How to pick an index manager

Not all index managers are created equal

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Not all index fund managers are created equal

Index funds have been increasing in popularity because they can offer investors a cost-effective and straightforward way to invest in a variety of markets or market segments. Their investment strategy makes them easy for fund managers to manage and gives investors a simple way to diversify their portfolio. But this simplicity can lead some advisers to treat index funds like a commodity to buy on price only. Not all index funds, nor index fund managers, are created equal and failing to consider all aspects of a fund or fund manager can expose you or your client to unknown risks.

This guide provides some guidance to help you run a comprehensive due diligence process when selecting an index fund or fund manager.
What to look for in an index manager

Different index managers operate in different ways. Differing approaches can lead to different risk and return profiles and potentially unexpected results for your clients. As an adviser, you can add value for your clients by making sure the funds your clients invest in fit their risk tolerance and investment objectives. Before making a decision, you should consider a variety of factors, including:

- Costs and cost transparency
- Tracking techniques
- Tracking error and excess return
- Securities lending
- Risk management
- Fund structure

How index funds work

Index funds, also called tracker funds, aim to track the performance of a particular market as represented by an index. Indices, such as the UK FTSE All-Share reflect a market or a specified subset of a market. Countless indices exist for a variety of markets, market-subsets and asset classes.

Because indices reflect the underlying market performance, fund managers use them as benchmarks. Active fund managers will try to ‘beat the benchmark’ by selecting securities that they believe will perform better than the market average. Index or tracker funds, on the other hand, aim to reproduce the performance of the market, usually by buying and holding the securities that make up the benchmark as they are weighted in the benchmark.

Because index funds require fewer resources, they can be considerably cheaper for an investment manager to operate.
Choosing an index manager: a small part of a large process

This guide expands on the investment advice model in the Vanguard guide ‘Building a robust investment advice process’. Choosing an index manager forms a small part of the top-down asset allocation process.

*Available on the financial adviser section on www.vanguard.co.uk*
Choosing an index manager: a small part of a large process

A systematic, top-down investment advice process begins with assessing your client’s ‘real intent’ and financial goals and works through to developing a robust written plan to help them, based on your client’s risk profile. You can determine the appropriate asset allocation for the portfolio from that investment plan. Only when you have an agreed plan and asset allocation in place should you begin the fund selection process. The following sections provide some insight into the factors to consider as part of fund selection and due diligence.

Investment advice model overview

1. Know your client
   - Review of client’s financial position
   - History, values, life transitions, goals
   - Goals-based planning

2. Develop a plan
   - Categorise and evaluate
   - Determine risk/return requirements
   - Develop a written plan

3. Construct portfolio
   - Strategic asset allocation
   - Sub-asset allocation
   - Passive/active mix
   - Asset location
   - Manager selection

4. Implement plan
   - Best execution
   - Tax efficient trading
   - Automate rebalancing

5. Monitor progress
   - Periodic financial check-ups
   - Significant life events
   - Review progress

See diagram on following page
The top-down approach to portfolio construction

Bottom-up approach can result in haphazard outcomes, as well as misalignment with client objectives and risk profile.

1. Strategic asset allocation
2. Sub-asset allocation
3. Passive/active mix
4. Asset location
5. Manager selection

Top-down approach results in portfolio most closely aligned with client goals and risk profile.

This guide deals specifically with the final step of the portfolio construction process: picking managers and funds.
This guide deals specifically with final step of the portfolio construction process: picking managers and funds.
Costs matter

Costs have a significant effect on investment performance over the long term, as the impact of costs compounds over time just like interest, but negatively. Reviewing a fund’s cost structure represents one of the most important steps in any due diligence analysis.

Understanding the cost structure of a fund will help you evaluate the different fund charges in the context of the fund’s investment objective, market and regulatory environment.
AMC vs. OCF

Fund managers most often quote the Annual Management Charge (AMC), which covers the manager’s cost of managing the fund over the year. However, with most managers you will also typically pay additional running costs out of your investment. These usually include administration fees, audit fees (where an independent auditor checks that all accounts are fair and honest), custody fees (paid to a custodian to safeguard the fund’s assets on behalf of the fund’s investors) and other operational expenses. The AMC, and these additional running costs, make up the fund’s Ongoing Charges Figure (OCF).

