Indexing Vs. Strategic Index Asset Class Investing

FINANCIAL WEALTH BUILDERS SECURITIES

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Overview

Many investors may believe that passive investing means simply buying index funds. However, there are some key differences between index investing and strategic index investing. The following discusses some of those differences.

Many investors realize that a passive investment approach offers many benefits when compared with an active investment approach. Passive investing involves buying and holding market components, whereas an active manager tries to pick the next winning stock or time where the market is headed next. A passive approach offers these major benefits.

- By holding entire market components, one maximizes the benefits of diversification.
- By "titling" the portfolio to riskier of less risky components, the investor can expect to capture the highest market return given his or her risk tolerance.
- The investor maintains control over his or her own portfolio's components (by avoiding active funds' tendency to style drift without the investor's knowledge.
- Expenses can be minimized.
- Tax efficiency can be maximized

To implement a passive investment approach, investors can choose from;

- Index Mutual Funds
- Exchange Traded Funds
- Strategic Index Asset Class Funds

Investors may wonder, "Why shouldn't I just by index funds instead of strategic index class fund? What is the benefit of strategic index asset class management versus "index" investing?"

This historical evidence has shows that the index investing and strategic index asset class investing in individual stocks or actively managed mutual funds. But building a portfolio of strategic index asset class funds expands upon the benefits of index investing while minimizing some of its potential negatives.

First let's explore the differences between the two. To use an analogy, strategic index asset class funds relate to the index funds as squares relate to rectangles.

- All squares are rectangles, but not all rectangles are square.

- All index funds are passively managed, but not all strategic index asset class funds are index funds.

An asset class is a group of stocks with similar risk characteristics, such as domestic or international, large-cap or small-cap. An asset class also is a combination of similar risk characteristics, such as "US small-cap values stocks" or "international large-cap growth stocks." An investment firm can create its own definition of an asset class and then passively manage a fund based on that definition. In such cases, there may not always be a specific index that represents or tracks that asset class.

Strategic index asset class funds retain the benefits of indexing. They are relatively low cost, low turnover and tax efficient. However, they improve on the index model through additional strategies. Let's look at some of the ways a strategic index asset class fund can improve returns.

Creating a Buy-And-Hold Ranges

Index funds must sell a stock when it leaves the index. For example, if a small-cap stock increases in market capitalization so that it is no longer par to the small-cap index, the fund tracking that index must sell it. This creates turnover and tax inefficiency.

In contrast a Strategic Index Asset Class fund has the flexibility to create buy-and-hold ranges that enable the fund to hold a stock even if it falls out of the appropriate index. Properly implemented, buy-and-hold ranges help reduce turnover and increase tax efficiency while still enabling the fund to remain true to its stated asset class definitions. For example a Strategic Index Asset Class small-cap fund might establish a range in which it buys all stocks in the smallest 8 percent of market cap. But the same fund might establish that it won't sell the stock unless it grows beyond the smallest 10%.

Eliminating Certain Stock Types

Based upon academic evidence, some stock types have been demonstrated to result in historically poor returns and passive asset class funds can screen these stocks. For example, initial public offering (IPO) stocks have demonstrated poor historical returns in the initial years following the IPO. Based on this evidence, a strategic index asset class fund might eliminate all the IPO Stocks have demonstrated poor historical returns in the initial years following the IPO. Based on this evidence, a strategic index asset class fund might eliminate all IPO stocks until they have a seasoned a certain number of years, at which point they become eligible for purchase.

The NASDAQ stock exchange has much less stringent listing requirements than does the New York Stock Exchange. As a result, the NASDAQ experiences for more stocks that eventually "delist" due to frauds and other financial weaknesses. By establishing a screen calling for greater financial requirements (such as those of the National Market System) a strategic index asset class fund can reduce its exposure to stocks that eventually delist.

Establishing Additional Common-Sense Screens

Strategic index asset class funds are essentially free to establish additional screens that can be demonstrated to improve net returns. For example, the trading costs of the small-cap stocks can be significantly higher than those of large-cap stocks, small-cap stocks, as small-cap stocks typically experience lower levels of liquidity. Therefore a strategic index asset class fund might establish a screen that no stock will be traded unless there are a certain number of minimum “market makers” (i.e. parties interested in trading the stock)

Taking Advantage of Block Trading Techniques

A small-cap passive asset class fund can also take advantage of its ability to remain flexible regarding its precise market cap weighting, whereas an index fund generally must maintain it specific defined weighting. By acting as a market maker in small-cap stocks, the strategic index asset class fund can earn not only the bid-offer spread, but it can also earn market impact costs.

