Why do keren pensya S&P tracks perform so differently?

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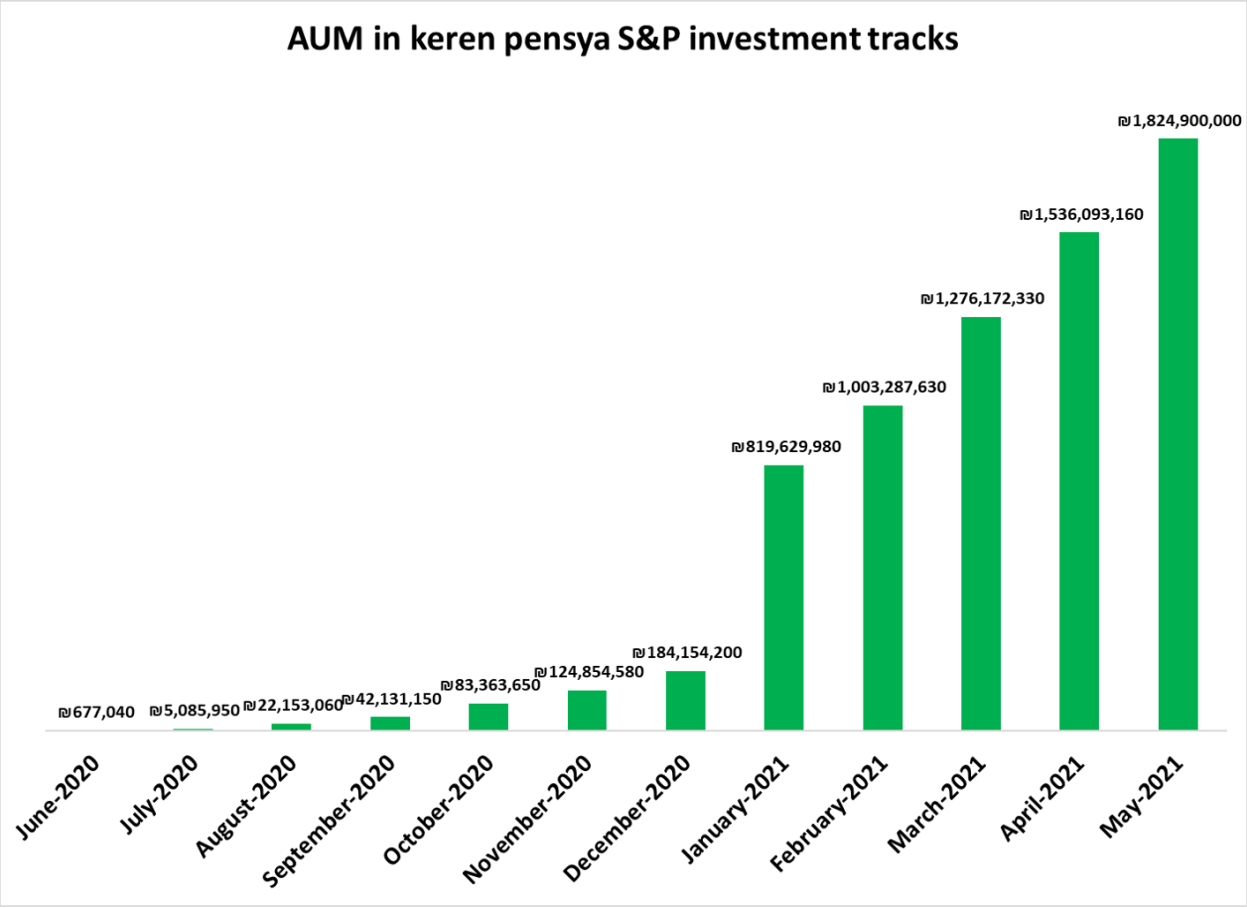
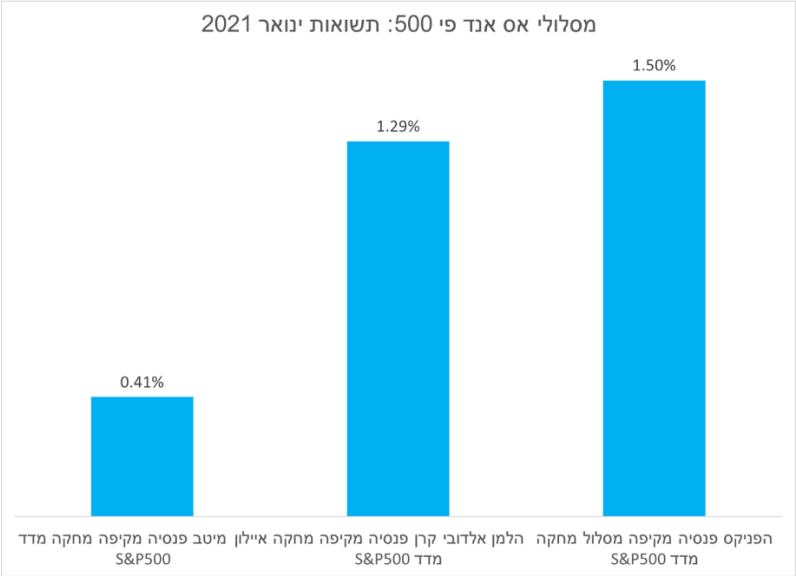
Background

