A force to be reckoned with

ETFM asked a panel of experts to discuss the growth of fundamental indices and how they are performing during the current economic climate

How would you respond to critics who say fundamental indices are just another name for value indices?

Yves Choueifaty: TOBAM launched its range of anti-benchmark funds in the first half of 2006. In May 2009, it introduced equity indices using its maximum diversification methodology: the MaxDiv indices.

MaxDiv indices are designed to fully capture the available risk premia in a given market by maximising diversification. This approach will not represent any particular bias like the value, growth, size or volatility styles but instead represents the unbiased portfolio that should represent investors' core equity exposure. This approach is quite different from other alternative weighting indices, many of which have explicit or implicit biases included in their design or construction.

MaxDiv indices are based on a very different approach. The philosophy, very simply put, is that the best access to the available risk premia is through diversification without imposition of any view or implied bias. Contrary to the construction of other indices, MaxDiv indices do not presume that any style or sector should over perform any other.

MaxDiv indices simply consider that the main flaw in market cap weighted benchmarks is the fact that they are far from staying diversified and that the best answer to their inefficiency is that investment risks should be diversified as much as possible.

Attempts have been made to create indices that offer better diversification across, for instance, sectors, but these approaches are incomplete; the MaxDiv approach doesn't just spread the risk but diversifies it optimally. In addition, it does not consider that risk factors are stable but operates directly at the security level.

We believe that there are different ways for an investor to be more efficient than the index, we also believe that most of them have, as a common characteristic, increased diversification as a side effect. MaxDiv is the only one whose sole focus is on maximising diversification.

Jason Hsu: The capitalisation-weighted indexing crowd views the fundamental index approach as a value strategy. Relative to the cap-weighted market, it is. Capitalisation weighting is a growth-tilted strategy relative to the economy: paying a premium multiple and, accordingly, an outsized weight to companies whose growth expectations are large. We don't argue that the fundamental index methodology has a value tilt. However, its value tilt is unique because it is dynamic. As investors bid up any segment of the market taking active bets, the fundamental index strategy contra-trades against those bets by rebalancing to target weights that are anchored in a company's economic size. To the extent those active bets favour growth stocks, the fundamental index portfolio will move further into value – the greater the gap in favour of growth, the deeper the value orientation of a fundamental index portfolio. The value orientation is, therefore, dynamic and oscillates in position on a style map between core and value.

How do these indices fit into the portfolio?

Yves Choueifaty: MaxDiv indices can fit in any portfolio, and have been considered as equity core investments.

Some investors will choose to use MaxDiv indices as the new reference for core portfolios. Indeed, MaxDiv represents the risk/return profile portfolio managers with no active views on markets should achieve. Therefore, it is quite logical to use MaxDiv indices as a benchmark of comparison for active managers who implement their views on markets.

For those investors who need to use market cap-weighted indices, the MaxDiv indices are also valuable for their diversification properties. For them MaxDiv is a diversifying strategy to their cap weighted portfolios. In fact, one of the most beneficial characteristics of MaxDiv is that the most diversified portfolio is also a very diversifying portfolio. So these investors are happy to add a diversifying strategy which can substantially improve their overall risk/return profile.

Finally, the MaxDiv index is the neutral risk allocator, while the market cap weighted benchmarks are, in fact, dynamic risk allocators. The bets implemented in the market cap weighted dynamic risk allocation have one underlying assumption, namely that concentration in the market will increase. In all other cases, diversification is a better decision and the MaxDiv index will outperform market cap weighted indices.

Jason Hsu: Research Affiliates Fundamental Index (RAFI) strategies serve as core holdings in a portfolio. They are appropriate as either replacements for or complements to cap-weighted strategies. The reliance on capitalisation weighting and its lack of rebalancing between portfolio positions is a drawback of many passively managed strategies. The RAFI strategy does rebalance, however, allowing it to avoid market speculation and bubbles.

