



An Indexed Approach to Active Management

For those who believe that indexed and active management cannot peacefully coexist, Howard Present, the CEO of F-Squared Investments, has an answer. Present has developed a solution that offers advisors a diversified portfolio of actively managed funds that can be utilized like index funds, with the goal of performance that beats a passive benchmark. Most importantly, these products can be delivered with expense ratios that are below the average for the fund industry, and less than that of typical actively managed funds. We had the opportunity to meet with Present and discuss his strategy.

Present has created a set of 18 indexes, spanning 15 asset classes, which are constructed with the aid of three independent consultants – Mesirow Financial, Klein Decisions, and Kanon Bloch Carré (KBC). Mesirow, an institutional management and research firm based in Chicago, creates six indexes focused on different industry sectors, such as Technology, Health Care, or Financial Services. Klein, based in North Carolina, is a research firm that uses proprietary databases to construct nine indexes, corresponding to the Morningstar equity style boxes. KBC, a division of Boston Private Bank, known for its risk management technology, creates three indexes geared to investors in the de-accumulation phase. These are value, growth, and blend funds in the large cap space.

Each of the 18 indexes typically contains ten actively managed mutual funds. Present cites two significant advantages of his approach. First, with ten funds, manager-specific risk can be diversified. Advisors might find it easy to screen from 100 fund candidates down to a list of ten funds, but then are faced with the much more daunting task of narrowing that list down to a single fund. With Present's approach, advisors can buy the basket of ten funds. And, with ten funds, Present believes the diversification he introduces does not negate the value of active management. Second, a forced sell discipline is introduced, so that each index is reconstituted annually, with on average two to four funds being replaced. Present cites research from Ron Santangelo, an industry consultant and former Manager of Merrill Lynch's Managed Solutions and Analytics Group, which shows that less than 20% of the managers in the top two quintiles in any three year period will survive to the next three year period. Where most investors typically hold a fund until it has bottomed out, Present believes his disciplined approach will result in proactive selling in advance of poor performance.

In the active versus passive debate, Present is clearly in the active camp, and believes that between 7% and 19% of actively managed funds will beat their



index (on a risk-adjusted basis) over a long cycle (at least 5 years). The problems are, first, these managers are difficult to identify, and cannot be easily found through commercially available mutual fund databases. Second, once a good fund is identified, advisors and investors are often reluctant to sell the fund when its performance starts to diminish. As Present asked rhetorically, “can you imagine an advisor calling a client to say that they are selling this fund that they just bought a year ago?”

The traditional active versus passive debate is led by indexers who ask whether active funds can beat index funds, and the overwhelming evidence is the average active fund will fail in this respect. Present believes he can redefine the debate by shifting the focus away from the average active fund, and instead asking whether a select portfolio of highly skilled actively managed funds can beat index funds. The track record of his indexes, several of which go back over 10 years, show that on average his approach will beat traditional indexes over rolling 5 year periods by 67%, versus the 7%-19% figure for an average fund. His indexes also outperform the median mutual fund in their categories over rolling 5 year periods more than 73% of the time.

One piece of supporting evidence comes from a [study](#) by Matthew Hougan that appeared in the Journal of Indexing. Hougan looked at a sample of actively managed Vanguard funds and compared their performance to Vanguard index funds over a ten year period. While the methodology was not as rigorous as would be found in most academic studies, the result was that approximately 70% of the actively managed funds beat their index. The significance lies in the fact that the Vanguard active funds are managed in a sub-advisory portfolio structure, much like the consultant approach that Present uses, and that Vanguard’s fee structure is closely aligned with the fees that Present will be charging. The parallels to the Vanguard model lend credence to the belief that Present has created an investment vehicle that delivers true value in the marketplace.

This strategy mimics that of highly successful endowments and pension funds. While these institutional investors are getting enhanced returns from hedge funds and alternative investments, Present believes that they are also utilizing a portfolio approach of active management, utilizing a select group of funds in each style box or sector.

Cynthia Liu, a member of F-Squared’s Board of Advisors and a former fund manager at Schwab, commented that “in the best case, managers generate alpha by betting correctly on cyclicity; in the worst case, the alpha generated by managers simply decays.” Given the inevitable decline in alpha from fund managers, she believes disciplined selling employed by F-Squared will yield substantive results.



