



ENHANCED APPEAL: GOING AFTER THE ETF CROWN

Can a new breed of hybrid enhanced index funds match the mass market appeal of exchange-traded funds?



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Enhanced index funds offer investors a unique hybrid between active and passive management techniques, by broadly matching a benchmark index, while utilising a range of factors to enhance performance, such as value or earnings momentum.

Kasim Zafar, portfolio manager at EQ Investors, highlights the flexibility such funds provide.

'The pros of these products are that they offer a cheap and passive exposure to some common investment styles that allow portfolio managers to act quickly when opportunities arise, if we don't have

managers approved on the buy list,' he says.

'Also, where active managers provide exposure to a style, it becomes possible to more accurately measure and compensate for alpha delivered.'

The variety in investment styles from enhanced index managers also offers investors an array of different approaches when running the rule over prospective investments.

This choice can prove beneficial, but as Zafar explains, it must be made with real consideration.

'On the cons side, the products available do not all use the same methodologies to provide exposure to the various index enhancements. Hence, investors must take care

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KASIM ZAFAR
EQ INVESTORS



when analysing processes and comparing performance,' he adds.

With one foot in both the active and passive camps, the suitability of enhanced index funds can often come down to a matter of perception. This is a view shared by Thomas Watts, investment analyst at Cumberland Place, who suggests that it should perhaps come as no surprise that today's investors are seeking a best of both worlds approach.

'Any opinion on enhanced index funds has to derive from an investor's view on the effectiveness of either traditional active or passive funds,' he says.

'Both have their faults and perhaps the rise of enhanced indexing



unds can be largely attributed to portfolio managers wanting to diversify through asset classes that incorporate the best of both worlds.'

Of course, enhanced index funds do not possess a monopoly on the concept of generating enhanced returns from a portfolio closely aligned to an underlying benchmark. Smart beta exchange-traded funds (ETFs) also offer investors exposure to a benchmark optimised for enhanced performance – but that's not all these funds have in common.

MORE INFORMATION NEEDED

As more enhanced index and smart beta products are launched to the market, some investors believe they are not being paired with sufficiently adequate information, detailing the mechanics of the respective strategies. As Mark Williams, investment manager at Charteris, explains, this is something that may be hampering investor demand for enhanced index funds in some quarters.

'There isn't enough information or awareness surrounding this product in the current marketplace, but that may be because the investor demand is not there. When an investment vehicle becomes popular, you tend to find that more information and awareness is forthcoming,' he says.

'This product still has the specialised tag hanging around its neck, and in the current financial climate, that is not what investors seem to be seeking. If there was more information surrounding these types of products that heightened the understanding, maybe the investor demand would rise over the longer term.'

Williams feels enhanced index funds are not doing enough to persuade him to add any to his portfolios. 'Despite being the "new kid on the block" in the mid-70s, enhanced index funds haven't caught the imagination or popularity that other investment products like ETFs have managed to do, either with investors or institutions,' he says.

'We have, as a company, zero exposure to enhanced index products at the moment and that is unlikely to change in the short to medium term. However, if there comes a point in time where this product matches the suitability and requirements of a private client, then we would not be doing our jobs properly if we were not investigate this product as an option.'

ACTIVE MANAGEMENT ELEMENT

For those looking for an index-like experience with an added edge, the actively managed element of the enhanced index approach can be an attractive feature.

As Williams points out, however, melding active with passive can prove to be a double-edged sword – particularly within today's stormy financial waters.

'Pros for this product would be the goal of doing better than the index you are tracking and enhancing returns, but that is by no means a guarantee,' he explains.

'Traditionally, these products are associated with higher fees, higher turnover inside the product (as it is usually actively managed) and the ability to encourage extra leverage, which is always associated with being in the "higher risk" category. Market timing when leverage trades are placed will also be brought into question.'

Conversely, Zafar sees far more potential for enhanced index funds to rise in popularity – albeit with the caveat that providers still have work to do.

'Awareness and availability of this type of investment is increasing, but it's still relatively early days,' he says.

'Some institutional investors have made large changes to their investment processes in recognition of the opportunity. We expect the wealth management market will also gradually adopt these products.'

But will solid interest translate into firm take-up? Zafar believes so, suggesting that enhanced index funds add another string to the bow

of portfolio managers.

EQ Investors already use one such product to access the value premium in the US equity market, and moving forward, Zafar believes others may well do the same.

'They [enhanced index funds] mix the best of both passive and actively managed funds, although it's obviously still early days. The funds also carry lower expense ratios compared with active funds, which should appeal to most investors,' he says.

PASSIVE COMPARISONS

Although acknowledging the potential enhanced returns on offer, Williams remains sceptical about the heightened risk element when comparing enhanced index funds with other passive products.

'If a client wants to track an index and it suits their requirements, that's the level of exposure they wish to have to markets. The number of tracker products out there that just track an index (foreign or domestic) is plentiful and those products move up, down or sideways with the market, and investors are familiar with the levels of volatility that those main indices can have,' he says. 'Why have additional risk on top of that?'

'If I want to invest in a fund that will attempt to beat a major index, not only are there loads to choose from, but I am not restricted to buy a tracker product.'

Drawing on the smart beta comparison, Watts believes enhanced index funds fall into what he describes as the 'they work well, until they don't' category of investments – where back-tested data usually gives such funds a pristine return profile.

In his view, the product's lack of a human element can be both a curse and a blessing.

'It is tough to determine what combination of strategies is best for a portfolio, let alone assess what future return profiles should look like,' he explains. 'Such issues exacerbate the charges enhanced index funds can

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MARK WILLIAMS
CHARTERIS



often demand. It seems the investor is paying an awful lot for a fund that is being tweaked occasionally, adding risk to gain potential rewards, enduring prolonged periods of volatility and underperformance, when a standard tracker often beats many of the products out there.'

Despite this, Watts sees a capacity for enhanced indexing funds to grow in popularity, should providers strive to improve investor understanding. He points to the success smart beta products have enjoyed in recent years as a blueprint providers could follow.

'For several years now, smart beta has been even more smartly marketed, and I expect the sector to grow in popularity,' he says.

'Enhanced index funds, despite their shortcomings, still offer transparency, liquidity and act as a diversifier alongside more traditional asset classes – something all investors crave.' ■