S&P Dow Jones Indices

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InstitutionalTalks

Why Multi-Factor Index Construction Matters

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InstitutionalTalks is an interview series where industry thinkers share their thoughts and perspectives on a variety of market trends and themes impacting indexing.

Jeb Burns is the Chief Investment Officer of MERS of Michigan, where he directs the USD 15 billion investment program.

Julian Ramirez, CFA, is an Investment Officer and Portfolio Manager at MERS.

S&P DJI: Tell us a bit about your roles at MERS and the individuals you serve.

Jeb: The Municipal Employees' Retirement System (MERS) of Michigan is an independent, professional retirement services company created to administer the retirement plans for Michigan's local units of government on a not-for-profit basis. We manage various investment programs for over 900 municipalities throughout the state. We serve more than 100,000 participants, including local firefighters, nurses, and the men and women who plow our roads and keep our communities safe. Total assets for MERS as of June 30, 2021, were valued at USD 15.19 billion, with the defined benefit (DB) portfolio being the largest program, at USD 11.89 billion.

In my role as CIO, I am responsible for the investment management of the plan's assets. This includes maintaining a successful investment team and culture, recommending and implementing the asset allocation for our investment programs, and regularly reporting to the board and investment committee on investment matters.

Julian: As an investment officer and portfolio manager, my main responsibility is the management of the global equity portfolio, which includes managing the sub-asset class allocations, developing and maintaining our internally managed equity strategies, and external manager selection and monitoring. I also serve as a part of the asset allocation team, responsible for the asset allocation and risk management for the total portfolio.

S&P DJI: What is MERS' investment philosophy?

Jeb: Investing in today's financial market is increasingly more complex as a result of the rapid exchange of information, increased volatility, and global realignment. Thus, it is important to identify core principles in order to simplify the investment decision-making process.

First, we believe asset allocation is the most important decision faced by investors, and it is the key determinant of risk and returns in our portfolio. We manage our asset allocation using a valuation-driven process over a long-term time horizon, which can help generate outperformance by exploiting market inefficiencies in the short term. We take risks to generate stronger returns, only in areas where higher expected returns compensate us. Additionally, to help achieve our return objectives, we focus on low-cost implementation. We keep costs low by investing passively when appropriate and developing in-house investment capabilities. To manage risk, we seek to diversify our investments. We diversify across asset classes, sectors, geographies, and time horizons.

MERS' Office of Investments believes that framing discussions around these central tenets will help achieve the stated investment goals and increase the probability of long-term investing success.

S&P DJI: What is your view on active and passive investing?

Jeb: How "active management" is defined is debatable. The decision to select a specific passive index strategy is a management decision. There are construction differences between the available equity market indices that could lead to differences in performance over time. S&P DJI's core equity indices have a quality bias built into their index design, while Russell's do not, and there are size differences between how they define the market capitalization segments. The U.S. equity portion of the MERS' policy benchmark uses the Russell 3000; however, we implement our U.S. equity exposure through strategies tracking the S&P DJI indices. We think these core strategies will continue to add value over the long term. Although this exposure is considered passive, it requires an active decision.

Regarding the traditional definition of "active management" (fundamental stock picking and bond selection), we believe that active managers can add value in inefficient markets like U.S. micro caps, international small caps, emerging market equities, emerging market debt, and private market investments. As for more efficient markets, like U.S. large caps and core fixed income, the S&P Indices versus Active (SPIVA®) Scorecards support our thinking that it is difficult for traditional active managers to outperform a passive index consistently over time. When active managers do outperform, most of their excess return can usually be explained by either factor exposures or excess risk-taking.

The growth of ETFs offered within equity and fixed income also greatly influenced this decision and the way we think about active investing. Investors can now choose the type of active exposure they desire and implement it with passive investment vehicles.

S&P DJI: We recently created three multi-factor indices based on the S&P 500®, S&P MidCap 400®, and S&P SmallCap 600® that MERS uses. What was your goal wanting to use these indices?

Jeb: The goal was simple; it was to have access to better beta. We wanted something to use that had the benefits of passive investing (simple, low cost, transparent, scalable) but had the potential to add value over S&P DJI's core benchmarks with potentially lower risk. Additionally, we wanted a passive exposure that better matched our strategic investment philosophy.

We were looking for something with potentially lower risk for a couple of reasons. First, our asset allocation drives most of the total risk and active risk for the total portfolio; we take sizable active positions at the asset class level. So, we wanted any underlying active management to complement this risk and not amplify or offset it. Secondly, it is difficult to add value consistently in U.S. equities with higher tracking error strategies. Some active strategies can outperform over the long term, but they can go through periods of pretty dramatic underperformance. Also, the time and resources it takes to identify, hire, monitor, and terminate these managers and strategies are costly.

