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Why passive investing is not a good idea for fixed interest investors

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The debate around the merits of passive[1] versus active investing continues. Over the last few years passive investing has become more popular, as many fund managers have struggled to outperform the aggregate market as measured by different indices. The most common argument in favour of passive investing goes like this: The return on the index (let’s use the JSE All Share Index) is the change in each stock value multiplied by its relative size (weight) in the index. Given that the index is “the market”, the average return of all investors in the market has to equal that of the index itself. So, for every investor who outperforms the index, there is an investor that underperforms. The discussion then moves to finding those managers who consistently outperform the index and will continue doing this in the future. Given that finding the future outperformers is not really possible, the argument goes, rather just invest in the index. Of course, the more emotionally compelling argument, which is often used by advocates of passive investing at what might be exactly the wrong time, is to look at a certain history that proves their point.

Assuming that an investor was convinced that passive investing is the best alternative, there is another decision that needs to be made. Which index to invest in? The important point to understand when following this strategy is that the return on such funds is practically identical to the benchmark and “forces” its characteristics on the fund. And here lies the risk that investors might be unaware of.

[1] Passive investing is a strategy whereby the risk and return of the investment is identical to a pre-specified index

In the case of passive investing in the South African Fixed Interest market the popular choice would be the JSE All Bond Index (ALBI) [2]. This is a well-established index which includes 21 bonds mainly issued by the government (94%) and Government guaranteed entities (5.2%). The index is extremely liquid and easy to replicate (an important part of passive investing).

So what is the risk? To understand the risk associated with passive investing in the fixed interest market, a quick explanation of the construction of the ALBI is necessary. Bonds are included in the index on the basis of their market value (similar to equities market cap) and liquidity. So, as the amount of a certain bond increases as a result of (for example) increased government borrowing, the weight of that bond increases in the index.

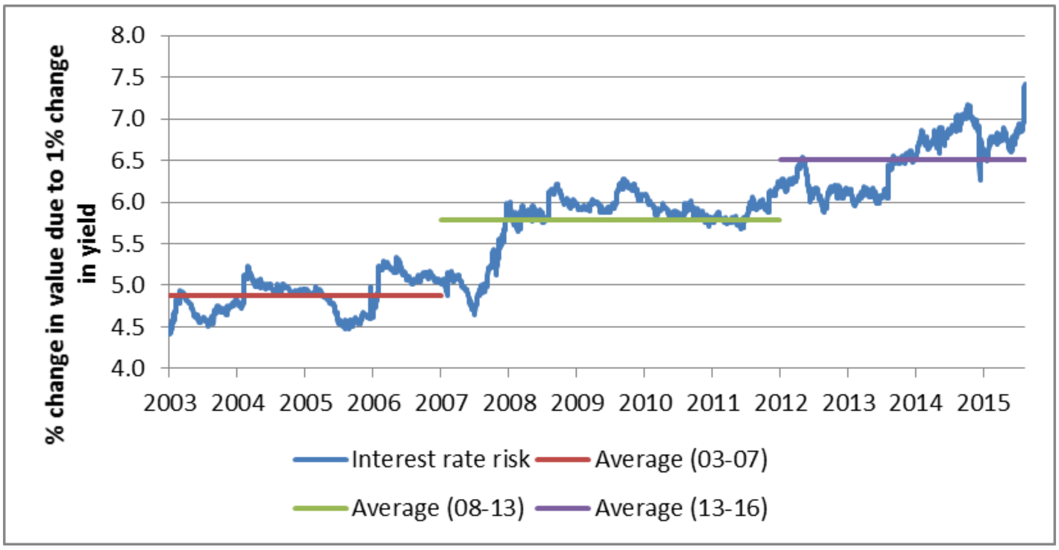
From a South African investor's perspective, there is practically no credit risk in the ALBI because it is not likely that poorly rated corporate or bank bonds will be included in the index. The ALBI is, however, vulnerable to interest rate risk – i.e. the risk of capital loss as a result of the change in the level of interest rates, implying that there could be a material change in the value of one's investment. It's the interest rate risk that investors should be aware of when "passively" investing in the ALBI.

In the mid 2000's South Africa was benefiting from a very favourable global growth environment which allowed it to grow at a pace that, long term, would have helped alleviate unemployment and poverty (the SA economy grew by an annual average of 4.4% from 2000 to 2007). This allowed government to reduce its deficit to such a level where it was able to reduce its debt in relative (as a % of GDP) and absolute terms. Subsequent to the financial crisis, however, in an effort to support economic growth, government has been running significant budget deficits which have been financed by new bonds. It is the term to maturity of the new bonds that government issued that has changed the interest rate risk of the ALBI.

At the end of 2003 government bonds had an average term to maturity of 7.4 years. Given the increase in debt since then and government's decision to issue bonds with a long term to maturity, the average has increased to 15.2 years. Therefore, given that interest rate risk increases with the term to maturity (ceteris paribus), the interest rate risk of the ALBI has increased. Figure 1 below shows the change of interest rate risk over the last few years.

