Revisiting The Big Debate –

Active versus Passive Investing and the influence on investment performance and retirement income

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Executive Summary

Majority of members in Botswana retirement funds retire with insufficient incomes. What / Where is the solution?

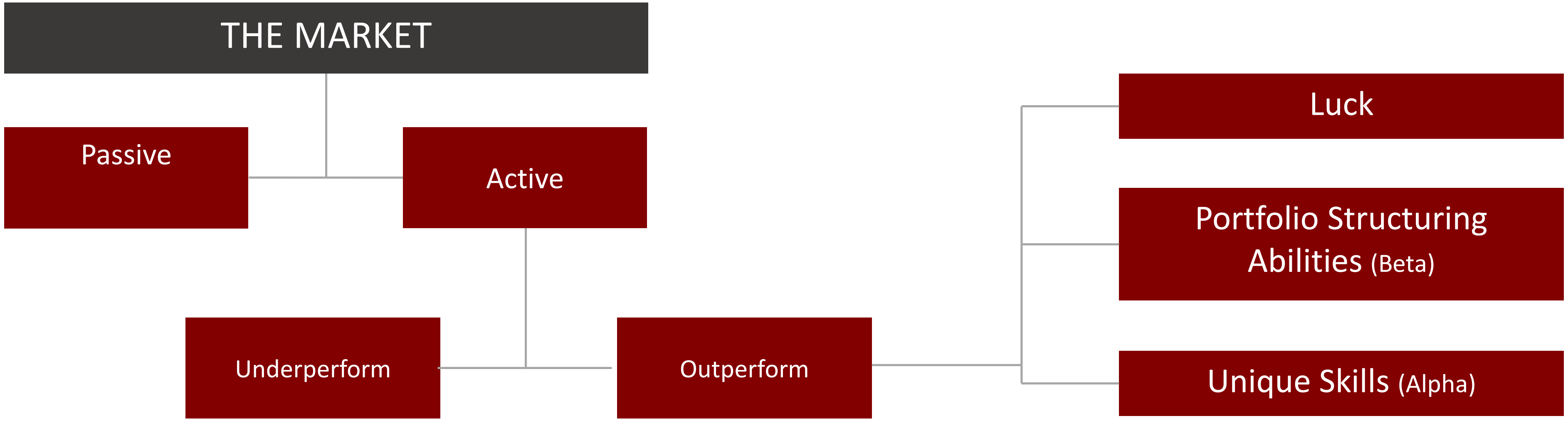
- Given the significance of our retirement assets invested offshore, the passive vs. active debate is a very important consideration for retirement fund members.
- We believe that there is a place for both passive and active management in portfolios but depends on type of investment strategy.
- Costs must be balanced against potential value add.
- Alpha (outperformance), even if small, can have a significant impact on members' expected retirement benefits.
- There are several important considerations for trustees in the current investment landscape to improve retirement incomes and returns:
  - Asset allocations decisions are becoming more complex in a lower growth and return world.
  - We need to challenge conventional thinking in order to build a better framework for understanding investment objectives and risks for retirement fund members in Botswana.

The Passive vs. Active Debate

The Passive vs. Active Debate

Market Structure

Skill and Luck
(Fundamental or Systematic)



"Your long-term investment performance ultimately depends on two factors: your investment mix (how much you are invested in shares, bonds, cash) and how much that return is reduced by fees."

Passive Management

Definition

- Attempts to replicate the return pattern of a specific index or benchmark.
- This investment process is purely administrative as the investments within the portfolio are simply rebalanced, added or removed as the index it is tracking changes.
- The idea is to minimize investment and trading fees and to avoid the adverse consequences of failing to correctly anticipate the future.

Active Management

Definition

- A strategy investors use when trying to outperform a generally accepted market index or appropriate benchmark.
- An explicit intention to deviate from the prescribed benchmark or index to generate better returns. Active investing may follow a rules-based process.
- Exploits market inefficiencies by purchasing securities that are undervalued or by short selling securities that are overvalued. Either of these methods may be used alone or in combination.

The Passive vs. Active Debate

Global Perspective

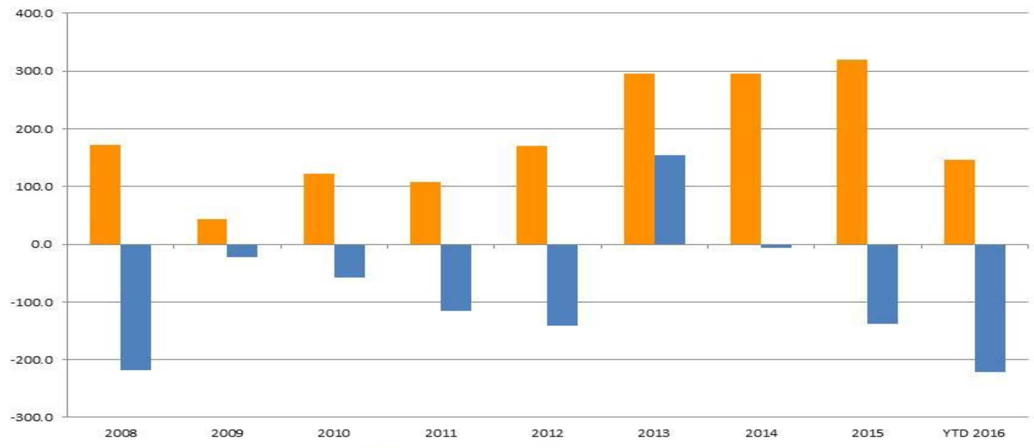
- The first passive / index portfolio was pioneered by the Samsonite Pension Fund in 1971:
  - A US$6 million portfolio designed to match the NYSE Index.
- Index tracking is more commonplace in the developed world:
  - An estimated 10-15% of all US pension assets are passively managed
- Concentrated industry with more than 75% of passive assets are managed by three players:
  - BlackRock, StateStreet, and Vanguard.