Protecting investors from dilution

The fund often bears the costs of trading in the underlying securities of that fund. This lowers the value of investors’ holdings in the fund in an effect called ‘dilution’. An increase in the number or frequency of investors joining or leaving the fund magnifies the effect.

Some managers protect existing investors by charging these costs to the investor that causes them, e.g. the new investor or the leaver, by using an ‘anti-dilution levy’ on large deals. Anti-dilution levies return to the fund to help protect long-term investors’ holdings from dilution. Fund managers can also charge a pre-set dilution levy to protect existing investors from dilution through trading and taxes. These charges benefit investors who know that once they are in a fund, the anti-dilution levies protect their holdings from excessive turnover costs caused by the actions of other investors.

Pre-set dilution levy vs. entry and exit charges

Investors may encounter a variety of entry and exit charges on different funds. These charges may include anti-dilution levies which benefit investors, but may also cover a variety of costs such as custodian charges. It’s worth taking the time to understand these costs and how they may, or may not, benefit your clients.
Fund managers track indices either physically, by buying all or a sample of the underlying index securities, or synthetically, using derivatives. Both forms of index investing have pros and cons, and no universally right or wrong choice exists. A physically replicated fund is backed by the actual securities that make up the index. Synthetic replication can offer access to less liquid or more complex markets, but they can be less transparent and straightforward. Understanding the characteristics of both will help you make an informed choice for your clients.
Physical replication

Traditionally, in order to replicate an index, a fund buys all of the underlying physical securities according to their weight in the index. Fund managers can carry out physical tracking in three ways.

Full replication

Fund managers often track an index by buying the whole range of securities underlying the index in equal proportion to the weight each security has in that index. Typically this method, known as full replication, leads to a very precise reproduction of the benchmark, before costs. But indices containing a large number or illiquid securities may make full replication difficult.

Optimisation

Fund managers often use optimisation for hard-to-replicate indices. With optimisation, a fund buys a representative subset of the securities from the index that matches the index in terms of risk and return as closely as possible. Typically fund managers use sophisticated computer models to select securities that, together, have a strong correlation with the index.

Hybrid

Fund managers can also combine the two methods. So called hybrid replication works well, for example, for replicating indices that consist partially of illiquid assets. Fund managers buy as many securities contained in the index as possible and use optimisation to compensate for the remaining securities and to make their portfolio of securities match the index performance.
### Understanding tracking methods

<table>
<thead>
<tr>
<th>Full replication</th>
<th>Optimisation</th>
<th>Hybrid</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Buy all securities in the benchmark index</td>
<td>• Buy a representative sample of securities that will replicate the risk and return characteristics of the target benchmark</td>
<td>• A mix of full replication and optimisation</td>
</tr>
<tr>
<td>• Typically results in lower tracking error</td>
<td>• Well suited to benchmarks that hold a large number or illiquid securities</td>
<td>• Buy as many of the securities of the index as possible</td>
</tr>
<tr>
<td></td>
<td>• Manager’s skill in matching risk characteristics of benchmark is important</td>
<td>• Use optimisation to track unavailable securities</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Manager’s skill in matching risk characteristics of benchmark is important</td>
</tr>
</tbody>
</table>
Synthetic replication

Synthetic index funds use derivatives to track their benchmark. A synthetic fund buys a basket of securities, from its reference index or any other, and enters into a swap contract with a counterparty that involves an exchange of collateral. Crucially, the return for investors does not come from the basket of securities, but rather, directly from the counterparty. The diagram below depicts the process in detail.

Simplicity vs. risk

With synthetic funds, the fund receives the exact return of the index from the counterparty and delivers the return of the collateral to the counterparty. However, due to this structure, synthetic funds carry counterparty risk, or the risk a counterparty may default on their commitment. In difficult market environments the collateral could lose much of its value or become volatile or less liquid than expected, putting investor capital at risk.
Understanding tracking error and excess return

Together, tracking error and excess return indicate how well a fund tracks its index. Poor tracking represents a cost that accumulates over time and can have a significant impact on long-term portfolio returns.