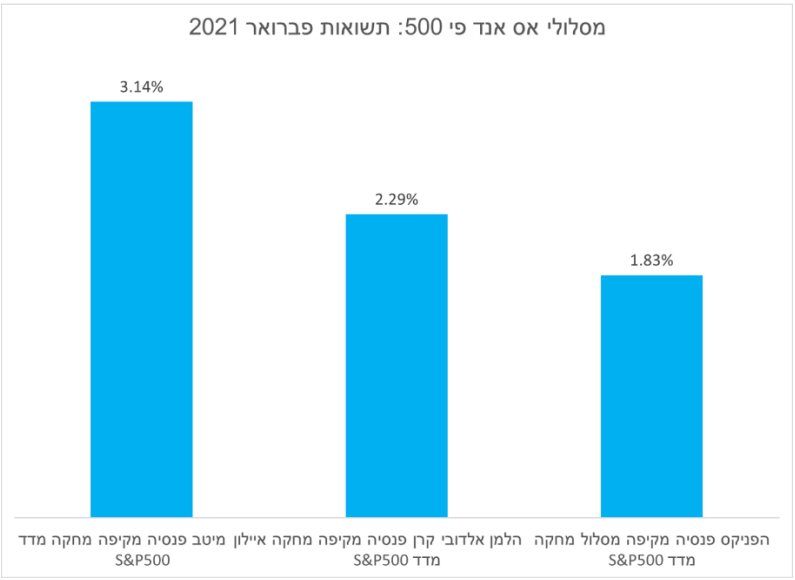
Israeli pension investors have fallen in love with S&P investing. The amount of money invested in keren pensya S&P tracks have more than doubled in the first five months of this year:

