beyond equities
  - ETFs with non-equity underlyings allow for multi-asset class exposure via stock exchange
  - *Benefit* : ease of transaction; security of custody, clearing, settlement

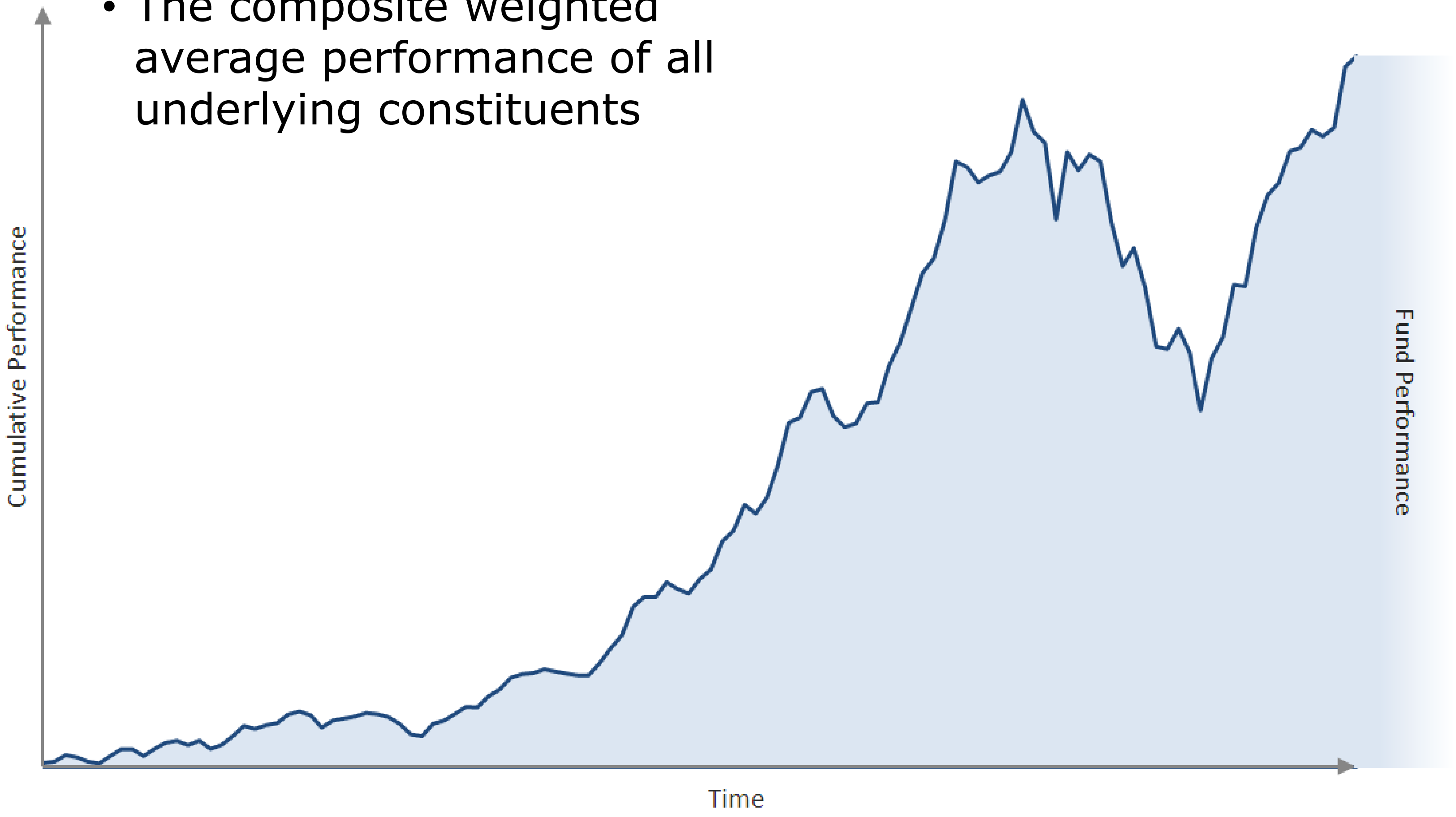
Make-up of SA industry
Asset Classes



Source: JSE via ProfileMedia, etfSA calculations, as at 30-Oct-17

Equity Fund Performance

- The composite weighted average performance