Enhanced Indexing
Targeting the return/risk ‘sweet spot’

March 2010

In the great debate between advocates of active and passive investment strategies, there is in fact, some middle ground: enhanced indexing. These strategies target the ‘sweet spot’ of portfolio return/risk efficiency—between purely passive strategies (which strive to replicate, but not exceed, benchmark performance) and fully active strategies (which target higher, and generally more volatile, above-benchmark returns).

While taking a measured degree of active risk, enhanced indexing is distinguished by a rigorous, multi-dimensional approach to risk management. It is this acute focus on risk which, if well-executed, can enable these strategies to closely track a benchmark while still providing the opportunity to generate risk-efficient alpha.

We believe that given these return/risk characteristics, enhanced index strategies should be considered (along with more active as well as passive strategies) by any investor maintaining a sizable allocation to equities. This is the case whether the investor is interested in:

• taking some active equity risk off the table by moving toward passive investing, or

• generating greater returns from a predominantly passive equity allocation by adding more active risk

In the aftermath of the financial crisis, investors are more determined than ever to ensure that they are appropriately rewarded for every ounce of active risk they take while minimizing unintended risk exposures. In this article we illustrate how adding enhanced index strategies may improve a portfolio’s efficiency, and identify the characteristics required for a manager to deliver these efficiency benefits.

Enhancing Portfolio Efficiency

Before delving into the potential “efficiency” benefits of enhanced index strategies, we start with a measurable definition of “efficiency.” Active equity managers—enhanced indexers included—are measured on the alpha or excess returns they generate, relative to a benchmark. They are also assessed on the incremental risk taken in generating those excess returns. The more “efficient” the manager, the greater the amount of excess return (ER) generated for every unit of incremental risk (or Tracking Error (TE)). Information ratio (IR) measures this “efficiency” of alpha.
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generation (see sidebar for a definition). Higher IRs are desirable as they imply a greater probability of positive excess returns over an investment horizon.

The following simple examples illustrate the potential efficiency-enhancing benefits of allocating some portion of an equity portfolio to enhanced index strategies. Here, the investor has three equity strategies to choose from (Passive, Enhanced and Active), which have the return and risk characteristics given in the table in Exhibit 1 and plotted in excess return/risk space in the accompanying chart.

**EXHIBIT 1: RETURN AND RISK CHARACTERISTICS—ILLUSTRATIVE EXAMPLES**

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Target excess return (%)</th>
<th>Target tracking error (%)</th>
<th>Target information ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Active Manager</td>
<td>2.00</td>
<td>4.00</td>
<td>0.50</td>
</tr>
<tr>
<td>Enhanced Index</td>
<td>0.75</td>
<td>1.00</td>
<td>0.75</td>
</tr>
<tr>
<td>Passive Index</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td><strong>Portfolio options</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(A) 50/50 Active/Passive</td>
<td>1.00</td>
<td>2.00</td>
<td>0.50</td>
</tr>
<tr>
<td>(B) 48/52 Active/Enhanced</td>
<td>1.35</td>
<td>2.00</td>
<td>0.68</td>
</tr>
<tr>
<td>(C) 25/75 Active/Passive</td>
<td>0.50</td>
<td>1.00</td>
<td>0.50</td>
</tr>
</tbody>
</table>

Source: J.P. Morgan Asset Management. Chart for illustrative purposes only.

Note: Correlations between managers are assumed to be zero.

**INFORMATION RATIO—DEFINED**

Information Ratio measures the “efficiency” with which excess returns are generated:

\[
\text{Information Ratio (IR)} = \frac{\text{Excess Returns (ER)}}{\text{Tracking Error (TE)}}
\]

Where:

- ER = annualized excess returns over a benchmark
- TE = annualized standard deviation of those excess returns

**Example 1: Reducing active equity risk**

An investor with a 100% actively managed equity portfolio wants to reduce active equity risk and is considering shifting to Portfolio A with a 50%/50% active/passive mix (i.e. moving down the dotted blue line from the 100% Active portfolio). As seen in Exhibit 1, this accomplishes the goal of reducing active risk (target tracking error), but sacrifices a commensurate amount of expected excess return, leaving the efficiency (IR) of the equity portfolio unchanged.

Alternatively, the investor could shift to Portfolio B with a 48%/52% enhanced mix (moving down the less steep orange curve from the 100% Active portfolio). Referring again to Exhibit 1, Portfolio B accomplishes the same reduction in tracking error as Portfolio A, but provides 0.35% additional expected excess return, and has a higher IR than the active/passive mix.

**Example 2: Enhancing excess returns**

Conversely, an investor whose equity portfolio has a high allocation to passive index funds (e.g. Portfolio C with a 25%/75% active/passive mix) and who is willing to introducing more active management risk to enhance expected returns, could move to a 100% Enhanced Index portfolio, maintaining Portfolio C’s 1% TE while adding an additional 0.25% to expected excess returns.