During the tech bubble, growth stocks exhibited incredible outperformance – valuation multiples rose to historically high levels. If an institution invested in a cap-weighted index in March 2000, it would have had over 35% of its assets in the tech industry just when the tech bubble burst. Similarly, the cap-weighted global portfolio allocated more than 50% of its weight to Japan at the height of the Japan bubble in the early 1990s. The RAFI strategy avoids the problem of overweighting the overvalued stocks, sectors, and economies by breaking the link between price and portfolio weight. The RAFI strategy, anchored in its fundamental measures for weights, avoids pricing bubbles that can dominate the growth-heavy cap-weighted indexes.

How have they performed relative to cap-weighted indexes through the credit crisis?

Yves Choueifaty: The volatility reduction over the period has been very strong, with volatilities being reduced by around 20% across all regional MaxDiv indices compared to their market cap weighted counterparts. Despite highly correlated stock moves and the market meltdown being spread across many risk factors, outperformances have been achieved. Over the period from June 30 2008 to June 30 2009 (gross of fees):

• The US Anti-Benchmark has outperformed the market cap weighted index by +0.84%;
• For the Eurozone strategy, the excess return has been +6.17% and in the UK +5.25%;
• The global equity anti-benchmark excess return has been +3.98%;

When markets are suffering the typically lower beta of MaxDiv should outperform, but MaxDiv indices also tend to be better placed when new trends appear because they will already have some exposure to the next important risk factor.

Jason Hsu: In November 2007, monthly declines in world equity markets began. Since then, RAFI performance relative to cap-weighted indices has been exceptional. From November 1, 2007, through August 31, 2009, fundamental index portfolios surpassed comparable cap-weighted indexes in every major economic region.

On an all-world basis, the annualised return of the FTSE RAFI All World 3000 Index outpaced the MSCI All World Index over this time period by 6.15%. In the United States, the FTSE RAFI US 1000 index exceeded the Russell 1000 index by an annualised 5.36%. In the US small company space, the FTSE RAFI US 1500 index exceeded the Russell 2000 index by an annualised 5.96%.

In Europe, the FTSE RAFI Europe index outperformed the MSCI Europe index by an annualised 3.32%. And in emerging markets, the FTSE RAFI Emerging Markets index bested the MSCI Emerging Markets index by an annualised 3.57%. This substantial outperformance across regions was an outcome of the fundamental index methodology's approach of systematically overweighting underperforming stocks relative to a cap-weighted index precisely when they are cheapest in relation to the market as a whole.

Has the economic downturn had an impact on the way, or the frequency with which, you reconstitute the indices? If so, what does this mean for investors?

Yves Choueifaty: No, there has been no impact on the way that the indices are constructed or reconstituted, neither has there been a change in the frequency of rebalancing. For investors, this means that they can be confident that MaxDiv indices are not modified to suit different market conditions.

Jason Hsu: Given the systematic nature of the composition of the passive indices, we do not alter how we reconstitute our portfolios based on current economic environments. The strategy's contrarian rebalancing to company fundamentals, which occurs once a year, can be interpreted as a proactive attempt to take advantage of the distressed valuation levels seen for some stocks and sectors, while preserving price momentum benefit intra-rebalancing. The value tilt of the fundamental index strategy is most pronounced when value stocks are cheapest and most muted when growth multiple premiums are smallest. This dynamic value exposure in the portfolio means that investors do not need to allocate to growth or value satellite managers in order to take advantage of the growth/value cycle.

Jason Hsu

Jason Hsu is principal and director, research & investment management, at Research Affiliates (RAFI). He manages all investment operations associated with the firm's sub-advisory and hedge fund businesses. In addition, he oversees research on the asset allocation models and equity strategies that underpin RA's fundamental indexation concept. Hsu graduated summa cum laude from California Institute of Technology and earned his PhD in finance at the University of California, Los Angeles.

Yves Choueifaty

Yves Choueifaty built TOBAM in 2006, as head of the quantitative asset management business in Europe and head of Lehman Brothers Asset Management France. Prior to joining Lehman Brothers, Choueifaty was chief executive of Credit Lyonnais Asset Management, and was chief investment officer of CLAM since 2000. Choueifaty graduated from ENSAE.

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