NAV prices are currently available on the 18 indices through the AMEX. Present is at work licensing the indices to ETF and fund manufacturers, with the goal making these investments commercially available by the first quarter of next year. Performance results so far have been impressive.

Comparison to the Advisor Perspectives Universe

We wanted to see how some of the fund selections in the F-Squared indexes compared to the most popular funds in the Advisor Perspectives (AP) Universe. We looked at the three large cap style box funds (those constructed by Klein Decisions) and compared their holdings (as of 9/30/07) to the [most popular funds](#) among actively traded US equity funds. A couple of notes about our methodology:

- In some cases our classification of funds was different from that of F-Squared and, in those cases, we reclassified our funds according to F-Squared's classification.
- We only ranked the funds among actively traded funds; all index funds and ETFs were eliminated from this analysis

The results show a high degree of correlation for large cap value funds. Eight of the ten funds in the F-squared index are ranked in the AP universe. For large cap growth there was less correlation, with five of the ten funds ranked in the AP Universe. There was very little correlation for large cap core funds, with only three of ten funds ranked in the AP universe.

Here are the detailed results:

Large Cap Value (IRALV)

Fund Symbol	Fund Name	Weight	AP Ranking
AAGAX	American Beacon Large Cap	8.38%	#9 (US LCV)
DDVAX	Delaware Value Fund	8.28%	Not in AP Universe
DODGX	Dodge & Cox Stock Fund	8.22%	#1 (US LCV)
LSGIX	Natixis Loomis Sayles	8.37%	Not in AP Universe
LSVEX	LSV Value Equity Fund	8.37%	#22 (US LCV)
PBEAX	JennDry Funds - Jennison	8.38%	#37 (US LCV)



PEQIX	Pioneer Equity Income Fund	8.28%	#19 (US LCV)
PNBAX	Allianz NFJ Large Cap	8.41%	#20 (US LCV)
PNEAX	Allianz NFJ Dividend	8.32%	#13 (US LCV)
VEIRX	Vanguard Equity Income Fund	8.37%	#15 (US LCV)
VWNAX	Vanguard Windsor II Fund	8.33%	#3 (US LCV)
VWNEX	Vanguard Windsor Fund	8.29%	#4 (US LCV)

Large Cap Growth (AIRALG)

Fund Symbol	Fund Name	Weight	AP Ranking
AAAGX	Thrivent Large Cap Growth Fund	9.17%	Not in AP Universe
ANEFX	American Funds – The New Economy Fund	9.06%	#31 (US LCG)
BSSPX	Dreyfus Premier S&P Stars Fund	9.06%	#206 (US LCG)
FDOX	Fidelity Advisor Diversified Stock Fund	8.99%	Not in AP Universe
FLCSX	Fidelity Large Cap Stock Fund	9.03%	#140 (US LCG)
ITGIX	ING T Rowe Price Growth Equity Portfolio	9.03%	Not in AP Universe
NGWAX	Allianz NACM Growth Fund	9.23%	Not in AP Universe
PGLIX	Principal Investors Fund Inc – Partners Large Cap Growth Fund	9.26%	Not in AP Universe
PGWAX	Allianz OCC Growth Fund	9.07%	#126 (US LCG)
PRGFX	T Rowe Price Growth Stock Fund	9.05%	#6 (US LCG)
VMRAX	Vanguard Morgan Growth Fund	9.03%	#23 (US LCG)



Large Cap Core (AIRALC)

Fund Symbol	Fund Name	Index Weight	AP Ranking
CESPX	CMG Enhanced S&P 500 Index Fund	9.98%	Not in AP Universe
EVSAX	Evergreen Enhanced S&P 500 Fund	9.94%	Not in AP Universe
FDLEX	Fidelity Exchange Fund	9.96%	Not in AP Universe
GESSX	GE Savings And Security Program Mutual Fund	9.88%	#414 (US LCC)
ILFLX	The Industry Leaders Fund	10.02%	Not in AP Universe
ITVAX	GE Value Equity Fund	9.88%	Not in AP Universe
MFQTX	Managers AMG Funds - FQ Tax Managed US Equity Fund	10.19%	Not in AP Universe
MUEAX	MFS Union Standard Equity Fund	9.98%	Not in AP Universe
TIGRX	TIAA-CREF Institutional Growth & Income Fund	10.18%	#384 (US LCC)
VTCIX	Vanguard Tax-Managed Capital Appreciation Fund	9.98%	#67 (US LCC)

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