The common theme among these high-tracking error strategies is that they tend to focus on selecting the companies they believe are most likely to outperform. We believe the selection of these indices, gives us a better chance to add value more consistently, albeit by a smaller amount. Doing so with an index that retains many of the qualities of the underlying benchmark (low active share, low active risk) solves many of the issues we had with active managers. We can scale the allocation to a more significant amount and hold onto the positions for the long term without any reluctance or hesitation.

Another goal was for the strategies to be simple and easy to explain to our board and plan participants. That simplicity and transparency is essential because we want buy-in from everyone from the start.

S&P DJI: How and why did you select this index concept?

Julian: We reviewed the multi-factor indices currently available and could not find anything that had the low tracking error we were seeking. Upon reviewing S&P DJI's suite of multi-factor indices, the simplicity and transparency of the S&P 500 Quality, Value & Momentum Multi-Factor Index's construction resonated with us.

S&P DJI was looking for ways to enhance its multi-factor index lineup. The new indices S&P developed with input from MERS use several features of the existing methodology, with a couple of noteworthy modifications. First, rather than selecting the top quintile of each universe, the focus is on excluding the bottom decile. Second, the constituent weighting is proportional to the float market cap to reduce tracking error. The same methodology is applied across the three indices.

- S&P 500 Quality, Value & Momentum Top 90% Multi-factor Index
- S&P MidCap 400 Quality, Value & Momentum Top 90% Multi-factor Index
- S&P SmallCap 600 Quality, Value & Momentum Multi-factor Top 90% Index

S&P DJI: Can you elaborate on how you will use these indices?

Julian: These indices are designed to track companies in the top 90% of the universe, ranked by their multi-factor score which is based on the average of three separate factors: quality, value, and momentum. This factor combination represents a diverse group of well-known factors that drives returns over the long term. Historically, they have tended to be quite complementary in terms of how they react to different phases on the business cycle. The individual quality, value, and momentum factor scores are calculated using S&P DJI's standard factor definitions.

The S&P Quality, Value, and Momentum Top 90% Multi-factor Indices select a high proportion of the underlying universe, excluding only those ranked in the lowest decile. Therefore, a company has to score quite poorly across all three factors to be excluded from the index, giving us little reason to want to own the company. Once the securities are selected for inclusion in the index, they are weighted by float-adjusted market capitalization (subject to constraints).

The resulting portfolio of stocks is "benchmark-like," with low active share and low active risk. The indices are rebalanced on a quarterly basis. Given the low active share and the liquidity of the underlying universes, this rebalance schedule tends to keep turnover low while being frequent enough to incorporate any new information.

MERS will use these strategies to replace our traditional beta exposure within U.S. equity and use it for comparison purposes for active managers. The indices will initially make up over half of our U.S. equity exposure, but the plan is to replace most, if not all, of our passive exposure with the new indices.

S&P DJI: You decided that ETFs would be your preferred investment vehicle to give exposure to these strategies. Why is that?

Julian: We had a few options to consider when it came to the implementation of these strategies. We evaluated the feasibility of replicating the indices internally or outsourcing the management of the indices to an asset manager in a separately managed account. However, we adopted the use of ETFs over the past two years as an integral component of our asset allocation implementation due to their low cost, flexibility, and liquidity.

Scalability is another reason we prefer the ETF wrapper versus managing the indices internally. The MERS team can handle managing a few indices internally, but we would like to access similar strategies outside of the U.S. So, as we look to expand our use of multi-factor strategies across the equity portfolio, being able to invest in them via ETFs gives us the flexibility we need to also manage the asset allocation for the total portfolio.

S&P DJI: Do you think passive access to factor combinations could be the way forward for asset owners and asset allocators and where might these strategies fit in?

Jeb: Yes, the investors we speak with like the simplicity, transparency, and cost effectiveness of passive investing. To be able to access factor combinations that could potentially add value while having the benefits of passive investing should be attractive to investors.

How these strategies might fit in will depend on the individual investor's active risk tolerance. For example, strategies like the S&P Quality, Value & Momentum Top 90% Indices may be viewed more as a replacement for traditional beta. On the other hand, the higher tracking error multi-factor strategies could be considered more as a potential replacement for active managers. I am not saying that this will potentially replace traditional passive or active investing completely, but the frictions that prevented investors from adopting an approach like this, such as high costs and lack of passive investment vehicles, have been significantly reduced.