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# INDEX TRACKING – IS THERE A 'BETA' WAY?

**Passive managers aim to capture market returns by investing in line with an index which is typically weighted by the market capitalization of its constituent stocks. A 'Smart Beta' or Alternative Index aims to provide additional diversification and capture additional (or alternative) risk premia than that available with traditional market cap indices.**

## Traditional Market Capitalization Indices

Passive management involves tracking an appropriate index. The most common indices used to reflect the performance of the stock 'market' are based on capital weighted indices such as the FTSE 100 or the MSCI World Index. This means that the largest stocks dominate the index.

For example, let's assume that we had a theoretical index comprising two stocks, and that the market cap of both stocks was £150m. If one stock was valued at £100m, that stock would represent two-thirds of the index. As a result larger companies tend to dominate the index. For example, the top 10 UK stocks account for 34% of the FTSE All Share Index.

Market cap weighted indices have other drawbacks. Investors using a market cap weighted index automatically become momentum investors. This is because if a company is doing well and its shares rise faster than other stocks, they automatically become a larger part of the index, thus attracting further investment.

Traditional bond indices - by virtue of their market capitalization weighting methodology - have an inherent structural bias to overweight companies with high levels of debt.

## Alternative or 'Smart Beta' Indices

Alternative or Smart Beta indices attempt to find a better way to generate 'market' returns by finding other ways to construct the index. The term 'Beta' refers to the return of the 'market'.  In its simplest form, an alternative benchmark index could be constructed where each stock has an equal weighting, or a market cap index could limit the allocation to an individual stock to, say, 5% of the portfolio.

Other 'Alternative' indices include being based on stocks that exhibit lower volatility, are 'value and dividends' biased or are weighted by country GDP. In some cases style based funds will retain an element of market capitalization weighting.

More complex alternative indices such as the RAFI 1000 index attempt to screen stocks on the basis of financial analysis of each company, measuring dividends, cash flow, book value, sales and other measures of fundamental value. In all cases the indices are rules based and can be replicated.

Some commentators suggest that alternative indices bridge the gap between active traditional passive funds. Detailed back-testing of returns from alternative indices have been carried out and many of them have out-performed traditional market cap indices.

## Performance

We have calculated the Sharpe ratio (the returns divided by the standard deviation of returns) for the MSCI World Index and a selection of alternative equity indices over the seven years to 31 March 2015.

| Equity Index | Sharpe Ratio |
|---|---|
| MSCI World Index | 1.2 |
| RAFI Developed 1000 Index | 0.9 |
| MSCI World Equally weighted Index | 1.3 |
| MSCI World Risk Weighted Index | 1.6 |
| MSCI World Value Weighted Index | 1.1 |

Source: FE Analytics

The index with the highest Sharpe Ratio has achieved more return while taking on no more risk than peers - or, conversely, has achieved a similar return with less risk. Although the MSCI Value Weighted index has the highest Sharpe ratio over the period, not all alternative indices have outperformed the market cap weighted MSCI World Index.

Downside risk over the period has also been higher for all alternative indices except for the MSCI World Risk Weighted Index.

## Costs

Investing in alternative indices tends to cost more than index-tracking a market capitalization index but typically costs less than active management.

Fees tend to range from 0.15% p.a. to 0.50% p.a. depending on the complexity of the index and how frequently it is rebalanced.

## Other considerations

Stock turnover in alternative indices tend to be higher, and this could result in a drag on performance. For example, a 10% increase in turnover can result in a 0.05% reduction in net return. In addition, many alternative beta strategies have a bias towards small cap stocks where liquidity may be an issue in times of market stress.

With a plethora of alternative indices available it is important to examine how the index is constructed, how changes to the index is made, and how frequently these changes are implemented. Whilst higher turnover can be a drag on returns, infrequent changes can provide inconsistent returns.

## Conclusion

The idea of constructing a better, alternative index to market capitalization index has considerable appeal. However the available evidence suggests that Alternative or Smart Beta strategies are unlikely to outperform the traditional market cap index in all market conditions. In addition, investors could achieve similar results by investing a larger proportion of assets in small-cap or 'value' stocks that alternative indices often invest in.

However they can bridge the gap between passive and active management, and provide a low cost means of diversification. As a result they are worthy of consideration as part of an investment portfolio.

If you would like to discuss this please contact your usual BROADSTONE consultant or:

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