of all underlying constituents



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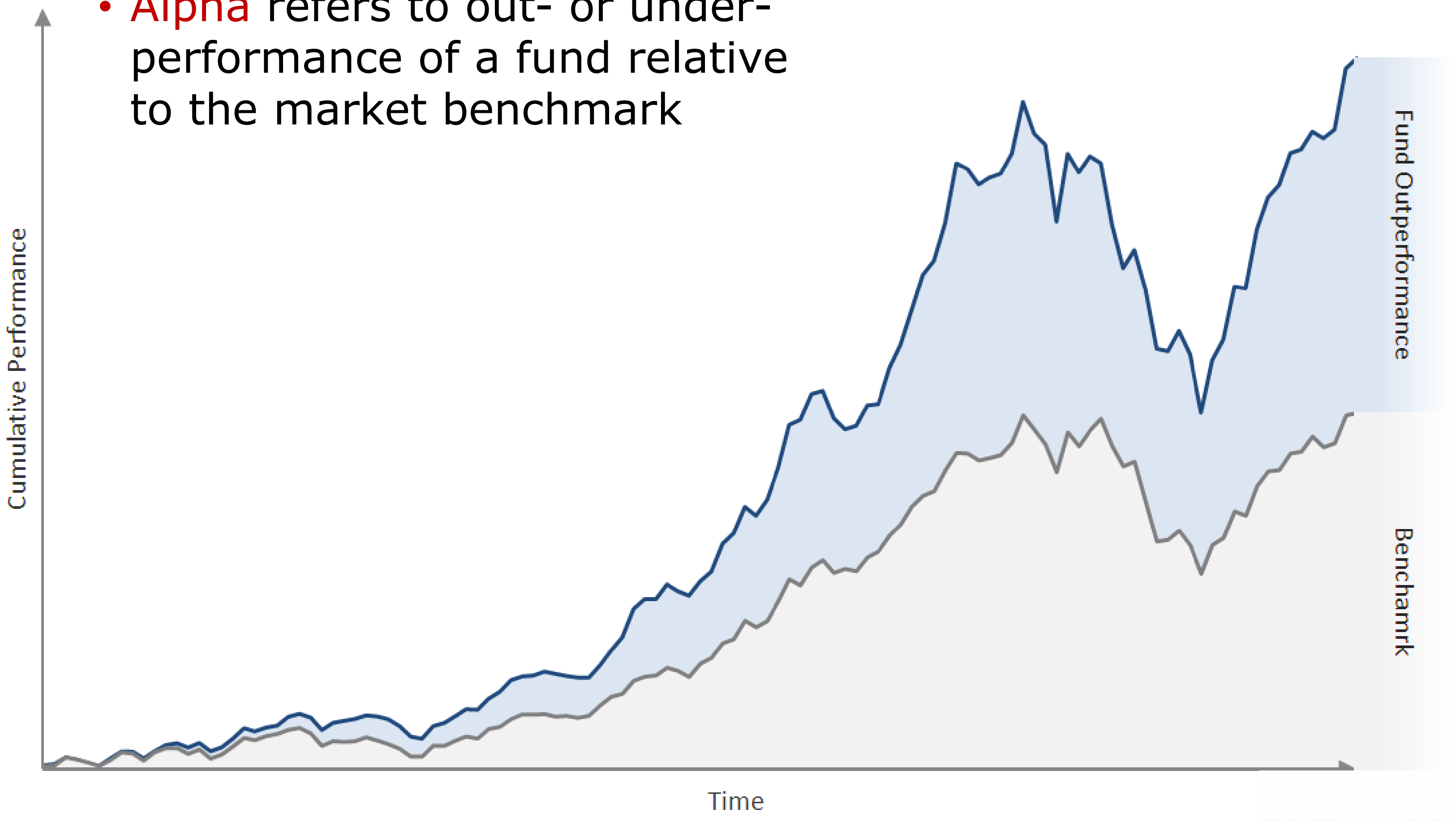
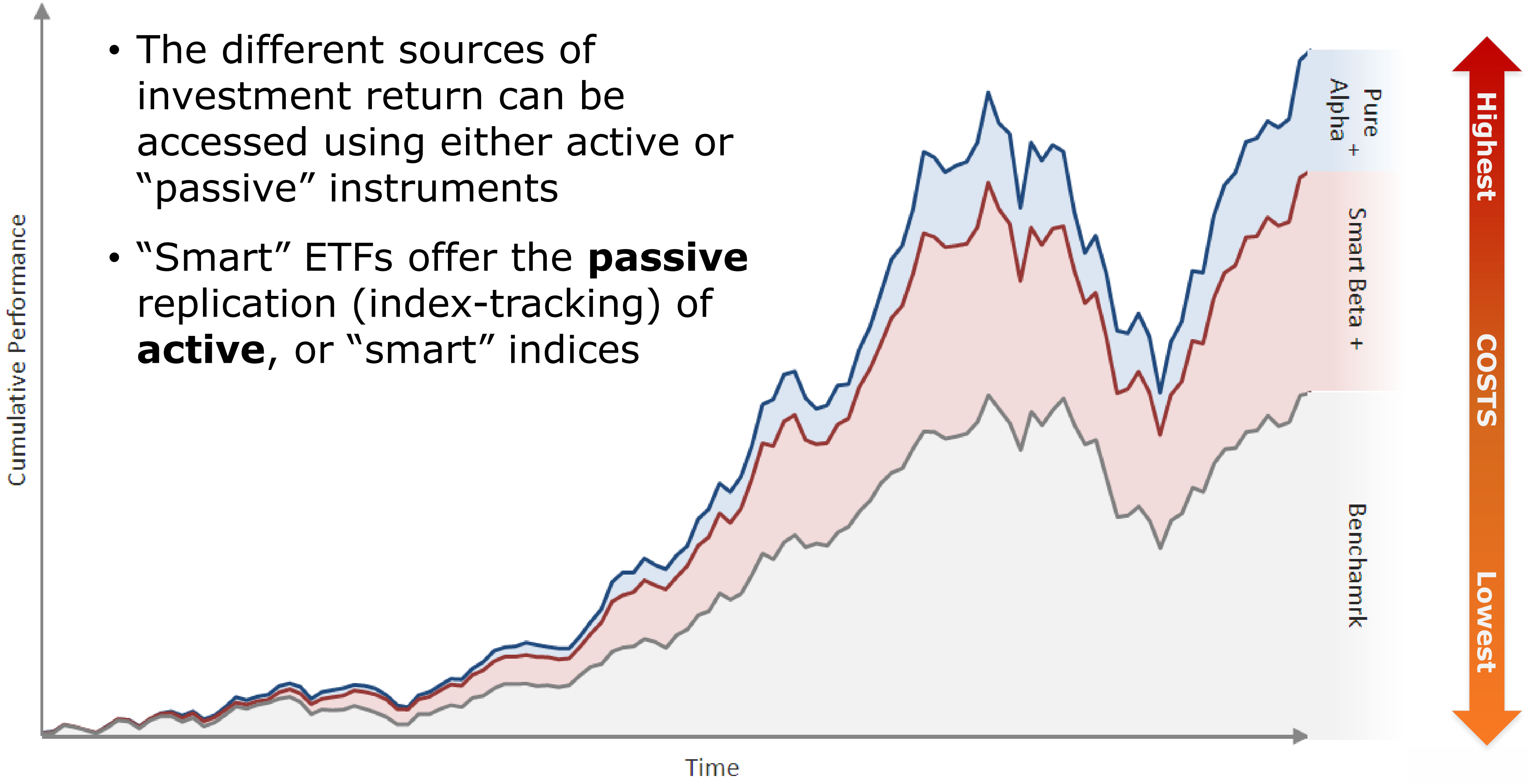
Beta ≡ Market (Size) Performance