The Passive vs. Active Debate

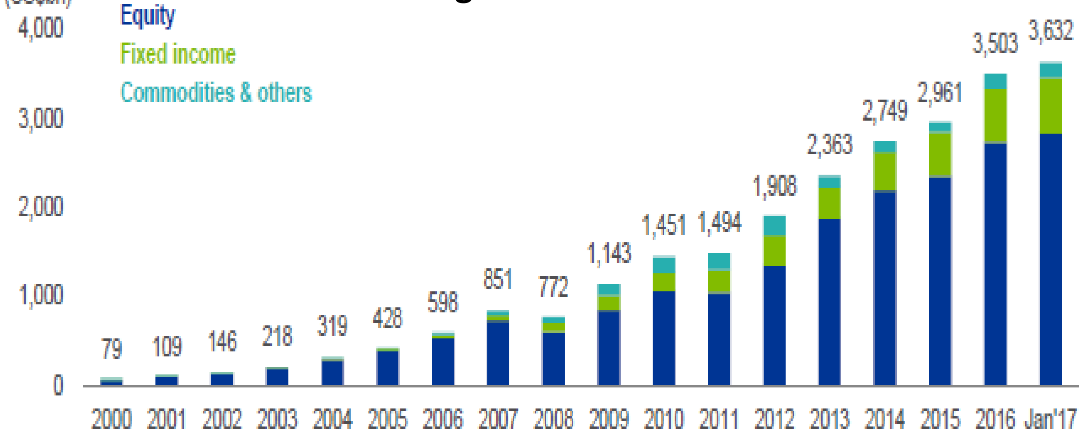
Global Perspective

- Actively managed funds dominate total global assets:
  - Global Active Management Size ≈ $20trn
  - Global Passive Management Size ≈ $4trn
- Passively managed funds have experienced higher net flows every year since 2008.

Exhibit 1 Passively Managed Equity Funds' Versus Actively Managed Equity Funds' Annual Net Flows ($Bil), 2008–Third Quarter 2016



