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Passive investment products have enjoyed a heightened status in recent years and now investors are going in search for additional alpha. What if there was a way to invest in a strategy which looks and feels like an indexing strategy yet can also outperform its benchmark after fees?

Research enhanced index strategies operate exactly as their name suggests and possess the capability to manufacture excess returns through extensive analyst research. In other words it brings an active quality to index investing.

In this article J.P. Morgan Asset Management lead portfolio manager for global and international research enhanced index (REI) strategies, Piera Elisa Grassi, explains how these strategies aim to deliver positive alpha with a risk profile which almost matches the benchmark.

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Research enhanced index strategies: Passive with active insights

In search of low-cost ways to capture market performance, many investors have piled into passive investment strategies. Looking at the industry flows over recent years will tell you just how significant the passive pie has grown.

Passive products essentially mimic a market index by owning many pieces of thousands of stocks and are operated automatically, reducing their running costs. Over the long-run, cheaper passive vehicles providing basic market exposure can make sense for many investors, but buying funds that simply track an index will always underperform the market when fees are taken into account.

Importantly, holding passive products also eliminates the potential for any market-beating returns to be generated, or for any risks to be mitigated by active decision-making.

"Investors need to be aware that they are essentially 'leaving money on the table' when they invest in passive strategies and in this lower for longer return environment, every little bit matters," says Piera Elisa Grassi[01], lead portfolio manager for the global and international research enhanced index strategies, J.P. Morgan Asset Management.

The significant shift towards passive has spurred active managers to develop hybrid "in-between" solutions, such as research-enhanced index strategies, which aim to offer investors an index-like portfolio with a risk profile similar to that of the benchmark but with an added information advantage derived from research-driven, stock selection insights.

This approach seeks to generate consistent excess returns while keeping portfolio construction and volatility level with the benchmark. When markets are down, these research-enhanced index strategies essentially aim to minimize the negative returns. Similarly, when markets are up, the active stock insights help to boost returns. So effectively, investors experience a smoother return profile than if they were investing purely in a passive investment.

How is it different from an ordinary passive product?

A research-enhanced index strategy's added value comes through applying the resources of fundamental research analysts and sector specialists. They provide stock-specific views and based on these insights, the portfolio management team will take marginal over- or under-weight positions in stocks relative to the benchmark.

"For example, more weight in the portfolio can be given to companies with stronger growth and return potential, based on the views of analysts who study companies in-depth and meet management, as well as more attractive valuations, helping to improve risk-adjusted returns," explains Grassi.

Research-enhanced strategies don't aim to do a lot of asset allocation relative to the benchmark, or to take big sector bets. Instead they are focused on driving stock-specific alpha by not owning as much of the expensive stocks and owning incrementally more of the cheap stocks that are poised to grow earnings. For example, one way analysts rank companies is by forecasting long-term future cash flow streams. Owning more companies with the best growth prospects and good valuations, and owning fewer of the laggards, is one way to compound incremental excess returns over time.

Research-enhanced index strategies are designed to be region, sector and style neutral, but can vary in their individual stock holdings within sectors in order to exploit active insights.

"What's important to understand is that over longer periods of time, even small margins of outperformance over the benchmark can compound returns," emphasises Grassi.

As such, this combination of low cost, low turnover, diversification and enhanced insights is designed to offer investors the best of both passive and active management – providing investors with the opportunity to boost the return component of their portfolio without materially increasing the risk.

Manager selection is key

Choosing a good research-enhanced index strategy requires careful due diligence, since the manager needs to provide valuable stock insights (identifying growth and value opportunities) in addition to providing an efficient, low-cost index like investment vehicle.

This tends to favour fund managers with large fundamental research teams with deep sector and country expertise, who are able to cover a global investment universe. These managers can harness the power of their active insights to improve risk-adjusted returns substantially over longer periods of time versus a plain vanilla passive product.

"At J.P. Morgan Asset Management, we have an extremely large and very experienced research team with 70 analysts in London, New York, Tokyo and Singapore covering around 2,000 stocks. We apply a disciplined, fundamentally driven approach across sectors and regions to ensure our research analyst insights are effectively captured," says Grassi.

"This depth and breadth of coverage provides us with a clear information advantage and is key to managing a successful research-enhanced index strategy. Our well-resourced global research team focuses on identifying attractively priced stocks with sound fundamentals and prospects for strong, sustainable growth. Risk control is also an integral part of our enhanced index investment methodology. Our rigorous process allocates the active risk budget (or tracking error) not to region or sector bets, but rather, to stock selection—our information advantage," added Grassi.

The JPMorgan Global Research Enhanced Index Equity Fund* goal is to deliver 0.75 to 1% of annualised excess returns (gross) at a tracking error of 0.75 to 1.25% p.a. The fund, which is available both hedged and unhedged, was launched in April 2015 (unhedged) and the underlying strategy has a 13-year track record of outperformance. With a low management fee of only 0.20% p.a., the fund has 'Recommended' and 'Highly Recommended' ratings by both Zenith and Lonsec respectively.

"Theoretically, the combination of low cost, low turnover, diversification and insights offered by these strategies, coupled with the aim to beat the benchmark, means that the JPMorgan Global Research Enhanced Index Equity Fund provides investors with the best of both worlds," concludes Grassi.

In a lower for longer return environment, every bit of extra return matters. And when small amounts of outperformance compound over long periods, a small amount of difference goes a long way. FS

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The quote

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