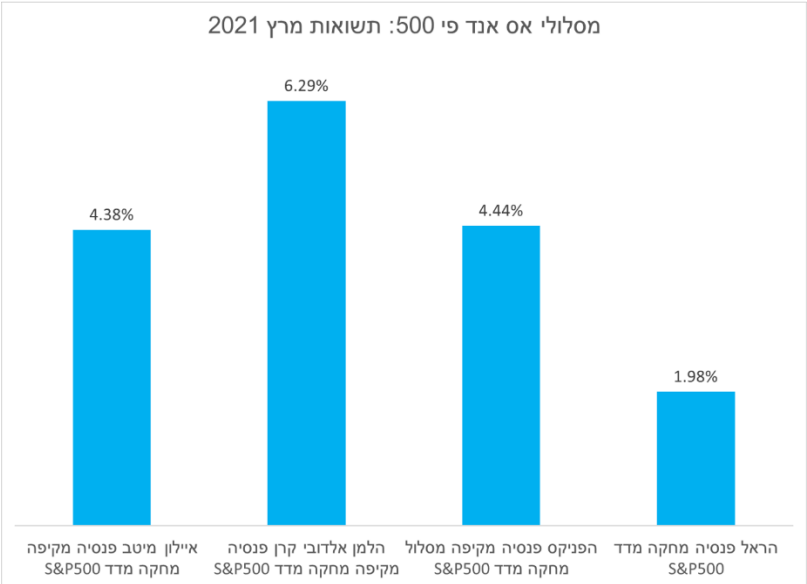


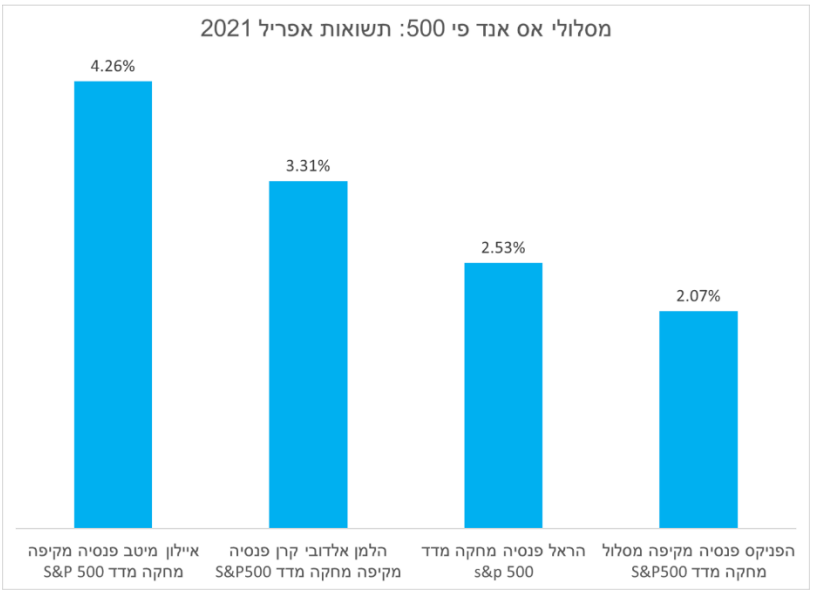
Differential performance of keren pensya S&P tracks

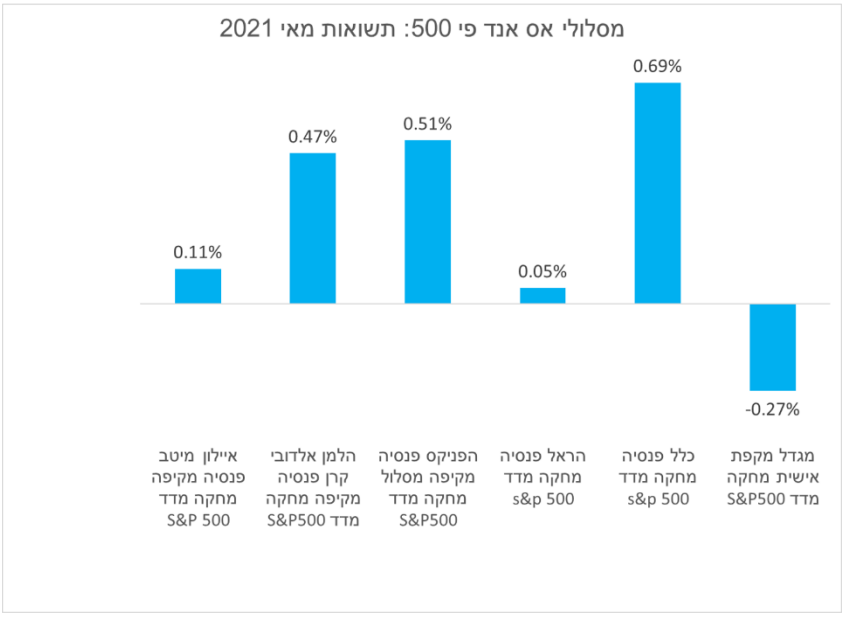
All keren pensya S&P tracks go by the name "מחקה מדד." Yet, their performances differ starkly:


מסלולי אס אנד פי 500: תשואות ינואר 2021
1.50%
1.29%
0.41%
הפניקס פנסיה מקיפה מסלול מחקה מדד S&P500
הלמן אלדובי קרן פנסיה מקיפה מחקה איילון מדד S&P500
מיטב פנסיה מקיפה מחקה מדד S&P500


מסלולי אס אנד פי 500: תשואות פברואר 2021
3.14%
2.29%
1.83%
הפניקס פנסיה מקיפה מסלול מחקה מדד S&P500
הלמן אלדובי קרן פנסיה מקיפה מחקה איילון מדד S&P500
מיטב פנסיה מקיפה מחקה מדד S&P500


מסלולי אס אנד פי 500: תשואות מרץ 2021
6.29%
4.38%
4.44%
1.98%
הראל פנסיה מחקה מדד S&P500
הפניקס פנסיה מקיפה מסלול מחקה מדד S&P500
הלמן אלדובי קרן פנסיה מקיפה מחקה מדד S&P500
איילון מיטב פנסיה מקיפה מחקה מדד S&P500