Global Exchange Traded Products Assets



Source: BlackRock, Thomson Reuters

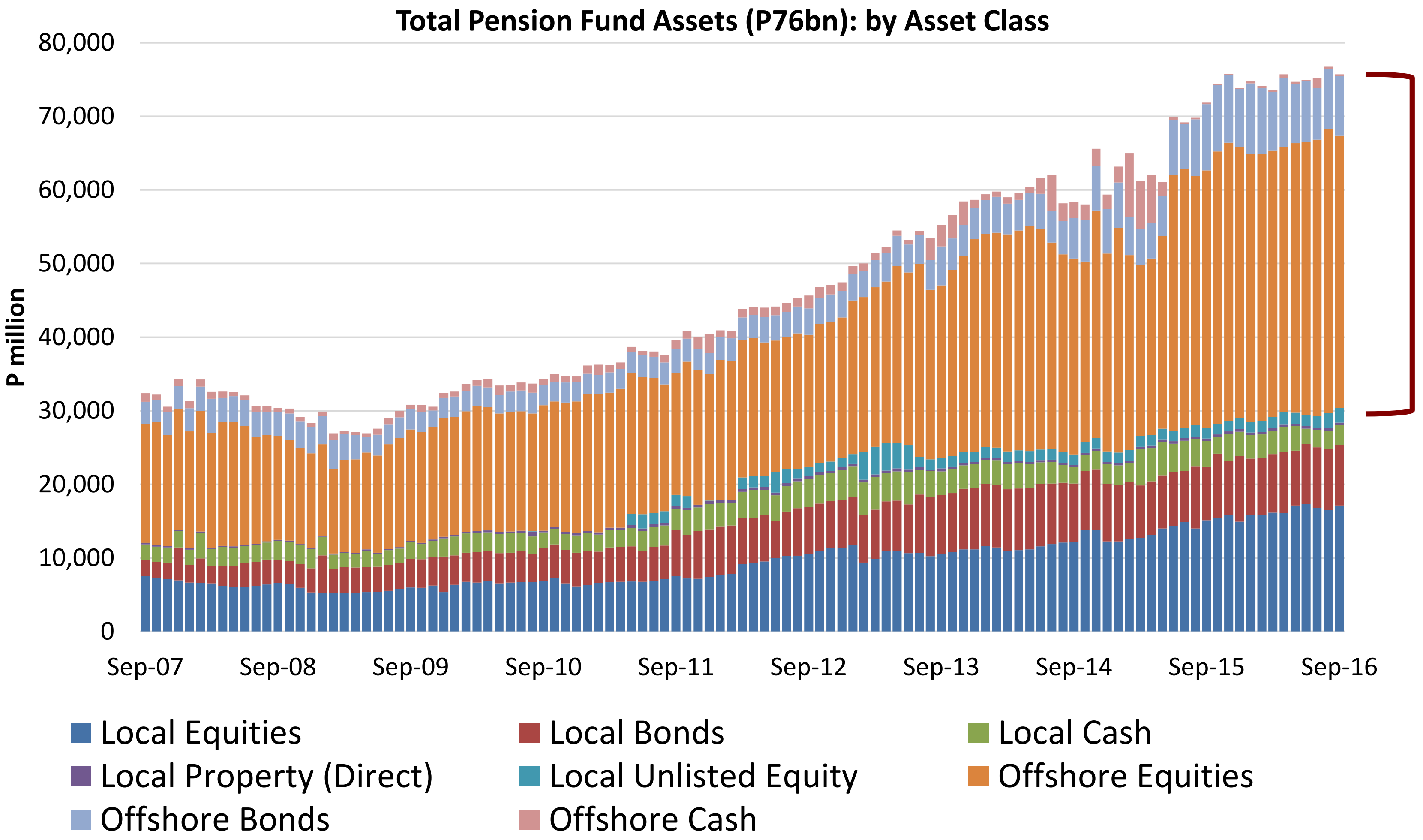
The Passive vs. Active Debate

Botswana Perspective

- Active funds dominate retirement fund investing in Botswana.
- No passive investment strategies available for local asset classes given illiquidity and market depth.
- Most of the 60% of Botswana's retirement fund assets invested offshore are actively managed.
- History shows active managers have generally done well.
- However not everyone can beat the market all the time.

Half of our retirement assets invested in Global Equities

Botswana Perspective



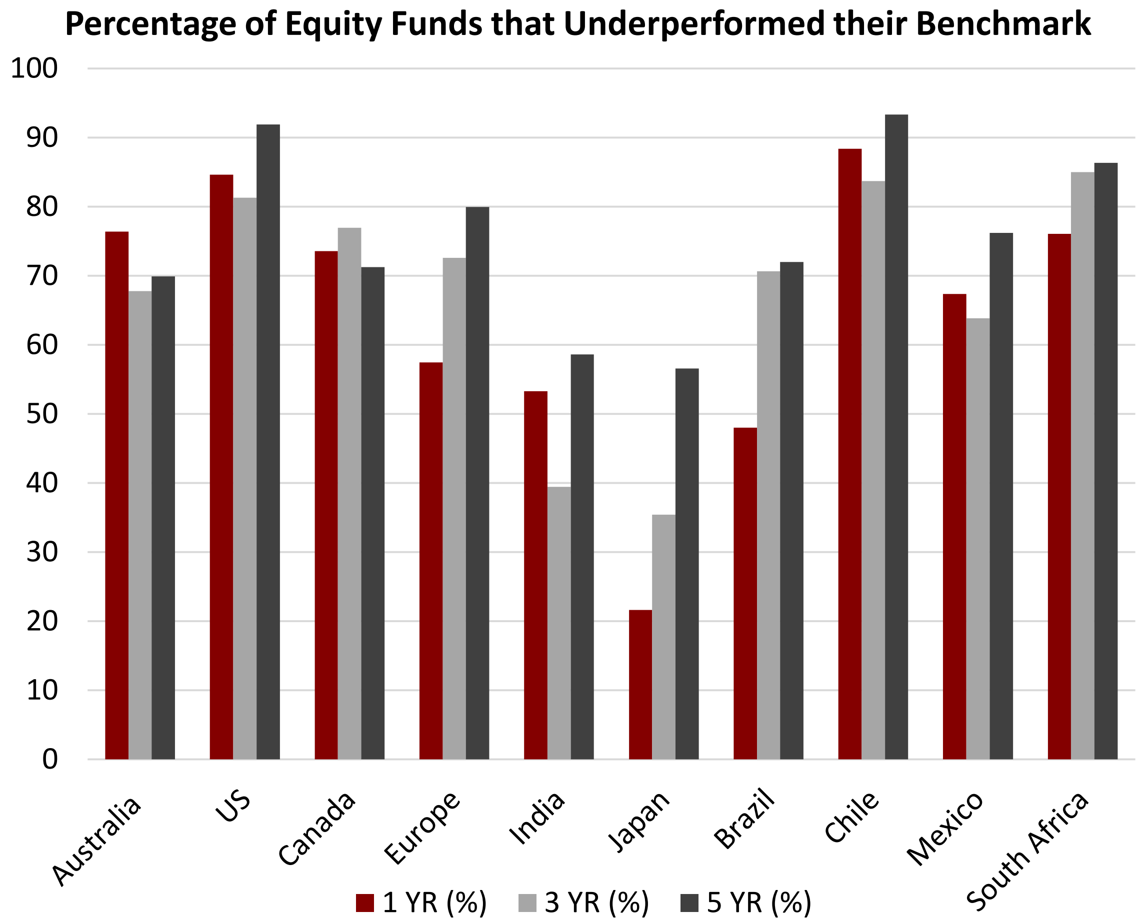
- 60% of total retirement assets are invested offshore.
  - with 50% of total retirement assets invested in Global Equities.