- Alpha refers to out- or under-performance of a fund relative to the market benchmark



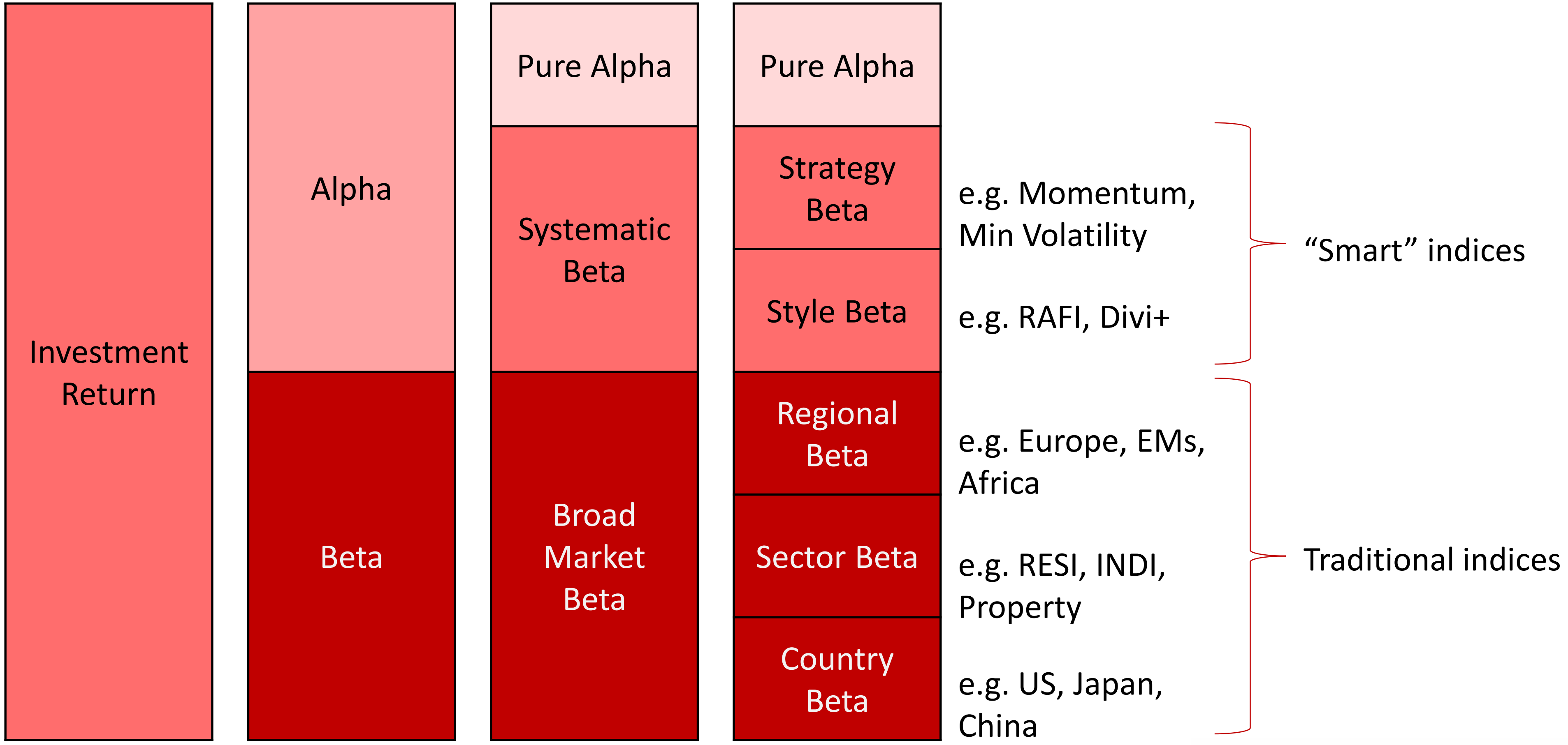
"Smart Beta" Reflect Different Sources of Investment Return

- The different sources of investment return can be accessed using either active or "passive" instruments
- "Smart" ETFs offer the **passive** replication (index-tracking) of **active**, or "smart" indices



Illustrative

Indices Reflect Different Sources of Investment Return



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- Expansion of "passive" to other asset classes
  - Application of indexation beyond equities
  - ETFs with non-equity underlyings allow for multi-asset class exposure via stock exchange
  - *Benefit* : ease of transaction; security of custody, clearing, settlement
- Rise of "smart beta" and alternative investment strategies
  - Rules-based investment decisions, commoditisation of active decision making
  - Index construction evolves from "performance benchmarks" to "allocation guidelines"
  - *Benefit* : multi-factor performance drivers; exposure consistency & style purity

Examples of “passive” building blocks – JSE-listed ETPs

- 82 Exchange Traded Products (ETPs) – cover most major asset classes
  - Domestic equity
    - Traditional (size-based)
    - “Smart” (factors; thematic)
  - Domestic bonds
  - Domestic property
  - Global equity, bonds, property
  - Commodities
  - Currencies
- Can construct fully diversified, Reg.28-compliant, balanced fund portfolios using only ETPs

Part III

What are the benefits?

Let’s talk costs

What makes an ETF less expensive?

- The ‘package deal’ allows for economies of scale
- There is only one “wrapper”, only one transaction
- Nobody is paid to make investment decisions for the fund

Total Expense Ratio (TER)

Average Total Expense Ratios (TER)		
ETFs	Basis points	(%)
*Satrix 40**	*10*	*0.10%*
Ashburton Top 40	*17*	*0.17%*
Stanlib Top 40	*25*	*0.25%*
Average of all **local ETFs**	32	0.32%
Average of all **local Index-tracking Unit Trusts**	71	0.71%
Average of all **SA General Equity Funds**	152	1.52%
Source: ProfileMedia; etfSA.co.za from ETF Issuer fact sheets, Jun-17		

And we know that the TER does not include all the costs!

Reduced from 38 bps from 1-Oct-17

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Comparative pricing of ETFs and unit trusts

- TERs do not tell the full story (*information*)
- Evaluate relative performance of portfolios tracking the same index (*evidence*)

NB question: why do index-tracking unit trusts underperform ETFs that track the same index?

