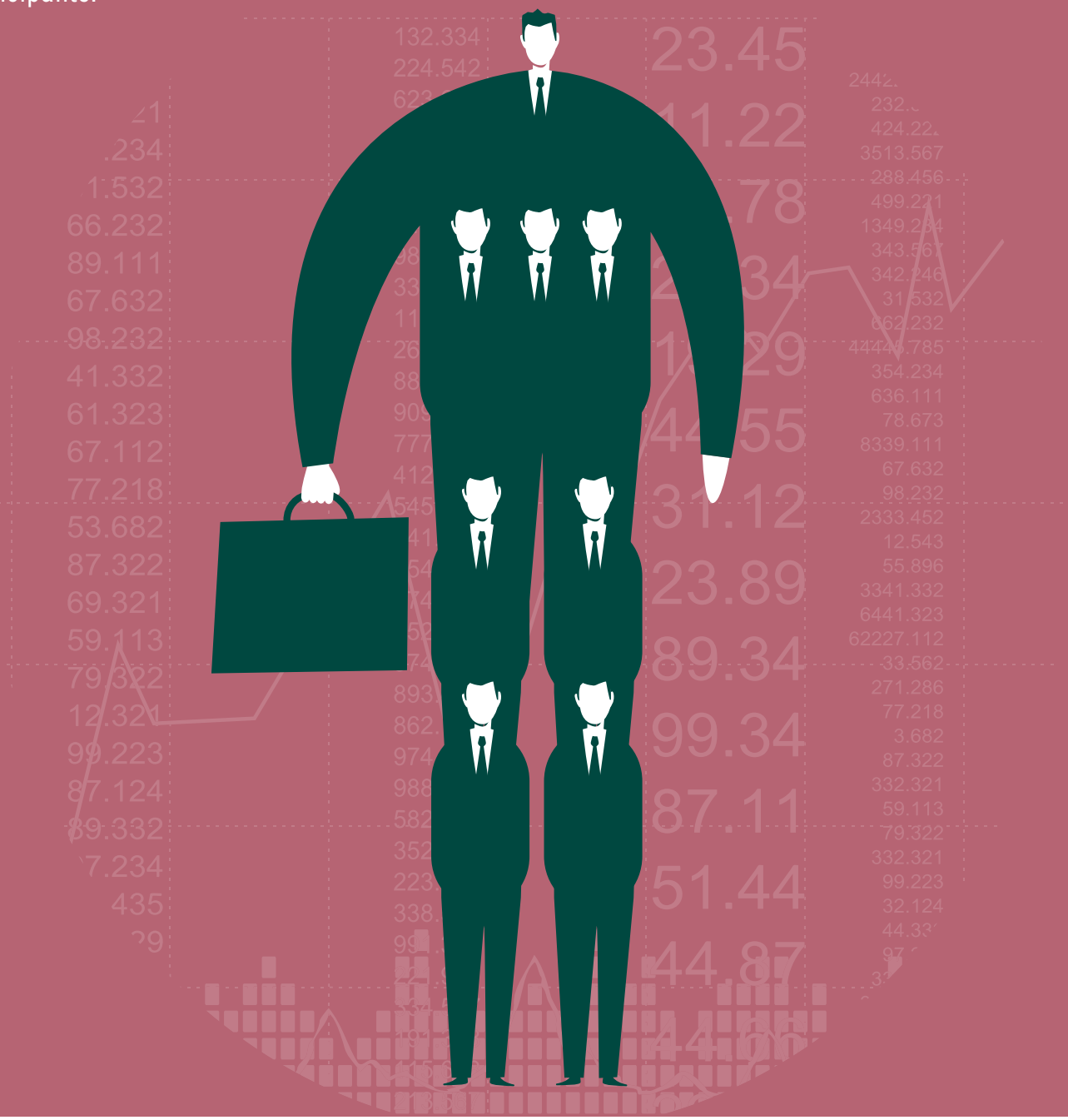
Indexing Versus Active Management

Providing efficient portfolio building blocks for participants.

BY CHIP CASTILE



Increased focus on fees, investment expenses and transparency is fueling a growing trend toward index strategies in DC plans. Of course, indexing is not new in DC; it has long had a significant role in mega and large institutional DC plans. But now, the industry is seeing indexing gain interest and momentum in the small- and mid-sized plan markets as well.

