

# Where Next For The Index Business Model?

Bringing low cost to the world of active management

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Illustration by Todd Davidson

Indexing's history is one of amazing growth. From humble beginnings, indexing has grown into a major force in modern finance. Its story has been well documented, as has the philosophical and academic thinking behind its growth.<sup>1</sup> As long as market participants wish to segment their investable universe, this growth will continue, and could progress to the point where indexes outnumber assets, if they don't already. Some of the new indexes populating the finance world borrow strategies from active management in a cross-pollination that is good for both the market and the investor. We aim to show how active investors might learn from indexing, particularly through the implementation of a new business model that separates the development of an investment strategy from its execution. The result is an "Active Index" that promises to deliver active strategies to investors at lower costs and with better transparency.

In contrast to indexes and passive management, active management has received very bad press in recent times. There are a number of valid reasons for this. Successful active managers are hard to find. Even if an investor can find a manager who outperforms for a full year, the probability that the manager will repeat that performance a second year running is between 50 percent and 62 percent.<sup>2</sup> It is a mathematical certainty that the average manager<sup>3</sup> will underperform the market by his fees.<sup>4</sup>

Unsurprisingly, much of the growth in indexes has come at the expense of active managers. Ever more innovation by index providers has been accompanied by increased understanding of indexes by the financial community. Recently, this has led to the introduction of non-cap-weighted indexes, ranging from advanced style indexes to dividend- or fundamental-weighted indexes, and even a resurgence of equal-weighted indexes. The growth in this new field is illustrative of indexing as a whole.

Unfortunately, this growth has been accompanied by an equivalent growth in confusion over exactly what these new products are and how they best can be used. Any investor trying to make sense of this situation would be forgiven for their confusion; after all, there is considerable disagreement between the providers of the new indexes themselves.

Part of the reason is that the finance industry is encumbered with a large amount of jargon. Even words like "active" and "passive," for example, have different meanings to different investors in different situations. As we try to make sense of a new product area, this can inhibit our understanding. In discussions with clients, the definition of terms takes up as much time as anything else.

### Seeing Through The Jargon

Finance literature is full of attempts to help investors understand financial products. Schoenfeld draws a distinction between index investing and passive investing, saying that index investing focuses on replicating index returns, while passive investing focuses on reducing costs and risks while using an index as reference.<sup>5</sup> Bogle defines an index fund as "a fund designed to return investors 100% of the returns delivered by the stock market, less a nominal charge for expenses..."<sup>6</sup>

These types of definitions shape not only the market's thinking, but also the market itself. As we consider the new

field of non-cap-weighted indexing, it is necessary to be doubly precise, hence the need to clarify and separate the concepts of "active" and "passive." It may seem misleading to some to draw a line in the sand between these terms, given that there are clearly many shades of grey in between. But it is necessary to be precise in our definitions if we are to further our understanding of new indexes.

The term "active" denotes energetic activity. To be "passive" is to accept or submit to something without objection or resistance, or to give no response to an action. Within finance, the best broad-brush definition of a passive approach is replication. A manager who replicates an index, for example, has no desire to improve on that index. His job is to passively accept the index return as it is, and match or replicate it to the best of his abilities. For this reason, we call the replication of an index return "passive management." The term "active" can be applied to a fund manager whose sole aim is to outperform an index, either with higher returns or with the same returns at lower risk. We therefore define an active strategy as one that seeks to improve upon its benchmark's return.

One area of confusion about the definitions of "active" and "passive" is style. The segmentation of the market into value and growth, a response to the cyclical outperformance of one segment over another, has prompted index providers to publish style indexes. The approach of selecting stocks using these styles, however, was originally an active strategy, and the use of these indexes can still be considered active. For example, a manager could use a value index to actively tilt her exposure to the Fama-French value risk factor.<sup>7</sup> That said, the indexes themselves are passive because they replicate the value or growth segment of the market.

It is also necessary to state the obvious and separate the role of an index provider from that of a fund manager. Fortunately, this is fairly straightforward. An index provider publishes an index. A fund manager implements a portfolio. Typically, an index provider is passive, because his indexes replicate a market.<sup>8</sup> The resulting association of passivity to index-providing inhibits our understanding of non-cap-weighted indexes; perhaps some of them should not be classified as passive. Figure 1 clearly separates these terms.

Figure 1

	PASSIVE	ACTIVE
INDEX PROVIDER	Traditional index providers replicate a market with an index.	?
MANAGER	Index trackers replicate the market index returns.	Active fund managers aim to improve on index returns.

### What Can Active Managers Learn From Passive Managers?

The definitions of "active" and "passive" are difficult to pin down, but highlighting the differences between the business models is much more straightforward.

