Abridged Summary

ETF& Index investing: Plug and Play?

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1. What do ordinary investors really want?

Ill-informed (advised) investors expect maximum returns at minimum (no) volatility risk.

Many professional investment consultants and managers can attest to the unrealistic expectations often held by investors. Moreover, investors are more interested in absolute gains than returns relative to a benchmark. We obviously can address investors' expectations in two ways, namely to exploit investors' worst instincts, namely greed and fear, or following the more difficult (perhaps even less rewarding) approach of educating and toning down investor expectations to more realistic levels. While it is relatively easy at times to market specific investment products, especially when backed by recent great performances it is irresponsible for any investment professional not to pay close attention to the possible downside of an investment.

Market-beating returns?

Active investment managers have set themselves a benchmark of beating the market returns over time, but of course the market is nothing but predominantly the same professional investment managers. This gives rise to the notion that the market is very difficult to outperform, because it is dominated by very bright people indeed. Moreover, the collective view is often much more informed and well-calibrated then those of individual market participants. Not surprisingly, we seldom found among investment managers consistent outperformance of the market which in itself often leads investors to switch from one performing manager to another.

Or, reasonable returns at reasonable costs managed by reasonable people/institutions following a reasonable investment process.

I would argue that most investors have a holistic set of investment objectives, and not only the single objective of market-beating or splendid returns, but also the need to trust the investment manager and/or the investment process and justification of the costs involved to invest and manage his or her hard-earned savings. In fact, many investors do not specifically demand market-beating returns all the time nor do they necessarily pay close attention comparing their returns to market returns. It is rather about the whole investment experience and whether it met their expectations over time. Thus, while we often focus on investment returns only, we should realise the relative importance of the other, perhaps less quantitative aspects of the investment experience.

2. Active investment management and evidence from the marketplace

When evaluating different investment managers we appreciate that like-for-like performance comparisons are sometimes an immensely difficult task. Similarly, we know that attributing outperformance only to investment skill downplays the role of luck in the outcome of the investment process. Mean-reversion is alive and well in the investment business – and we found ample evidence thereof among asset class returns, investment styles and fund performances.

A number of statistical trends and phenomena determine the outcome of active investing over time, for example: There is among actively-managed equity funds a relatively low probability of outperforming the market in the long run (less than 20%), especially when properly accounting for survivorship bias. Moreover, relative fund performances are not persistent at least over shorter term intervals. This leads to erratic investor behaviour (investors are chasing the latest hot performers) with often dreadful market timing consequences that cause investors to earn often much less than those returns reported by the funds.

Success in the investment industry bred success, i.e. performing managers attract large investors' inflows and while it is great for the business operation (profitability) it is not necessarily the same for investors. Fund sizes may have adverse effects on relative performances as the windows of meaningful investment opportunities are closing down with mega-sized funds. Moreover, most of today's star performing funds were relatively small funds ten years ago and attracted not much investors' attention at the time.

We found in general an inverse relationship between total expense ratios (TER) of funds and their performances, i.e. the lower-cost funds tend to outperform their high-cost counterparts over time. Theoretically there should be a linear relationship between fund performances and TERs – high-performing funds charge outperformance fees while average-performing funds won't – but at best there is no evidence of such a relationship.

All in all, while the long-term market-beating returns of today's star performers are well-documented, one must realise that not many investors necessarily shared in those splendid returns, nor did too many investors knew at the time to invest specifically in those funds.

3. Index and ETF investing

The aforementioned analyses clearly make a strong case for index investing as the preferred investment strategy for most investors. Moreover, we know that low-cost index investing yields above-average returns compared with the averages of active investing, thus while we should expect "average" returns from index investing the actual outcome are often much better (equivalent to top or second quartile ranking) than that of active investing over time.

Most investors, however, opt not to invest in index funds – simply because they not aware of the possible advantages of index investing, or they are not advised to invest in such products, or emotionally they do not feel comfortable to invest in a fund that will yield only "average" returns, or that managers (human beings) are not in full control of investment decisions.

ETF investing has made index investing "sexy" and worldwide became a popular investment destination in recent times (attracting more net inflows than mutual funds at the moment). Also, many ETF investors perhaps do not realise they are following an index strategy–they are primarily attracted to ETFs because of the low fees and liquidity of the product, relative good performances of many of the ETF products and then of course investors can gain direct exposure to "hot" asset classes such as certain commodities groups, etcetera.