In both of these cases—and all along the curve in Exhibit 1—the active/enhanced mix provides higher excess returns than the active/passive mix, at each risk level. As investors contemplate lower capital market returns going forward on core portfolio assets, an extra 25bps to 50bps of alpha from their equity lineup can become meaningful.
How Enhanced Index Managers Deliver Attractive Risk-Adjusted Returns

Realizing the benefits of enhanced indexing illustrated in Exhibit 1 assumes, of course, that enhanced index managers are able to deliver on their return and risk objectives. This requires an investment philosophy that is strictly adhered to and a process that integrates risk management throughout. Key components include:

1. A systemic, reliable valuation process
   An important requirement of the valuation process is that it have both the breadth of coverage and the depth of expertise to effectively rank and score a substantial proportion of stocks in the investable universe. These extensive rankings of stocks must reliably inform the multitude of small over/underweight decisions that are essential for well-diversified, efficient enhanced index portfolios.

   - **Quantitative** processes are utilized by the majority of enhanced index managers. These processes lend themselves to the evaluation of the massive amounts of statistical information used in generating the required breadth of valuation rankings. Generally this is done using quantitative factors and models estimated on the basis of extensive, though backward-looking, historical data.

   - **Fundamental** processes are less prevalent in this space. These research-enhanced index strategies typically rely on the forward-looking earnings projections or stock recommendations of an integrated team of sector specialists with a deep and intimate knowledge of the companies they follow. These estimates and/or opinions can be systematically incorporated into a consistent ranking process which, along with the analysts’ highest conviction insights, support the portfolio manager’s small but numerous stock-specific investment decisions. Research platforms with the breadth and depth of expertise needed to generate the required earnings projections and company insights are difficult to build and hard to replicate. When in place, however, they can provide a valuable prospective view of macro trends and shifting company dynamics.

2. A robust, disciplined portfolio construction process
   An effective portfolio construction process should make an explicit return/risk trade-off for every stock in the investable universe. Diversifying stock-specific risk by holding a large number of stocks with small under/overweights relative to the benchmark is the primary lever for risk control in enhanced index strategies. Macro factors, such as sector and style biases (e.g. growth/value, momentum/contrarian) must also be monitored to avoid the unintended biases/risks that stock picking models may introduce. A robust risk model is required to assess these macro risk characteristics across a large universe of stocks.

   Given the multitude of stocks in the enhanced index manager’s investable universe and the variety of risk factors associated with each, an optimizer is generally employed in determining the allocation to each stock, choosing those with high alpha potential, while carefully weighing and neutralizing stock-specific and macro risks across the portfolio. Like the stock valuation and ranking process, portfolio construction and risk management may also be purely quantitative or may combine varying degrees of qualitative input as well. For example, the portfolio manager with access to a team of specialized sector analysts may call on their expertise to assess the potential risk of thematic developments (e.g. oil price shocks, a housing market meltdown, etc.) for the companies they follow. These insights may help the manager to identify and diversify an otherwise unintended dimension of portfolio risk. Additionally, an analyst with a finger on the pulse of a company he/she follows may become aware of developments which could impact (negatively or positively) the level of conviction in that company’s earnings estimates. The portfolio manager may incorporate such insights into portfolio decisions.

Lessons From the Downturn

The recent financial crisis tested all managers—enhanced index managers included. Rigorous risk controls going into the crisis and the ability to react to a rapidly changing market environment were among the defining characteristics of those best able to navigate through the turmoil. Many quantitative strategies were severely tested. In some cases, factors and signals underlying these models became less effective in identifying “good value” in a market where forced selling continued to push prices of “cheap” stocks even lower. At the same time, macro factors relied on for risk diversification began moving together. In our view, this doesn’t mean that quantitative strategies are “broken” or that they won’t generate attractive results as markets normalize. In fact, for investors considering enhanced indexing, a blend of quantitative and fundamental approaches may have diversification benefits.
Perhaps the key lesson to be learned from the financial crisis in terms of evaluating enhanced index managers is the importance of forward-looking, adaptive security selection and portfolio optimization processes, fine-tuned over time with the experience that comes from navigating multiple market cycles. Whether this means managers with refined quantitative factors and models, the ability to fully leverage the forward-looking insights of their research analysts, and/or an effective blend of quantitative and qualitative inputs, the process must be responsive to changes in market trends and relationships in order to deliver the consistent, attractive risk-adjusted returns investors desire.

Conversely, those with a large allocation to passive strategies but in need of excess return may determine that enhanced index strategies hit their sweet spot on the return/risk spectrum. Delivering on these efficiency benefits requires: strict adherence to a proven investment philosophy; a robust platform for generating stock return forecasts, rankings and scores; a rigorous portfolio construction process which explicitly weighs risks and returns for every stock in the strategy’s investable universe—and the adaptability to respond to changes in the investment environment.

J.P. Morgan Asset Management has over twenty years of experience managing fundamentally-based enhanced index strategies.

For more of our perspectives on enhanced index alternatives and their relevance for your portfolio objectives, please contact your J.P. Morgan representative.

Conclusion
Enhanced index strategies, given their emphasis on modest excess returns and rigorous risk management, can be an important part of the solution for improving portfolio return/risk efficiency.

Investors considering a shift from traditional active equity strategies to passive index funds, in an effort to decrease active equity risk, may find a more risk-efficient solution in enhanced index strategies.