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Satrix Rafi 40 ETF (JSE:STXRAF)

23.02.2023

Fund suitability

This ETF suits investors who want passive exposure to fundamental weighted equities over a long-term investment horizon.

Fees

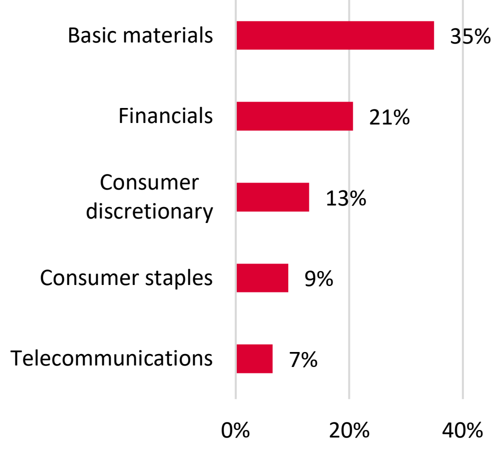
The fund has a total investment cost of 0.59%.

Alternative funds

No alternative funds

"Fundamental analysis combines the state of the economy, industries and the financial performance of companies to arrive at an estimate of the intrinsic value of a company's shares."

Sector allocation (%)



Benjamin Graham, dubbed the "father of value investing" is famously known for saying "in the short run, the market is a voting machine but in the long run, it is a weighing machine." This means that while the market is driven by sentiment in the short term, it is driven by fundamentals in the long term.

It is with this quote in mind that we review this week's ETF pick, the Satrix Rafi 40 ETF. The ETF, which tracks the performance of the FTSE/JSE RAFI 40 Index, assigns weights using fundamental factors, rather than market capitalisation (price multiplied by the number of shares outstanding).

Specifically, the FTSE/JSE RAFI index - first pioneered by investment research firm Research Affiliates (hence the "RAFI" acronym) – ranks firms using **sales**, **cash flow**, **dividends** and **book value**.

We explain the local version of the index (provided by FTSE Russell) below. Sales are measured by weighting shares according to the average of revenue generated over the last five years. As such, we expect companies growing revenue to achieve a higher index weighting. Cash flow is defined as operating income plus depreciation and amortisation. This similarly leads to companies with higher cash flow receiving a higher weight in the index.

The dividend factor is measured by companies' total dividends averaged over the last five years. Book value, which can be calculated using balance sheet data of a company per share, is the last factor. This factor is useful for companies with a large amount of tangible assets. Specifically, when calculating the price:book value per share (P/B) ratio, a value of less than one shows that a company's share price is trading at less than the value of its assets, making it potentially attractive if the company financials and prospects are strong.

The index is constructed by taking the top 40 eligible shares from the FTSE/JSE All Share index. Shares are then tested using a liquidity screen (to make sure they are tradeable) and weights are capped at 10% for risk and compliance purposes.

The ETF is slightly expensive with a total investment cost of 0.59%, however, this is to be expected, given the specialised nature of the index.

Investing the fundamental way

Research Affiliates argues that the outlook for the RAFI methodology (fundamental index) that the firm pioneered is at its most attractive since the equity market low of 2008.

Firstly, it argues that the fundamental index is cheap due to its is strong relation to value shares – shares that appear to be trading lower than their estimated intrinsic or book value (think of the factors above) but with relatively attractive prospects. Value shares are often compared to growth shares, which include companies investors believe have above-average prospects relative to the economy (often because of new products or differentiated business models).

Indeed, data from global index provider MSCI show that the MSCI World Growth index had a trailing price:earnings ratio of 28.2 at the end of January compared to the MSCI World Value multiple of just 13.5. This confirms Research Affiliates' assertion that value (and by extension, the fundamental index) is cheaper than growth. Also, further analysis from Research Affiliates shows that US value shares returned significantly higher rates of return above core consumer inflation during inflationary periods between 1930 and 2020. As such, it expects the fundamental index to perform well over the long term given its value-tilt.

Finally, the analysis further indicates that the fundamental index performed well during recessionary periods as well as in periods immediately following a recession. As such, its expectations of persistent inflation (until mid-2023) and a mild recession in the US augments the investment case of the index.

Locally, we focus on one factor which we think is the most important as part of the RAFI ETF strategy: cash flow. FirstRand (4.6% of the fund) is a financial services group that is known for its businesses such as FNB (commercial banking) and WesBank (vehicle and asset finance).

These and the group's other businesses combined well to generate a 6.7% increase in FirstRand's cash generated from operations over five years to R150.4bn in FY22. Shareholders were also handsomely rewarded over the same period – group dividends per share grew in line with operating cash flow – increasing by 6% annually to R3.42/share in FY22.