Source: Bank of Botswana

Arguments for Passive have become more prevalent in the market current cycle*

- There are times when the industry's argument for either passive or active management becomes more prevalent and it is important to understand these cycles.

- Since its first publication 14 years ago, the SPIVA Scorecard has served as the de facto scorekeeper of the active versus passive debate.

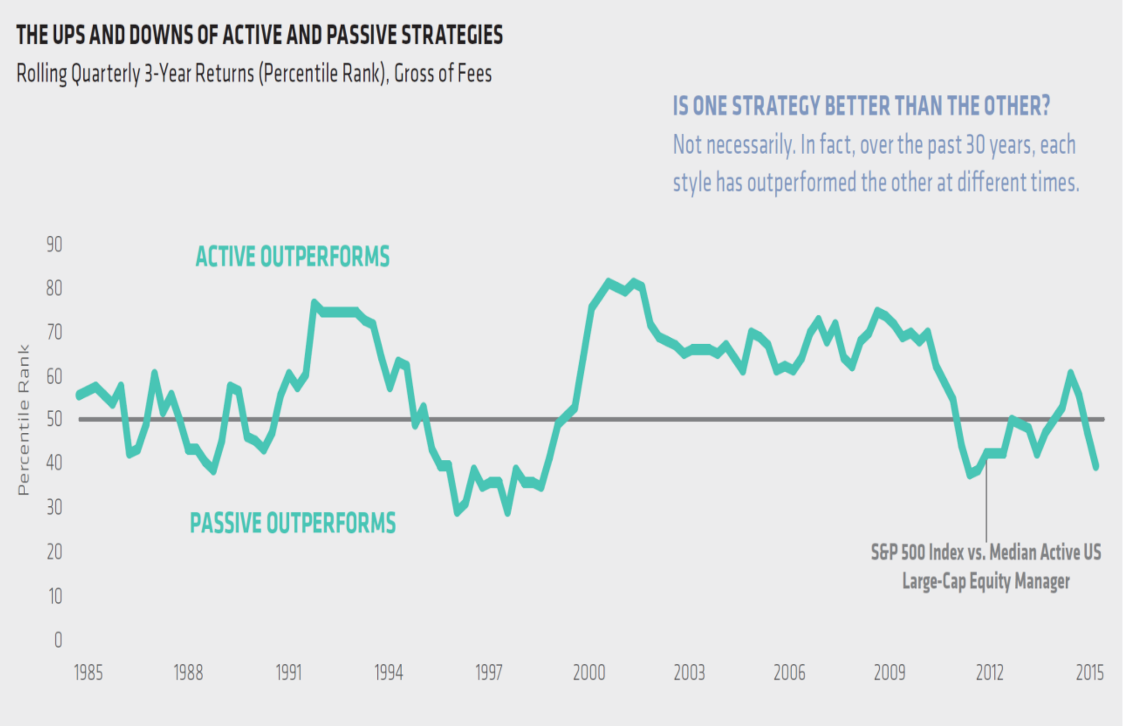


*Results depend on period considered

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

Arguments for Passive Management become less compelling over the long-term*

- Both active and passive management have their advantages and disadvantages and so it is therefore crucial to use them in the correct ways in order to isolate the benefits of each.



*Results depend on period considered

Source:eVestment and S&P

When Does Active Management Pay?

Advantages of Active Management

Research	Active managers can add value through good security selection, driven by their fundamental research.
Market Efficiency	Less efficient financial markets e.g. small caps and emerging markets can provide a greater opportunity set for active managers to exploit inefficiencies.
Capitalism	Capitalism predicates on the efficient use of capital; active managers seek to deploy investors’ capital to the most efficient users of the capital.
Costs	Passive solutions are generally cheaper than active managers although a good active manager should be able to offset their fee and provide additional outperformance over the longer term.
Flexibility	Passive solutions have less flexibility and cannot decrease/increase their exposure to certain countries, sectors or stocks but must simply replicate the relevant index. You could liken this to driving by looking in the rear-view mirror: you don't know where you are headed or what is coming next.
Diversification	Passive solutions can be over-diversified leading to individual stocks not having a material impact on performance, whereas active managers running high conviction portfolios can still have sufficient diversification while enabling individual stocks to have a positive impact on performance.
Momentum	Market-cap weighted index exposure leads to momentum-driven investing as you buy more of what has increased in value.
Behavioural Biases	Passive solutions remove the emotion from investing although good active managers should be aware and able to compensate for their behavioural biases.
Operational Challenges	Some asset classes are much more difficult to track within a passive investment solution e.g. property, private equity.
Bear Markets	Active managers can use cash to protect capital in bear markets, providing the desired risk/return profile while passive solutions forgo this benefit.
Trading Costs	Mathematically, passive solutions will always underperform the market due to their costs and other miscellaneous fees due to their trading.

