The Value of Active Index Management

The emergence of the index mutual fund as the vehicle to mimic the returns of a standard market index received little notice back in 1972 when the first index fund—the Qualidex Fund--was launched. This fund was based on the Dow Jones Industrial Average of 30 stocks. In 1979 it was acquired by John Galbraith and renamed American Industry Shares. In 1984 it became part of the Templeton Funds organization and because of John Templeton's aversion to the index investing concept the index fund was liquidated!

In 1973, Burton Malkiel wrote A Random Walk Down Wall Street, which presented academic findings for the public. It was becoming well known in the financial press that most mutual funds were not beating the market indices. At the same time, John Bogle who founded what is known today as the Vanguard Group launched the firm's S&P 500 index fund aiming to capture the same returns as the Standard and Poor's 500 index. (The index was structured in 1957 and was the first U.S. market-cap-weighted stock market index meaning that the largest companies by market capitalization have the biggest influence on performance of the index). When this fund was launched, the founder of the largest mutual fund company at that time, Edward Johnson of Fidelity Investments, was reported as saying he "couldn't believe that the great mass of investors was going to be satisfied with receiving just average returns".

As institutional investors gravitated toward the index mutual fund approach primarily due to a combination of low costs and low risk, markets responded by creating additional indices. In turn, mutual fund companies created indexed mutual funds to duplicate the performance of these new indices. Today, it is estimated that there are over 2,000 index funds covering almost every conceivable market sector, niche and trading strategy.

Initially, investors were persuaded by the idea behind the index fund that investing in just the S&P 500 would provide a reasonable rate of return. As new indices proliferated, such as market capitalization of the underlying stocks, investors were presented with the ability to invest in multiple funds that could offer a different risk and return profile. In an environment such as 2015-2016 where actively managed funds underperformed selected index mutual funds, the flow of funds into these vehicles accelerated.

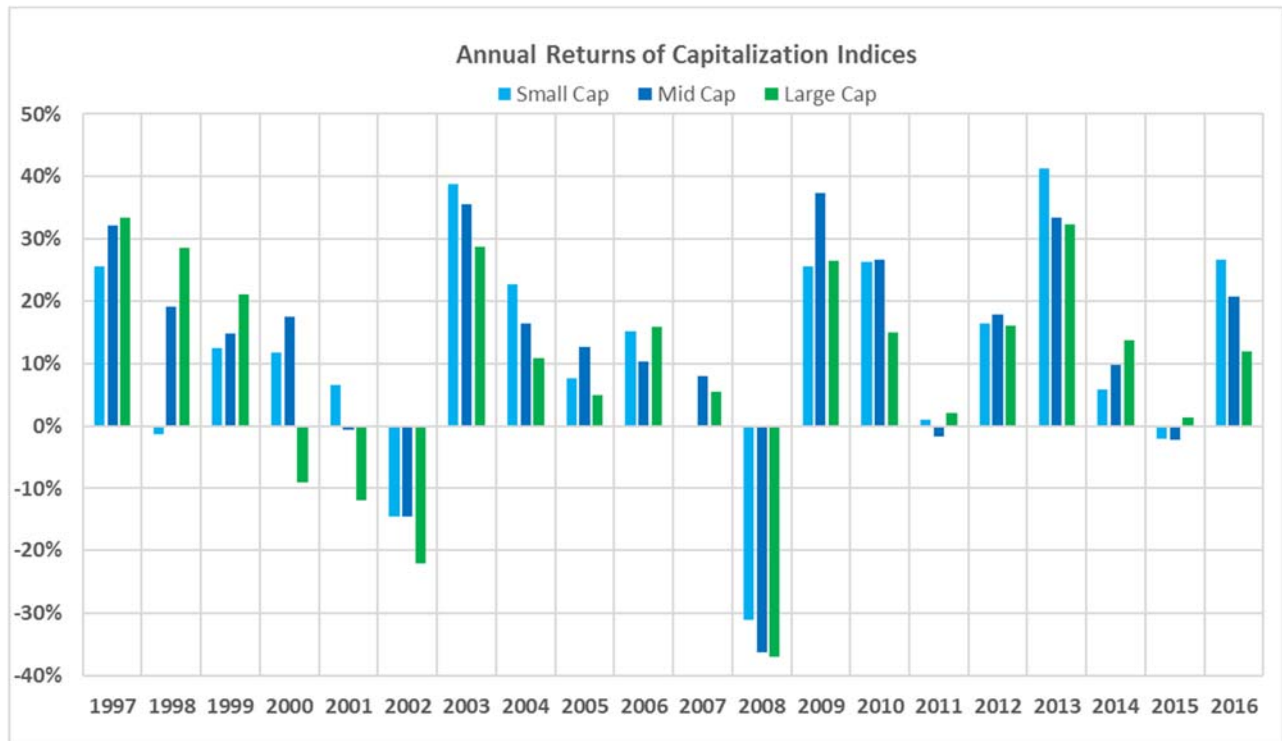
To keep up with this trend, mutual fund companies invented indices based on parameters other than market capitalization. Some simpler approaches included an equally weighted index of the S&P 500 components and the selection and weighting of stocks based on company revenues and earnings. As these new funds experienced varying rates of return, there was the expectation that fund companies would advertise the better performing funds. Investors would then be challenged to come up with a suitable mix of funds for their portfolios—somewhat like picking stocks.