- For example – three years to 10-Oct-17 (*source: ProfileMedia*):
  - **Satrix Top40** ETF(A): **9.63**% p.a. vs.
    Satrix 40 Index Fund(A1): **9.13**% p.a.
  - **Satrix RAFI40** Total Return ETF(A): **8.15**% p.a. vs.
    Satrix RAFI40 Index Fund(A1): **7.43**% p.a.
  - **Satrix Divi+** ETF(A): **5.27**% p.a. vs.
    Satrix Dividend+ Index Fund(A1): **4.81**% p.a.
- It's all about the **trading costs** associated with investment flows – depends on
  - Frequency and size of cash flows
  - Churn (turnover) rate

Most Underrated Benefits of ETPs

Transparency

Consistency

Benefits of Listing

- Introduces a second regulatory oversight – makes the investment even more secure
- No back office required for client administration – STRATE maintains the electronic share register (further costs savings in the process)
- "Democratisation of investments" – only one fee class, all investors are treated the same
- Opportunity to develop the investment industry – scope for more issuers, market makers, different style of fund managers, different analytical skill set

Corporate Activism

- Index-tracking ≡ lack of activism? Not true!
- Active investor can sell if he doesn't like it

  "Passive" investor has no choice, it's in his interest to engage and encourage change
- As index-tracking increases, activists only have to engage a handful of index investors, rather than a multitude of active investors
- For more information:

  http://knowledge.wharton.upenn.edu/article/passive-investing-increases-corporate-activism/

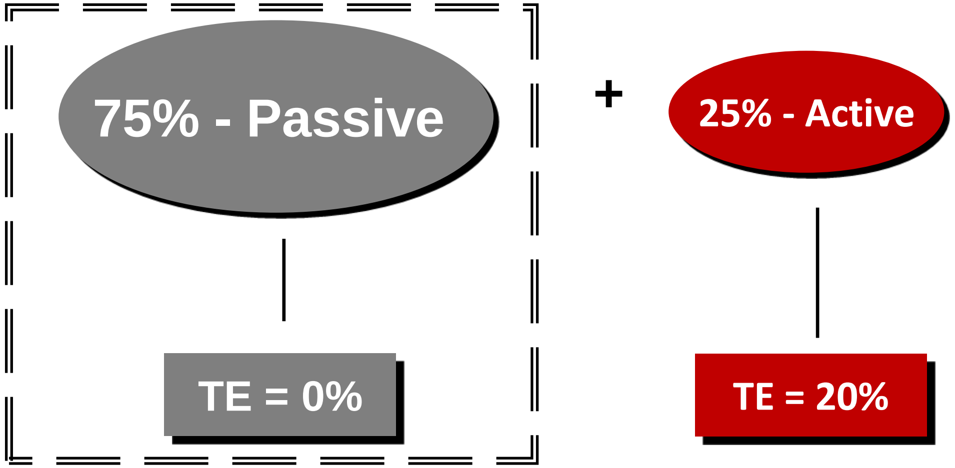
  http://knowledge.wharton.upenn.edu/article/passive-but-powerful-how-index-funds-exercise-their-clout/

Part IV

How can it be used?

Using Index Tracking
– the early years

- Using beta/passive to reduce costs in a single asset class (equity)
  - Allowable tracking error (or risk budget) for portfolio: 5%
  - 75% Passive (beta), 0% tracking error, very low cost
  - 25% Active, 20% tracking error, pay active management fees
  - Achieve allowable 5% tracking error at much lower cost



= same tracking error (5%)
but much <u>lower cost</u>

“All Investing is Active”…

…it’s just the level of activity that varies

Passive	‘Active’		Dynamic Active	
	Low-churn		Top-down	Bottom-up
Buy & Hold	Traditional ‘Passive’ - Market cap weighted indices (eg S&P500, FTSE100, Top40, etc.)	‘Innovation Creep’ through ‘smart’ indices & ETFs	Rules-based Active Skill Div+, RAFI, Low volatility, etc.	Traditional Active Skill - Value Investing - Growth/Momentum - etc.