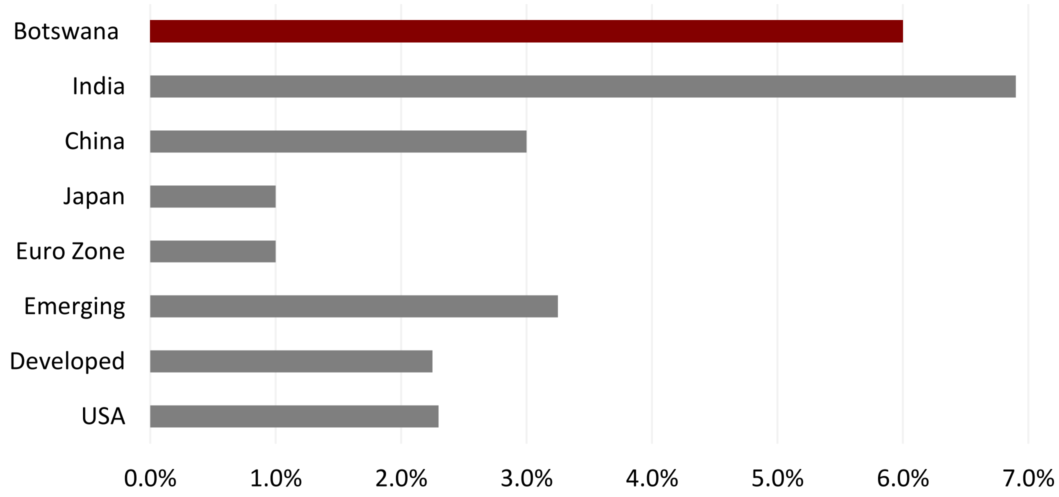
Important considerations in the current investment landscape to improve retirement incomes and returns

Decisions for Asset Allocators have become more complex

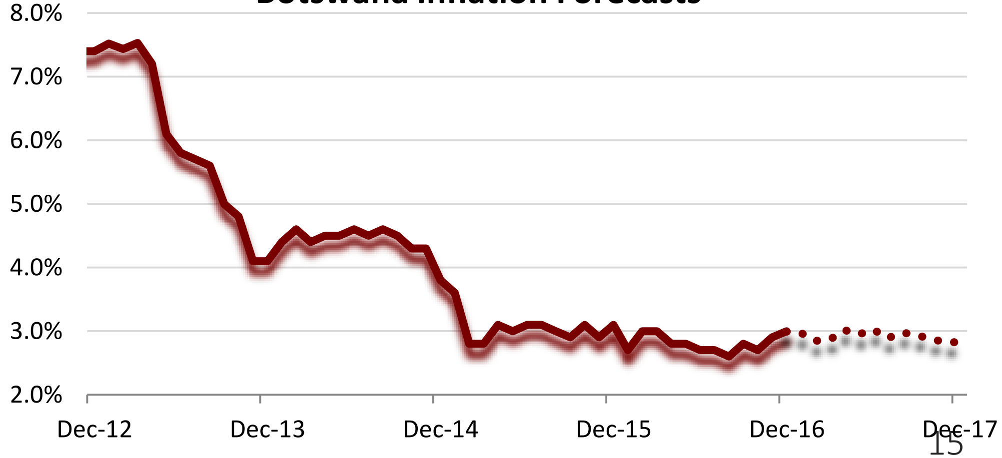
Build off of Domestic Inflation Forecasts

- Capital Market Assumptions (CMAs) define expectations:
  - Expected Inflation
  - Expected Return
  - Expected Yield
  - Expected Risk
  - Expected Correlations
- Generally target long-term real returns of 5%

What is the inflation rate that investments need to beat?



