The age of investment strategy indices

Global Pensions gathers key industry experts to talk about investment strategy indices, which offer an alternative to traditional market cap-weighted indices

ALEX BEVERIDGE: This style of index is often referred to by multiple names, including investment strategy indices, fundamental indices and wealth-weighted indices. Are there any differences between them or do all of these terms refer to the same thing?

IMOGEN DILLON HATCHER: I'll leave it to the actual creators of these particular indices to explain the differences between them, but at FTSE we're about creating some kind of choice for our audience on a global basis. So we put forward various partnership indices, be that FTSE GWA, FTSE RAFI, our own dividend plus type series, all under the umbrella of investment strategy indices. Each has its own kind of trademark or strapline behind it, all offering interesting performance stories.

ANDREW CHESELDINE: Clearly each of the different indices has a different job to do, but as a generic term we're quite comfortable with any of those terms.

EMMANUELLE CHOUKROUN: We have launched a number of ETFs tracking a variety of investment strategies, which are clearly not alike one with the other. I would say I disagree as the family of investment strategies is quite broad and needs to be clearly segmented: it includes leverage or bear strategies on traditional cap-weighted indices; optional investment strategies, such as for instance the BuyWrite strategy; the family of fundamental indices, ie indices in which stocks are weighted by fundamental factors rather than market cap; and will certainly include some other families of indices.

ALEX BEVERIDGE: Does it create confusion with clients?

ANDREW CHESELDINE: No because clients don't really have a clear view of fundamental indices yet. Although most consultants have talked to them about them, at least in simple terms, there's little depth to the conversations yet.

EMMANUELLE CHOUKROUN: I would say no, but for a different reason. In France, the denomination "investment strategy index" has been imposed by the regulator and by the stock exchange in order to group all investment strategies that are different from the strategies that consist of being long only to a market-cap index. This distinction has the merit of clarifying the two sets of alternatives.

TONY SUTTON: We believe wealth-weighted strategies have a clear investment philosophy, and GWA's philosophy is that a company's share price must follow the wealth that company creates. Therefore only wealth measurements are used for building the GWA portfolios, namely, book value, net profit after tax and operating cash flow. These are the elements of discounted cash flow analysis.

ADRIAN JARVIS: From my point of view, the indices that are captured by these different names are much more alike than they are different. They're all attempting to weight stocks using a market valuation approach, and in trying to do that, they're also attempting to be representative of the particular stock market, as opposed to an equal weighting approach.

They all tend to have periods of outperformance and underperformance relative to conventional indices, but there's strong evidence that they come out ahead in the end. So the difference between the different index providers is perhaps secondary; they might appear important on a one or two year timeframe, but in the long run they will have the same overall direction to the return profile.

JASON HSU: I certainly agree that the fundamental index and the related wealth-weighted index are in a category of investment strategy indices, but they are different from some of the potentially higher turnover and less transparent investment strategy indices. I would put them in a special category by themselves. At the core, they are trying to be a beta source rather than just an investment strategy. The difference between the FTSE GWA product and the FTSE RAFI products is in the underlying construct and the underlying sensitivity to turnover and transaction cost.

They would appear similar in the short term to investors who are comparing those products against standard price-weighted products, but over time there is going to be a disparity in performances driven by the index construct and it will become clear to an investor which product is appropriate in what capacity.

ALEX BEVERIDGE: Georg, from a trustee point of view, is it confusing having all these different names?

GEORG INDERST: It's early days, but in my view, some explanation is needed. What is the rationale for these indices? What is the theory behind them? Many trustees have just managed to understand the theory behind market cap-weighted indices. This implies that you are almost opting for an investment strategy by choosing an index, and I think that's a concept that needs to be explained.

PAUL VON STEENBURG: We view 'investment strategy indices', 'fundamental indices' and 'wealth-weighted indices' as being one and the same, essentially very similar names for what are like strategies. They all use some sort of factor-weighted methodology to develop an index of stocks, using that term 'index' in its most loose sense. They are attempting to, in some cases, redefine the opportunity set for investors away from the capitalisation-weighted index that's typically been utilised to gain exposure to the equity markets.

NIZAM HAMID: The indices are very similar, but what they offer people is a structured approach to an active investment policy. This differentiates it from the lack of reliability you've had within the active fund management community over the past four or five years.

