Professional Pensions
aop Digital Publisher of the Year 2010

N° and issue date : 110922 - 22/09/2011
Circulation : 12572
Frequency : Weekly
PROFESSIONALPE_110922_36_304.pdf
Web Site: http://professionalpensions.com
Page : 36
Size : 95 %
1350 cm2

Press Index

HELEN FOWLER finds that a flurry of activity in alternative indices over the past year shows these strategies are becoming much more mainstream

Alternative indices continue to rise

Professional Pensions
Digital Publisher of the Year 2010

N° and issue date : 110922 - 22/09/2011
Circulation : 12572
Frequency : Weekly
PROFESSIONALPE_110922_36_304.pdf
Web Site: http://professionalpensions.com
Page : 36
Size : 95 %
1350 cm2

Traditional indices may not yet be in their death throes, but there are signs that their tyranny on pension fund investment is weakening, as boundaries between active and passive investment continue to blur. Alternative indices ranging from fundamental indices to minimum volatility strategies are becoming much more mainstream with large pension funds embracing these strategies, and leading consultants recommending them to clients.

The vast majority of indices – estimated at more than 95% of all passive investment - are still calculated via the time-honoured route of multiplying the number of outstanding shares by their price.

But criticism of the method - known as market-cap-weighted (MCW) indices – has spawned a host of rival indices that rely on different calculation methods and claim to provide better performance.

Signs of disillusion

The largest pension fund in the US has allocated a sizeable chunk of its global equities portfolio to a so-called 'alternative' index. The move provides evidence of the extent of investor disillusion with traditional indices.

Sacramento-based pension scheme California Public Employees' Retirement System, (CalPERS, $237bn [£151.2bn] in assets at end-June), manages around 5% of its $120bn global equities portfolio using fundamental indexing. The technique measures the weight of stocks according to their economic fundamentals, rather than the company's share price.

Dan Bienvenue, CalPERS' senior portfolio manager, says: "These alternative-type indices are growing. Their historic path is growth. We envision lots of these alternative beta streams. Each one has efficacy but each one will underperform at some point. By having lots of them, we ensure a diversified stream."

After discovering that securities with lower volatility experienced higher returns, Bienvenue and his team at CalPERS are looking to run a pilot scheme managing money by tracking a customised volatility index.

They are also looking to run a similar project based on a variant of small cap and momentum strategies. "We think there's something there, although it's not as

Professional Pensions
aop Digital Publisher of the Year 2010

N° and issue date : 110922 - 22/09/2011
Circulation : 12572
Frequency : Weekly
PROFESSIONALPE_110922_36_304.pdf
Web Site: http://professionalpensions.com

Press Index
Page : 36
Size : 95 %
1350 cm2

compelling as for the fundamental and volatility space," says Bienvenue.

In June, leading index provider FTSE Group announced it was teaming up with French asset manager Tobam to launch a range of 'anti-benchmark' indices. Tobam, spun out from Lehman Brothers Asset Management two years ago, has already amassed more than $2bn in assets. More than 90% of these assets are pension fund money.

The FTSE Tobam Max Diversification Index Series aims to build the most diversified index possible based on a quantitative strategy. In April, Tobam won a $150m global equities mandate from CalPERS to be run using a technique aimed at maximising diversification.

