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The persistence of active share and tracking error in the context of South African mutual funds

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ABSTRACT

Many active fund managers aim to generate a return in excess of their benchmark (net of fees), i.e. they wish to add alpha to the investment and add excess return. Fund managers aim to earn fees by out-performing a benchmark, typically an index – this is a 'reward' for their expertise and skill. They aim to generate a return that is greater than that of the benchmark that they have set in order to provide their investors with a profit that is greater than their passive counterparts. A comparison with a benchmark indicates actual performance relative to the desired portfolio management strategy. Benchmarks provide a starting point for portfolio holdings; a manager will deviate from these weights and often these securities in order to try and take active positions to earn a greater return. By serving as the starting point, benchmarks are also the control mechanism for active risk as one can measure the active risk of a portfolio by looking at Tracking Error or by looking at Active Share.

This study looks at the persistence of Active Share and Tracking Error in the context of South African mutual funds - a sample of unit trusts, representing approximately 63% of the revised assets under management in the South African general equity fund industry, was selected. It was found that Active Share and Tracking Error are persistent in South Africa – indicating that the Active Share / Tracking Error today is a good indication of the Active Share / Tracking Error tomorrow.