Lowest cost ← → Highest cost

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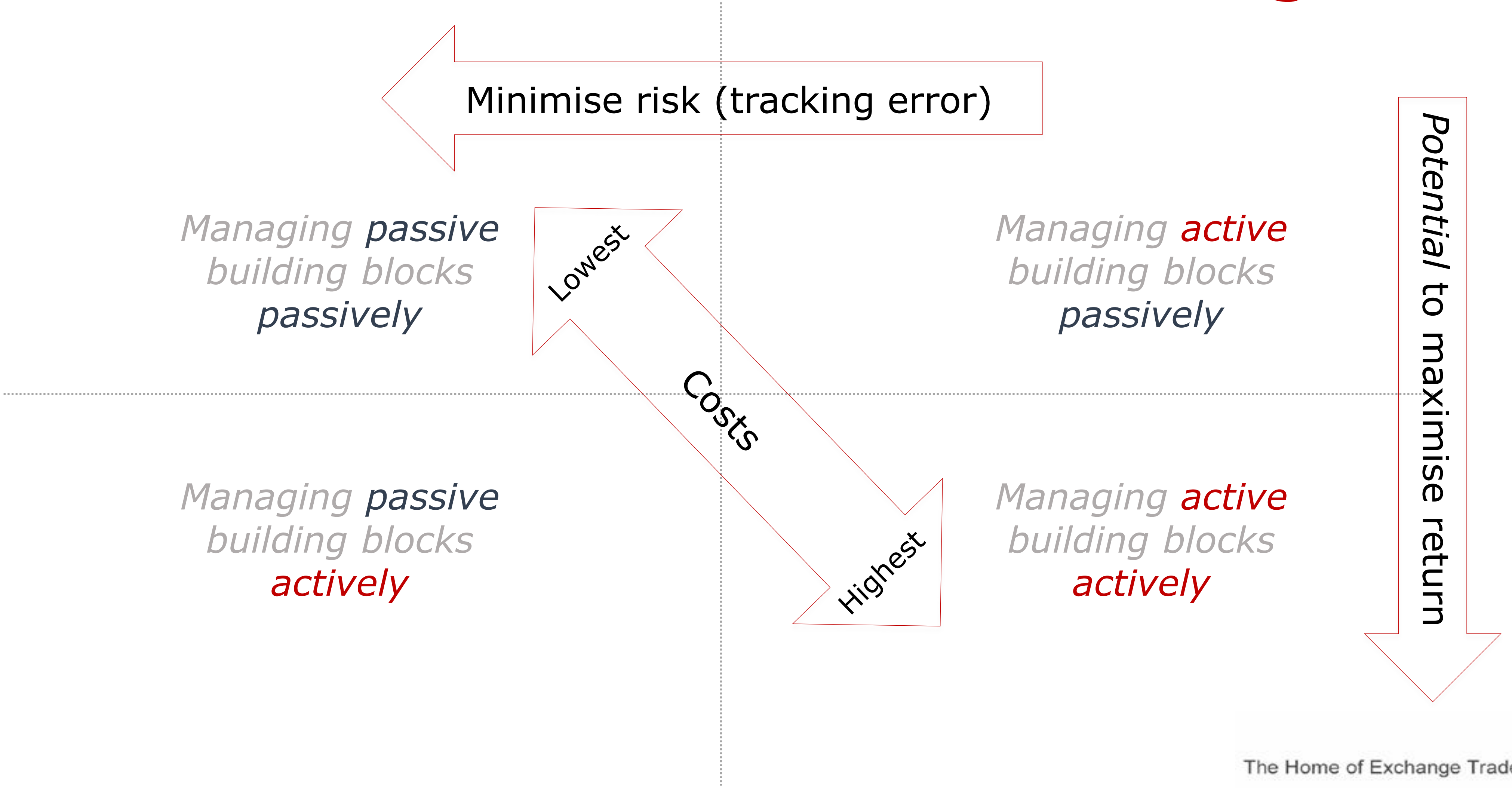
What constitutes "passive" investment for multi-assets / multi-managers?



Current trend:
ETP Managed Portfolios

- Investment strategies with >50% of assets invested in ETFs
- One of the fastest growing segments in the managed account universe:
  - Jun-17: $107bn in assets, 27.4% y-o-y, 7.3% q-o-q growth
- Reasons for strong growth amongst financial advisers:
  - Growth in fee-based models (rather than commission-based)
  - Fiduciary responsibility is shifting towards adviser
  - ETF strategists facilitates access to institutional-type diversification and portfolio management; adviser can focus on gathering & retaining client assets and managing overall financial profile
- Provides access to a broad range of strategies – from stand-alone strategies to one-stop, complete-solution offerings