Botswana Inflation Forecasts

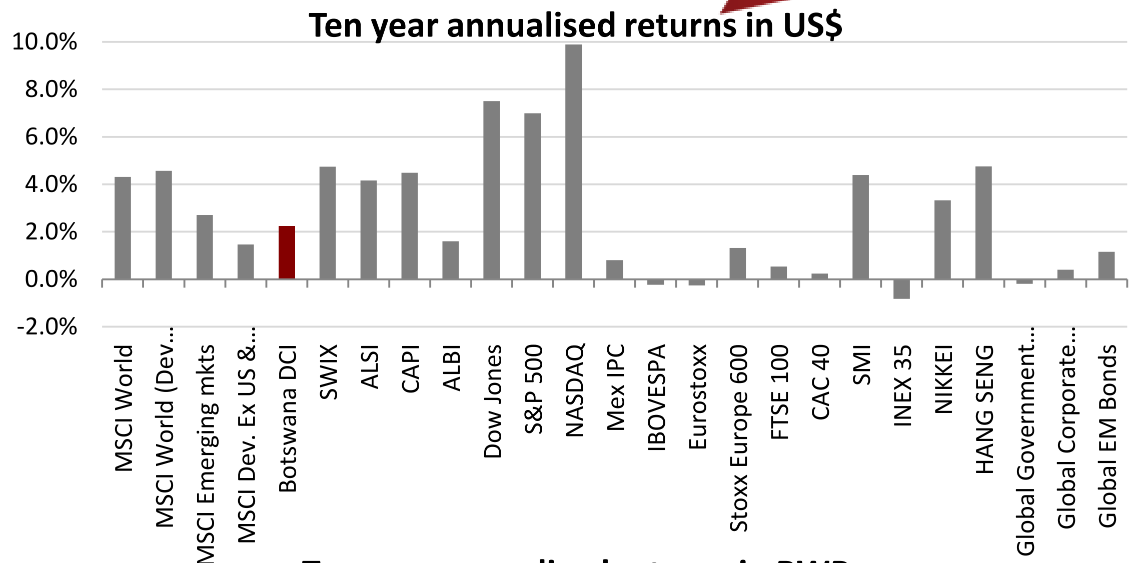


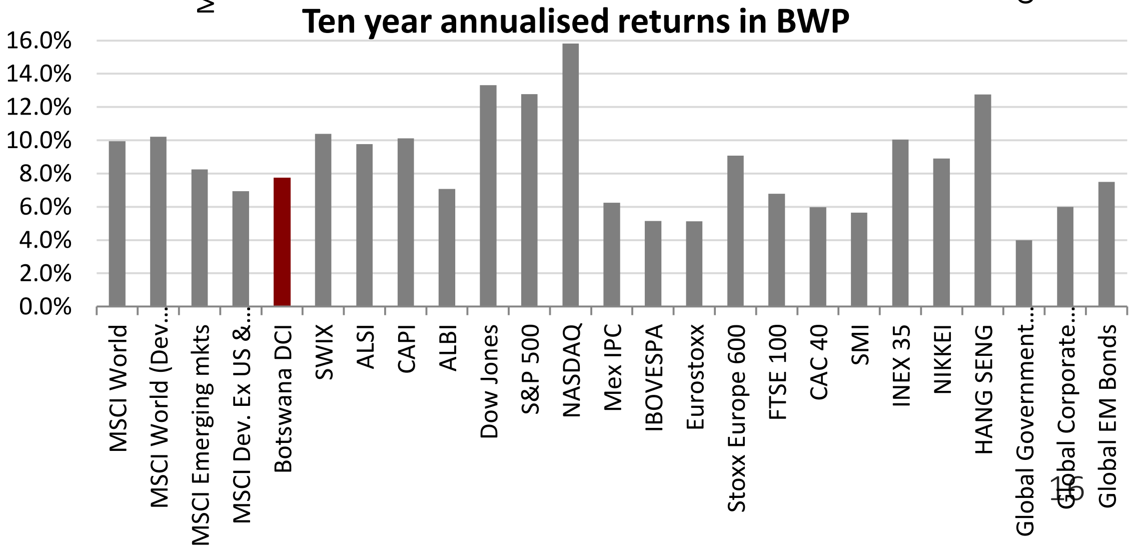
Source: Stats Botswana, Afena, JP Morgan

A look at the last decade of returns

Pula weakness was a major contributor to offshore returns

- Market returns are beyond manager control.
- 1980s and 1990s were best period in 130 years for traditional 60-40 global stock-bond asset mix.
- Returns have been very average since then.





Source: Economist

Historic Low Global Growth Environment

Lower global market returns expected

- Globally, we are operating in a low-return environment where real returns are becoming increasingly difficult to achieve.

- Correct asset allocation and stock selection will become even more critical, and the profile of investor portfolios may in future differ materially from the past.

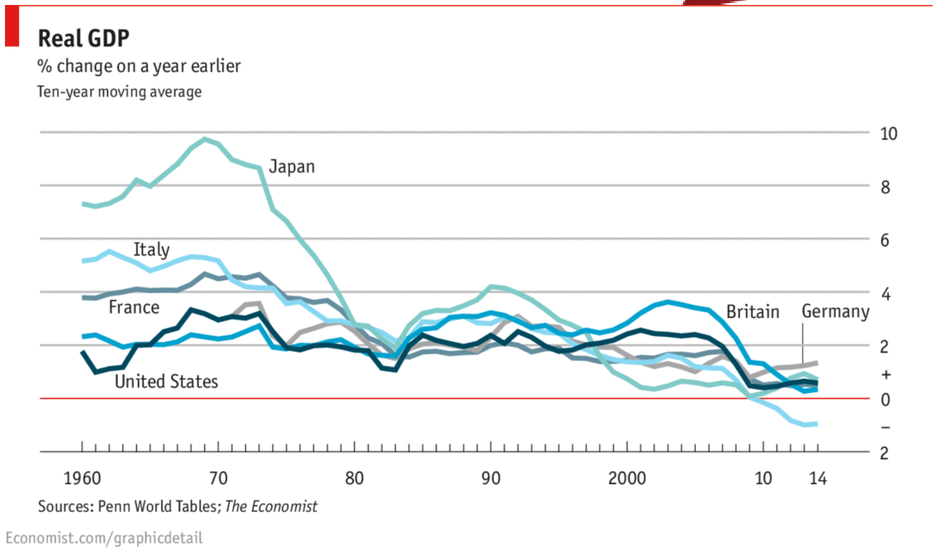
- With the likelihood of achieving future real returns in the region of 5% – 6%, alpha becomes an essential building block to achieving long-term retirement targets.

