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Active research delivers excess returns

The JPMorgan Global Research Enhanced Index Equity Fund looks and feels like an indexing strategy but underneath is an active element providing enhanced returns.

It's built like a passive strategy yet the JPMorgan Global Research Enhanced Index Equity Fund* possesses an active quality that allows it to manufacture excess returns – a crucial element in the lower for longer return environment.

As its name suggests, the fund is supported by the manager's fundamental research capability: a team of 70 career analysts who target excess returns by actively exploiting stock-specific ideas.

J.P. Morgan Asset Management portfolio manager Piera Elisa Grassi says the long-term excess performance of Research Enhanced Index (REI) strategies is generally attributed to the ability of these analysts to deliver in-depth, stock-specific investment insights. Portfolio managers then focus on maintaining benchmark-style exposure without taking large sector, style, or regional risk.

Grassi says portfolio managers behind the JPMorgan Global Research Enhanced Index Equity Fund take a large number of small active positions in global stocks – overweighting positions in names the analysts find attractive and underweighting positions in the names they don't. It allows the managers to maximise exposure to the analysts' insights while keeping a benchmark-like skeleton.

"This is why the breadth and depth of research coverage by the asset manager is an important factor when investors are selecting the right enhanced index strategy," she says.

"Those managers that have the ability to cover a large proportion of securities in most benchmarks will have an advantage over those that have limited coverage. This is key to being a successful enhanced indexer."

The fund's goal is to deliver 0.75 to 1% of annualised excess returns (gross) at a tracking error of 0.75 to 1.25 percentage points versus the benchmark.

Grassi adds that enhanced index strategies are designed to outperform their respective benchmark and to do so with risk characteristics similar to that benchmark (see Figure 1).

Similar to an index fund, "REI strategies are close to fully invested at all times and therefore do not engage in market timing. Sector weights are also tightly controlled relative to the index and risk factor exposures are continually monitored relative to the index."

This rigorous risk management results in portfolios that look like the index in terms of risk, yet are designed to offer potential excess return. Additionally REI strategies are focused on delivering consistent outperformance which minimises active risk or tracking error, Grassi says.

"The advantages of passive management, aka indexing, are well known and obvious. Indexing is cheap, maintains the full risk diversification benefits derived from a plan's asset allocation decisions and holds few surprises beyond what the market delivers," she says.

"The disadvantages are also well known: One can do no better than the benchmark; stock selections are determined by the index providers; and stock weights are determined by the market.

"What if there was a way to potentially outperform the benchmark after fees and to do so with a risk profile very similar to the benchmark? Research enhanced index (REI) strategies are designed to offer such a solution."

The JPMorgan Global Research Enhanced Index Equity Fund can be invested either hedged or unhedged, with the investment objective to achieve long-term returns in excess of the MSCI World Index benchmark. Since inception in April 2015, the unhedged fund has outperformed the index by 0.15% net of fees.

The result, the fund manager says, is a core fund that aims to deliver positive alpha with low active risk.

It adds that both the hedged and unhedged funds achieve index-like characteristics with a disciplined focus on removing systematic risk, deploying risk controls such as region neutrality, sector neutrality within a region, small country deviations and style neutrality. It reinforces the manager's rigorous process of allocating active risk to the investment insights of its in-house research analysts.

Grassi says besides being low cost and low relative risk, one of the key benefits of the fund is that it provides an active overlay which is particularly useful given the current uncertain economic environment.

"With passive investing, an investor cannot outperform the benchmark. When markets are moving unpredictably, it is this added layer of active management, where the portfolio manager assesses the 'risk' and can make adjustments to the portfolio where necessary, that makes a difference. The JPMorgan Global Research Enhanced Index Equity Fund does this, while keeping the characteristic of the benchmark, and at low cost."

In the fund's April update to investors, J.P. Morgan Asset Management said consumer non-durable and industrial cyclical stocks contributed to performance over the month. On a regional level, stock selection was positive in all regions except Japan during April.

"Our overweight holding in Constellation Brands (consumer non-durable) performed well after reporting strong results and fears of Trump negatively impacting Mexico beer importation abating," the asset manager says.

Banks (capital markets), and basic industries detracted from fund performance – also where the manager is slightly underweight.

"Our overweight position in Capital One Financial detracted from performance after the company reported earnings below analysts' forecasts after increasing provisions for losses in the US card business."

"Our investment process emphasises stocks that rank attractively on the basis of our analysts' valuations: wide valuation dispersion provides an environment where there is potential for above average upside in these stocks," it says.

"The global economy continues on an economic upswing; in Europe and Japan, investors are increasingly expecting improvement in corporate profit and economic growth, where high corporate operating leverage combined with better nominal GDP growth should drive earnings growth.

"Globally political risk remains high, in Europe, with the ensuing elections and the UK's exit from the European Union, and in the US, doubts remain over Trump's ability to pass growth-invigorating policies." **FS**

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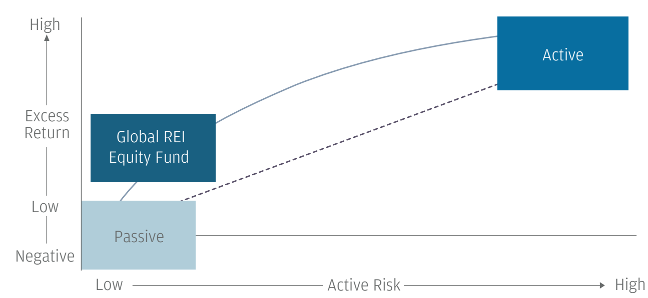
Figure 1. **Global Research Enhanced Index Equity Fund: Risk/Return profile**



The quote

The breadth and depth of research coverage by the asset manager is an important factor.

Watch the video on www.fsitv.com