How Index Composition Affects Active Strategies

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"… as long as the music is playing, you've got to get up and dance." – Chuck Prince, Former CEO of Citigroup (2007, a few months before Citi took a $1.5 billion write-down tied to its leveraged loan portfolio)

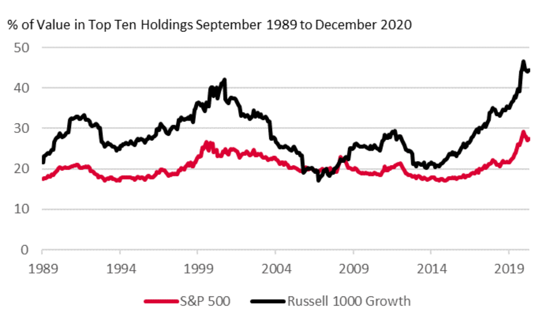
In August of 2020, we looked at how certain stocks' strong relative performance had led to unprecedented concentration in certain market indices, notably those representing US and ex-US large-cap equities. Naturally, we focused on the impact on index funds. More often than not, however, index composition affects investors in actively managed strategies, as well.

SUMMARY

- Several of the most tracked indices remain highly concentrated compared to historical levels (including the S&P 500 and Russell 1000 Growth)
- Other indices have meaningfully changed composition (MSCI and CRSP, for example, have incorporated China A-shares into foreign equity indices).
- Investors expect index funds to be tightly constrained to index holdings; however, most actively managed equity funds used in DC plans are tied to index composition in some manner as well.
- Changes in index allocation or composition can have significant impacts on the portfolios of active funds that have holdings constraints.
- Holdings constraints aren't necessarily bad things, but investment committees must be aware of their funds' policies and recognize how index changes may impact their active strategies.

SIGNIFICANT INDEX DEVELOPMENTS

In our August brief, we examined holdings concentration across a range of equity indices. We saw that concentration in the top holdings of the S&P 500 and Russell 1000 Growth indices stood at historic highs. We also discussed the impact of the growth of Chinese equities and the progressive inclusion of mainland China-registered China A-shares on the MSCI Emerging Markets Index.



While we focused on the impact of these evolutions on index funds in that article, changes in index composition can cause meaningful follow-on effects for many active managers, as well.

THE TIES BETWEEN ACTIVELY MANAGED FUNDS AND THEIR BENCHMARKS

Many actively managed strategies, including most active funds used in defined contribution plans, have some form of explicit holdings limitation that shapes their portfolios. Compared to the index-mirroring constraints inherent in index funds, the limits that active managers impose on their portfolios are less visible. However, they should be equally important to prudent fiduciaries.

Relative limits

Relative limits often come in the shape of a maximum under or overweight of a stock, sector, or country versus a fund's benchmark index.

- Example 1: The Hypothetical Large Cap Growth Fund has a +/- 5% limit on individual security allocation relative to the Russell 1000 Growth Index, meaning that the fund's allocation to a given security can't be more than 5% lower or 5% higher than the benchmark index's allocation to the same security. At the end of December 2020, the Russell 1000 Growth's allocation to Microsoft was 9.04%; therefore, the Hypothetical fund would be bound by policy to hold between 4.04% and 14.04% of its assets in Microsoft.

Absolute limits

Holdings limits can also be expressed in absolute terms. For example, a fund may limit maximum exposure to a single country, regardless of the fund benchmark's allocation to that country.

- Example 2: The Pretend Emerging Market Fund limits single country exposure to 15%. At the end of December 2020, the MSCI Emerging Market Index's allocation to China was 43.6%; therefore, the Pretend Fund would be bound by policy to underweight China by at least 28.6%.

THE LOGIC BEHIND THE LIMITS

Managers put holdings limitation policies in place as risk control measures (in a few senses).