When selecting index funds for your clients, excess return and tracking error can help you evaluate a fund’s performance, but only if you compare funds on a like-for-like basis. Differences in tracking methodologies and the methods to calculate performance can make comparisons difficult.
Excess return

Excess return shows how a fund’s performance compares with that of its benchmark over a stated period of time. If a benchmark increases by 8% and the fund return by 8.5%, then the fund has achieved an excess return of 0.5%. Funds can also have negative excess returns when they underperform their benchmark.

Tracking error

Tracking error indicates the variability of a fund’s excess return during that same period. Fund managers measure the tracking error by calculating the annualised standard deviation for the time period. Think of standard deviation as a measure of how much the returns of a fund over a certain period have deviated from the total average return of the whole period.

What is the standard deviation?

Standard deviation seems complex, but it really isn’t. Think of two funds, both of which have achieved an average return of 8% over the last five years. Imagine the first fund returned 7%, 9%, 8%, 7% and 9% respectively in each year, so, on average, the fund returned 8%. Assume the other fund returned 5%, 11%, 3%, 12%, 9% in each year. On average, the second fund returned 8%, too. But because of the much higher dispersion of these results around the mean (8%), the second fund is said to have a higher standard deviation.
Understanding tracking error and excess return

The chart above shows the difference between tracking error and excess return. Fund A had a higher tracking error because the fund’s return during the time period varied more widely around its mean of -0.2%. Fund B’s return fluctuates more narrowly around the mean return of -0.4%. Fund A has, however, a higher excess return than fund B.

Fund A had higher tracking error. However, it still delivered a higher average return.

Fund B had lower tracking error. However, average return to investors was lower.

This hypothetical example does not represent any particular investment.
Source: Vanguard Asset Management, Limited.
Excess return and tracking error can help you evaluate a fund’s performance, but only if you compare funds on a like-for-like basis.
Securities lending: no free lunch

Investment funds can generate additional returns by lending securities to other investors. Fund managers can have very different approaches in dealing with both the lending and the profits it generates.

Understanding a fund’s policy regarding reinvesting collateral and counterparties and examining who ultimately benefits from the reinvestment returns helps you make an informed choice for your clients. In addition, some fund managers keep large parts of the lending profits for themselves; others redistribute them into the fund where they benefit your clients.
How securities lending works

Funds lend securities they hold to borrowers for a specified time period. The borrowers of these securities promise to return the securities at the end of the contract. Borrowers also deposit collateral with the funds during the period that they hold the loaned security. The funds can then reinvest the collateral to boost the funds returns. The diagram below provides an overview of this process.
Value vs. volume

Some fund managers take a volume approach, lending large volumes of widely available securities for a low charge and relying on the return generated by investing the collateral. Other managers prefer a scarcity approach, lending fewer, scarcer securities to generate returns through the scarcity premium.

Two possible approaches to securities lending

**Volume approach – reinvestment risk**
- Loan a high volume of securities
  - Return: 90% from reinvestment of collateral, 10% from scarcity premium

**Value approach – scarcity premium**
- Loan a few scarce securities
  - Return: 90% from scarcity premium, 10% from reinvestment of collateral

Securities lending return

**Very different risk profiles**
Reinvestment risk

Some fund managers invest the cash collateral more aggressively; other managers take a more cautious approach. Investing into riskier assets can generate higher returns but can also result in higher risk of losses for the fund.

Counterparty risk

Fund managers differ in their counterparty policies. Some have very strict rules and only deal with selected counterparties, other managers are less stringent. Funds can lose money if the borrower defaults on the obligation to return the securities, or if they take too much risk reinvesting the collateral. Stricter lending policies decrease this risk.
Understanding the risks

Risk management affects all areas of fund management. How a company manages risk matters, yet investors often ignore it. As an adviser, you can help to protect your clients from unnecessary risk by performing an in-depth due diligence analysis as you would for an active fund. This section covers some key questions you may want to ask about a fund manager’s risk controls when doing your due diligence on index funds.
Governance and culture

When undertaking a due diligence process on an index fund, asking about the risk management processes in a few key areas can help you to compare the relative merits of different fund managers.