[2] Passive investing is a strategy whereby the risk and return of the investment is identical to a pre-specified index

Figure 1 – All Bond Index interest rate risk history (modified duration)



Between 2003 and 2007 a "passive" investor in the ALBI would have lost (or gained) 4.9% of the investment if the aggregate yield to maturity of the ALBI increased (decreased) by 1%. This compares to 5.8%, 6.5% and 7.4% for the periods 2008-2012, 2013-2016 and now, respectively.

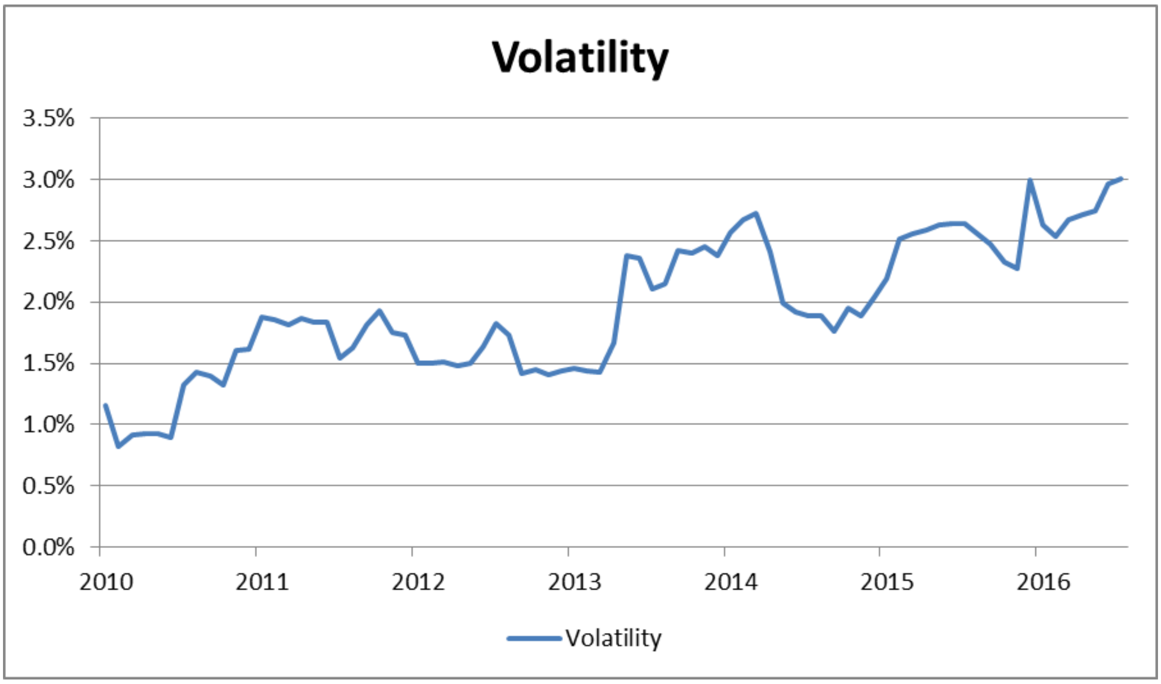
This means that the interest rate risk associated with "passive" investing has increased by 51% between 2003 and 2016. It is therefore not surprising that the volatility of returns of the ALBI increased over the last few years as shown in figure 2.

The most common strategy used by South African pension funds in the interest rate space is what we would term "flexible" passive. These strategies are benchmarked to the ALBI, but allow the fund manager some discretion around the level of interest rate risk that can be taken. This discretion is given at a level around the interest rate risk associated with that of the ALBI. So, for example, if the interest rate risk of the ALBI is 5 (where it was in 2008) then the manager is allowed to deviate from that by 1 (i.e. between 4 and 6). This means that even with some flexibility around the interest rate risk that the fund manager is allowed, the most "defensive" the fund manager can be today (6.4) is more "aggressive" than it could have been in 2008 (6).

There are two conclusions that can be drawn from the above. First, benchmarking against an index means that over time the characteristics of the investment can be altered "passively" in a material manner. Therefore, secondly, fund managers should be given more discretion than they have had in the past when managing interest rate risk in their portfolios.

It is for this reason that investors seeking to invest in Fixed Interest Funds should target funds that are designed to not simulate the ALBI – such as funds benchmarked to the STEFI index – which should not only provide returns with lower volatilities, but should provide higher returns than ALBI indexed funds.

Figure 2 - All Bond Index return volatility



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

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Jonathan served as the Head of the Fixed Interest Team at Cadiz Asset Management (2006-2015) where he managed the Unconstrained, House View and Inflation-Linked Bond funds. Jonathan's experience includes 11 years of being on the sell side where he worked as a Fixed Interest Strategist at HSBC (1995-2003) and then at RMB (2003-2006).