ALEX BEVERIDGE: How do investment strategy indices differ from the traditional benchmark indices and what advantages do they offer pension funds?

IMOGEN DILLON HATCHER: An index throws some transparency and structure behind measurement. We prefer to think of it along enhanced lines, so we're not actually going down the active route; we're offering the traditional benefits of an index through our partners, but with that performance story behind it as well.

PAUL VON STEENBURG: They offer pension funds a low-cost alternative to some of the factors that helped to drive a lot of active managers' returns historically. So to the extent that these factors continue to outperform the market in future, then it'll be beneficial for a pension fund to gain access to those factors in a transparent way.

GEORG INDERST: What would be the difference in a pension fund selecting a value index and a small cap index, or combination of those, compared to fundamental indices? If it provides cheap exposure to those factors, how would it differ from those more established small cap/value indices?

JASON HSU: This is one of the most often-asked questions. The question is: Can you replicate a fundamental index methodology by using a combination, say, of the core with overlay into value indices and size indices? You can't do it in a long only portfolio; you have to dynamically create it in a more complicated, actively rebalanced long/short portfolio.

The cost of that is going to be significantly higher than what you would have to pay to achieve a long only fundamental index product. Of course there is another question – going forward, will it be beneficial to you to have a strategy that you know will have some inherent value and size exposure over time? If you have used active managers with some success, then you probably already buy into the philosophy that value and size is a consequence of misvaluation, in which case you should be perfectly happy and even find some size and value exposure in your portfolio to be desirable.

TONY SUTTON: In highly speculative periods, price indices have a tendency to blow up. When this happens, a misallocation of capital occurs. Wealth-weighted strategies provide diversification to protect investors' core portfolios from such misallocation of capital. It is this diversification that pension funds find attractive.

NIZAM HAMID: A large number of institutional clients are looking at long/short strategies; 130/30 strategies; changing the way they analyse the benchmark, rather than being constrained, even by normal cap-weighted benchmark indices. So within that context, strategy indices fit within the jigsaw, but there are a lot of other parts that people are looking at now, as opposed to just traditional market cap-weighted benchmark indices versus the strategy indices or other historically normal comparisons.

ADRIAN JARVIS: I would completely agree, but it's actually quite fortunate that it fits in with this move towards opening up the investment set, because this type of index is quite significantly different to traditional indices. This is saying, in contrast to much of the previously received wisdom, markets are materially inefficient. It's a strategy which is quite capable of underperforming traditional indices for three, four, five, six years on the trot, whereas if one were to buy a value manager who was willing to accept the FTSE All Share benchmark, I'm sure they'd be telling you, 'We'll outperform on a three-year basis'. So it's a much longer term commitment to a strategy embedded within an index.

That's a fundamentally different, much more demanding decision to make, but it is the right time to be looking at this. Just as we might be looking at weighting companies differently within markets, we're seeing pension schemes weight-








ing their regional equity exposures completely differently to each other, considering alternative asset classes, and the one size fits all model is clearly disappearing.

ANDREW CHESELDINE: Certainly if you're looking at defined benefit pension schemes, the long term nature of what is, in effect, a bet, is potentially negative because a lot of trustees are going to look at things with a much shorter term view. I think most consultants would argue that there is potential for outperformance in the short term via an unconstrained environment, or long/short, where you can rack up the profits quicker.

The advantage I see for fundamental indices or investment strategy indices is the cost saving both in terms of trading and technical costs.

GEORG INDERST: There is a theory behind the market cap index, and there is a debate over the extent to which market cap-based indices are a good proxy for the market. I can understand that, what I am not clear on here is the theory behind this index.

It seems to me that in order to have theoretical backing of the concept, you need more than to say that sales, profits and dividends are important for wealth creation, so I'm just wondering how people go about giving a conceptual underpinning.

JASON HSU: Actually that's really a good question, because this is where, even though the wealth-weight index by GWA and fundamental index by Research Affiliates seem to be somewhat similar in terms of construction, the philosophy behind them is quite different.

TONY SUTTON: From a GWA perspective we certainly have the clear investment philosophy based on the simple economic truth that any change in the share price of a company must mirror the change in the wealth that company creates. So, the measurements we use in building our portfolio are taken directly from company financial statements which portray wealth creation. That is really, in our view, what it all boils down to.