In response to client demands, the indexing business model

separates the functions of index construction (the investment strategy) from index implementation and trading. This business model requires partnerships, with one company defining, calculating and publishing the index, and another company holding the stock portfolio and implementing the trades.

This contrasts with active management, where a single company both creates and implements the strategy. There are elements of any active manager's investment strategy which must take into account trading decisions, creating a beneficial overlap of skills between traders and strategists. Despite this, could it be advantageous, in some circumstances, to divide the functions of strategy creation and implementation? Is there a role for an Active Index?

## A New Business Model: An Active Index

Why a new business model?

Business science academics have documented how small companies innovate more successfully than large firms, but face barriers to entry.<sup>9</sup> One way of overcoming this is for small, innovative firms to partner with established players, as has been done in many other industries.<sup>10</sup>

In the investment industry, one way to go about this would be for a small firm with an innovative active strategy to partner with a large, global brand index provider. This business model allows new active strategies, which would otherwise not have received wide attention, to reach large institutional investors in the market.

This is an extension of the division of labor found within the traditional index business model. Now, in addition to the roles of index publishing and index replication, we add active strategy creation (Figure 2).

The framework for such a business model is an Active Index—the blank cell in our table on page 23. It involves

index providers in active management for the first time. This division of labor between index provider and active manager increases competition and productivity, and reduces the cost of active management for clients. The index provider can publish and distribute the new active strategy alongside its existing market indexes at marginal cost, allowing any passive manager to license the new active index and replicate it for a fee.

Within a large passive management house, costs can be lowered by combining the trading of different clients' portfolios to create economies of scale. With enough assets, crossing may be possible, further reducing transaction costs. These factors reduce the cost of indexing large pools of money, and would therefore also reduce implementation costs for an active strategy once it has been wrapped in an index. Low-cost active management becomes a reality.

Any Active Index must be clearly defined and transparent in order to meet the index provider's criteria. Transparency allows the investor to place emphasis on picking the idea rather than picking the manager. This means that changes in strategy will be controlled by the investor, rather than the manager. With the investor in control of her implemented strategies, the over-

lap between managers can be reduced, if not eliminated.

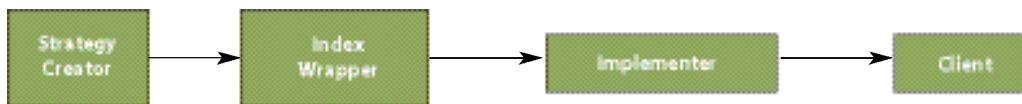
One challenge for the Active Index business model is to define clear lines of legal and performance accountability. The existing structure between index providers, implementers and clients does not make clear how a client could make a strategy creator legally accountable. Of course, this also raises the matter of regulation. GWA, for example, has taken the approach of preferring to sign a direct contract with the end client to simplify this accountability, and is in the process of becoming regulated.

Performance accountability is much more straightforward. The strategy creator is accountable for the strategy's performance relative to an appropriate benchmark; the implementer is accountable for any mismatch between the value of the client's portfolio and the Active Index's return. GWA's experience is that this accountability requires a good working relationship between strategy creator and implementer.

A further challenge for the Active Index business model is to find the correct fee structure. Increasingly, many active managers are offering performance fees, but the question of how this can be combined with the traditional index provider business model remains unsolved.

The most valuable outcome to be gained from dividing the skillsets of index providers and active managers in an Active Index business model is the opportunity to value the idea behind an active strategy. This, in turn, makes the production of robust active strategies financially attractive and rewarding for companies who create them. Increasing the incentives for investment innovation leads to a wider and more productive choice of active products.

Figure 2



## What Strategies Benefit?

Not all strategies are suitable for an Active Index. There would be no economies of scale, for example, in wrapping a high volatility, low capacity, high turnover method in an index. In order for a client to capture the advantages of an Active Index, the strategy must be high capacity, as the productivity benefits and economies of scale identified above can be achieved most effectively in large pools of assets.

Cost reduction will be most apparent in strategies which exhibit crossing, so a contrarian approach is desirable. Further, running contra to the market within a portfolio lowers risk. Risk management is particularly relevant following the dotcom bubble, with investors now focused on securing protection from speculative bubbles.

Investors require protection from speculative bubbles because, as a consequence of the successes of passive management, most portfolios now contain a large proportion of indexed money which participates fully in market extremes. The logic behind this indexed money (the 'passive layer') is clear—it is a very cost effective way of gaining beta (exposure to the market). However, the market can be very volatile, and during a boom-bust cycle, this exposure can be troublesome.

Indexed money participated fully in the spectacular 50 percent rise of the S&P 500 from 1,000 in September 1998 to above 1,500 in March 2000, but also experienced all of the fallback to below 800 by October 2002. As of March 2006, the S&P had still not recovered its previous high. By placing a contrarian strategy alongside the “passive layer,” an investor can be protected from such speculative excess.

