The Active / Passive Debate: PSG’s prevailing view

Who is passive good for?
A passive investment strategy is generally a good idea for investors that are very focused on costs or are not comfortable that they are able to pick stocks or fund managers that can consistently outperform the market over longer periods. That said, there are a number of capable stock pickers in South Africa that have long-term track records of beating the market by a sizeable margin. For example, the PSG Equity Fund has beaten its benchmark, the FTSE/JSE All Share Index, by almost 5% per year over the past 13 years — after costs.

What does value have to do with a passive strategy?
The real problem with an index-based passive strategy is that you buy a basket of stocks with no attention being paid to the price you are paying. And after a period when large capitalisation stocks have had a good run, your investment can be skewed towards a small sample of very expensive heavyweights. This is the case right now — just as it was in late 2007 and early 2008. Only back then, it was the resource shares that were much-loved and expensive. Today, it’s the industrials. Investors should be aware of the risks of buying into a passive, market-weighted strategy at this point in the investment cycle.

To illustrate, it is worth looking at what a passive investment in the FTSE/JSE Top 40 in June 2008 would have looked like: 60% of your capital would have been allocated to the resource sector at a time when mining shares were extremely expensive. Since then the sector has lost 40% of its value — and almost 19% would have been in Anglo American alone at a time when it traded above R500. Today it trades below R220.

An investment in the Top 40 today will see only 22% of your capital being allocated to mining and oil stocks, at a time when many resource shares are very cheap on most valuation metrics. Your investment into a Top 40 market-weighted tracker now will result in a similar allocation of roughly 22% to just two stocks, Naspers and SAB Miller; both of which are about as expensive as they have ever been on most valuation measures.

At PSG Asset Management, we define risk as the possibility of losing money for our investors. We think that buying a significant exposure to very expensive stocks is a risky strategy. Particularly now — buyer beware.

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Please note that this article does not constitute financial advice and should only be seen as a contribution towards the Active/Passive debate. What is appropriate for any investor should be determined with the assistance of a qualified and experienced financial adviser having taken into account the investor’s financial position, risk profile and needs.