JASON HSU: Our philosophy is entirely different in this case. For a product to be investable and useful for an institutional client, it has to maintain some of the core characteristics of standard indices, meaning it must be broadly diversified and very representative. You don't want to be investing in the US and not have exposure to GE and Microsoft.

Secondly, we know there is a flaw associated with cap weighting, and that flaw will always exist in so far that the market's not perfectly efficient, so any type of mispricing leads to over-allocation to the overvalued stocks and under-allocation to the undervalued stocks.

You can fix that by moving away from using price as your portfolio weighting mechanism. But you need to move in such a way that you still preserve diversification and liquidity. The way to do that is to capture size and economic activity using other metrics.

PAUL VON STEENBURG: I would just add that it's not that there's a flaw within market capitalisation-weighted indices, it's that there's a potential flaw in the prices of securities that make up the index. So to the extent that the markets are inefficient and prices are wrong, then therefore the market cap index security weightings are wrong.

That's the same argument that any active managers makes in order to actively manage any portfolio. At a given point in time when inefficiency no longer exists in the market, the rationale for these indices would break down.

ALEX BEVERIDGE: How successful was 2006 for investment strategy indices, and how successful do people expect them to be in 2007?

TONY SUTTON: We launched the FTSE GWA index series in late 2005 and since then we've seen a steady pick up by pension funds in their use, not so much in the UK but certainly globally.

JASON HSU: The fact that there's been a tremendous amount of interest and asset-gathering does represent a belief in the underlying construct and methodology. We have raised almost US$10bn to date.

We thought we were going to have a much stronger traction in the retail market first, but we actually have a much stronger traction right now in the institutional space.

So of the $10bn, 80% of that is probably institutional assets, primarily from large global public pension funds, both US as well as international. CalPERS is one of the first and of course one of the largest public pensions to have moved into the FTSE RAFI product, so that's made a lot of large pensions look at this carefully.

IMOGEN DILLON HATCHER: Typically when we partner or launch a new index series, it can take up to two years to gain any kind of real traction, and both our partners have been pleased to see the way that this has been taken up since the end of 2005. It says a lot about the strength of the partners, but also the global spread of that usage.

There's been big pick-up in the US, we're seeing a lot in Asia, Japan, Australia and Scandinavia. The area that hasn't fallen yet is the UK. A lot of people are on the cusp of making decisions but it's not quite happening yet. It's coming from the institutional side, but I think that's an educational play that we have to make as well.

ADRIAN JARVIS: It strikes me these are extremely smart investors with a huge governance budget; they can spend the time to understand something which is different and complex like this. It's going to be harder for those who perhaps don't have the same sort of governance budget or who are also thinking about alternative assets and liability management and a dozen or so other really complicated things.

EMMANUELLE CHOUKROUN: At Lyxor we get asked a lot of questions on the indices and on the concept and we are seeing investors try to understand the philosophy and the process. So for me, if success is measured by the number of questions that we get, we can say that the concept is definitely receiving significant interest.

In terms of performance, we observed that, at least for the European, US and Japanese RAFI indices, which we follow more attentively as there are Lyxor ETFs tracking them, they were very good, both in 2006 and 2007, compared to their cap-weighted alter-ego.

ALEX BEVERIDGE: Are there any issues to be aware of which might impact on these indices in 2007 from a pension fund point of view?

JASON HSU: The two markets where fundamental indices and FTSE RAFI have not outperformed in terms of beating the benchmark return have been Canada and Australia. We thought these were going to be the two markets where we'd have no success in terms of gathering assets but we were actually dead wrong.

We've spoken to two of the largest pension funds in each of the respective markets and their comment to us was, 'The reason why we're looking outside of the cap weighted index is because of the mini bubble we're seeing in the energy sector. We know in that type of a momentum and bubble period, we don't expect a fundamental index to do well, but we know that's going to be the style of investing if we were to include that in our beta diversification programme. That's going to offer a lot of downside protection.'

So in the markets where you're seeing a miniature bubble you're not going to see outperformance, but I would also argue that this is also precisely the time when it's interesting. In 2007, performance might not be as robust as we've seen in 2006, but the more sophisticated large institutional asset owners will actually see this as the right time to move to an alternative beta structure.