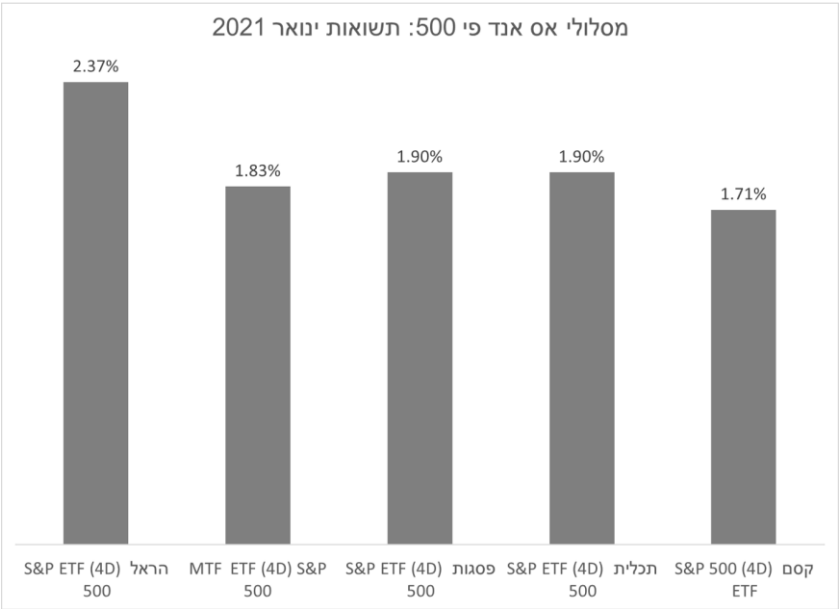


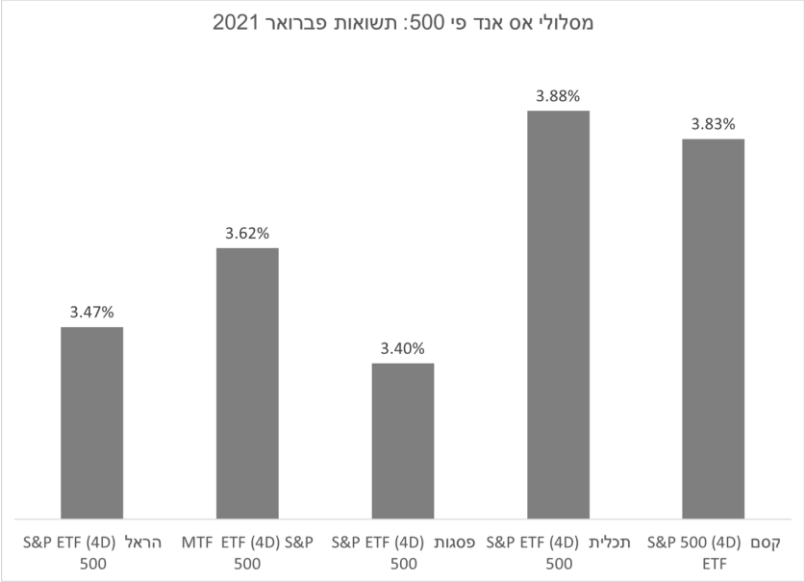


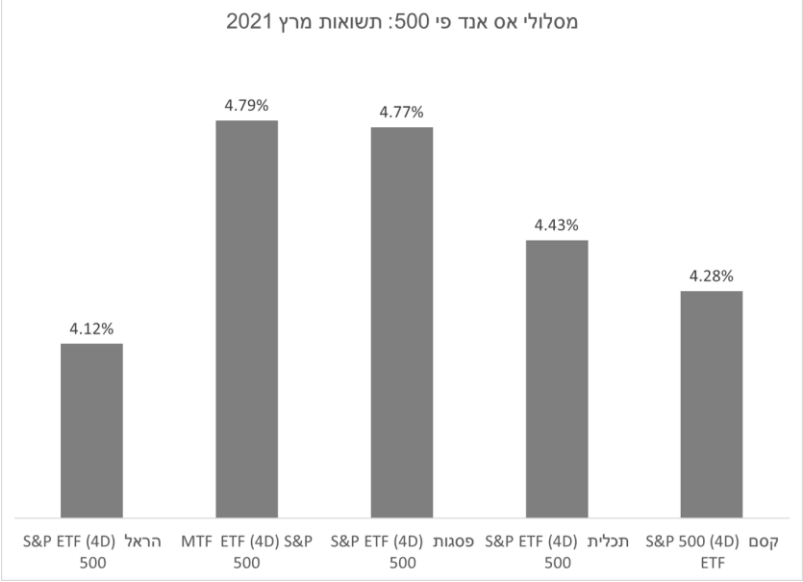
Data source: pensyanet

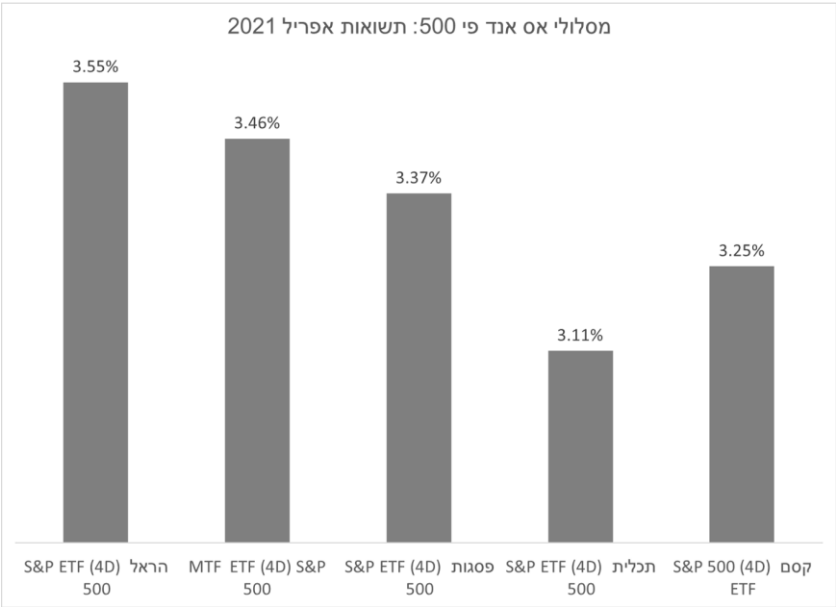
Can these performance differences be attributed to “tracking error?”

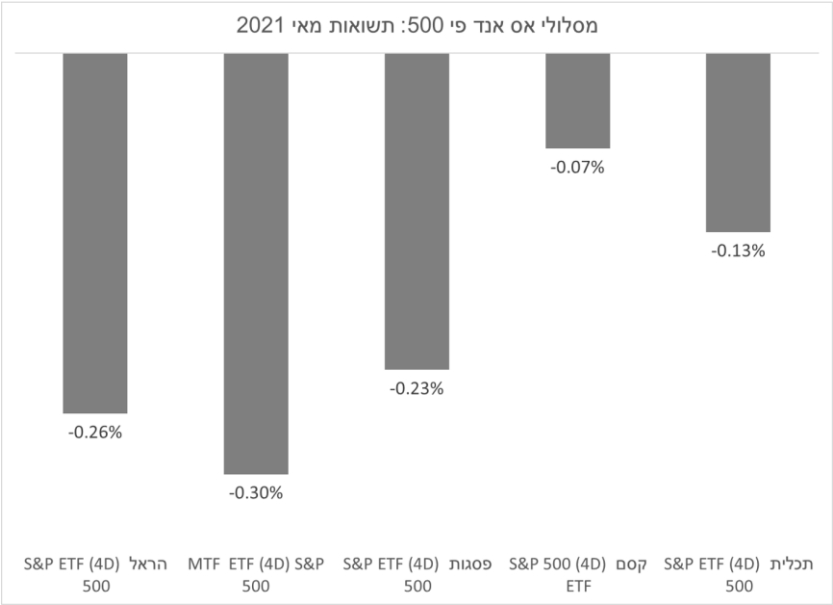
It is useful to contrast these performance differences with those of S&P tracking ETFs (not currency hedged):


מסלולי אס אנד פי 500: תשואות ינואר 2021
2.37%
1.83%
1.90%
1.90%
1.71%
הראל S&P ETF (4D) 500
MTF S&P ETF (4D) 500
פסגות S&P ETF (4D) 500
תכלית S&P ETF (4D) 500
קסם S&P 500 (4D) ETF