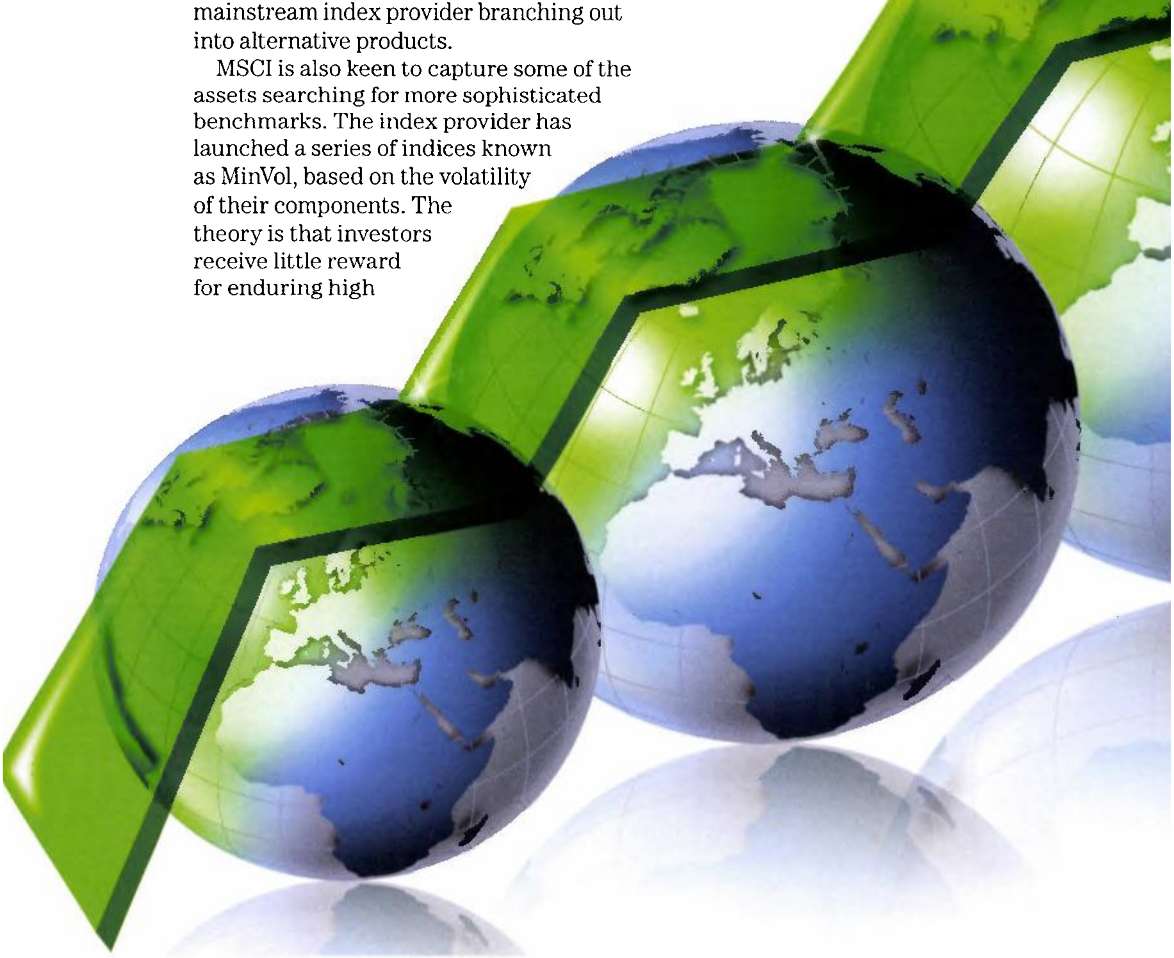
FTSE teamed up with fellow index provider Research Affiliates six years ago to offer fundamental benchmarks. It is not the only mainstream index provider branching out into alternative products.

MSCI is also keen to capture some of the assets searching for more sophisticated benchmarks. The index provider has launched a series of indices known as MinVol, based on the volatility of their components. The theory is that investors receive little reward for enduring high volatility, so there should be interest in minimising exposure to the peaks and troughs of investing.

In November last year, MSCI launched a series called Valuated, which based the weight of individual stocks on their fundamental variables, such as sales and earnings. The launch of its risk-weighted series followed in January.

The shift from market cap indices

According to Theodore Niggli, MSCI's head of indices, investors are taking funds from the active part of their portfolios to allocate to newer, passive strategies. Says Niggli: "If you have a conviction there is a value premium in these strategies, you might want



Professional Pensions
Digital Publisher of the Year 2010

N° and issue date : 110922 - 22/09/2011
Circulation : 12572
Frequency : Weekly
PROFESSIONALPE_110922_36_304.pdf
Web Site: http://professionalpensions.com
Page : 37
Size : 95 %
1850 cm2
Press Index

Ossiam, an affiliate of Natixis Global Asset Management, earlier this year announced the launch of exchange traded funds (ETFs) offering access to equal-weighted indices. In doing so, Natixis became the first firm to offer this type of ETF in Europe.

Equal-weighted indices work by attributing the same weight to each of the underlying stock constituents, eliminating the bias towards large companies found in market-cap indices. In addition, Ossiam is using quantitative and fundamental research to select and weight companies based on reducing risk.

Citing demand from investors for alternatives to the dangerous concentrations found in market-cap weighted benchmarks, Ossiam launched its Minimum Variance ETFs that will select and weight securities from the S&P 500 and Stoxx Europe 600 based on mitigating risk.

"Passive providers will become more sophisticated. They will provide streams of return that in the past active managers could claim were the results of their skill"

Nick Sykes, Mercer

"A lot of investors are asking for alternatives to market cap-weighted benchmarks and they are seeking diversification," says Isabelle Bourcier, head of business development at Ossiam and former global head of ETFs at Lyxor Asset Management.

Active disappointment

Driving the development of so-called 'alternative' indices is disappointment with active investing. "If you are a very large sovereign wealth fund, it is increasingly difficult for you to invest actively," says GWA's Morris.

The crisis alerted investors to the fact that many of the returns generated by 'active' management came from nothing more complicated than making allocations to smaller companies.

People realised they could achieve the same effects themselves more cheaply, by investing in the right indices. "People are saying we don't need to pay active fees, we can get this effect passively," says Mercer's Sykes.

MSCI's Niggli calls the indices that encompass both passive and active elements 'strategic'. Says Niggli: "There will be an acceleration in the use of these strategic indices. They seem to be seen as a proxy for some active strategies."

Predicts Mercer's Sykes: "Passive providers will become more sophisticated. They will provide streams of return that in the past active managers could claim were the results of their skill."