ADRIAN JARVIS: Relating to what Jason just said, it's encouraging if investors are choosing not to look at the short term performance in a trend-following way. We've had our eye on the Japanese and UK indices, and it's noticeable in Japan, where this sort of strategy's been incredibly consistent, but actually if you looked ahead you'd find that there's compression going on.

The style risk of the index, which obviously changes over time, its industry risk is getting quite limited. So I'd suggest that we're not going to see the same return scale for Japan. It may be that the UK's moving up the opportunity set and Japan is moving down, even though in performance terms it's the other way around.

IMOGEN DILLON HATCHER: The clients that we're speaking to are saying as the FTSE 100 approaches record highs, the timing could be interesting, certainly for the UK market.

ALEX BEVERIDGE: Consultants effectively act as a gatekeeper for many products that are marketed to pension funds. I'd like to ask the product providers: what's been your experience with the consultants?

JASON HSU: Our experience with consultants in the US has been fairly positive. The larger na-

Alex Beveridge

Alex is the editor of *Global Pensions*. Prior to joining the magazine, he was a news and website editor for Charterhouse Communications, where he covered the UK mortgage market. Alex Beveridge has a degree in politics and communications studies from the University of Liverpool and a post graduate diploma in journalism from the Journalism Training Center in London.

Emmanuelle Choukroun

Emmanuelle is global ETF developer for Lyxor AM. Prior to joining Lyxor, Emmanuelle worked for seven years in the structured product group at SGCIB equity derivatives department. She began her career at Fortis Investment Management and graduated from Toulouse Business School.

Nizam Hamid

Nizam is director of portfolio trading and index strategy at Deutsche Bank. He has 20 years of experience as an analyst in the investment industry. After receiving a degree in economics from the University of Liverpool, Nizam started work in 1987 as an equity research analyst in London and Tokyo focussing on fundamental and quantitative research. In November 1998, Nizam moved to Deutsche Bank to head up the global portfolio trading and index strategy team. Nizam is currently a member of FTSE and STOXX index committees.

Georg Inderst

Georg is an independent consultant based in London. He is a member of investment and advisory committees for pension funds and institutional investors across Europe. Georg was a professional trustee and director at Law Debenture Pension Trust Corporation. Previously, he was a director at Foreign & Colonial Investment Management, where he headed the global asset allocation and fixed interest teams. He has a PhD in economics and social sciences from the University of Vienna and an MSc in economics from the London School of Economics.

Tony Sutton

Tony Sutton joined GWA in 2006 as head of research, where he is responsible for measuring the wealth creation of more than 2,500 companies, comprising all live mandates and associated performance analysis. Prior to this, Tony worked for five years at Goldman Sachs JBWere in Australia as a member of their highly rated quantitative equity research team.

Andrew Cheseldine

Andy joined the defined contribution (DC) leadership team at Hewitt in December 2005. He has over 25 years of experience in the employee benefits market. He primarily guides employers and trustees through the design, establishment, transition, communication and ongoing monitoring of DC pensions, but also advises on investment issues in other forms of pension including cash balance, career average and final salary schemes.

Imogen Dillon Hatcher

Imogen is managing director for Europe, Middle East and Africa, the largest business unit within FTSE Group. She joined the company in December 2004. In this role, she holds responsibility for FTSE's regional business strategy, development, sales, client services and marketing activities in Europe, Middle East and Africa. She heads a team of financial services professionals, based in London, Paris, Frankfurt and Madrid. Imogen has worked within the financial sector for over 20 years, and has experience in financial sales and marketing.

Jason Hsu

Jason Hsu is principal and director, research & investment management, at Research Affiliates. He manages all investment operations associated with the firm's sub-advisory and hedge fund businesses. In addition, he oversees research on the asset allocation models and equity strategies that underpin RA's fundamental indexation concept. Jason graduated summa cum laude from California Institute of Technology and earned his PhD in finance at the University of California, Los Angeles.