The passive layer is ripe for diversification as it remains the only segment of a typical portfolio with a single strategy—market-cap weighting.<sup>11</sup> This segment would benefit from a wider range of strategies, but the enviable success of indexing has prevented any other strategy gaining a hold. An Active Index might solve this conundrum.

### Who Is Calling Themselves An Active Index?

The views of the authors of this paper have been shaped by their experience of the new Active Index market. GWA recently launched an Active Index based on company wealth because we believe, for the reasons outlined above, that this business model is the best way for clients to access and use the wealth-weighted product. Obviously, this means our perspective comes with some bias.

Following the massive speculative boom and bust of the Japan stock market in the late 1980s, MSCI published an index covering Europe, Australia and the Far East (the MSCI EAFE Index) that weighted countries by gross domestic product (GDP). Within the countries, individual stocks were weighted by market capitalization. For this reason, our industry refers to this approach as Active-Passive. MSCI was the first to publish an index with active attributes, and their GDP-weighted index is still in use today.

The Active-Passive approach of using market-cap-weighted indexes as the building blocks for an active portfolio is well understood in finance. Schoenfeld refers to this methodology as Active Indexing,<sup>12</sup> and GWA took this approach with one of the preliminary wealth-weighted products, which went live in 1998. The portfolios were constructed based on the MSCI universe, to provide wealth-weighted country allocations.

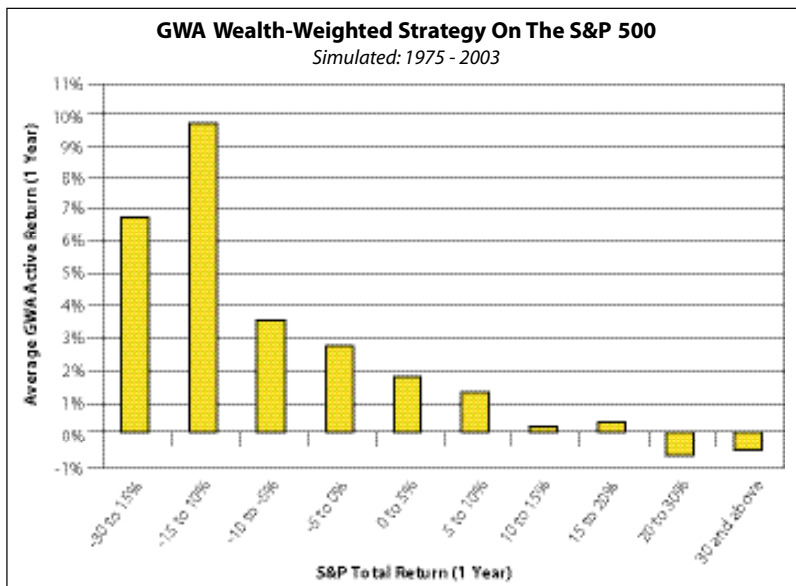
Probably the first fully Active Index was a product called Intellidex, launched by the American Stock Exchange in 2003. Despite selecting on “quantitative criteria” and then using “a modified equal-dollar weighting,” this index was defined by the creators as Dynamic.<sup>13</sup> Our view is that this is an Active Index.

A second quantitative criteria index, this time launched by MarketGrader, recently has been gaining publicity. Its absolute 12-month performance to February 2006 of 36.1 percent is certainly eye-catching. Neither this nor the Intellidex index offers particularly high capacity, and neither is appropriate for the “passive layer,” though these were factors we considered important for the suitability of the new business model. In this case, the wrapping of an active strategy in an index is appealing for other reasons. Perhaps the Active Index business model has more to offer than we initially thought.

GWA reached an agreement with FTSE in December 2004 to launch the first Active Index explicitly marketed as such. GWA reweights the underlying FTSE market capitalization index by company book value, cash flow and net profit.<sup>14</sup> FTSE then wraps this active strategy in an index. The approach aims to outperform the underlying market-cap index, not replace it. We believe the Wealth strategy is suitable for use as an Active Index because it is high capacity, complementary to the traditional market cap index and, for an active strategy, low cost.

The following chart demonstrates how the GWA Wealth strategy could complement a market cap indexing approach. The Wealth approach outperforms the market in all conditions, except when the market is rising very rapidly. Wealth-weighting performs best in falling markets, and in this way

Figure 3



smooths the absolute returns experienced by an investor holding indexed assets. Wealth-weighting protects investors from speculative bubbles.

