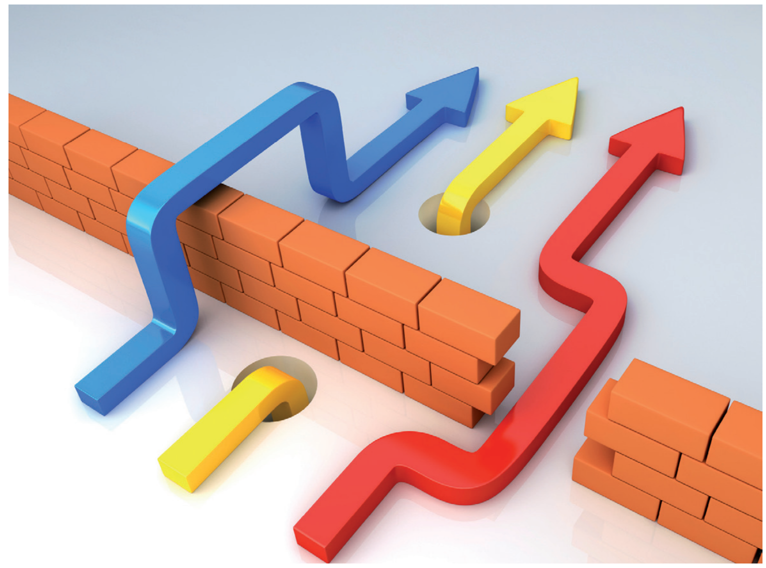
# Index-tracking investing

## Investment strategies

# Path of least resistance

Index-tracking strategies have come of age in the past decade, with increasing numbers of portfolio managers using passive investments tactically **By Stephanie Spicer**



One of the most striking changes in investor behaviour of the past 10 years has been the increased use of index-tracking products. Passive mutual funds, exchange traded funds (ETFs), and more recently smart beta products have increased in volume in the teeth of both recessions and equity market booms.

In 2014 alone, there was an €80bn net inflow into passives, pretty much evenly split between open-ended funds and ETFs – see chart 1 for a full breakdown.

If you look at graph 2 on page 16 you can see how the biggest three categories of ETFs did: equity, bond and commodity. Aside from a couple of glitches (fixed income in 2011 and commodities in 2013 and 2014) money has poured into ETFs for the past five years. There is a similar story with open-ended passives.

Looking ahead, it does not look like this trend will change soon. Graph 3 on page 16 shows that across Europe more than a quarter of all fund selectors and asset allocators are intending to use more passives in their portfolios over the next year – only a small number are planning to reduce their weighting.

That aggregated number does hide a substantial variability – only half of the Portuguese investors use index trackers, as opposed to 90% in Luxembourg – but broadly it is clear that these products remain popular with high level fund selectors.

What is driving the trend? When asked, individual fund selectors cited a variety of reasons, but in the main it was to make short-term bets.

Fund selectors are also invested fairly widely in terms of asset classes and regions depending on their respective portfolio risk profiles and assessment of regional and sector economies and performance.

### Country trends

Focusing on France, we can see from chart 3 that fund selectors there are moderate fans, with 16% seeking to increase their allocation and 63% to maintain it.

While having always used trackers for small investments of up to 10% of a portfolio, Tristan Delaunay, chief executive officer and head of fund selection at Athymis Gestion in France, currently holds 0% to 2%. He adds that he has a new "small position in one smart beta fund" representing 2% to 3% of portfolio.

In Finland, index trackers are very popular, with more than 40% of fund selectors looking at increasing their allocation. Consistent investing in these instruments has been the strategy for Evli Bank in Finland.

