



INVESTMENT ADVISORY

Fundamental Indexing

PENSIONS



Over the last few years there has been considerable academic and institutional research looking into methods to improve the returns from passive investment, the goal being to find better methods of investing passively to control risk and improve returns.

We look at whether this approach has merit for pension schemes.

Background

For clients who have decided to invest passively, traditionally there has been one main approach to benchmarking performance – the use of Market Cap Weighted (MCW) indices.

- This is where each stock’s weighting in the index is based on its market capitalisation (i.e. market value net of debt)

As a result of research into new approaches, there is a new breed of indices called “Fundamental Indices” which seek to construct the portfolio more efficiently.

What’s wrong with traditional Passive?

Broadly speaking, there is not a great deal wrong with traditional passive. It provides good diversification with low management fees.

However, the main criticism of the approach is that it can overweight overvalued companies and underweight undervalued companies, thereby propagating “bubbles”.

This idea assumes that markets may not be efficient (i.e. share prices do not reflect all publicly available information) and so over-valued stocks may constitute a larger proportion of the index than they ideally should.

What is Fundamental Indexing (FIX)?

A fundamental index is constructed based on a company’s “economic footprint” which is in turn based on fundamental measures of size.

The idea is to try to improve the construction of the index itself and provide better risk-adjusted returns than a traditional approach.

One pioneer of the implementation of this approach is Research Affiliates, who have licensed their methodology (RAFI) to several fund managers and FTSE (e.g. FTSE RAFI Developed 1000 Index).

In the case of RAFI (other fundamental indices are similar) the process uses four equally weighted fundamental factors:

- Sales
- Cash flow
- Book value
- Dividends paid

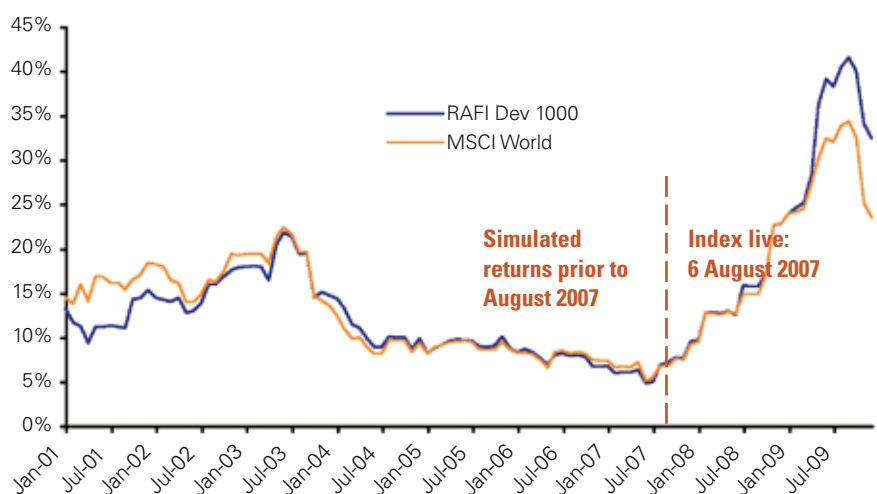
Do these approaches work?

We have analyzed the results of a leading fundamental index (the FTSE RAFI Developed 1000 Index) versus the MSCI World index.

The key conclusions were as follows:

- There is evidence of outperformance (both live and simulated pre August 2007) of c. 2% p.a.
- FIX portfolios seem to add value in markets where prices deviate significantly from fair value
- Volatility (risk) has been higher for the RAFI index during the past year due to a relative overweighting of financial stocks in the aftermath of the financial crisis but has been similar over the longer term

FTSE RAFI Dev 1000 vs MSCI World Trailing 12 month volatility



Source: KPMG

Our other findings

We have made the following additional key findings:

- FIX based portfolios have in the past underperformed an investment bubble but outperformed a crash. This implies they provide a “smoother ride” compared to traditional passive, which some investors would value
- FIX tends to have a ‘value’ style bias. This means the portfolio tends to bias away from stocks pricing in high growth expectations. This is something that may appeal to some investors and not others

- There does not appear to be a small cap bias. The approach does not bias away from large companies. Rather, they bias away from overvalued companies which could be large or small.

Costs and rebalancing

Fees are relatively high for a ‘passive’ FIX mandate and range between 15bps and 40bps (0.15% - 0.4% p.a.).

This is especially the case where a methodology is licensed which adds 10-15bps to the cost. If there is an expected additional return from using FIX, this increased cost can be justified.

Rebalancing costs are also higher for a FIX. Compared to a traditional passive index which experiences average annual turnover of 6%, a FIX might experience turnover of around 10%. Based on a bid/offer spread of 0.5% this increased turnover would equate to an extra cost (or drag in return) in the order of 2bps pa.

However, the impact of this is mitigated to some extent in that much of this turnover is contra-trading (going against the market flow – i.e. selling out of stocks that are growing in value relative to their fundamentals). In addition, under the RAFI methodology the portfolio is only rebalanced once a year.

Is fundamental indexing right for you?

Fundamental indexing offers investors an alternative to traditional passive MCW portfolios, whilst still remaining free from the governance drawbacks of selecting and monitoring an active manager.

Our research into FIX has concluded that it represents a sensible method of investing in a way that complements limited governance structures, but there are arguments that FIX is not definitively superior to MCW.

In many respects FIX is akin to a very diversified active quantitative strategy, albeit with low turnover. As such FIX may be expected to outperform MCW in the future by removing the bias towards overvalued stocks. However, the rationale for considering FIX should not be driven by pursuit of outperformance of MCW, as outperformance may not materialise.

For clients looking for the lowest cost option, MCW remains the cheapest in terms of fees.

If you would like to consider FIX in more depth, we would be happy to cover this in more detail and set out the implementation options available to you.

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