Subsequently, RAFI reached a similar agreement with FTSE to index what we view as an active strategy. Using four fundamental metrics (sales, dividends, cash flow and book value), RAFI screens an independent universe of stocks according to the size of each metric to obtain the largest 1,000 stocks in the U.S. and, separately, in the World ex-US. FTSE then indexes these active strategies. The benefits of the “Fundamental-weighting” approach are well-documented,<sup>15</sup> but the best use of these indexes is still up for debate.<sup>16</sup>

RAFI views Fundamental Indexes as an evolutionary improvement on, and a replacement for, market-cap indexing. We view any debate on what is the “best” index positively, and admire RAFI for challenging the status quo. Using our earlier definition of a passive approach as replication, it is possible to view the Fundamental Indexes as passive products—they are attempting to replicate, in the RAFI terminology, the “Main Street” market rather than the “Wall Street” market.

Having now worked with some of the index providers, we see that the decision over what companies to include in an

index is complex. We see, for example, that a company's out-performance of the market does not necessarily lead to its inclusion in any particular index. Our view is that one index's out-performance, relative to another, while attractive from the perspective of an active product, does not necessarily make it a better index.

Recently, index providers have brought to market what are, according to our defined terms, active strategies. For example, we view dividend indexes weighted by dividends paid as an active strategy. This presents a case in point for discussion as to whether a particular product is a passive or an Active Index. This example serves to underscore the confusion in the market that we talked about at the beginning of this paper, and which we have tried to clarify.

## Conclusion

The success of passive index management has proved to be hugely beneficial to investors. At the same time, there are potential negatives to the growth in indexing.<sup>17</sup> As more and

more money follows market-cap weighting, fewer managers are attempting to value companies, meaning that the allocation of capital becomes less efficient. This problem is compounded by the fact that the conservative fund manager is typically the first to be replaced by the index. The manager remaining in the market tends to be more speculative.

Fortunately, there is a natural counterpoint to this effect. As more money is indexed, active managers find it is easier to achieve higher absolute returns.<sup>18</sup> The average active investor will continue to underperform the market by his fees, but at some limiting point, passive investors realize that this provides little comfort if the market as a whole is performing poorly.

While we believe this situation is far from being realized, there remains a need for balance between active long-term investment and passive indexing. In order to maintain this balance, we active managers must take some lessons from the index business model, which has succeeded so spectacularly in delivering what investors need: capacity, low costs, transparency and good performance.

## Endnotes

- <sup>1</sup> Schoenfeld, Steven A., *Active Index Investing: Maximizing Portfolio Performance and Minimizing Risk through Global Index Strategies*, John Wiley & Son, 2004. See Chapter 2 and the notes to that chapter.
- <sup>2</sup> Grinold, Richard C. and Ronald N. Kahn, *Active Portfolio Management*, McGraw-Hill, 2000, p. 559. There is a range of numbers within the literature. Suitable information may also be found in Carhart, Mark M., "On Persistence in Mutual Fund Performance," *The Journal of Finance*, Vol. LII, No. 1, March 1997, pp. 57-82.
- <sup>3</sup> The impact of profits or losses by private investors, i.e., assets not invested by managers, adds a small random element to this outcome.
- <sup>4</sup> Sharpe, William F., "The Arithmetic of Active Management," *Financial Analysts Journal*, 47(1), pp. 7-10.
- <sup>5</sup> Schoenfeld, p. 260.
- <sup>6</sup> Bogle, John C., "The Chief Cornerstone," *Journal of Indexes*, March/April 2006.
- <sup>7</sup> Fama, Eugene F. and Kenneth R. French, "Multifactor Explanations of Asset Pricing Anomalies," *The Journal of Finance*, Vol. LI, No. 1, March 1996.
- <sup>8</sup> In the context of the CAPM market, an index provider attempts to split the whole CAPM market into different segments: by country, capitalization band (such as large-cap vs. small-cap) or other feature.
- <sup>9</sup> Christensen, Clayton M., *The Innovator's Dilemma: When New Technologies Cause Great Firms to Fail*, Harvard Business School Press, 1997.
- <sup>10</sup> Botkin, James W. and Jana Matthews, *Winning Combinations: Coming Wave of Entrepreneurial Partnerships Between Large and Small Companies*, John Wiley & Sons, 1992; and Forrest, Janet E., "Strategic Alliances and the Small Technology-Based Firm," *Journal of Small Business Management*, July 1990.
- <sup>11</sup> Watson Wyatt, "Introducing Diversity into the Index Layer," *Global Investment Review*, 2006, pp.18-19.
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- <sup>16</sup> Schoenfeld, Steven A. and Robert E. Ginis, "Worth Weighting For?" *Journal of Indexes*, May/June 2006.
- <sup>17</sup> Woolley, Paul, "Economic Implications of Passive Investing," *Journal of Asset Management*, Vol.3, 2003.
- <sup>18</sup> Ambachtsheer, Keith P., "The Best Of Both Worlds," *Journal of Portfolio Management*, Working Paper.



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