<table>
<thead>
<tr>
<th>Compliance procedures</th>
<th>Try to find out how robust a fund manager’s compliance procedures are by asking for a description. Ask yourself if you are willing to stake your reputation and standing on their procedures.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Information security</td>
<td>Likewise, how strong are their information security protocols? Would you trust your own personal data to them?</td>
</tr>
<tr>
<td>Operational risk controls</td>
<td>Ask if the fund manager has a dedicated risk management committee. Does the company hierarchy and reporting lines allow risk managers to act independently from the people they supervise? Does the company explain the risk management procedures in detail?</td>
</tr>
<tr>
<td>Remuneration policies</td>
<td>Ask about the remuneration policy and look for one that aligns the employees’ interests with those of their clients. You should examine the company’s disclosure on remuneration and make sure you understand how it works. If you don’t understand how it works, it might not be appropriate.</td>
</tr>
<tr>
<td>Conflicts of interest</td>
<td>As a fee-based adviser you should ask about any conflicts of interest that may arise as part of a fund management company’s distribution policy or ownership structure. For example, will they put you and your clients first, or their own shareholders?</td>
</tr>
</tbody>
</table>
Choosing a fund structure

Index funds come in a variety of structures, such as Exchange Traded Funds (ETFs), Open Ended Investment Companies (OEICs), Unit Trusts and Investment Trusts. Choosing the right fund structure for your clients depends on the market, asset class and your clients’ objectives and requirements. Comparing the characteristics of the four main structures can inform your decision.
Choosing a fund structure

Exchange Traded Funds (ETFs)
An open-ended investment fund that’s built like many OEICs, but with shares that are traded on a stock exchange. ETFs are priced and traded throughout the business day, and traded through a stockbroker. ETFs can be actively managed or indexed, although the vast majority of ETFs currently own assets differently to other types of funds.

OEIC (Open-Ended Investment Company)
A pooled investment fund similar to a unit trust, but established under company law, rather than trust law. As such, it issues shares, rather than units, but these are not traded on a stock exchange, they are issued and traded by the OEIC directly with the fund manager. Like ETFs, OEICs increase or decrease the numbers of shares issued in response to demand from buyers and sellers.

Unit trust
A pooled fund established as a trust. A unit trust is an open ended investment. This means that the manager can create or cancel units depending on public demand.

Investment trust
A closed-ended fund (a fund with a limited number of shares) established as a company, with the aim of producing returns by investing in other companies. Investment trusts trade like shares on stock exchanges and are priced and traded throughout the business day. They can be bought and sold through a stockbroker.
<table>
<thead>
<tr>
<th></th>
<th>ETF</th>
<th>OEIC</th>
<th>Unit Trust</th>
<th>Investment Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Pricing</strong></td>
<td>Dual priced with bid-offer spreads, with price linked to NAV. Price also affected by market demand (but arbitrage helps keep the price close to the NAV)</td>
<td>Single pricing, linked directly to NAV</td>
<td>Dual priced with bid-offer spreads apply, with price directly linked to NAV</td>
<td>Price indirectly linked to NAV and driven by market demand, can vary dramatically from the NAV</td>
</tr>
<tr>
<td><strong>Trading</strong></td>
<td>Anytime during market hours at real-time prices</td>
<td>Once a day on unknown future prices</td>
<td>Once a day on unknown future prices</td>
<td>Anytime during market hours at real-time prices</td>
</tr>
<tr>
<td><strong>Access</strong></td>
<td>Purchased and sold on stock exchanges through stockbrokers. There will be a fee charged by the stockbrokers.</td>
<td>Directly with fund manager, online platform or adviser</td>
<td>Directly with fund manager, online platform or adviser</td>
<td>Purchased and sold on stock exchanges through stockbrokers.</td>
</tr>
<tr>
<td><strong>Investment style</strong></td>
<td>Active or index</td>
<td>Active or index</td>
<td>Active or index</td>
<td>Active (small no. of index)</td>
</tr>
<tr>
<td><strong>PEP/ISA?</strong></td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>
Choosing the right fund structure for your clients depends on the market, asset class and your clients’ objectives and requirements.
What next?

Choosing an index manager comes only at the end of a much larger process. As an adviser, you can add value for your clients through all steps of a robust investment advice process.

If you found this information useful, you may want to visit the Adviser Support section of our website where you will find a variety of papers and resources to help you build your advice process and support your clients.

Better yet, why not give us a ring? We’d like to hear about what sort of information or resources would be most helpful to you. Contact Vanguard Adviser Support on 0800 917 5508, or visit vanguard.co.uk and click on Financial Advisers.
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