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New series of indexes track top actively managed funds

By **Sue Asci**
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A Massachusetts investment advisory firm has launched a series of indexes based on actively managed mutual funds.

For each index, Active Index Solutions, a subsidiary of F-Squared Investments LLC of Wellesley, used quantitative screens to select the top 10 performing managers in 18 broad asset classes and industries.

Grouped into retirement income, risk-adjusted return and PrecisionAlpha sector categories, the Acti-Index indexes will be reconstructed once a year, and underperforming managers will be replaced.

The indexes were constructed and are being managed by third-party consultants — including Kanon Bloch Carr of Boston, Mesriow Financial Holdings Inc. of Chicago and Klein Decisions LLC of Raleigh, N.C. — and are calculated and distributed by the American Stock Exchange in New York.

F-Squared plans to introduce a package of investment products based on the indexes early next year.

The goal of the indexes is to capture the momentum of successful managers and combine it with a re-balancing strategy, said Howard Present, co-founder, president and chief executive of F-Squared Investments.

The key to making the strategy work is acknowledging the rise and fall of alpha, and capitalizing on it while the market is in an upswing cycle, he said.

"Alpha creation is not linear. And the average investor is buying high and selling low," Mr. Present said. "Active managers can add value. How do you access that if you ignore the alpha cycle? We can give them a sixfold increase in the likelihood of success."

He said the consultants are responsible for selecting funds that are high performers and possess forward momentum so that they are likely to perform well over the next 12 months. Their methodology must be quantitative, he added.

In a 10-year back-test, Mr. Present said, the new indexes outperformed traditional indexes and Morningstar peer groups 60% to 73% of the time.

The indexes are not the first of their kind. Lipper Inc., a New York-based research and information firm, launched a series of more than 25 Active Indices six years ago for benchmark purposes. The Lipper indexes, based on fund holdings, are broader in scope and include all actively managed funds based on classifications.

The new indexes raise the perennial issue of whether active management outperforms passive management over the long run when costs are included.

"I believe in active management. You can find active managers that have good track records and outperform, but not 100% of the time," said F. Dennis DeStefano, president of DeStefano Wealth Management of Kihei, Hawaii.

"When the markets go down, active managers are able to do something about it," he said.

Other advisers doubt that quantitative screening will improve performance.

"The thought that you can identify these guys and that they will be persistent outperformers in the future is a difficult deliverable," said Chuck Neff, a wealth manager at Balasa Dinverno & Foltz LLC of Itasca, Ill. He noted that in many categories, passively managed funds outperform actively managed mutual funds most of the time.

"If they are doing a top 10 list, they'd be constantly shuffling out managers. It's tough, conceptually. There is going to be a lot of manager turnover," Mr. Neff said, adding that transactions can generate fees and taxes.

Others agree. "A market index will outperform an index of active managers," said Rick Miller, a financial planner at Sensible Financial Planning of Cambridge, Mass., noting that he does not believe that the strategy will work.

"If you look at how you can demonstrate an ability to outperform among active managers you are looking to find something that is unexplainable," said Steven Weydert, executive vice president at Bowyer Weydert Wealth Planning Partners Inc. in Park Ridge, Ill.

"More than 95% of returns are explainable by average market capitalization and the average statistical ratio of book to market value. Those factors explain returns within 4% to 5%," he said. "We already know where the returns are coming from, and they are not from anybody's skill; they are from the characteristics of the portfolio."

To remain in the new index, the managers must be top performers, Mr. Present said.

"We're not trying to predict; we are trying to find an investment strategy that allows us to implement active management to have the odds in your favor for investing," he said.

"Even among the most die-hard indexers, none believes that all active managers lose value," he said.

The 12-month reconstruction of the index with a "forced-sell" discipline is what differentiates the indexes, Mr. Present said.

"It's possible that less than 5% of the managers will look good three years later," he said.

"Why would I want to buy them and hold for more than three years? The difference in what we are saying is that you need to match your behavior to the reality of the marketplace," Mr. Present said.

For the American Stock Exchange, offering an index of actively managed mutual funds is a first, said Scott Ebner, an Amex senior vice president.

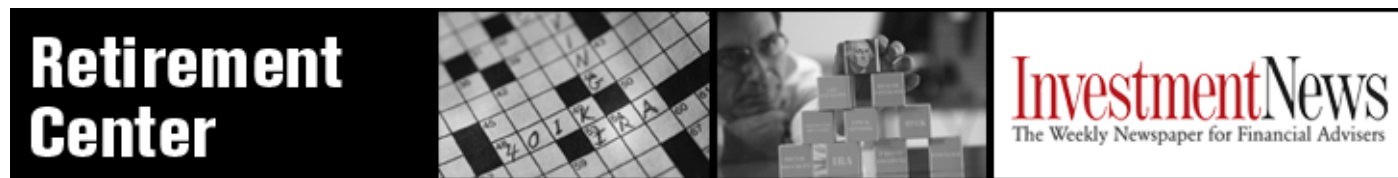
"I believe these are the first ones incorporating a selection process to include only highly rated managers rather than reflecting the broad range of managers," Mr. Ebner said, noting that ETFs have inspired many new index ideas.

"Active managers are often compared to the stock market; it makes sense to compare them to their peers," he added.

The indexes are available on the company's website, activeindexsolutions.com.

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