THE PROGRESSION OF THE SOUTH AFRICAN EQUITY BENCHMARK

The Johannesburg Stock Exchange (JSE) was founded in 1887 during the first gold rush in South Africa (SA). Since then, it has evolved into a globally-recognised stock exchange, linking buyers and sellers of various types of investments, and regulating the transactions in the best-interest as well as safety of market participants. Today the JSE offers investors and other market participants the opportunity to invest and trade their investments across a wide variety of equities, bonds, financials, commodities and interest rate derivatives.

The different SA equity indices

Just as the JSE evolved, so too have the equity markets listed on the exchange. The listing and delisting of companies over the years has resulted in an ever-changing landscape. This shifting landscape has been further compounded by the increasing accessibility of the JSE, globally, which has translated into a rising demand for ownership of shares in SA listed companies.

The transformation of the JSE over the years has changed the way that local equity asset managers are able to compare their respective performance relative to the performance of general financial markets. This is known as an investment benchmark performance comparison. Investment benchmarks are, in their simplest form, the reference point that's used to gauge market sentiment or performance. These are the most widely used local equity indices to benchmark and evaluate performance against:

1. **FTSE/JSE All Share Index (ALSI):** this represents 99% of the full market value of shares eligible for listing on the main board of the JSE. In essence, this is (almost) all of the investable shares listed on the JSE.

2. **FTSE/JSE Shareholder Weighted All Share Index (SWIX):** this uses the same shares as the ALSI, but it differs by excluding any shares held on other foreign stock exchanges (foreign share registers) for JSE-listed companies. If there is no free float (shares available to invest in locally), then the shares are excluded from the index.

3. **FTSE/JSE Capped SWIX Index (Capped SWIX):** this follows the SWIX construction methodology and differs only in that the weight of individual securities is capped at 10%.

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The Financial Times and Stock Exchange (FTSE) is involved in developing indices all over the world, spanning across several markets. The group has also been involved in the development of the JSE indices, which has warranted their acronym being used in the naming conventions

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There is no perfect index, but a key attribute of an appropriate index is that the index should have adequate risk diversification if it is to be an effective benchmark against relative performance.

Sources: Johannesburg Stock Exchange and Alexander Forbes Investments

Over the years, significant structural shortcomings have seen concentration risk creep into SA equity indices. Concentration risks exists when a few shares form a significant part of an index (market capitalization or weight) dominate the index from a risk and return perspective.

For example, the ALSI became dominated by companies that were predominately owned by investors who reside outside South Africa, which created a problem because these shares weren't truly available to local investors. As a result, the JSE experienced high concentration in its indices and to address this it launched new indices over the years.

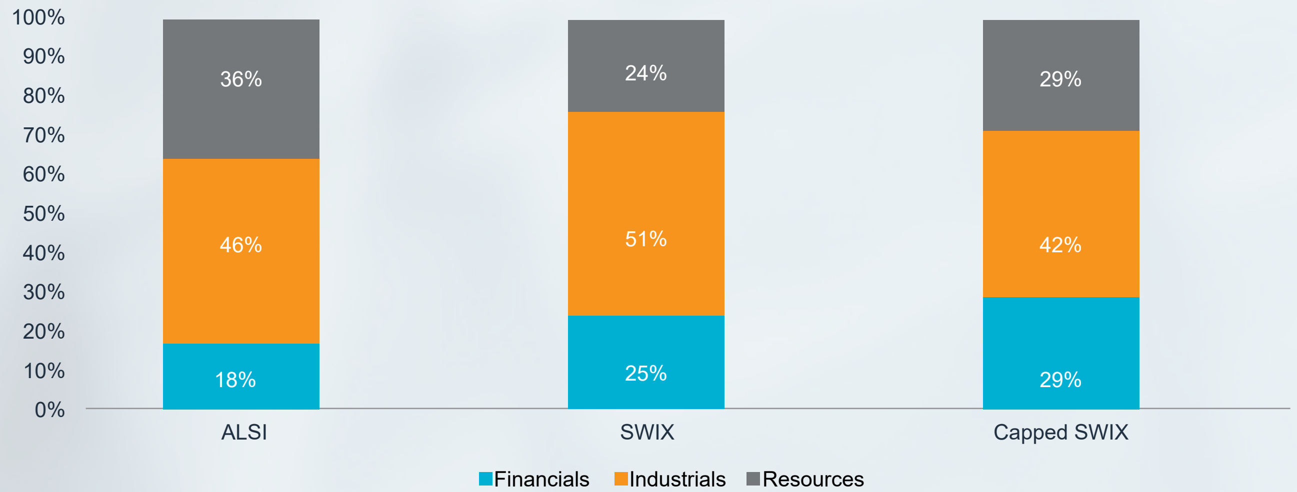
The SWIX was introduced to mitigate the concentration risk by trying to identify and represent a more reflective picture of the 'investable market'. Further to that, the Capped SWIX was introduced as a modified version of the SWIX, which tries to prevent massive shares (such as Naspers) from dominating an index, limiting exposure to a single share at 10%.