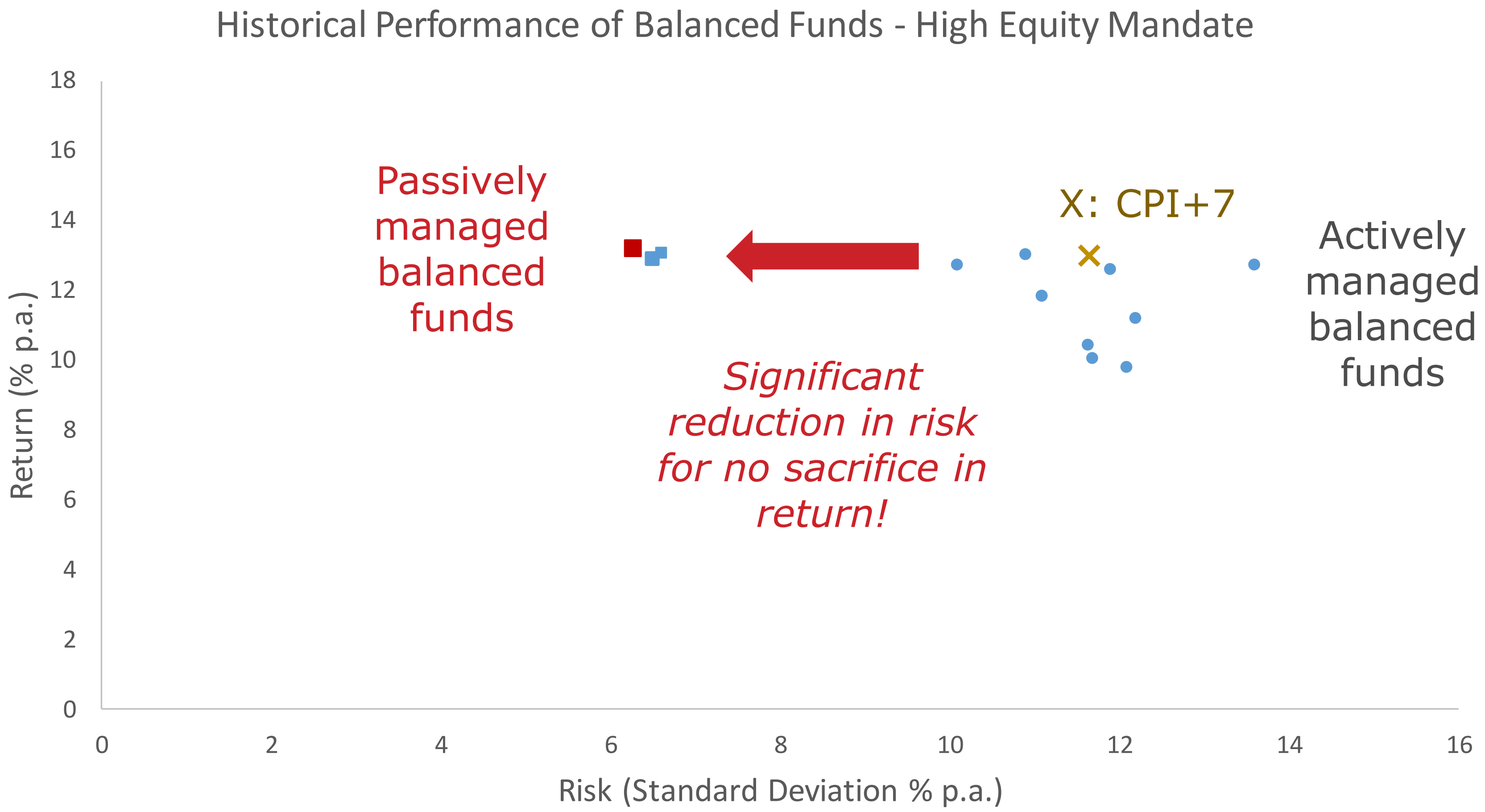
Source: Morningstar Inc.

Rules-based, Modular Portfolio Construction – Multi-Asset

Balanced Fund: Strategic Allocations into Multi-Asset Classes

Equities	Fixed Income	International	Alternatives
Large Cap	Inflation-linkers	Developed Markets	Commodities
ESG	Vanilla Bonds	Emerging Markets	Currencies
High dividends	Cash	Fixed Income	
(Property)	(Preference Shares)	Real Estate	

Comparative Risk and Return Profiles of Passive and Active Strategies



Notes: Average performance for the 5 years to Oct-16
Source: ProfileMedia data; etfSA calculations

“Passive” strategies for different time horizons

Strategic (multi-year)	Both strategic & tactical	Tactical (<1 year)
Core index or Enhanced index exposure	Achieve target exposures starting from active positions	Allocate cash inflows based on target exposure weights
Implementation of strategic investment policy	Over- or under-weight (tilt) relative to index exposures	Active / tactical overlay to strategic allocation strategy
Asset allocation / Top down investment strategies	Risk factor management – single or multi-asset	Completion strategy – fill gaps or change effective exposure
Strategy / factor / ‘smart’ index as active manager alternative	Thematic or Style tilt investing	Portfolio transition during manager or policy shift

