

Active Indexing—An Evolution, Not a Revolution

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- Recent industry efforts to find cost-effective ways of outperforming a benchmark have been gaining momentum.
- So-called “active indexing” can be beneficial, but our research has identified several important caveats.
- SEI is uniquely positioned to develop construction-based approaches in a multi-manager framework.

Demand for alternatives to traditional equity indexing has been growing, as investors seek cost-effective ways to outperform benchmark indexes. We believe these new approaches offer significant promise, but our research also highlights some challenges and opportunities for refinement of the concept. We are also in a unique position to incorporate and develop these ideas in a manager-of-managers framework.

Active Approaches to Indexing

Over the past decade, in recognition of the shortcomings inherent in capitalization-weighted indexes, the finance industry has seen rising interest over the past decade in approaches that seek to combine characteristics of both active and passive investing. (For a closer look at indexing methods, see our Investment Fundamentals article, “Stock Market Indexing—Traditional Methods and Recent Innovations.”) One of the more prominent results of these efforts is widely referred to as “smart beta,” an unfortunate misnomer. Beta is a statistical measure of how sensitive a stock’s or a portfolio’s returns are to movements in the broader market; “smart” refers to the hoped-for result of outperforming an index by differentiating from it in some standardized way. However, this movement is all about weighting certain risk factors differently from a benchmark index, rather than sensitivity to the market. And whether that differentiation is “smart” depends on the insight and ability of whoever’s doing it. Better labels include active indexing, alternative beta and alternative indexing (although the latter should not be confused with alternative investments, such as hedge funds and private equity).

The active-indexing approach seeks to outperform a benchmark index by taking component weightings out of the market’s hands and reweighting them systematically based on certain observable characteristics that, over time, are expected to produce better performance. For example, proponents of this approach observe that the market sometimes under- and over-prices certain security

characteristics (commonly referred to as risk factors), resulting in outsized (and in many cases exploitable) risk premiums. By choosing to overweight securities offering significant risk premiums (for example, a low market capitalization relative to book value), an investor can attempt to outperform an index over time. A similar approach can be taken to securities exhibiting short-to-intermediate-term price or fundamental (for example, operating performance or returns on capital) momentum, as that momentum tends to persist for a time. Finally, companies with greater operational stability have tended to be underpriced historically; this is one of the cornerstones of SEI’s Managed Volatility Strategies. These three examples—risk premium, momentum and stability—can be referred to as *risk factors* that have historically (although not always) provided better returns than cap-weighted benchmarks. They can also be distinguished from pure security selection, which consists of identifying and overweighting (or underweighting) idiosyncratic opportunities in order to harvest returns (or avoid losses) that cannot be explained by market exposure and known risk factors.

The Roots of Active Indexing

Active indexing has its roots in the work of (among others) economists Eugene Fama and Kenneth French. Fama and French identified two “factors” in addition to market exposure that did a good job explaining security returns—size and value. Historically, the stocks of smaller companies have tended to outperform larger-capitalization stocks, and stocks that are cheap relative to the issuing company’s book value have tended to outperform more expensive stocks.

Researchers Narisimhan Jegadeesh and Sheridan Titman extended Fama and French’s work by adding a momentum factor that also helps to explain security returns; stocks which have performed well in the recent past tend to outperform stocks that have underperformed.

(For a more in-depth discussion of the behavioral forces that seem to drive these return factors, please see our recent commentary, “Examining Some Behavioral Forces at Work in Equity Markets.”)

Factor-Based Active Indexing—Better, but Bumpy

Thanks to Fama and French’s research and its extensions, some index providers and investors have realized that tilting a portfolio toward smaller-cap stocks, undervalued stocks and stocks with positive momentum can enhance returns. And advances in information technology allow investors to create and manage such portfolios cheaply and efficiently. As a result, some investment managers are now offering standalone factor portfolios—for example, index funds that actively tilt toward small caps, value stocks or momentum—but a close look at the historical data (which is quite extensive—the Fama-French data set goes back to the 1920s) raises some red flags. While the size, value and momentum portfolios do tend to outperform a cap-weighted index, performance can vary by economic regime, and tracking error is rather significant. Even more importantly from an investor’s standpoint, a factor-based portfolio can underperform for long stretches of time, despite the long-term tendency of these factors to outperform. This indicates that a standalone factor approach requires tremendous discipline and time horizons that may be beyond the comfort and expectations of many investors. (In periods where a particular factor was underperforming, we suspect few investors would have the patience or fortitude to watch their balances fall year after year while taking no action.)

Construction-Based Approaches—a Logical Next Step

A handful of providers have proposed methods for lowering the volatility and periodic uncertainty of single-factor portfolio returns. This is an area that we have studied carefully, as we believe it holds promise for enhancing returns with lower tracking error, less volatility and a better chance of avoiding periods of prolonged underperformance. As a result of these desirable characteristics, we expect the industry to trend in this direction in the coming years.

Construction-based approaches seek to diversify into a portfolio of factor exposures in order to both smooth out the experience associated with single-factor strategies and produce better risk-adjusted returns. For example, in our analysis of the Fama-French data on momentum, size and value from November 1926 through March 2013, we found that a construction-based approach resulted in better information ratios (excess return relative to tracking error) than standalone factors. We obtained these results using two construction methods—equal weighting, which allocates equally to each factor, and risk parity, which

allocates to the factors in proportions that balance each factor’s contribution to portfolio volatility.¹

The justification for equal weighting is straightforward. It is simple, assumes no conviction-based views, and has the benefit of bringing diversity to the construction process through equal weighting of capital. A key drawback is that it may result in suboptimal allocations, either in terms of return or risk.