מסלולי אס אנד פי 500: תשואות פברואר 2021
3.47%
3.62%
3.40%
3.88%
3.83%
הראל S&P ETF (4D) 500
MTF S&P ETF (4D) 500
פסגות S&P ETF (4D) 500
תכלית S&P ETF (4D) 500
קסם S&P 500 (4D) ETF


מסלולי אס אנד פי 500: תשואות מרץ 2021
4.12%
4.79%
4.77%
4.43%
4.28%
הראל S&P ETF (4D) 500
MTF S&P ETF (4D) 500
פסגות S&P ETF (4D) 500
תכלית S&P ETF (4D) 500
קסם S&P 500 (4D) ETF





Data source: Tel Aviv Stock Exchange historical data[1]

We see that the average difference between high and low performers is 4x as large for keren pensya S&P tracks as for S&P tracking ETFs:

[1] Monthly returns are calculated by the formula: (Adjusted closing price at the end of the month - Adjusted closing price at the end of the previous month)/ Adjusted closing price at the end of the previous month

	Difference between highest and lowest return: keren pensya S&P tracks	Difference between highest and lowest return: S&P ETFs
January-2021	1.09%	0.66%
February-2021	1.31%	0.48%
March-2021	4.31%	0.67%
April-2021	2.19%	0.44%
May-2021	0.96%	0.23%
Average difference	1.97%	0.50%

The conclusion is that keren pensya performance differences cannot be reasonably attributed to tracking error.

Why the investment tracks perform differently

One key reason for the performance difference is that different kranot pensya—while doing the same thing in name—have adopted different investment policies (מדיניות השקעה).

S&P tracks (and all stock tracks) can gain exposure to the S&P in two ways:

a) "direct" exposure to the S&P via ETFs and index funds, without leverage
b) "synthetic" exposure to the S&P via derivative contracts ("total return swaps")

When an S&P track gains exposure in the second way, it pays its counterparty (typically a bank) a financing rate (typically LIBOR + some spread) in return for receiving the total return (return + dividends) on the S&P. Typically, the S&P track needs to put down only a fraction of the exposure (e.g., 5%-20%) in collateral. This frees up AUM for additional investment in safer asset classes (e.g., government bonds). As such, more than 100% of AUM gets invested – leverage. As such, S&P tracks using synthetic exposure try not to perfectly mimic the S&P, but to beat it.

The need for transparency

Exploiting the leverage that synthetic exposure can provide IS NOT an arbitrage. The gain in return comes with risks.

One of these is that leverage reduces the power of אג"ח מיועד to hedge large drawdowns in the S&P. Suppose for example that, next month, the S&P were to drop by 20%. Ignoring currency fluctuations, an S&P track exposing 73% of its AUM to the S&P and 27% to אג"ח מיועד would lose about 14.5%. By contrast, an S&P track using synthetic exposure and leverage to achieve a 100% exposure to the S&P and 27% exposure to would lose about 19.9% (ignoring currency fluctuations, the return on the collateral and the financing rate).

The risk-adjusted performance (i.e., Sharpe) ratio of אג"ח מיועד is infinite, since these bonds provide a guaranteed 4.86%. Their benefits to ***any*** portfolio that can acquire them should not be minimized.

A second, insufficiently understood risk is that the receiver of a total return swap takes on the risk that its counterparty won't be able to pay. While such events are unlikely, they are not impossible, as anyone who has studied the history of banking crises and the 2008 market crash is certainly aware of.

Finally, an S&P investment track may set a goal of tracking the S&P's performance as faithfully as possible – minimizing tracking error. Alternatively, it may seek to achieve "S&P plus," beating the S&P most months via the creation of leverage through derivatives and its use for gaining additional return. So, if the S&P goes down by 1%, the S&P track seeking to minimize tracking error will "want" to go down by 1%, while the track seeking better returns will not – thereby *increasing* tracking error. In our opinion, only S&P tracks seeking to achieve the first goal should be labelled מחקה מדד.

<u>In summary: our position</u>

Free choice: It is a good thing that S&P tracks exist, and pension investors should be free to choose them

Transparency: Pension investors can make effective decisions if they are provided clear and accurate information

Synthetic exposure to the S&P: Pension investors should be free to choose investment tracks offering synthetic exposure to the S&P. However, this type of exposure entails risks that even many sophisticated pension investors are not be aware of. These risks need to be transparently communicated to pension investors.

"מחקה מדד": Only S&P tracks seeking to faithfully reflect the total return of the S&P and not achieve a higher return than it should be called מחקה מדד.