Spotlight on index fund management

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Change is afoot once more for the Local Government Pension Scheme (LGPS). Over the past ten years, falling yields and increasing longevity have pushed up liabilities just as equity markets have been more volatile. While this has meant increased deficits, the real effect has been a renewed focus on how the LGPS functions, what it buys and how much it pays for investment products and services.

In 2014, it is clear that achieving the best outcomes and value for money has to be a key consideration for the LGPS.

The importance of index funds

Pension schemes have long been attracted to index funds: these provide a relatively simple, cheap way to access market returns. In addition, committee members typically need to spend less time monitoring index funds, as performance fluctuations relative to benchmark should be smaller than those seen on active funds.

Index funds are sometimes viewed as an unglamorous, undemanding, staid area of the investment world. We believe that this image is wrong. Investors are increasingly aware that there are different approaches to index management.

As well as approaches to replication, different managers take different approaches to dealing with factors such as index changes, rights issues or stock lending. For instance, index changes can be effected very simply, but not very efficiently, by just buying and selling the relevant stocks on the day of an index change. However, our experience shows that careful planning and setting a strategy for each change can deliver considerable value for investors. Introducing small tolerances and spreading transactions over a period around the change can often result in a better average price being achieved for the fund.

The evolution of index

In addition to traditional index vehicles, ongoing developments in this area are providing a greater, more targeted range of index vehicles. The general premise behind investing is simple: the greater and more efficient the return on an initial investment, the better. Isolating and exploiting the drivers of return through index-based "factor investing" has increasingly gained traction.

Factor-based investing is not a new concept. Academic research has focused on identifying factors (or specific drivers) of performance since the 1960s. The idea of multiple "factors" as the fundamental force behind investment returns was first coined back in the 1970s.

Indeed, huge amounts of academic resources have been dedicated to factor research. And the research remit has been broad, with macroeconomic, statistical and fundamental factors such as book to value ratio, considered alongside more obscure or questionable measures such as the number of Google clicks on a stock or, even more ambiguous, the price per eyeballs on screen.

Academic research is not always practical and not all factors identified are necessarily investable or repeatable for local authority investors. In the past, investors allocated to passive market capitalisation (market cap) indices for beta (or market) exposure and relied upon active managers to source alpha (or excess) returns. Only market cap indices represent a truly passive allocation where market prices are reflected. Factor investing represents an active viewpoint implemented passively. The investor must believe that a specific factor, or combination of factors, will result in better returns.

Today, the factors identified (more on this on the next page) are wide enough to be investable on an institutional scale, helping

Figure 1: Systemic factors

Factor	What it is?	Captured by
Value	Excess returns of stocks that have low prices compared to their fundamental value	Book to price, earnings to price, book value, sales, earnings, cash earnings, net profit, dividends, cash flows
Small Cap	Excess returns smaller companies relative to their larger counterparts	Market cap
Momentum	Excess returns driven by strong past performance	Relative returns over 3/6/12 months or historical alpha
Low volatility	Excess returns of stocks with lower volatility, beta and/or idiosyncratic risk	Standard deviation, beta
Dividend yield	Excess returns from stocks with higher than average dividend yields	Dividend yield
Quality	Stocks perceived as quality with stable earnings and growth outperform	Return of equity, earnings stability, balance sheet strength, accounting policies, management strength, cash flows

Source: MSCI Index Research – Foundations of Factor Investing (Bender, Briand, Mela and Subramania

factor investing gain traction. While the concept is nothing new, accessibility is.

Fundamental factors

Fortunately, the area has been so widely researched that the validity of the factors frequently quoted today are supported by multiple theories. Six fundamental factors (see Figure 1) are widely accepted as key drivers of return today, and importantly, these are investable on an large scale. Factor index funds can deliver returns previously only available through active management at potentially lower fees and risk levels.

How do investors get the potential benefits while minimising the drawbacks?

All these factors have solid credentials as to why they may provide a premium, but as "non-standard" index selection criteria, local authority investors need to give due care to the following considerations.

1. Unique investment objectives and constraints. Choosing which factors form the basis of an investment not only reflects an active or particular viewpoint of the investor (e.g. they believe that small cap stocks will outperform), but will also reflect broader investment objectives. For example, investors looking to reduce downside risk may make different factor choices from those looking to replicate the performance of a certain style of active management, such as growth at a reasonable price. In addition, local authority investors may be subject to certain risk profile and governance constraints that will influence the choice of factor exposure.

2. Implementation strategy and ongoing investability. There is evidence of short-term cyclicality, and indeed periods of underperformance in factor-based investing. Therefore, investors must give due care as to the timing of their initial investment, and be aware that the excess returns from factor investing are generally derived over long-term horizons. Sophisticated monitoring and well thought through implementation strategies should help avoid some of these risks.

3. Diversification. Adopting a multiple-factor approach provides diversification benefits and a better risk and return trade-off as, historically, different factors have responded to specific macroeconomic and technical forces in uncorrelated ways. Therefore, investors may be better off diversifying their factor allocations in a way that suits their investment objectives.

Used and implemented correctly, investment in factor-based indices can be used in lieu of more opaque active manager options with positive implications for risk management. At the very least, factor-based indices may provide a more relevant benchmark to measure how and where an active manager adds value.

A shift in allocations

The arrival of factor-based investment exposure accessed through transparent and rules-based index funds heralds a real change in the choices open to local authorities when deciding on their allocations. In the past, investors could only access excess returns by investing in an active manager with the flexibility to reflect certain factors. Now, investors can use factor-based indices, which have the usual index benefits of low cost, scalability, and which also remove active manager selection risk. However, we don't think this is the end of active management. Rather, we think that a combination of three elements is likely, with a passive allocation to traditional market cap exposure for beta-like returns, and an allocation to both factor-based indices and to specific active managers in order to access excess returns.

More than an investment process

The LGPS has long-term investment horizons. As an investment manager, we understand that they want partners with an equally long-term commitment to this market. At the same time, transparency in terms of what we do and how we do it are a pre-requisite.

We expect index investing to continue to develop over the next decade. As a result, local authority schemes will have access to an increasing number of approaches and investment strategies. The challenge for the LGPS is in achieving the best value-for-money outcomes in core index strategies, while building in exposure to alternative index strategies where these can help meet specific objectives.

Figure 2: A shift in institutional investor allocations