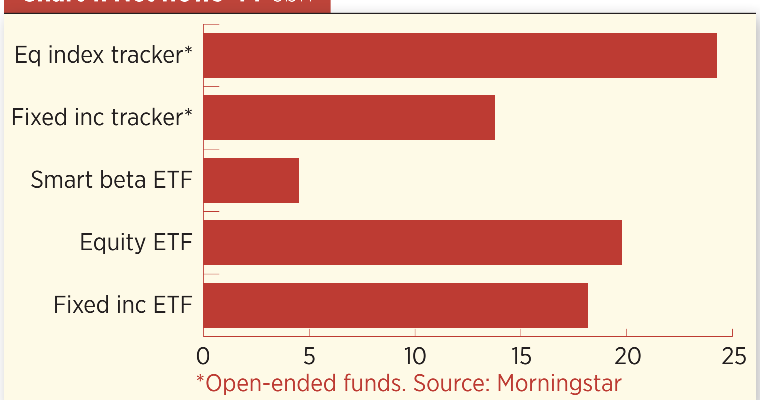
"We have kept the levels the same for almost two years in passive index tracking ETF-products," says Tanja Wennonen-Kärnä, senior portfolio manager for Evli Bank.

She says the passive products the bank uses vary a lot depending on the type of client – private bank, institution, foundation, company. And while Evli does not currently have any smart beta products in its portfolios, Wennonen-Kärnä says it is something Evli is considering.

In Norway, the average fund selector would appear to be selling off their passive holding, but others are bucking this trend.

Arild Orgland, managing partner at Industrifinans in Norway, says: "Overall, we have increased the use of passives quite substantially," he says, "but that's mainly because our institutional client business has increased a lot. Our private clients are more absolute return oriented and are still primarily using active funds." ▶

**Chart 1: Net flows '14** €bn




*Open-ended funds. Source: Morningstar

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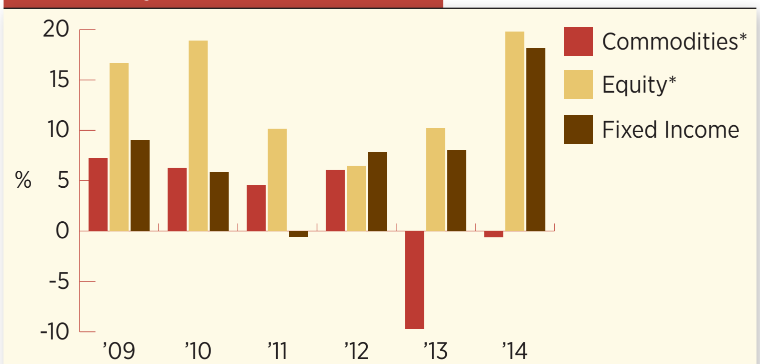
**Arild Orgland,** managing partner, Industrifinans

**Summary**

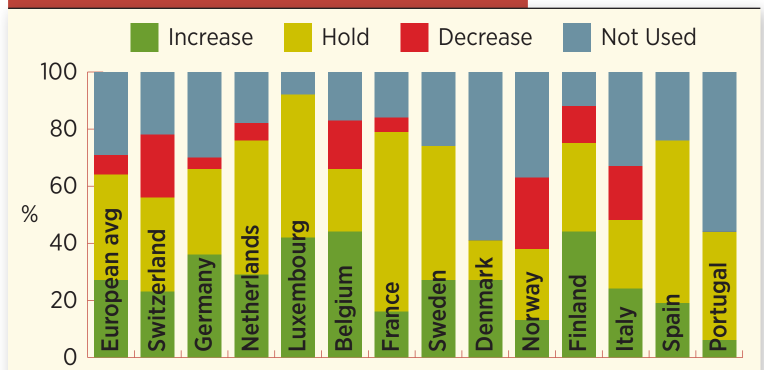
- The use of index-tracking funds continues to grow among European fund selectors.
- They are used primarily for three reasons: one, where the market is so efficient that there are very few alpha-generating fund managers; two, to get quick access; and three, to get access to smaller markets where there are few active managers.

