

Index funds: Building predictability into portfolios

9 April 2009



Cheap and pretty cheerful. That's one way to describe the indexing market at the moment. With investment returns predicted to remain subdued for several years, indexing may be a product whose time has come.



According to SSgA Australia's head of global structured products Susan Darroch, indexing provides advisers with a valuable tool in an environment where investment costs are under scrutiny.



"With indexing as the core, it is a great way to get the market return, and it is cheap and reliable," she said.

Investment Trends director Mark Johnston believes the recent market downturn and volatility are changing attitudes towards indexing throughout the planning industry.

"There is an increasing focus on lower cost investment options, which is a natural focus when people are losing money," Johnston said.

"To date, indexing has been mainly institutional money but that is changing. Retail use is increasing and the ETF [exchange-traded fund] market is a big component of that."

Never saying sorry

Although indexing may not be exciting, its proponents argue that unlike active managers, they are never forced to explain their failure to achieve market returns.

While the boom was supposed to be a good time for active management, the story is still the same now, according to Vanguard Investments Australia head of retail, Robin Bowerman.

"You can't have it both ways. Active management always holds out the promise of outperformance,"

he said.

"The evidence is that most active managers will underperform in both growth and bear markets."

Bowerman feels advisers need to view indexing as a cost-effective tool for accessing market returns and for the development of superior investment portfolios.

"We need to get past the idea of whether it is a good time for active management or not."

Darroch believes the performance from indexing is more reliable.

"You know whatever the market does, the index

portfolio will do as well."

It is an argument that proved to be very persuasive in rising equity markets.

In 2002, only 10 per cent of total assets in the US managed funds industry were indexed, but by 2008 this had grown to 17 per cent, according to Bowerman.

In terms of net cash flows, index funds received 32 per cent of inflows in 2002, but by 2007 this had reached 47 per cent.

In 2008, the Barclays Global Investors Year End ETF Market Review found listed index products were the only ones with a positive cash flow.

Risk management