THE APPLICATION AND TESTING OF SMART BETA STRATEGIES IN THE SOUTH AFRICAN MARKET

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ENGLISH SUMMARY: Smart Beta portfolios have recently prompted great interest both from academic researchers and market practitioners. Investors are attracted by the performances produced by these portfolios compared to the traditional market capitalisation weighted indices. The question that this thesis attempts to answer is: Do smart beta portfolios outperform the traditional cap-weighted indices in the South African market? According to BlackRock's smart beta guide (Ang, 2015), the smart beta strategies aim to capture stock return drivers through rules-based, transparent strategies. They are generally long only and usually implemented within an asset class, in the case of this assignment, only equity. Smart beta is thus an investment strategy that positions itself between active and passive investing. Smart beta strategies are active in the sense that they invest in factors that drive return to improve risk-adjusted returns. In the same way, these strategies are closely related to passive strategies in that they are transparent, systematic and rules based. In this assignment five different fundamental factor portfolios (value, quality, momentum, volatility and a combination of the four, called multi-factor) were created based on the smart beta methodology. The factors that were used are well researched in the market and have been proven to provide investors with excess return over the market. Firstly, stock selection was done using two different techniques (time series comparison and cross-sectional comparison). The best stocks were selected based on their fundamental factor characteristics. Secondly, two different smart beta weighting strategies as well as a market-cap weighting strategy were applied to the selected stocks in order to create the various portfolios. The risk and return characteristics of the created portfolios were compared to those of the two benchmarks (JSE All Share Index and the JSE Shareholder Weighted All Share Index). The smart beta portfolios created in this thesis outperformed the benchmarks as well as the market-cap weighted portfolios. Lastly, the estimation of the macroeconomic exposure of the smart beta portfolios using a methodology outlined in a Citi Research paper is presented (Montag, Krause, Burgess, Jalan, Murray, Chew and Yusuf, 2015).

AFRIKAANSE OPSOMMING: Akademiese navorsers en beleggers het in die laaste aantal jare al hoe meer in Smart Beta portefeuljes begin belang stel. Beleggers is veral beïndruk met die opbrengste wat die portefeuljes asook indekse relatief tot die bestaande markkapitalisasie geweegde indekse gelever het. Die werkskut probeer dus die vraag beantwoord: Gaan die smart beta portefeuljes die tradisionele mark indekse uitpresteer asook die markkapitalisasie geweegde indekse? Volgens BlackRock se smart beta gids (Ang, 2015) is die doel van die strategie om sodoende die faktore vas te vang wat die opbrengste dra. Die bestaande mark indekse en die portefeuljes dra respektiewe geïnvesteerde fondse. In die werkstuk is daar vyf smart beta portefeuljes geskep wat elkeen gefokus het op 'n spesifieke fundamentele faktor. Die portefeuljes het 'n verskeidenheid van stelte van vaste reëls en 'n deursigttige belegging strategie. Die portefeuljes het die bestaande indekse uitpresteer en die portefeuljes het die bestaande indekse uitpresteer. Die portefeuljes het ook die makro-ekonomiese faktore beraam deur gebruik te maak van 'n metodologie omskryf deur Montag, Krause, Burgess, Jalan, Murray, Chew en Yusuf, 2015.)

South Africa's, economy on the other hand, is stagnating at a time when it should be taking advantage of being in the limelight of emerging markets; and 5. Political changes, including geo-political risks, terrorism and major regulatory overhaul which may become unfortunate stumbling blocks at a time when Africa is ready to take its place in the global economy. Despite the magnitude of the disruptive trends, the South African market remains well regulated and financially sound. Although the industry is dominated by a few large conglomerates, there are also a good number of midsized companies, which fosters competition and innovation. The marketing of Smart Beta strategies leaves much to be desired. The truth is not being told. The unexplained risks and costs in the strategy have been hidden by industry hype. Investing in Smart Beta strategies has three shortcomings relative to investing in a low-cost total stock market index fund. They are: Higher cost. Higher risk. Extended periods of underperformance. Higher cost: The total cost to investing in market-tracking total stock market index funds is dirt cheap. In fact, I like to say that beta is essentially free.