Adrian Jarvis

Adrian is Interim CIO of Morley Fund Management. He joined the firm (as Norwich Union Investment Management Ltd (NUIM)) in 2000 as a senior quantitative analyst before becoming head of strategy. Prior to joining NUIM Adrian spent three years at NPI Asset Management, during which time he was promoted from director of strategy & quantitative analysis to head of global asset allocation. Adrian holds a BSc and MSc in economics from the London School of Economics, and studied investment management at the London Business School.

Paul Von Steenburg

Paul is vice president of Wilshire. He joined Wilshire in 2004 to work with the firm's consulting clients, including public, corporate, endowment and foundation funds. He earned a BSc from Rutgers University and an MBA in finance from Cornell University. He holds the Chartered Financial Analyst and Chartered Alternative Investment Analyst designations.

tional consultants in the US say they've had much more success educating their clients and positioning fundamental indices or FTSE RAFI as an enhanced or active strategy that can be used to outperform their current benchmark. We're still a fair way away from having consultants say 'Why don't you change your benchmark away from the standard cap-weighted benchmark and use a FTSE RAFI benchmark?' But they have no problem recommending it as an investable product.

TONY SUTTON: Yes, certainly we're having the same experience in the UK. The view definitely is that it is an active strategy – the benchmarks are the underlying FTSE market cap indices – and we have no issue with that at all. Obviously our aim is to beat the FTSE market cap indices.

ALEX BEVERIDGE: What are the consultants views on this?

PAUL VON STEENBURG: We obviously work with RAFI, which is in a couple of our client portfolios. We view them as active management strategies versus the cap-weighted benchmarks and I don't see any point in time when that will change.

ANDREW CHESELDINE: Consultants are professional sceptics. It's our role to challenge and to see the evidence before we push trustees in one direction rather than another. We've certainly got a concern that moving to fundamental or investment strategies just removes one set of biases and puts in another set. Having said that, I think there are plenty of opportunities. There's a potential opportunity in the UK in personal accounts that will come in 2012, which is effectively compulsory DC for anyone who isn't already in a pension scheme.

The DWP estimate is about £5bn a year of contributions going into those. Personally I would argue that a fundamental index could be a valid way to go for those sorts of products. My reasoning is that the big issue with individual members contributing to a pension fund is that once they invest, it's virtually impossible to get them to do anything different with it. Therefore a long term strategy is what fits. And if you can offer them something that effectively is an active strategy, but with more of a passive charge, that is potentially a positive move.

ALEX BEVERIDGE: With a lot of products like this, you reach a tipping point where, as with many of the alternatives, people wouldn't look at them at all and then all of a sudden they became very popular. Are we close to that with these products, or are we some way off?

GEORG INDERST: I don't think we've reached that point. The pension funds with the largest resources often look into new concepts and new ideas first. In terms of the broader market of consultants and trustees, there is a long way to go. In some ways you could say there are bigger fishes to fry, bigger issues out there at the moment that pension funds are dealing with. This question of what type of equity market indices to use in different regions doesn't seem to be a primary question for most pension funds at this juncture. But that doesn't mean that it won't come up.

Also, if we are talking about an enhanced strategy or an active management decision, then the question is: Who is the right person or body to make it? Is it the trustee body? Is it the investment committee? Is it the chief investment officer? Is it a consultant? Is it the fund manager? The governance models are different in different countries and it's not quite clear who's going to take on that responsibility.

PAUL VON STEENBURG: As you've touched on, there's a lot going on within pension plans these days, a variety of different asset classes and investment strategies that they have to deal with, so is this really something that they can take on? And to the extent that you are saying now that this is a benchmark change, which 1) we fundamentally disagree with and 2) then creates a much bigger issue for the pension plan to deal with, thereby framing it in an active strategy, which we think it is, it becomes a much simpler issue than reconfiguring the entire equity asset class or opportunity set for a plan.

NIZAM HAMID: Over the last 12 to 18 months the biggest area we've seen from both pensions and institutions has been revisiting ethical investing, corporate governance styles and sustainability, in addition to fundamentally weighted indices. I see more demand in terms of people's concern as to what they're managing within their benchmark, not necessarily being concerned about cap weighting or fundamentally-weighted indices.

Perhaps there's scope for having ethical fundamental weightings. If there's some way of adding all these different styles or factors within that sort of melting pot, we see that as being a very big area.

