Evidence-Based Investing Captures What Traditional Indexing Leaves Behind

Ryan Jennings, Wealth Advisor

Prior to joining Buckingham Strategic Wealth, I worked with institutional clients educating them and supporting their use of indexes within their global equity portfolios. At the time, I was working with MSCI – the index giant – out of their Chicago and San Francisco offices. My clients included some of the largest public pensions in the world.

My meetings usually included one of two discussions: Index data for performance comparisons against the client's manager line up (active), or using an MSCI-based index as a means of creating an index fund (passive). More and more of my conversations began to be centered on the latter as the rise of passive investing began to take hold.

A pension client would come to MSCI and ask us to create a custom index. We would work with that client and an asset manager – think Blackrock or State Street, or some other large asset manager – and together we'd create a custom index fund that the client would allocate a portion of their portfolio to. The client was using the index to get exposure to a piece of the global market where they didn't believe active management was worth the money.

Beyond just using a market capitalization index, where I really grew busy was working with clients who were interested in using MSCI's growing suite of factor indexes. To review, factor indexes are like regular indexes, except they take a certain characteristic and tilt towards or away from that characteristic. One that got a lot of attention while I was at MSCI was their Low Volatility Index. This is where the index captures excess returns to stocks with lower than average volatility. Small cap and value are additional examples of factors.

This investment approach made sense to me. Historically, if certain factors outperformed the market, then I should have exposure to those factors, and overtime, I'll earn more than the market. The benefits here were not only long-term outperformance, but also very low fees, given implementation was done using an index fund.

Here at Buckingham Strategic Wealth, we use the evidence-based investment approach, which retains the benefits of indexing, yet improves upon the traditional indexing model with additional strategies.

Indexing has received a lot of press over the last decade and for good reason. Low expenses, low turnover, and smart ways to invest (think growing number of ETFs) have made indexing an easy way to get exposure to the markets. On top of this, active managers have continued to perform poorly against their respective benchmarks, making indexes an easy default investment choice for many market participants.

Based on my experience working for an index firm, and now managing portfolios for clients using an evidence-based investing philosophy, I'd like to highlight a few areas where an evidence-based investing approach can capture what traditional indexing leaves behind.

Rebalancing

Although there are different index providers in the marketplace, each one has some form of rebalancing approach that is used throughout the year. The indexes are set up one day, allowed to drift and then on another day of the year, the index rebalances – some companies drop out as they no longer meet the criteria – usually a market-cap size – some companies are added as they now meet the set criteria. There is a warranted rigidity that is needed for indexes, however, this component of the index maintenance process throughout the year is one area where evidence-based prefers a different approach.

By creating buy and hold ranges, an evidence-based approach has the flexibility to reduce portfolio turnover throughout the year. When opportunities do arise to gain more from the positions within these funds, our fund managers are able to strike.

Additional Screens

When working at MSCI, it was known that you had to memorize the methodology of how our indexes were created. This methodology was the competitive recipe of our indexes and it was so smartly created. Similar to rebalancing though, the screens that were used within the index creation process needed to be applicable across all stocks, globally. Inherently there needed to be some structure in place to provide this consistency on a global basis.

With evidence-based investing, additional screens can be applied less globally but more specifically to improve returns. Be it avoiding certain types of stock or ensuring that the holdings of the evidence-based funds comprise companies that are being traded among a minimum number of market makers.

Block Trading

Block trading is one of those aspects of investing that most people don't care to know, but given the structure of evidence-based investing, there are small opportunities across the trading spectrum that clients can benefit from. Given the black and white nature of indexes, when a holding is included or excluded from an index, that issue must be purchased or sold in its entirety. When those transactions take place, the trade is at the mercy of the market that day. This 'block trade' takes place regardless of market conditions.

With evidence-based investing, the manager has an inherent flexibility that an index manager just doesn't have. The EBI (evidence-based investing) manager can be more flexible in entering or exiting positions. By exploiting this flexibility during the trading process, additional returns can be earned.

Most investors would benefit from adhering to an index-based investing philosophy for a large portion of their portfolio. Especially those investors who have historically played in the arena with active management funds. A reduction of expenses would be one of the most immediate results.

However, as laid out above, although there are positives with indexing, by accepting tracking error risk and integrating evidence-based investing within your philosophy, you're able to take advantage of what indexing brings to the table, while at the same time improving future expected returns.

By clicking on any of the links above, you acknowledge that they are solely for your convenience, and do not necessarily imply any affiliations, sponsorships, endorsements or representations whatsoever by us regarding third-party Web sites. We are not responsible for the content, availability or privacy policies of these sites, and shall not be responsible or liable for any information, opinions, advice, products or services available on or through them.

The opinions expressed by featured authors are their own and may not accurately reflect those of The BAM ALLIANCE®. This article is for general information only and is not intended to serve as specific financial, accounting or tax advice.

© 2019, The BAM ALLIANCE®