Firstly, holdings limitations can reduce the risk of aberrant performance. Most institutional investors measure the performance of actively managed funds by comparing a fund's performance to that of a benchmark index. Most investors are more concerned by underperformance than they are by overperformance (the psychological bias called "loss aversion"). When the maximum position in a single security is limited (on either a relative or absolute basis), the investor gives up some of the potential upside that could be generated by a more concentrated position in a stock that performs well. In exchange, the investor also avoids the risk of possible loss that could be created by an outsized position if the stock tanks (think AIG's loss of 97% in 2008).

The reverse is true as well. If a minimum position is required, a manager may not be able to entirely omit a stock that has a large allocation in their benchmark. Because they're forced to allocate to the stock, the manager won't be able to completely avoid a loss if that stock performs poorly. On the other hand, they won't completely miss out on the return created if that stock happens to perform beyond expectations (think Telsa's gain of 695% in 2020).

Secondly, and specifically regarding index-relative limitations, most investors value "style consistency" and define a fund's category or style relative to an index. The logic follows this pattern: the Russell 1000 Growth index is a large-cap growth index; therefore, a fund that looks similar to that index must be a large-cap growth fund. Relative holdings limitation policies reassure investors that their large-cap growth fund will continue to be classified as a large-cap growth fund because it will continue to look somewhat like its large-cap growth benchmark index. Since categorization is a handy tool when building or communicating a 401(k) menu, fiduciaries (committees and consultants) often gravitate to funds that can be readily and consistently categorized.

Finally, even if not mandated by investment policy, "career risk" can incent an active manager to consider their benchmark's security and sector weights. In an index-relative world, a manager who makes dramatic deviations from the index weight of a dominating stock potentially does so at their peril. For example, underweighting Apple by 5% in the first quarter of 2020 would have reduced a fund's relative return, versus the Russell 1000 Growth Index, by over 1% for those three months. Depending on the audience, explaining a bad return due to an incorrect "active" decision can be more uncomfortable than explaining the negative effect of a benchmark-weighted position.

IMPACTS FOR ACTIVELY MANAGED FUNDS

Boiled down: manager decision-making isn't the only factor shaping funds' portfolios. Holdings policies have meaningful impacts on portfolio construction, as well. For actively managed strategies that have holdings limitation policies in place, possible effects can include:

1. As the index gets more concentrated, your fund may, too.
    - If a fund has a +/- 5% limit on individual security or sector allocation and technology stocks dramatically outperform the rest of the market, the fund will probably have to increase tech holdings.
2. Your manager may not be able to avoid a stock they hate.
    - If a fund has a +/- 5% limit on individual security allocation and Apple makes up 11% of the index, the fund will have at least 6% invested in Apple no matter how pessimistic they are.
3. Your manager may not be able to invest as much as they'd like in a stock they love.
    - If a fund has a +/- 5% limit on individual security allocation and Tesla makes up 3% of the index, the fund will be limited to investing a maximum of 8% in Tesla no matter how optimistic they are.
4. Index composition changes can change the universe in which your manager invests.
    - If in index integrates China A-shares, managers benchmarked to that index will likely increase exposure to A-shares.

OUR PERSPECTIVE

Despite the typical division of investment strategies into "active" and "passive," more portfolios are influenced by their benchmark's composition than aren't. Active strategies with holdings limitations may be significantly impacted by changes in index weightings of individual securities or universe coverage (e.g., the concentration within the S&P 500 Index or the addition of China A-shares to the MSCI Emerging Markets Index).

Holdings limitations are not necessarily good or bad; they're simply portfolio management tools intended to produce desired effects. It's the job of the investment committee and its advisor to decide how appropriate and prudent those limitations are, given the investment's employment.

What does all this mean for an investment committee? As we said in 2020, pay attention to your index funds. More pertinent to this article, be familiar with the investment process and approach of your plan's actively managed funds. Understand their investment universe and holdings limitation policies well enough to know if or how they'll be impacted by changes in their benchmark indices (or hire competent professional help that will understand, track, and explain). Not only will that understanding provide greater context to quarterly performance reports, but it will also help you make more prudent decisions when it comes to hiring and firing the managers for your menu.

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