ALEX BEVERIDGE: Which investment strategy indices have proved most popular with pension funds so far?

IMOGEN DILLON HATCHER: We've seen a broad variety. We've seen the industry sector breakdown, geographical groupings, eurozone. There's a bit of a mix depending on whether you're talking about the US, Asia or EMEA.

TONY SUTTON: From our perspective it certainly has been very broad, but with a greater focus on the international mandates. The developed world has been most popular and this continues to be the case.

PAUL VON STEENBURG: US mandates have obviously been popular from our vantage point, and we've seen some increased interest in international.

JASON HSU: Within the family of the different FTSE RAFI indices, the global ex is probably the most talked-about product. When you approach a consultant or an asset owner, there seems to be great confidence that they could find a good manager who could outperform the domestic market.

There's a much greater appetite and much greater dissatisfaction with performances of active managers in the global ex space.

NIZAM HAMID: We've seen more of a variation on dividend indices within the European space, if only perhaps because people can adjust to that more easily from a dividend weighted index, rather than coming to grips with the greater complexity of the RAFI indices or GWA indices.

ALEX BEVERIDGE: How are pension funds actually using these indices in their portfolios? Could these indices be part of a core satellite strategy?

PAUL VON STEENBURG: Typically they can be used as a core to core value enhanced index type of approach. It's not necessarily an absolute diversifier, but an investment structure diversifier or an excess return diversifier.

JASON HSU: Usually we are seen as an enhanced part of the core, sometimes core value, but we've been included in a number of mandates where we show up and everyone else in the room is an active equity manager.

ADRIAN JARVIS: Do clients usually adopt the conventional cap weighted benchmark?

JASON HSU: Yes, they usually benchmark us against the S&P or Russell for a US large cap mandate, and for international against the FTSE indices.

ADRIAN JARVIS: The problem is this is capable of looking like a bad decision on a three-year timeframe. But do the clients who don't change their benchmark, that adopt this inactive strategy, really understand that this is not something one should step into and step away from a couple of years down the road?

This is a long term allocation of capital, so I would be a little bit worried if clients were simply saying this is another type of active management. I think it needs to be a long term commitment of capital to work out well.

PAUL VON STEENBURG: That's a fair statement, and it is part of the education process that we try to conduct with our clients so that this type of strategy is given a bit of a longer lead time than traditional active managers are given.

GEORG INDERST: I'm getting more confused now whether we are talking about a passive management or active management here.

For trustees, it's all fine for them to say 'Oh yes, we want this index as a benchmark', but if their fund manager doesn't feel comfortable with that then there's no point. If the only fund manager that feels comfortable with that sort of benchmark is sitting here, then we might have a bit of a competition issue.

EMMANUELLE CHOUKROUN: From what I understand, it's really about passive asset management. Why? Because you are constantly exposed to the same investment universe, the same stocks. The fundamental weights are fixed once a year and are not revised depending on market anticipations, as opposed to what an active manager will do. It is an investment solution that provides the insurance that you will not be overexposed to overvalued stocks. The whole market may be overvalued but at least, you will avoid the amplification effect created by a market-cap weighting. It is not a miracle solution: if the market goes deeply down, you will certainly go down as well with a RAFI index, but at least will you will have the insurance that each stock is weighted with a factor that keeps a link with reality.

PAUL VON STEENBURG: Actually one client came up to me recently and said he was thinking about anecdotally benchmarking his active managers versus RAFI portfolio, in the sense that if these active managers can't outperform this very simple rules-based strategy, then what does that say to him about active management? It's more of a test of active managers' capability to add value over the long term versus a benchmark.

ALEX BEVERIDGE: I'm just trying to clarify this for myself now. Who sees it more on the active side and who sees it more on the passive side?

JASON HSU: I'm leaning toward active, low turnover, rules-based.

ADRIAN JARVIS: Actually I'm going to add to your confusion, because I think it's an active strategy, but it has a belief structure about stocks. It's like a passive strategy in that the managers follow a set regime, they're not going to start chucking out sectors within the market, but then again effectively it's the client's decision to go into it, almost regardless of whether the individual manager's benchmark gets cap-weighted or not.

So that's like an active management decision at the level of trustees or plan sponsor. It clearly doesn't fit easily in one or other category.

