

Looking to alternatives

Global Pensions talks to David Morris of GWA about fundamental indexing



Global Pensions: Alternative indices have been garnering interest from institutions in Europe, North America and Asia. Why has this been the case?

David Morris: The need for scale curtails performance of even the best active managers and this has given passive market index tracking a role to play with much lower fees and a fully transparent, stable process.

However, market indexing has not provided the complete answer because it is susceptible to speculative waves.

In each of the last three decades, great bubbles occurred in: Japan (1989), the Technology Bubble (1999), and Global Financials (2008/9 – the anti-bubble). When speculators focus upon a few 'hot' stocks the relevant market index becomes very concentrated, destroying its diversification.

Furthermore, during periods of market decline, all securities tend to move down together, becoming more correlated. This also reduces diversification.

In my view, the interest in alternative indices comes from the desire to maintain adequate diversification in their core portfolios in order to lower risk.

Global Pensions: With so many different products emerging, what questions should an investor ask when trying to find the best strategy for their portfolio? What risks should they be aware of?

David Morris: Let me say at the outset that in my view alternative indices are not a substitute for the performance benchmark that is the market capitalisation index. Some people think that the market capitalisation index is flawed and should be replaced with a new index. This makes little sense in my view because the market capitalisation index defines

the opportunity set for all investors at any one point in time. It is the ultimate performance target to which we are accountable.

Having said that, the first question to consider is to which of two broad categories does any alternative index product belong: Non-price indices or non-market capitalisation indices?

Within non-price indices there are those that re-weight existing performance indices and those that simply rank stocks to create a new index. GWA re-weights existing FTSE indices using accounting measures of wealth. Therefore, we are accepting the index provider's definition of the market which ensures that all our portfolios are scalable like those of FTSE.

Non-price indices that simply rank securities to provide a predetermined number of constituents, say 1,000 or 1,500, without considering liquidity or index membership, would be less scalable.

In both types of non-price indices, various financial statement items are used so it is imperative to question the rationale for the ones chosen. GWA chooses metrics consistent with traditional economic theory about company valuation based on discounted income.

Non-market cap indices are very different from non-price indices. They

incorporate security prices but avoid market capitalisation weighting. These indices may aim to exploit well known market inefficiencies. Alternatively, they may aim to minimise price volatility and correlation among single securities or clearly defined groups of securities like sectors or industries.

Global Pensions: Because they are not purely replicating market-cap indices, many of these blur the lines between active and passive strategies. Do you consider this an active or passive strategy? Why?

David Morris: Some are active and some are passive.

In the late 90s our wealth weighted portfolios were distributed to implementers quarterly, in spread sheets, not daily as indices. Those portfolios had all the features of a market cap index: a rules-based process with no human intervention, replicable and transparent. Today we publish ground rules and FTSE sends implementers a daily index of weights rather than GWA sending a quarterly spread sheet.

The only difference between GWA and a market cap index is that we use wealth metrics, as reported in financial statements quarterly, rather than share prices as reported by stock exchanges daily.

The typical passive investor chooses to make the performance target their strategy. Analogously an investor that makes a re-weighted performance index their strategy is also a passive investor. One is passive with respect to market prices, the other with respect to market wealth.

It is important to understand that, in the long run, market cap weights must converge to equality with wealth weights. This is common sense because a company's share price cannot grow faster or slower than the wealth (income) that com-

pany creates over the longer term. In the short run, however, market cap weights are random – just a preponderance of accidents of the moment.

To the extent that human intervention occurs, either by smoothing data, adding or subtracting constituents relative to the underlying market benchmark or by enhancing or suppressing market price movements an alternative index becomes active.

Global Pensions: What role can these play within a portfolio?

David Morris: GWA Wealth Weighted indices complement market capitalisation tracking strategies as part of the core portfolio. They increase diversification and this lowers risk. They also outperform market cap indices over the long run with much lower fees than active managers.

Global Pensions: What do think the next evolution of alternative indices will be?

David Morris: I think the future will bring more active strategies into the alternative index array of products. The development of the ETF market is already pulling in that direction. The constraint is the willingness of managers to disclose fully what they are doing.

David Morris, GWA founder and CEO, began his career in economic development in Africa with the Canadian government. In 1992 he set up a pension consultancy in London and by 1996 had developed an investment strategy that built portfolios without using security prices. In 2005, GWA launched the world's first non-price index in partnership with FTSE.