Putting aside the specific factors that might drive the choice for an individual plan, the choice between indexing and active management by plan sponsors is driven in part by practicality and part by investment philosophy. On the practicality side, index management is generally going to be less expensive than an equivalent actively managed exposure. As for investment philosophy, if your goal is to capture market returns as closely as possible, then indexing may be the right choice. If, however, you believe that a good investment manager can capture above market returns — the ever-elusive alpha — then that can only be done through active management, often through stock selection or by having the flexibility to go to cash when the manager sees a lot of uncompensated risk in the market.

It is usually an either/or choice — plans either use index funds or they use active managers.

However, this is not generally an either/or choice by the plan sponsor. From the plan design point of view, the first-tier choice should be a qualified default investment alternative, such as a target date fund or an allocation fund that may use indices or active managers.

The second tier may be comprised of the building blocks of a diversified portfolio. A suite of efficient, professionally managed index funds based on a range of recognized indexes provides the ideal building blocks and allow investment managers or individual participants to execute allocation strategies with minimal concern for tracking error.

The third tier may be comprised of more specialized exposures, including both index and actively managed funds, for more investment-savvy participants.

We're seeing a trend toward indexing in the small- and mid-plan space, particularly with respect to mutual funds. This is partly in response to the recent regulatory focus on fees and the desire for increased transparency. Plan sponsors like the fact that mutual funds have publicly available prices and detailed, standardized disclosures for prospectuses and order communication. Of course, we have seen the trend toward indexing for some time in the Collective Trust Funds (CTF) space, which generally serves mega and large plans.

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Industry wide, it's expected that assets in index products will have doubled from 2005 to 2015. This makes sense when you recognize that this would bring it closer in alignment with the percentage of indexing we see in defined benefit plans.

Index-based target date funds are an attractive option for many of the same reasons. But you need to frame up the conversation about index and active management in target date funds differently. You need to talk about how that difference in investment philosophy influences the glidepath as a target date fund matures. The glidepath is designed to achieve an expected terminal value, but there is a distribution of expected outcomes around that terminal value. This is regardless of the investment horizon, although the longer dated a target date fund is, the wider the distribution is likely to be.

The question is: can you get the distribution that you want through the use of index or actively managed funds? We think you can with either.

As for how the active/passive choice influences the range of expected participant outcomes, let's assume we're building a target date fund with a maturity 15 years out. As you follow out your expected risk and returns across 15 years, the range of outcomes broadens as you approach maturity. It's really the glidepath, which captures 15 years of strategic asset allocation adjustments, that is shaping this distribution of outcomes. The difference in range of outcomes between active and index management is marginal in comparison. Marginal, but still important.

Indexing will provide a slightly more narrow range of outcomes. Lower fees are part of that tighter distribution. The distribution of outcomes from active management will spread a little higher in the range, offering more return if it is successful and a little lower because it has more risk in it. Successful active management can get you higher consumption for the same level of savings.

Active management also offers the potential to shape distributions, ideally by cutting off the lower range of expectations and reshaping the range of outcomes to skew more positively. This can be done on the manager level, if the individual manager has a flexible enough mandate, or at the asset class level by reoptimizing a multi-manager allocation to manage risk. On the other hand, the stronger your belief in the glidepath and the consensus strategic assumptions built into it, the more attractive a pure index approach may be. You give up the potential to shape distributions, but gain greater certainty that you will accurately capture the market.

Of course, you can do both within a glidepath and we think it's a potentially attractive way to go. It gives you the choice of how to spend your risk capital and where to seek your alpha opportunities. Within the large cap asset class, for example, you can take on active risk by selecting managers within certain style boxes, such as growth, value and so on, add index exposure, and reoptimize the portfolio to potentially achieve greater returns for the same level of risk.

Ultimately, it's a matter of understanding the differences. Index funds give you a tighter distribution of outcomes. If that's important to you, then that is the approach to take. But that means giving up any opportunity that active managers have to reshape the distribution of outcomes in a favorable way by taking less risk when they don't expect to get paid. That is a perfectly reasonable trade-off to make. The key is understanding what you're doing and being really explicit about what you want the outcomes to look like. Both can be incorporated into a plan's design in a thoughtful way.

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