The preceding terminology can be daunting to even relatively sophisticated investors, so let’s look at an example. Suppose an actively managed fund is selling a large block of a small-cap stock that is trading at 10 bid-10.5 asked (which means the broker/dealer is willing to buy at 10 and sell at 10.5). The stock has typically been trading just 30,000 shares a day, but the active fun wants to immediately sell 100,000 shares. However selling such a large number of shares relative to the stock’s typical trading level will drive the price much lower… even before they are done selling.

Before moving on with our illustration it is important to understand that the stock’s next move is random, per the Efficient Market Hypothesis. The fact that an active funding manager is attempting to sell a stock does not actually indicate whether the stockroom move up or down. Therefore a strategic index asset class fund can benefit from what is more than likely a misplaced sense of urgency on the part of the active manager. For example, strategic index asset class fund might establish a range of appropriate market-cap weightings it is willing to own – such as ranging from half to double its target holdings.

Returning to our illustration, the strategic index asset class fund manager might check in the funds current holdings, determine it is holding 200,000 shares and conclude that it can hold up to 400,000, given the range it has established. Knowing that he or she can purchase the 100,000 shares and that the active fund is desperate to sell, the strategic index asset class fund manager might submit a bid of 9.5. If the bid is won, the likelihood is that the stock will return to trading at 10 bid-10.5 ask. The strategic index asset class fund might then offer a small amount of stock at 10.375. It may even find a buyer who is looking to buy a large block and pay premium for it. By earning the bid ask spread the market impact cost, the strategic index asset class fund has created the potential to his return to enhance returns through negative trading costs.

ADDING TAX MANAGEMENT STRATEGIES

As we have seen strategic index asset class funds have many advantages over index funds. However strategic index asset class funds that also engage in tax management strategies can do even better.

While strategic index asset class funds are already relatively tax efficient (compared with actively managed funds), there are additional strategies that can be employed to further improve their after-tax returns. These strategies include the following techniques.

- Fund managers can avoid taking international short-term capital gains. Stocks that should be sold because they have moved beyond their hold ranges are not sold if they are not yet eligible for long-term capital gains treatment. Once the required one-year holding period is reached, the stocks will then be sold. This lowers the tax rate on the capital gain from ordinary long-term capital gains rate.

- Stocks that have significant losses can be sold to harvest those losses. The stocks can then be repurchased following the 30-day waiting period required to avoid violating the wash sale rule.

- Specific lot accounting is used to minimize realized gains on sale. The stocks sold have the highest cost basis.

- Fund managers can avoid purchasing stocks just prior to the ex-dividend date. This reduces the amount of income that will be taxed at higher or ordinary income tax rates.

SUMMARY

The academic world has provided investors with a roadmap to a prudent investment strategy based on strategic index asset class investing. Building a globally diversified portfolio of strategic index asset class funds is most likely to allow all levels of investors to achieve their financial goals with the least amount of risk, particularly when they partner with an investment advisor who is experienced at implementing and maintaining a strategic index asset class portfolio

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Next Step: Simply complete a request for info at www.fwbsecurites.com or call us at 1-866-735-5581 and ask for Paul Philip or Ennio Longo.

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Paul Philip

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Today's traditional financial planning is sorely lacking. Financial institutions and the media are in business for themselves and it's up to the consumer to recognize this and take responsibility for their own future. For most, finance and economics is too complex and fast changing to manage effectively by themselves. I believe what most people really want is expert professional guidance that they can trust, someone who has their back….and at a fair price. I believe in openness, transparency and value for your hard earned money.

Paul lives in Toronto with his wife Susana and their 2 daughters, Julia and Jacqueline. He is active in his community and is a volunteer coach for underprivileged youth. He is an avid squash player, and loves to have a good time skiing and travelling with his family.

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Ennio Longo, BBA, CFP has been in the financial services industry since 2007. Since that time, Ennio has sought to continually find new and better ways to help his clients in their financial lives. Ennio holds the Certified Financial Planner (CFP) designation and has successfully completed the Canadian Securities course. Ennio specializes in providing holistic financial planning for his clients, raising the bar above the traditional approach employed in the majority of financial institutions. His greatest achievement is seeing the peace of mind his clients receive as he helps them build , protect and enjoy their wealth.

Ennio resides in Toronto with his wife Daniela and their three children Julian, Victoria and Samantha and his favourite past time is being a soccer coach to all three.

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