Using ETFs in Retirement Funds

- Default option: stand-alone ETF Managed Portfolio
  - Designed to suit client mandate
  - Ultra-low cost
- Replacement of an active manager option
  - Achieve better diversification
  - Reduce costs and risks of overall portfolio
- Core-satellite model
  - Use "passive" balanced fund as core holding in portfolio
  - Possible satellites:
    - Tactical asset allocation tilts
    - Unconstrained, high conviction active

Closing Thoughts

Active "versus" Passive

- Let's get the basics right:
  - "Active" and "Passive" refer to investment **styles**, not investment **instruments** – it's NOT about ETFs vs. unit trusts
  - ETFs cannot be grouped together and compared on a relative basis as if they offer homogenous investment opportunities
  - Index-tracking unit trusts / segregated portfolios are also "passive" and "smart" indices incorporate varying degrees of "active" decisions
- Active-Passive is a continuum

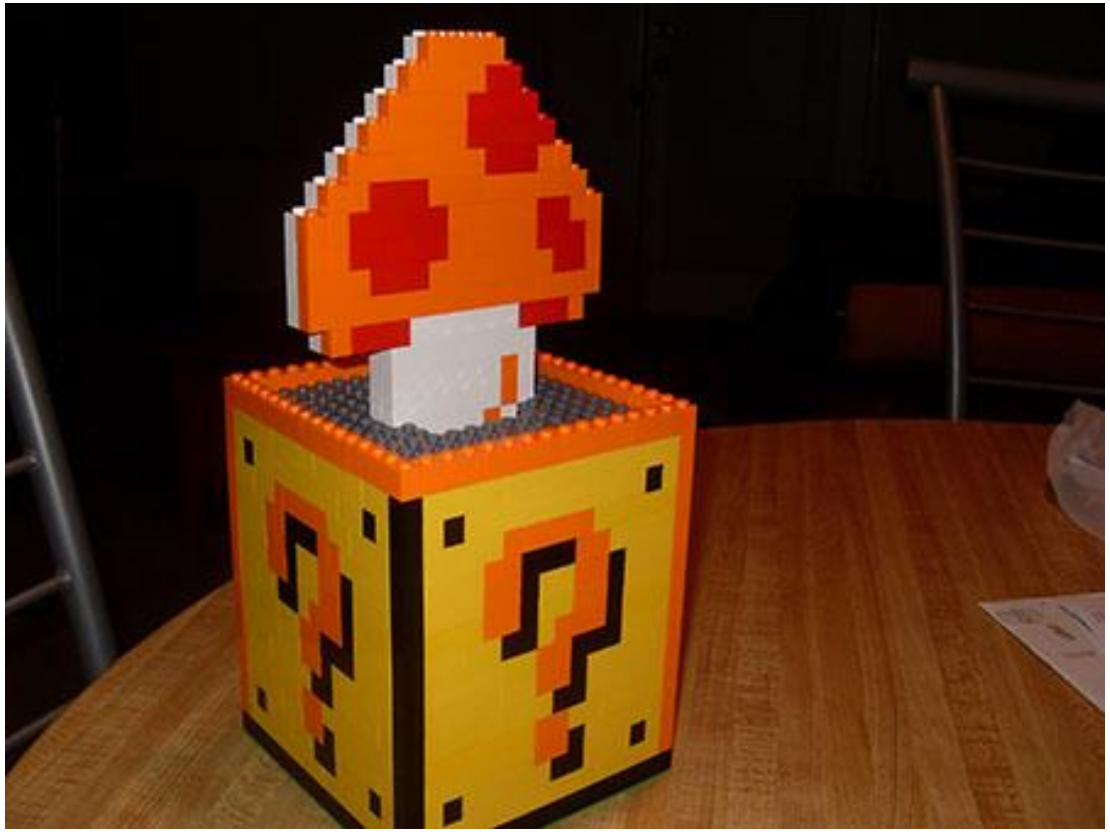
Challenges remain

- There is no such thing as a purely passive investment
  - You still have a target to reach – how will you get there?
  - Someone has to determine the asset mix, the indices to use, the allocations over time
- The key lies in a solution that has the highest probability of meeting your funding goal
  - Income, protection from loss, growth, liability matching all demand different investment strategies
- It’s not about the highest return
  - It’s about matching the strategy to the time frame and the certainty you require that you will get there
- Costs matter – understand them, understand what you are paying for

In Conclusion

- The new active manager is the one who can best combine all of this
- "Active" design of solutions around a risk budget that adjust exposure to different building blocks, in a pre-determined, rules-based framework, to meet goals like
  - Growth
  - Income
  - Capital protection
- Selection (or termination) based not on performance (returns) but ability to maintain control and meet goals

Questions – Discussion



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