Twenty-three years ago, the idea of mutual fund investing was replicated in a new investment medium—the exchange-traded fund (ETF). This vehicle advanced the art of investing by providing a mutual fund like portfolio but one that could be traded during the day -- not just at the close of business each day. In a few short years, these exchange-traded funds gained national prominence and today account for over $3 trillion in global portfolio investments.

In 1995, the founders of Victoria Capital Management, Inc. created an active asset allocation model using a variety of indexed funds. The structure of a range of portfolios with different weightings allowed for the active management of these indices based on long-term return characteristics and traditional economic and market analyses. The question might be asked: Does adding multiple indices to a portfolio make a difference? While history tells us that there is reasonable similarity among the cumulative rates of return of traditional indices, there is a noticeable difference in the short-term returns of indices.

The following exhibit provides a comparison among three traditional stock market capitalization indices: large, mid and small. First, while index investments don't prevent a substantial short-term price decline as in 2002 and 2008, those losses were recovered in the following two years of the decline. Second, the return differences among these indices can be substantial sometimes by 10 percentage points or more. Such a divergence presents an opportunity for tactical asset managers to weight a portfolio to take advantage of these short-term events.

In 2016, there was an 8.8 percentage point return difference between large-cap and mid-cap indices and a 14.6 percentage point return difference between large-cap and small-cap indices. Also, the exhibit demonstrates that there are no sustainable trends of better returns for one index over another.



Active asset allocation of indices provides for the ability to create a mix of funds that can provide targeted rates of return based on the historical rates of return of each asset class. While fixed income funds' total returns could be limited by current yields, equity index funds should produce the mean of historical returns given a reasonable time period—if history is any guide to the future. If there are dramatic differences in index returns from the historical mean, then portfolios can be weighted accordingly and not experience increased index risk by being over-weighted in one or two indices. Similarly, this weighted index fund approach can allow an investor to come up with an expected or target rate of return for his or her portfolio.

While future performance of any investment can never be guaranteed, a basic starting point of historical long-term actual returns can be useful in coming up with an idea of what those portfolio returns might look like. Using that data and applying it to the long-term alternatives of saving for the future, an investor can come up with a forecast of what active investing could do to a given portfolio either for a one-time contribution or for a dollar-cost averaging strategy during working years.

Depending on an individual's future needs, this approach could allow for the selection of alternatives that could either increase return expectations or lower portfolio risk. A continuous review of portfolio performance can help to assess the needs for any changes in the selection of an asset allocation portfolio.

Conclusions:

Using index funds as a method of inexpensive saving has led to a proliferation of index-based investment vehicles. Victoria Capital Management, Inc. has actively managed portfolios of indexed funds since May of 2001. Currently, these portfolios consist of exchange-traded funds that are structured to provide target rates of return that meet certain risk and reward parameters. The firm has prioritized the use of low cost index funds from the most reputable companies. For investors, the combination of low cost and extensive documentation about these funds can increase confidence and knowledge of how efficiently their savings are being managed. For investment advisors, this investment approach should demonstrate a commitment to act in the clients' best interest.

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