**Chart 2: 5-year flows into ETFs** €bn




*ETFs. Source: Morningstar

**Chart 3: Passive funds** allocation intention




Source: EIE Research snapshot Q1 '15

## Tactical investments

It tends to be the case that passive funds are short term holdings, held often for tactical reasons.

"ETFs are quoted and so are more liquid, and smart beta funds are easier to predict and able to mimic indexes that are difficult to beat," says Delauney.

Wennonen-Kärnä agrees: "We mostly use passive products tactically, short term, but also when active managers do not have their best period (as US managers did in 2014)."

Orgland says that institutional clients use passive funds both as core holdings and for tactical purposes and when rebalancing portfolios.

"The advantage of passive funds is that you avoid having to explain negative deviations in returns," he says. "They are also cost efficient. We notice, however, that the fee differences between passive and active funds are decreasing."

Fund selectors are broadly agreed that, whether investing for individuals or institutions, it is risk profile and the costs of portfolio management that dictate selection rather than any preference on the part of clients.

Where there is client input, Orgland says: "Institutional clients tend to be more oriented towards relative risks to benchmarks, measuring relative volatility, tracking errors and information ratios – while our private clients are more focused on absolute returns and sharp ratios. It is quite obvious in this context that index funds have the greatest appeal to institutional clients."

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**Tanja Wennonen-Kärnä,** senior portfolio manager, Evli Bank

## Asset classes

But what about asset class and region? Delaunay is invested in, among other areas, emerging debt in local currencies, where he sees attractive yield, with currencies stable against the euro and decreasing rates. In Chinese equities, he highlights the discount between A & H shares and considers financial equities cheap and correlated to markets.

In Norway, the core asset classes are Norwegian and global fixed income and Norwegian and global equities, according to Orgland. "There are three big sub-regions in developed markets and allocations to emerging markets," he continues. "Real estate is the big asset class in alternatives, while high yields are actively pursued within fixed income."

As for areas to avoid, Delaunay cites govvies and investment grade (IG) credit as too expensive, and Russia and Brazil as economies in crisis.

Wennonen-Kärnä has an overweight in European and Japanese equities and underweight in the US and the emerging markets.

"We try to avoid the markets that are most exposed to higher rates in the US, though have a difficult time increasing earnings," she says.

"On the fixed income side, we underweight European government bonds and overweight European high yields."

Orgland says the crucial question for everyone in these times is whether the current interest rate level is transitory or long lasting. "Risk assets have gradually been revalued by the market to the current interest rate level," he says.

As a consequence he tries to avoid low quality assets, while still participating in the bull market upturn. "US equities appear expensive with dollar and real wage increases as current headwinds. However, the US may have some of the best quality companies in the world. The big tail risk in the market would be some kind of big liquidity issue or credit crunch starting to unfold. The warning sign will be increasing credit spreads," he adds.

While index trackers and passive instruments generally with some smart beta investment considerations are proving extremely useful, there is still much focus on stock and asset selection and high yield options within acceptable risk parameters.

Certainly, when it comes to country averages; whether passive or active investing within those regions there will be fund selectors breaking away and following overweight and underweight positions contrary to their peers. That in itself is something to track.

The advantage of passive funds is that you avoid having to explain negative deviations in returns. They are also cost-efficient. ●

## Europe lags behind US

Assets held in index-trackers in Europe have grown by 140% since 2009 to €760bn by the end of 2014. This is just 7% of total assets under management on the continent, compared to more than 35% in the US, suggesting there is still a long way to go for passive investments

According to EIE data, ETF usage is more widespread in the Netherlands than in any other European country. Some 95% of fund buyers there use index-trackers, compared to 70% on average in Europe. Luxembourg is the only other country in Europe where more than nine in 10 fund buyers use ETFs. A reason for the popularity of ETFs in the Netherlands is probably the abolition of distribution fees last year, anticipating on the implementation of the MiFID II directive. This had made investors in the country more cost-aware, providing a boost to lower-fee products like ETFs.