Risk parity, on the other hand, seeks to diversify factor allocations by their expected contribution to portfolio risk or volatility. (Parity refers to the fact that an equal contribution to risk from each factor is desired. For a closer look at this topic in the context of asset allocation, see our Investment Fundamentals piece, “Risk Parity: The Concept.”) Whereas traditional approaches to optimization require forecasts of expected return that tend to be unreliable, risk parity uses measures of realized or expected volatility (or both) to come up with appropriate risk allocations.

According to our analysis, the results for the equal- and risk-parity-weighted portfolios were a marked improvement on the standalone factor portfolios. Relative returns were positive, tracking error was lower, and the depth and duration of periods of underperformance were substantially improved.

Developing an Active-Indexing Implementation

We followed this up with another study in which we applied an expanded stable of factors to the Russell 1000 Index, using return data from October 1998 through March 2013. Exhibit 1 highlights these factors. We expect this extended set of factors to provide an added measure of diversification while expanding the opportunity set for relative return enhancement.

Exhibit 1: Smart-Beta Factors

Category	Factor Examples
Value	Cash flow and earnings measures to value measures
Momentum	Twelve-month price momentum
Size	Smaller capitalization within cap-weighted index
Profitability	Returns on assets, equity, and invested capital
Stability	Low price and dividend volatility

We again compared equal-weighted and risk-parity construction methods, applying them within each return factor category and then across factor categories. The stability factor, which tends to be associated with lower-volatility stocks, was employed contextually. When expected portfolio volatility was high, exposure to stability

¹ Our backtesting employed daily return data from Fama-French and compared five portfolios. Three were standalone portfolios with long-only exposures designed to replicate the Fama-French momentum, size and value portfolios. Of the remaining two portfolios, one (equal weight) was equally weighted to each factor and rebalanced daily. The other (risk parity) used 60-day rolling periods to keep the factors’ contributions to portfolio-level volatility roughly equal; rebalancing occurred when the required trades represented at least 10% of the portfolio’s value. Returns and tracking were examined on a three-year rolling basis.

was increased in order to bring volatility back into line with the broader market. In this backtest, the risk-parity-construction approach produced more desirable results overall.

As a result of our internal research, as well as others' work on the subject, we prefer integration of multiple return factors, using a risk parity approach to portfolio construction. This technique can be employed as a carve-out within an active strategy, or offered as a standalone alternative-index vehicle. While single-factor implementations are capturing their share of investor attention, we believe their cyclical nature can be challenging for a typical investor to endure.

Potential Innovations in the Multi-Manager Space

SEI uses a disciplined process to determine appropriate manager weights within a portfolio. The factor exposures that result are largely the byproduct of the combined effects of each manager's investment philosophy and weight in a strategy. When markets appear to offer more compelling opportunities (or higher risks) for a particular manager's philosophy, we adjust manager weights accordingly. In our view, extending this process to the security level would be a natural progression.

We also believe portfolio construction could be enhanced by the use of an overlay manager, as this would facilitate a broader-based approach to managing factor exposures and other objectives, such as loss harvesting, rebalancing, management of diversification, volatility and tracking error, and implementation of forward-looking views. SEI has expertise and is a pioneer in the use of an overlay manager in multi-manager frameworks. For example, in our tax-managed equity offerings to taxable investors, we have employed overlay managers to harvest tax losses, while keeping the strategies in line with their other objectives, such as tracking error. We also employ an overlay manager in our separately managed account program to coordinate manager models at the portfolio level. We have found that using an overlay manager can provide more efficient cash management, facilitate allocation transitions between managers, enhance trading efficiency and provide other benefits.

The overlay approach would appear to fit quite well with a construction-based implementation. For example, an overlay manager could pursue multiple objectives,

including portfolio-level diversity, desired factor exposures, tracking error, etc., while limiting the overall impact on risk. Research, including our own, has shown that diversification is beneficial at all levels of investment, including weighting methodologies. An effective overlay strategy would offer an efficient means of ensuring portfolio diversification from top to bottom, from manager through factor and security exposures. We believe it would also offer a unified and more manageable framework for rebalancing at the manager, factor and security levels.

Logically, an overlay approach to portfolio construction could be designed with a set of objectives and constraints that make only measured adjustments to underlying managers' models, rather than wholesale changes. For example, a well-designed overlay strategy might set target-weight boundaries around each eligible security, and allow the overlay manager to position holdings accordingly to pursue strategy-level objectives.

While an implementation of this sort would represent an evolution of SEI's multi-manager heritage, it would not constitute a revolution. Sourcing and overseeing skilled active managers would remain our bread and butter, while a construction-based overlay would simply provide additional efficiency and granularity.

Conclusion

While we believe the still-nascent concept of active indexing will have lasting implications on our industry, it is more of an evolution than a revolution, in our view. It has produced some interesting alternatives to traditional passive-indexing approaches. In an active-management context, it provides additional levers for efficiently managing a portfolio's factor exposures.

SEI is in a unique position to apply our expertise to this concept in a way that few in the industry are doing. In addition to the generic benefits that active indexing offers, we have the ability to employ a construction-based overlay that we believe would provide multiple benefits. We believe it would enhance cash management, manager model integration and manager allocations, and also allow us to more directly implement our views and provide clients with a clearer picture of the value SEI brings to the table. Overall, we believe an approach along these lines would position us to more effectively deliver on our mission of pursuing consistent alpha for our clients.

Index Definitions

Russell 1000 Index includes 1000 of the largest U.S. equity securities based on market cap and current index membership; it is used to measure the activity of the U.S. large-cap equity market.

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