朱雀基金
Rosefinch Fund
T [021]2030 5888 F [021]2030 5999
A 58 Floor, New Bund Center, NO.555 West Haiyang Road/588 Dongyu Road, Pudong New Area, Shanghai
上海市浦东新区海阳西路 555 号/东育路 588 号前滩中心第 58 层，邮编：200126

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A Few Counter-intuitive Truths About Index Investing

We wait and wait, and finally the policies have been announced. Boosting consumption, expanding investment, stabilizing housing market, and revitalizing the capital market... Every move touch market's sore spots. Chen Guo, chief analyst of CSC Financial, described it as a "set menu" - each course may not seem like much on its own, but taken as a whole, you'll be full eventually. Right now, we've only had the appetizers. **So far, the market is just watching: without the main course, no one dares to pick up their chopsticks.**

When we open Wind application, the top research report is "Why has the US not declined yet?" The comment sections of government ministries' joint press conferences are flooded with "believe in the national fortune, commit to long-term investment." Behind the bravado lies certain bitterness, and everyone is hoping for China's own equity bull market.

As the market fluctuates repeatedly, the long-only equity funds are bearing the brunt of the volatility. One long-only fund index gained 132% in three years. It then quickly retreated 37%, and the lost ground has yet to be regained. People used to say: "Mutual funds make money, while retail mutual fund investors don't", but now, few mention the phrase as neither equity mutual funds nor retail investors are making money. What may be even worse than holding under-water positions is the loss of investor confidence. In

2023, the issuance volume of active equity mutual funds is lethargic at best, with even the star managers facing the setting sun.

In contrast, the scale of a certain CSI300 ETF surpassed 100 billion RMB, becoming the first non-monetary fund in the market to break through that impressive threshold. Although ETFs tend to be dominated by a selected few, the emergence of such a behemoth at this particular time can be considered a surprise.

Across the entire market, the scale of equity ETFs has exceeded 1 trillion RMB. It's still smaller than the 4.88 trillion scale of active equity mutual funds, but ETFs are charging ferociously - broad-based ETF increased by an annual average of 78 billion RMB over the past five years, with annual growth rates of around 100% for industry-specific and thematic ETFs. (Wind data as of end of 2022)

Contrary to people's perceptions, retail investors rather than institutions are the main ETF holders. Because ETF disclosure of investor structure considers ETF-linked funds as institutional, it may give the false impression that institutional investors are the majority. CITIC Securities drilled down through the fund AUM and found that overall, retail investors account for over half of broad-based ETFs, and nearly 70% for industry-specific and thematic ETFs. From end of 2018, the retail investor proportions for these three ETF types (broad-based, industry-specific, and thematic) have increased by 8.3%, 16.6% and 41.9% respectively. (Data as of end of 2022)

The reasons retail investors flock to ETFs are simple: you don't need to do individual stock research and worry about picking the wrong fund manager; holdings are diversified and transparent; buying and selling is flexible with low fees. Especially as active long-only funds are encountering headwinds, buying ETFs seems a natural choice for retail investors.

However, the essence of ETFs is actually active management. Taking CSI300 and CSI500 indexes as examples, their investment logic lies in the compilation methodology: first they remove the least liquid bottom half constituents, then they sort the remaining by descending market cap to form CSI300 (top 300) and CSI500 (301 to 800), finally the index is rebalanced semi-annually. In quantitative terms, this is a market cap factor screened portfolio.

Theoretically, if a single factor could pick out constituents with highest growth potential, then we can all just invest in that, lay back, and get rid of all investment managers and analysts. **In practice, broad market indexes underperform dedicated stock/factor hybrid funds over 3/5/10 year periods on average.**

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000300.SH	沪深300	74.5020	18.1326	-15.4674	-4.2623
000905.SH	中证500	68.6753	22.3776	-9.3107	-3.2599
885001.WI	万得偏股混合型基金指数	146.9750	63.6717	-8.4983	-12.8553

Source: Wind, Rosefinch as of 2023/8/8. This statistic doesn't constitute investment advice nor likely future development trend.

Another counter-intuitive truth is that the index can also be "buy high sell low." When the rebalancing is based on market capitalization, this means some stocks may be added in when they are running out of steam, and the index buyer became the last one holding the hot potato. Conversely, those moving out of the index may become under-valued and ripe for a sustainable rally. Based on the index constituents' data from 2008 to 2022, if we compare the portfolio of new stocks called "additions" vs portfolio of removed stocks called "removals", the "additions" have lost half of its value, while the "removals" have gained almost 400%.

A sage once said: one cannot step into the same river twice. Similarly, one cannot buy the same index twice. Compare with just five years ago, the CSI300 has already changed 43% of its components. As the economic structure transforms, CSI300 has shifted from finance, its top 10 constituents have moved from only white liquor and real estate towards more new energy battery and EV. As for ChiNext, it's no longer exclusively the index of small to medium companies. In fact, over 10% of its constituents have market capitalization of over 100 billion RMB. The new economy, as represented by battery, photovoltaic, medical, semi-conductor, software, now account for over 60%.

Ten years ago, A-shares only has about 2000 listed companies. At that time, CSI500 is representative of mid- to small-cap styles. But now, there are over 4000 listed companies, with the 301st to 800th stocks having noticeably bigger market caps. CSI500 is now more mid-cap companies, with corresponding lower earnings multiple. So next time you read the headline "index valuation is at its lowest level in 10 years", please hold your horses.

For investors who haven't thought through these points, and just robotically buy the index, they may be surprised by the results. Plus, when the sector rotation quickens, sector-selection becomes more important than valuation analysis. This is why in recent years industry-specific and thematic ETFs are growing rapidly. This reminds me of the poem Zhimo Xu once wrote: "I know not which way the wind is blowing – I am in a dream, and breaking my heart in its sadness."

Behind the catchy news headlines, active long-only managers face the n-th round of index investing challenges. While publishing the face-off between active and index investment styles may generate more internet traffic, it's not addressing the fundamental truth of investing. Behind NASDAQ's long bull market is not necessary the victory of index investing, but rather the dividends from technology companies. In the foreseeable future, active investing and index investing will co-exist. Even in the mature US equity market, active investing is still the mainstream. Based on ICI data, as of end of 2022, US equity ETF AUM is 3.94 trillion USD, while active investing mutual fund AUM is 11.35 trillion USD or roughly 3 times as large.

At the end of day, whether it's broad-based, industry-specific, or thematic index investing, whether it's using dividend, qualitative, valuation, multi-factor smart beta, they are just different weapons in the armory. To be a kung-fu master, we need more than access to the weapons, but also be trained in different application, styles, and mindsets. In the arena of active equity managers, it's not just a competition of weapons, but also a competition of their respective investing niches and investor portfolios.

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