While past performance is not indicative of future performance, the market does appear to be a weighing machine (driven by fundamentals) in the long term given the ETF's returns over three to ten years of at least 10% or more on an annualised basis. As such, we believe that the Satrix Rafi 40 ETF may be useful as part of investors' overall ETF portfolios.

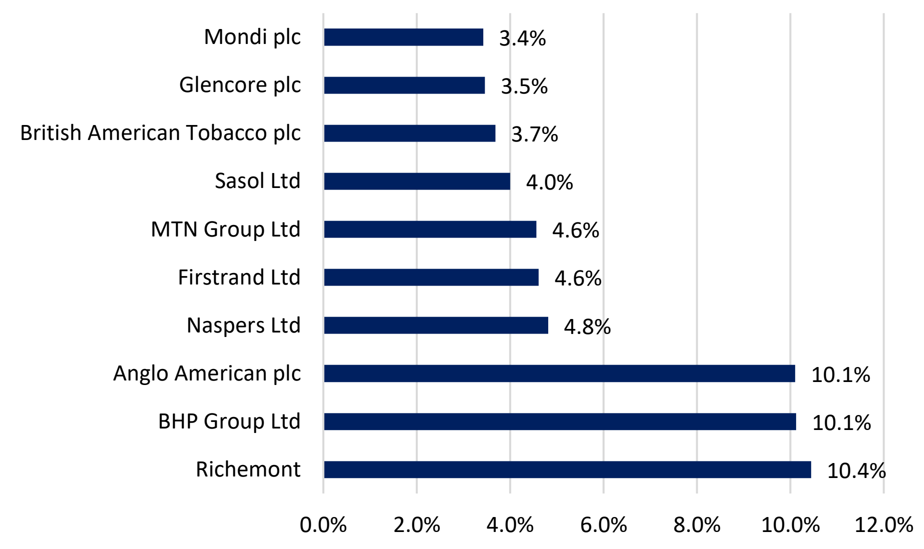
Investment term of the week: fundamental analysis

In equity research, fundamental analysis is the process of researching economic and financial factors to estimate the intrinsic value of a company's shares. This includes the state of the economy as well as industries and especially the financial performance of companies.

Investment approach and portfolio composition

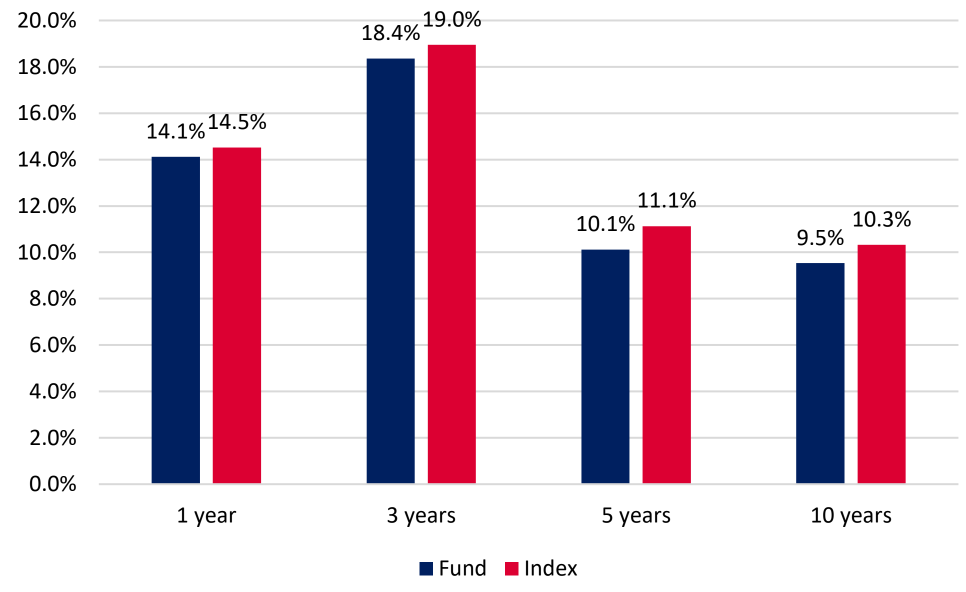
The Satrix Rafi 40 ETF tracks the performance of the FTSE/JSE RAFI 40 index before fees and expenses.

Top holdings (%)



Performance

Fund and index performance to end-January 2023 (annualised for periods longer than one year; with dividends reinvested).



Fund information: 31 January 2023

Launched on	16 October 2008
Trading symbol (JSE)	STXRAF
Total assets	R1.4bn
Total investment cost	0.59%
Risk rating	High
Benchmark	FTSE/JSE RAFI 40 Index

Market data: 23 February 2023

Spot price	R23.31
One-year high	R24.17
One-year low	R18.58
Average monthly volume	867,116
Estimated dividend yield	3.9%

Source: Infront, yahoo finance