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LOCAL INVESTORS SET TO BENEFIT FROM A PURER, SIMPLER BENCHMARK MEASURE OF THE EQUITY MARKET PERFORMANCE

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Stock market indices have long been used to convey the performance of the stock market and their importance has increased with the increasing universe of passive investments that track different indices. Popular examples of indices that investors monitor include the S&P 500 index in the US, the Eurostoxx 600 Index in Europe, or the Nikkei 225 Index in Japan, all considered benchmark measures for investment performance.

As South African equity indices have evolved over time, they have become overly complex because of the makeup of the local stock market. Some of the biggest SA companies have primary listings on offshore stock exchanges and thus a portion of their shares not available to local investors. However, this will change in March 2024 when the JSE indices will be rebalanced and reconstituted to provide investors with a purer and less complex representation of local equity market performance.

Equity indices have played a significant role in the history of investing. One of the best known US indices, the Dow Jones Industrial Average, heralded in a new era for investors who previously had to tediously consider the performance of each individual share to gauge overall market performance. Charles Dow, the American journalist and co-founder of the Wall Street Journal, famously created the Index in 1896. Since then, the number of indices that represent different groups of investments has increased dramatically, now estimated at around three million and all aiming to provide an objective measure of some select aspect of the market and its performance.

This is not surprising considering the increase in investor sophistication and bespoke investment requirements over time and the proliferation of passive investment strategies that specifically track indices. Instead of simply investing in stocks or bonds, the investment community has become acutely conscious of the exposures to different universes of stocks that these indices provide. For instance, a single instrument will often derive returns from several factors, such as currencies, inflation, commodity prices and interest rates. Indices enable investors to isolate and measure the performances of these return drivers.

Moreover, with a greater proportion of assets passively following benchmark indices, index providers arguably have a direct influence on capital allocation through their index construction methodologies. That makes the benchmark index selection decision an important one for investors and asset managers and puts the upcoming changes to the local index landscape front and centre.

In South Africa, there are primarily two methodologies that have been used to construct the broad benchmark indices, namely the vanilla FTSE/JSE methodology applied to the JSE All Share Index (J203), its variants, the JSE Top 40 Index, the JSE Capped Index or sector-specific indices, and the shareholder-weighted methodology applied to the JSE SWIX Index (J403) and its variants.

The key difference between these methodologies is that the SWIX Indices only reflect companies to the extent that they are available on the SA share registry. Simply put, the SWIX methodology intends to reflect the overall performance of the shares that are available to local investors and settled in the rands.

Consider, for example, companies like Anheuser-Busch and Anglo American. Although they have primary listings in Brussels (Euronext) and London (LSE), both are currently considered domestic shares in that they are traded in rands on the JSE. However, only a portion of their tradeable shares, known as their free float, is available to the local, rand-based investor. With their performance predominantly linked to foreign assets and investor behaviour, it therefore makes sense to adjust their weight in accordance with their local free float by applying the SWIX methodology.

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This was effectively mandated by National Treasury in 2011 when it was announced that “in order to enhance the ability to attract new listings on the JSE Limited and boost investments into Africa, all inward foreign listed shares on the JSE Limited will be reclassified as domestic assets for the purposes of trading on the exchange and will be included in its indices” provided that, among other criteria, their weight reflected only the shares available to local investors.

The complication has been that certain shares, such as Anglo American (and not Anheuser-Busch), were already included in the ALSI indices at their global free float and were thus granted a special ‘grandfathered’ company designation, which meant that these shares carry a disproportionally higher weight in the ALSI indices compared to the SWIX indices.

The March 2024 FTSE/JSE Index rebalance will finally correct the difference in the way these shares are treated resulting in a cleaner set of calculation methodologies that better represent the investment performance realistically attainable by local investors. This will be achieved by firstly applying the SWIX methodology to the ALSI indices and then decommissioning the SWIX indices. Overall, this moves comes at the opportune time, when the difference between the indices is least apparent, and will introduce a single objective and consistent method that removes unnecessary complexity and duplication, with the end result a purer representation of local equity market performance.

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