NIZAM HAMID: I think it represents a rigorous methodology that can effectively replace active managers via an index product.

TONY SUTTON: The confusion exists because the strategy is implemented in the passive space, however, we are of the view that it is an active strategy. At the end of the day the market cap index, by definition, is the only objective measure of investor preferences, and therefore of performance, and that is what we aim to beat.

ANDREW CHESELDINE: I think we've got to call it active. However, it operates in a mechanical way with low cost and therefore looks very like passive.

IMOGEN DILLON HATCHER: You're right in that it operates in a passive space, but clearly with active upside, a low cost solution, but that whole rules-based transparent methodology pushes you more down the passive end of things.

ALEX BEVERIDGE: How much diversification do these strategies give to somebody investing in them, given that you're still buying the same companies that would be constituents in a market cap index?

JASON HSU: There are two kinds of diversification. If you just look in the equity space, where you are already using a lot of active managers, all of them have different alpha sources, so this does represent another equity portfolio with an alpha expectation that is different from what you already have access to. So in that regard it's a diversifier.

Certainly if you look at the true passive core, where most people are indexed to only the cap-weighted style, that's utterly undiversified. In case the market is fairly inefficient and there's a potential for the cap-weighted construct to underperform over an extended period of time, then having part of your passive core money move into a fundamental index approach is truly diversified.

ADRIAN JARVIS: Yes, on average it's a diversifier, although one of the complexities is it time varies, so if you looked at the UK market at the moment, some people are uncomfortable with the concentration of risk in a few names. If those names happen to be attractive within these index definitions, you could actually find you've got even more concentration, so that would need to be understood.

NIZAM HAMID: We're diversified by nature of the construction. Whether it's the right way to diversify is really the question.

TONY SUTTON: The traditional approach to diversification has been to slice and dice traditional market cap benchmarks, for example; value-growth, small-large, regions, sectors etc. But these are all still price-based and are correlated, especially when markets are distressed. So compared to this approach, the true diversification is to actually move away from prices and towards wealth, which will drive prices in the long run.

ALEX BEVERIDGE: We've discussed at length the fact that in some ways these strategies are competing with active managers. Can a fundamental index get you the same result as your active manager?

JASON HSU: If it can, then you should just go to Imogen and ask for a licensing fee and fire your active manager, because it'll be cheaper.

ADRIAN JARVIS: If I were to think about an active strategy that most resembles RAFI, I think it is quant rather than value. Many quant managers would have a very high correlation with the active positions that would come out from these types of indices. That's the one that looks most similar to me.

ALEX BEVERIDGE: So the bottom-up managers would have less to fear.

ADRIAN JARVIS: I think so. If you buy a concentrated reactive manager, you're making a very different statement, or buying a very different sort of thing.

GEORG INDERST: The classic question to the quant managers in selection meetings is, 'How often do you tinker around with your model if you feel it is not working any more?' I would like to ask this question now to the experts; do you reassess the various factors and how they're being weighted or is it all cut in stone?

TONY SUTTON: We are set in stone. It stems from our investment philosophy of prices following wealth, and using only wealth measures. So in a traditional quant approach where they can change their model, we do not.

GEORG INDERST: But then the question might be, 'Well that may work for a certain period of time but there are structural changes in a market, for example dividend policy, payout policy, and share buy-back. How do you deal with that?'

JASON HSU: This is again where Research Affiliates' methodology is really different from the GWA thinking. For us, the choice of the metrics, and in this case we use four, and FTSE GWA uses three, is, to a very large extent, immaterial, meaning the factors are only used to proxy for capacity and liquidity in the representatives.

If we reach a point when there is a belief that a company which is large in cash flow, sales and book value is no longer large in a sense that it represents a big part of the economy and no longer gives you capacity and liquidity; that would be a time when FTSE and Research Affiliates would need to sit down and revisit the methodology.

But I don't think that's going to happen, because big companies, no matter how you slide and dice them, are going to get you liquidity, capacity and representativeness.

TONY SUTTON: That is probably the key point we disagree on. We view the choice of metrics as material. Lack of a logical belief system leads to arbitrariness. For example, the reason GWA chose not to go down the dividend path is because it is already included in cash flow and a large number of companies don't actually pay dividends.