The SWIX was an improvement on the ALSI, and the Capped SWIX was a subsequent improvement on the SWIX. Again, neither index can be deemed perfect and it is in the best interest of all investors to continually research and identify good benchmarks that are a true reflection of markets.

The main differences in SA equity indices

There are many differences in the construct of these indices, which have resulted in massive return dispersions over time. The make-up of these indices also show a telling story.

Chart 1: Super sector allocation of the different SA equity indices as at 31 December 2020



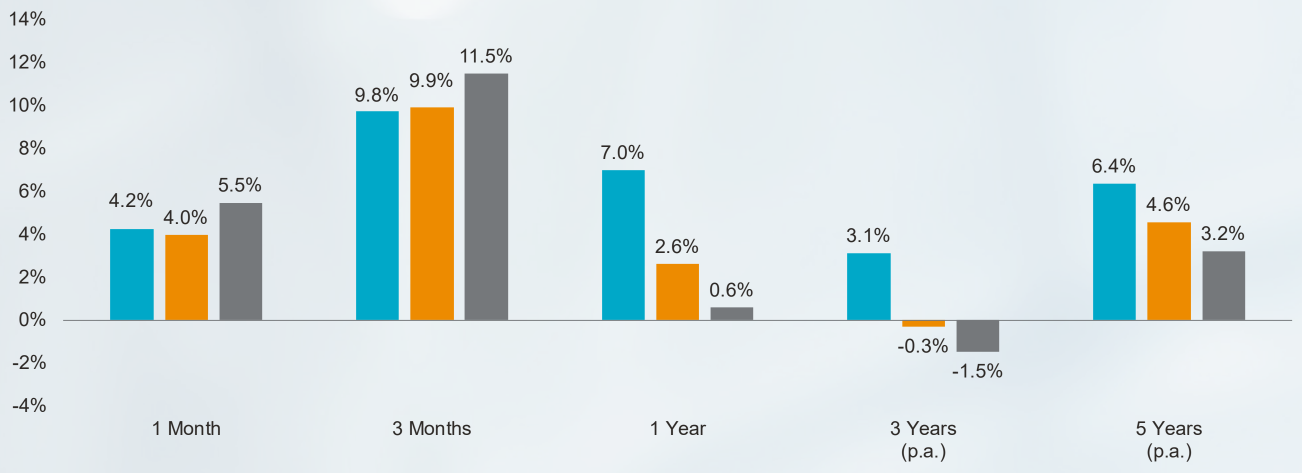
Sources: Alexander Forbes Investments and Bloomberg

Chart 2: Top 10 holdings of the different SA equity indices as of 31 December 2020

Sources: Alexander Forbes Investments and Bloomberg

Given that the three JSE indices display varying levels of concentration and diversification, it naturally follows that the performance differentials between these benchmarks are not always small over time. For example, the SWIX performed significantly better than the Capped SWIX over short-term periods, but it has lagged over the long term to the end of December 2020.

Chart 3: Investment returns of the different SA equity indices to 31 December 2020



Note: All returns longer than a year are annualised
Sources: Alexander Forbes Investments and Bloomberg

The performance of the three indices shows how important it is to choose an appropriate benchmark to compare performance against. It is not something that should be taken lightly as a one-size-fits-all approach but should rather be seen as part of the overall selection process in one's investment journey.

What this means for investors

Market indices are often used to benchmark and evaluate 'active' investment performance, so it is important that they are a true reflection of investable markets. This highlights the need to evaluate the three JSE indices against similar portfolios, which may have different long-term objectives and risk profiles.

What this tells us is that even if we are presented with two portfolios of identical strategic equity allocations, performance differentials would exist between them if each portfolio had a different underlying benchmark or performance target mandate (for example using an ALSI benchmark compared to the Capped SWIX).

If we are comparing performance figures between various portfolios, it is not enough to only ensure that they are genuinely comparable from a strategic asset allocation perspective, but we also need to assess each portfolio's performance in the context of their mandated benchmarks. Because of the varying magnitude of risk biases inherent in each index, there will be times when the performance differentials between like-for-like portfolios that employ different underlying benchmark indices could be significant.

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