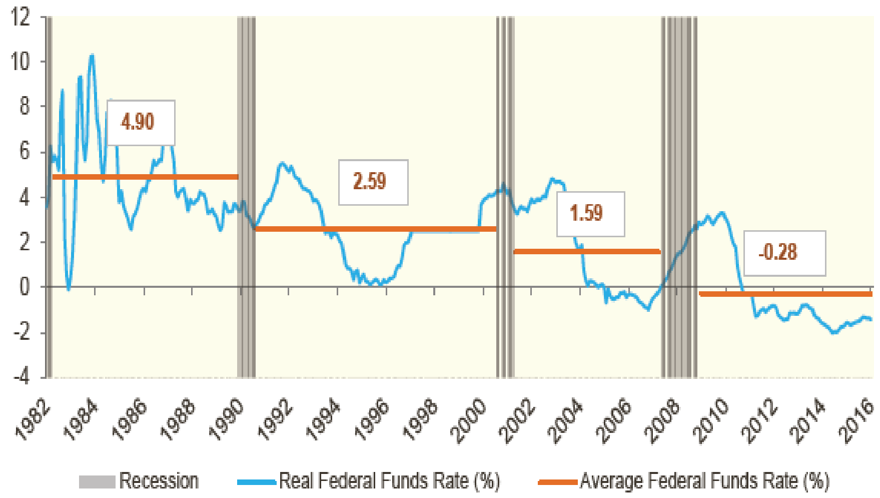
Source: Economist

Historic Low Global Growth Environment

Secular Stagnation with increasing propensity to save and a decreasing propensity to invest

- Almost no one in 2009 imagined that U.S. interest rates would stay near zero for six years, that key interest rates in Europe would turn negative, and that central banks in the G-7 would collectively expand their balance sheets by more than $5 trillion.





Source: Economist, Bloomberg

Challenging Traditional Ideas

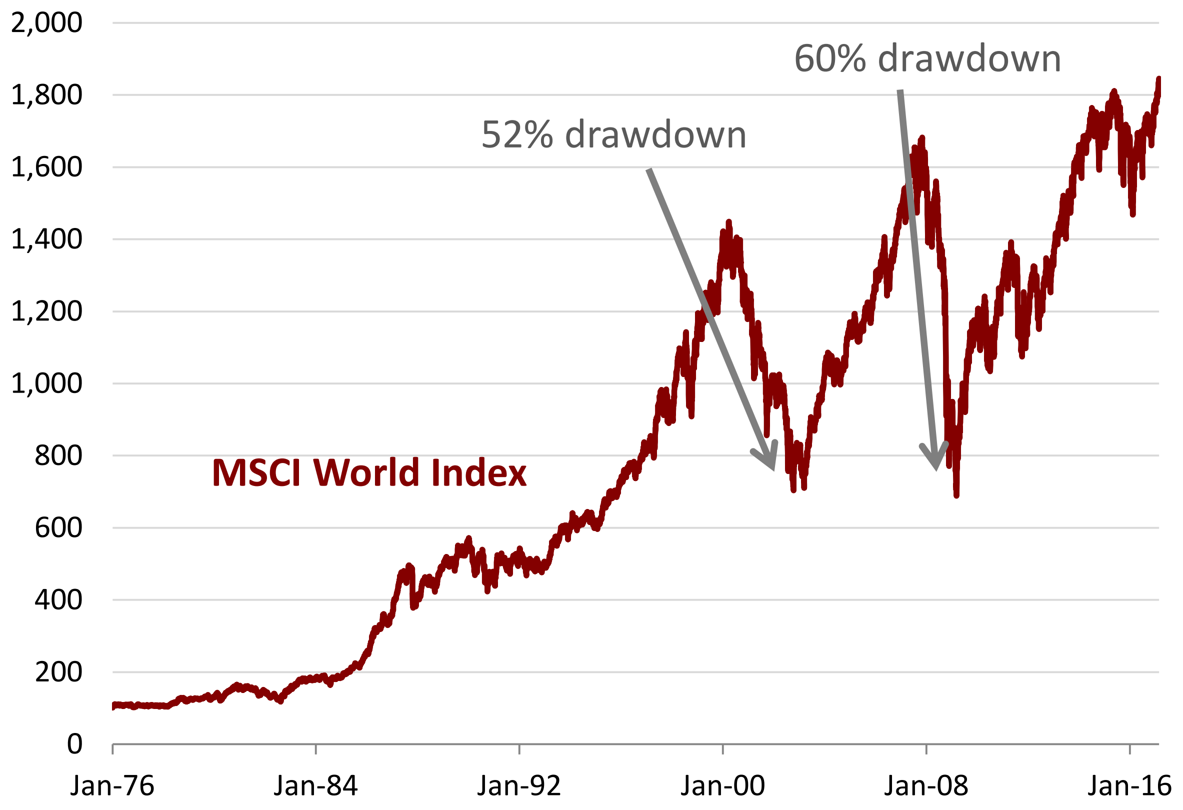
Rethinking conventional thinking…

- Passive investing is not riskless investing.
- The conventional definition of risk is inappropriate.
- Relative returns have very little meaning.
- There is a BIG difference between wealth and money.
- The Role of cash as a call option is often underappreciated.

Passive Investing Is Not Riskless Investing

Passive ≠ Safe

- Every index has a construction methodology that looks and acts like a strategy.
- Equity indices often look and act like price momentum strategies.
- Bond indices lean towards entities with the most outstanding debt issuance.



The Conventional Definition of Risk Is Wrong

Rethinking conventional thinking…

- Or at least misaligned with the goals of most retirement fund members.
- The definition of risk is not only price volatility.
- Most individuals/investors should equate risk as some variation on the permanent loss of capital.
- Risk = the possibility that my balance sheet does not balance.
- The simplest ways to reduce risk are to hedge, insure, or hold safe assets. A safe way to achieve a future consumption target is with local currency CPI-linked bonds.