When fundamental indices first appeared in the middle of the last decade, they were considerably more expensive to license than their market-cap-weighted rivals. "The fees were quite expensive," says Sykes. "Now there is more competition there is less of a premium." Fees have reportedly dropped from about ten to twelve basis points (bps) on some fundamental indices, to just a few bps.

Although traditional indices still dominate pension fund investments, serving as a yardstick for the majority of a scheme's portfolio, there are signs that may eventually no longer be the case.

to put some of your active allocation into these products."

Mercer, the investment consultant, is advising its clients to switch from using market-cap weighted indices. "There is merit in trying to be smarter than naively follow a market-cap-weighted index," says partner Nick Sykes.

The response from clients to Mercer's advice is mixed, but many of them are responding by switching indices. Says Sykes: "We have been talking to clients for about a year about why we think the market cap approach is flawed. Pension funds are embracing this to some extent."

In common with many other consultants, Sykes distrusts market-cap-weighted indices, arguing they are prone to asset price bubbles, biased to past success and risk excessive concentration. "We believe that market capitalisation indices are by their very nature flawed," says Sykes.

The FTSE All-Share index provides a graphic illustration of the dangers of concentration. Mercer's Sykes cites the fact that half the index is held in just a dozen or so stocks, bypassing opportunities in smaller companies.

According to Sykes, research proves that fundamental indices perform better than traditional approaches over most timeframes. "People assume there is something sacrosanct about market-cap-weighted indices," says Sykes. "Yet almost any other sensible index does better than them. That's the big revelation to a lot of people."

Yet some funds prove reluctant to abandon the familiarity of market-cap-weighted indices. "Some people get it straight away," says Sykes. "Some take a while to be persuaded."

Weighty matter

After launching one of the world's first 'alternative' indices in conjunction with FTSE in 2005, advisory firm Global Wealth Allocation (GWA) has succeeded in attracting $6bn to its

Professional Pensions
Digital Publisher of the Year 2010

N° and issue date : 110922 - 22/09/2011
Circulation : 12572
Frequency : Weekly
PROFESSIONALPE_110922_36_304.pdf
Web Site: http://professionalpensions.com
Page : 37
Size : 95 %
1350 cm2

wealth-weighted indices. These re-weight each component of traditional indices by assessing their ability to generate wealth, based on factors including book value, cash flow and net profit. "We are not a new index," says GWA founder and chief executive David Morris. "We are re-weighting an existing market-cap-weighted index."

According to GWA's Morris, take-up of alternative indices is increasing. "These products are beginning to take off," says Morris. "Uptake is growing and so is interest." All of GWA's clients are pension funds. They are more than 150 in number, based in countries including Japan, Australia and the UK.

Ossiam, an affiliate of Natixis Global Asset Management, earlier this year announced the launch of exchange traded funds (ETFs) offering access to equal-weighted indices. In doing so, Natixis became the first firm to offer this type of ETF in Europe.

Equal-weighted indices work by attributing the same weight to each of the underlying stock constituents, eliminating the bias towards large companies found in market-cap indices. In addition, Ossiam is using quantitative and fundamental research to select and weight companies based on reducing risk.

Citing demand from investors for alternatives to the dangerous concentrations found in market-cap weighted benchmarks, Ossiam launched its Minimum Variance ETFs that will select and weight securities from the S&P 500 and Stoxx Europe 600 based on mitigating risk.

"Passive providers will become more sophisticated. They will provide streams of return that in the past active managers could claim were the results of their skill"

Nick Sykes, Mercer

"A lot of investors are asking for alternatives to market cap-weighted benchmarks and they are seeking diversification," says Isabelle Bourcier, head of business development at Ossiam and former global head of ETFs at Lyxor Asset Management.

Active disappointment

Driving the development of so-called 'alternative' indices is disappointment with active investing. "If you are a very large sovereign wealth fund, it is increasingly difficult for you to invest actively," says GWA's Morris.

The crisis alerted investors to the fact that many of the returns generated by 'active' management came from nothing more complicated than making allocations to smaller companies.

People realised they could achieve the same effects themselves more cheaply, by investing in the right indices. "People are saying we don't need to pay active fees, we can get this effect passively," says Mercer's Sykes.

MSCI's Niggli calls the indices that encompass both passive and active elements 'strategic'. Says Niggli: "There will be an acceleration in the use of these strategic indices. They seem to be seen as a proxy for some active strategies."

Predicts Mercer's Sykes: "Passive providers will become more sophisticated. They will provide streams of return that in the past active managers could claim were the results of their skill."

When fundamental indices first appeared in the middle of the last decade, they were considerably more expensive to license than their market-cap-weighted rivals. "The fees were quite expensive," says Sykes. "Now there is more competition there is less of a premium." Fees have reportedly dropped from about ten to twelve basis points (bps) on some fundamental indices, to just a few bps.

Although traditional indices still dominate pension fund investments, serving as a yardstick for the majority of a scheme's portfolio, there are signs that may eventually no longer be the case.