4. ETF investing and potential pitfalls

While ETFs and the underlying investment philosophy are undoubtedly great for investing some of the inherent characteristics and features of ETF investing will make the product in some instances not suitable for all investors. In fact, it is likely that some investors may blindly follow the crowd without critical analysis or seeking proper investment advice in their ETF investment decisions.

ETFs are marketed as low-cost investments, but it is arguably not quite true for smaller investment amounts or regular investing (contributions). Investors have basically two options to acquire ETFs, namely through their stockbroking account or an investment platform. In the former option the transaction fees for especially smaller amounts are quite steep, whereas it can be done more economically through an investment administration platform. The latter option, however, implies higher administration fees when compared with a stockbroking account. The net result is that ETF investing is probably more expensive than typical index unit trust funds, especially for smaller amounts or regular investment contributions.

The liquidity and tradability of ETFs is sold as a major benefit for investors/speculators. However, it is unlikely that the majority of this group will really benefit from trading activities and one expects that the average investor's return will lag the reported returns over time, similar to what we observe with actively-managed funds. Thus on the aggregate value may be destroyed rather than created by speculative trading activities.

ETFs typically focus on the top 40 stocks listed on the FTSE JSE. An ETF investor, therefore, will have no or very little exposure to mid cap or small cap stocks in ETF portfolios. The latter two market segments typically outperformed large cap stocks in the past, thus an investor focusing exclusively on ETF investing might be missing out on some investment opportunities in those market segments. In addition, index investing styles typically suffer more than actively-managed equity funds during a prolonged bear market, simply because ETF and index funds are fully invested whereas an active equity manager has some discretion to hold cash or move portfolio holdings to more defensive stocks in the midst of a falling market.

A prominent feature of especially emerging markets is the level of market concentration found in market cap indexes, i.e. a few large stocks dominate the market cap weighting of an index. For example, a Top 40 ETF investor may be invested in forty plus stocks but the actual outcome of the portfolio is predominantly determined by, say, the top ten holdings in the portfolio, or alternatively the majority of the holdings in the fund have little bearing on fund performance. Notwithstanding, investors have ETF instruments at their disposal to create more equally-weighted or less concentrated investment portfolios.

Given the aforesaid it seems that ETF investing is not all that straightforward or simple. Some research and investment advice should be sought to determine the appropriateness of various ETF investments in an investor's portfolio. Otherwise ordinary investors are prone to classical investment mistakes, like basing their strategies only on past performances or perhaps investing in today's "hot sectors" of the market that often are touted to be "sure winners" in the future.

5. Final Analysis: Are we meeting investors' needs?

No clear winner emerges from the classical active/passive investment debate. A fundamentalist view is not appropriate because none of the strategies offers a "perfect" or "all-in-one" investment solution – with active management there is always a possibility that one could substantially lag market performance (after considering all the costs) whereas index investing is perhaps not satisfying our emotional (but not necessarily rational) needs for superior performance opportunities and active human involvement in the management of our investments.

A more practical approach is to integrate both strategies in one's overall strategy – formally known as a core-satellite investment approach. For example, investors can invest in low-cost, predominantly large cap equity index portfolios in conjunction with active managers concentrating on specific investment styles and mandates such as mid- and small cap, growth, value, and so forth. Investors following such a strategy are likely to experience relatively better returns and at lower costs than investing only with active investment managers over time.

ETF investing is one component of one's overall investment strategy. It is not a fad or some magical product that always will yield spectacular returns. An ETF can deliver only (and a bit less considering the tracking error and fees) what the index benchmark will yield over time. That being said, most equity managers will struggle to beat the market benchmark, especially over the longer term. Therefore, an ETF investor should experience quite acceptable returns relatively to those of active managers, especially if ETF investors are following a buy-and-hold (long-term) investment strategy. Another group of ETF investors are obviously buying and selling the ETF instruments for speculative trades. No guarantees, however, exist that such trading strategies will yield the desired results; in fact, it is quite likely that those speculative investors on the aggregate will be worse off than buy-and-hold ETF investors.

Finally, while ETF investing is a relatively straightforward concept, investors need to evaluate (or consult investment professionals) whether specific products and indices suit their specific risk profiles and expectations. Thus, while ETFs are typically passive investments investors should actively acquaint themselves with the intrinsic features and possible downside of the product.