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Lessons from the big guys

Large funds using indexed strategies

Michael Nairne, Serious Money

Dozens of studies have concluded that past performance is at best a weak and unreliable predictor of future performance. You may as well use a dartboard to select your managers, writes Michael Nairne.

What do the world's largest sovereign fund and the largest U.S. pension fund have in common? Sure, they both manage hundreds of billions of dollars. And yes, they both enjoy access to some of the world's smartest investment minds.

More important for serious investors is how they manage their equity investments.
The answer? They make significant use of indexed strategies. In fact, both funds -- the Abu Dhabi Investment Authority (ADIA) and the California Public Employees' Retirement System

(CalPERS) -- invest the majority of their equities in indexed strategies that seek to replicate the returns of market indexes such as the S&P 500 instead of using stock-picking active managers. They have found that over the long run, active managers are usually unable to make good on their claim of market-beating returns. In 2007, AIDA increased its allocation to indexed strategies to 60% from 45% after an outside consultant found many of their money managers lagged their benchmarks. CalPERSs invests between 52% and 82% of its global equities in indexed strategies.

These two funds have lots of company. In a soon-to-be released report, investment research firm Greenwich Associates disclosed that U.S. endowments and foundations, known for their cutting-edge thinking, are increasing their allocations to indexed management. Large endowments and foundations now have nearly 70% of their U.S. stocks invested in indexed strategies.

Savvy institutions have woken up to the mathematics of active management explained by Nobel laureate Bill Sharpe nearly two decades ago: Investors as a group -- comprising either indexed or active investors -- earn the market return before costs.

Since index managers replicate the market return, active managers as a group must also earn the market return. However, since active managers charge much higher fees than index managers, active managers, therefore, under-perform index managers net of fees. This irrefutable reasoning has become experiential reality.

What about hiring that one superstar manager who can be expected to outperform?

Sorry, but literally dozens of studies have concluded that past performance is at best a weak and unreliable predictor of future performance. You may as well use a dartboard to select your managers.

A dozen years ago, Canadian investors could not really emulate an index-based investment approach. Indexed strategies such as those replicating the S&P/TSX Composite Index or the DEX Universal Bond Index were not available. The few strategies that did exist --Toronto Index

Participation Shares that tracked the TSE's 100 largest stocks or Standard & Poor's Depository Receipts (called SPDRs or "spiders") that track the S&P 500, were not well-known. Active management was the only real option.

Today, the explosion in exchange-traded funds has been a real game changer. ETFs are investment funds that trade daily on stock exchanges. The majority of them are designed to track indices. There are now nearly 900 ETFs available in the United States and about 140 in Canada, allowing serious investors to design a globally diversified, multi-asset class foundation for their portfolios. ETFs also track value and growth stock indices, as well as large and small company indices and sectors, thereby allowing different exposures to these dimensions of the market.

It is no surprise that a recent U.S. survey found affluent investors are increasingly using ETFs as an integral part of their overall portfolio strategy. The many advantages of ETFs -- low cost, broad security diversification, transparency, liquidity -are often coupled with greater tax-effectiveness because of lower portfolio turnover and an ETF's unique redemption structure.

Move over, CalPERS, it doesn't take billions of dollars to invest wisely.

-Michael Nairne, CFP, RFP, CFA, is the president of Tacita Capital Inc., a private family office and investment counselling firm in Toronto.