Relative Returns Are Close to Meaningless Without Considering Liabilities

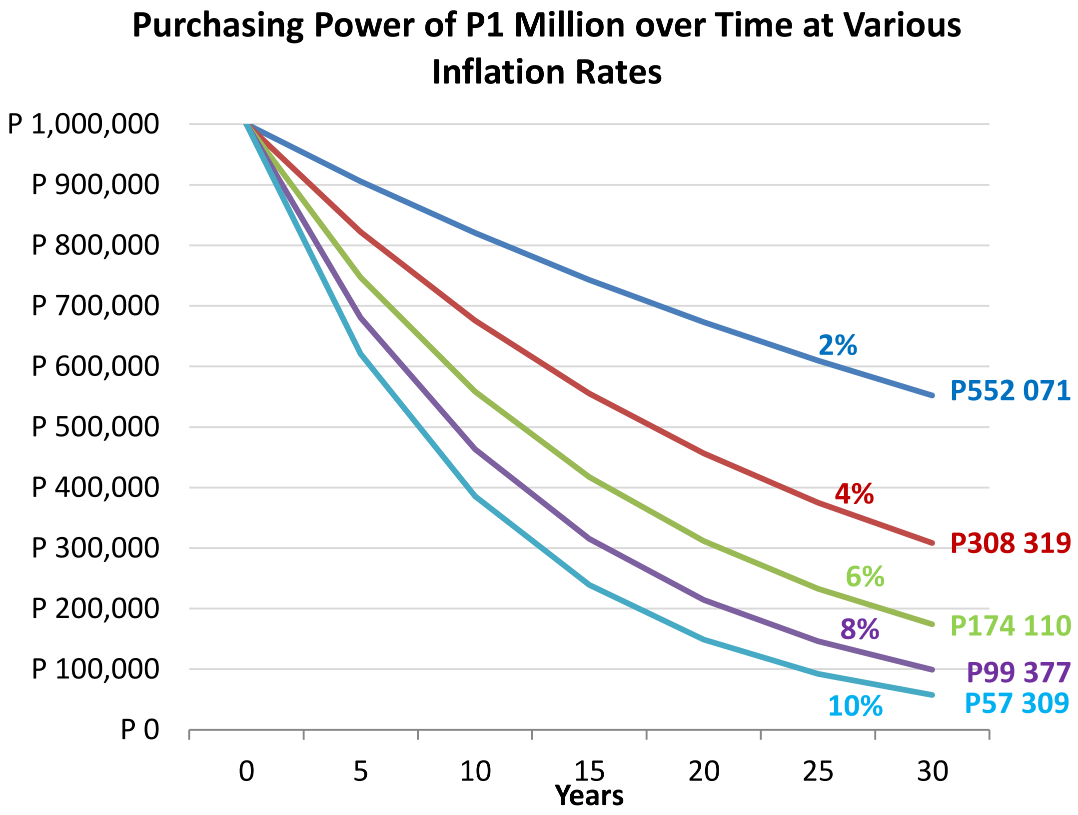
Rethinking conventional thinking…

- The ultimate objective of investing must be aligned with how progress toward that objective is measured.
- Did beating the global equity market in 2008 stand as progress toward your ultimate investment return and income goal?
- Preservation of wealth in down markets, plus participation in up markets, makes for attractive compounding.
- More consideration for a home country bias:
  - More prudent liability matching in BWP.
  - Providing capital to home country economy.

There is a Difference Between Wealth and Money

Rethinking conventional thinking…

- Money is nominal and wealth is real.
- The ultimate objective of preserving and growing wealth is a statement about purchasing power.
- To the degree that an investor's liabilities have an inflationary component, so too should his/her assets provide protection against that.



The Role of Cash as a Call Option is Often Underappreciated

Rethinking conventional thinking…

- The appeal of cash as an asset class lies not in its yield (or lack thereof) alone.
- Liquidity is a valuable asset when market stress makes it rare.
- The ability to take advantage of price dislocations is an appealing option.

Improving understanding of investment returns and risks

More focus on absolute return

- Retirement fund members should better understand the underlying strategies, potential drivers of returns and risks.
- "Robustness" to shocks.
- A clearly articulated reason why the investment manager might have an "edge" in certain markets.
- Over the long-term, higher returns (after fees and taxes) per unit of risk taken, where risk is appropriately measured.

Golden Rules on planning for a comfortable retirement

Some basic principles for improving retirements savings…

Understand your replacement ratio	Compares your income immediately prior to retirement against your income after retirement.
Period of Savings	The power of compounding so start early.
Contribution to Savings	Consistently save an appropriate monthly amount given your current income and retirement objectives.
Costs	Consider tax, investment management costs and advisor fees.
Non-preservation	Avoid “cashing-out” when changing jobs.
Annuity Factors	Keep abreast of the price of annuities and interest rates.
Salary Progression	Aim to keep your monthly saving contribution amount as a set percentage of your monthly salary.
Investment Returns	Develop an investment strategy that is appropriate for your retirement objectives.

Parting Thoughts

Thinking About the Future

- Take a long-term view in a short-term world.
- Shift from return on assets to return on asset/liability risk.
- Assets are just envelopes for risk – the goal is best return on risk.
- Add bond substitutes, e.g. Infrastructure and other alternatives where possible.
- Our pension funds can play a more significant domestic economic development role – and at a profit!

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