

hitting the target

Habib Nasrallah, Senior Product Specialist at Pictet Funds, makes the case for indexation.

January 2009

Indexed management can trace its origins back to the 1970s and is now an established mainstream product. Since the 1990s, alternatives to the traditional index funds have been introduced such as Exchange Traded Funds (ETFs), and although arguments exist for both, we believe index funds offer a proven, straightforward, strong and long-term investment proposition. The attraction of this approach to portfolio management can be attributed to two key factors: reliability and cost efficiency.

Some investors have become frustrated with active managers not delivering the promised outperformance. In order to achieve outperformance, active managers must take positions different from the benchmark and therefore run the risk of underperformance. Over a business cycle managers with strong style bias have been shown to experience periods of underperformance which can offset any outperformance achieved earlier.

focus on beta

By focusing purely on the beta (index performance) with a disciplined portfolio construction process, indexed managers have been able to deliver returns broadly in line with the index before management fees. Exposure is limited to market risk with negligible stock specific risk, reducing the potential downside relative to the benchmark.

Operating costs are lower not only because of low turnover and economies of scale, particularly through efficient trading methods such as basket trades,

but also because there is no need to carry out costly research.

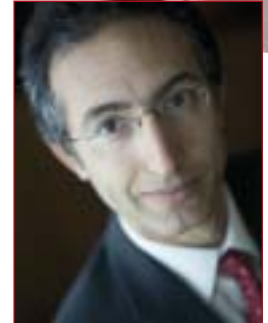
diversified market exposure

Indexed portfolios remain fully invested and therefore do not risk the underperformance that can arise from market timing. They are also fully diversified (at least to the extent that the benchmark is), while active managers sometimes find themselves holding cash in a rising market. Expecting fund managers to predict market turning points reliably is unrealistic.

Keeping up with the index during the later phases of a rising market, when market concentration is high, is notoriously difficult for active managers reluctant to pursue a risky, momentum-based strategy. Experienced together, these two scenarios can lead to underperformance.

long-term approach

It is still debated whether an indexation strategy – which exposes the investor to 100% of the market movement – is sensible in a falling market. We agree that active stock picking may offer the possibility of downside protection, but to do so relies heavily on the ability of a fund manager to predict market cycles and trends – and to position the portfolio to benefit from such events. Not many active managers can demonstrate this skill throughout the economic cycle, particularly those with a strong style bias. ●



Indexation – investment process

Pictet's indexation methodology is to build a portfolio which is as close as possible to a full replication portfolio, ie a portfolio which has the same stocks with the same weights as the benchmark. Whether a full replication can be reached depends on the following:

- the amount of money to be indexed
- the number of stocks in the index and their weight distribution in the index
- the nature of the turnover of the index
- the trading liquidity of the individual stocks in the index
- the minimum trade size compatible with reasonable transaction costs and round lot constraints
- the likely cash in/outflow

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