Beyond the benchmark

The 10 most crucial things to consider when choosing a diversified index fund

In recent years, the growing popularity of index investing has gained momentum and index funds have experienced an exceptional increase in assets under management (AUM).

This growth has pushed down fees for investors, while also commodifying single asset class index tracking strategies.

In contrast, differences among diversified passive funds have been proliferating due to the growing number of funds offered to investors and the absence of any industry standards around how they should be managed.

This means that seemingly similar diversified index funds can have significant differences in performance. It's critical investors understand that deviations in performance can occur and to be aware of the underlying causes.

Absence of industry standards

When investors invest passively in a single asset class, there are typically a small number of commonly accepted indices from which to choose – for example, the S&P/ASX 300 index for Australian shares. These indices operate under a transparent set of rules (known as an index methodology) which investment managers can closely track. Single asset class index portfolios have therefore become highly standardised, with competition largely revolving around fees.

Diversified index funds show few signs of standardisation because there are no accepted standards or rules governing things such as:

- which asset classes diversified portfolios should invest in
- the size of allocations to each asset class
- the specific indices which should be selected for each asset class
- how foreign exchange (FX) exposures should be managed
- risk profile definitions – what one manager considers a balanced fund, another may classify as a growth fund
- growth/defensive classification of asset classes
- how Environmental, Social and Governance (ESG) issues should be addressed.

ABOUT THE AUTHOR

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Stephen is the Senior Portfolio Manager for over $20 billion of diversified index portfolios and is also responsible for the North Professional range of actively managed diversified funds. He has worked at AMP for over 10 years and holds a Bachelor of Commerce from the University of Queensland, Masters of Economics from the University of Sydney, Masters of Applied Finance from Kaplan Professional and a Graduate Diploma of Teaching.

To help navigate this complexity, here are 10 important things to consider when choosing a diversified index fund.

1. INVESTMENT OBJECTIVES

Unlike single asset class passive funds, which have the sole objective of tracking a specified benchmark as closely as possible, investment objectives across diversified index funds can vary greatly. They may cater for a certain type of investor or express a distinct investment philosophy. These objectives play a pivotal role in guiding the portfolio construction of diversified portfolios and are a key underlying cause of portfolio and performance differences.

HOW NORTH INDEX DOES IT

North Index funds are specifically designed to cater to Australian investors who use the North platform. With a focus on providing low-cost, highly liquid, transparent and well-diversified portfolios, each fund is tailored to one of five distinct risk profiles. The portfolios are constructed to track the performance of underlying asset class indices, weighted by a strategic asset allocation (SAA). Although the minimum investment horizon varies by risk profile, these portfolios are designed for investors with a medium to long-term investment horizon. For more information on the investment objectives of each fund, please refer to the North Index PDS.

2. ASSET CLASS SELECTION

Not all diversified index funds invest in the same asset classes, and the inclusion or exclusion of certain asset classes varies significantly. This variability is greatest in infrastructure, property, emerging market equities, small company equities, cash and high yield credit asset classes. The asset classes held by portfolios is often influenced by the scale of the fund, how cost effectively they can access certain asset classes and what other products the fund manager offers to investors.

HOW NORTH INDEX DOES IT

The North Index funds provide exposure to nine distinct asset classes: Australian shares, global developed market shares, emerging market shares, Australian listed property, global listed property, global listed infrastructure, Australian fixed income, global fixed income and cash. This makes North Index one of Australia's most diversified passive multi-asset offerings.

As Nobel laureate Harry Markowitz famously said, diversification is "the only free lunch in investing". It enhances risk-adjusted returns by reducing risk without compromising performance. Being well diversified goes beyond just asset classes, we also aim to maximise diversification in the North Index funds by security, geography, factors, industry and currency wherever appropriate.

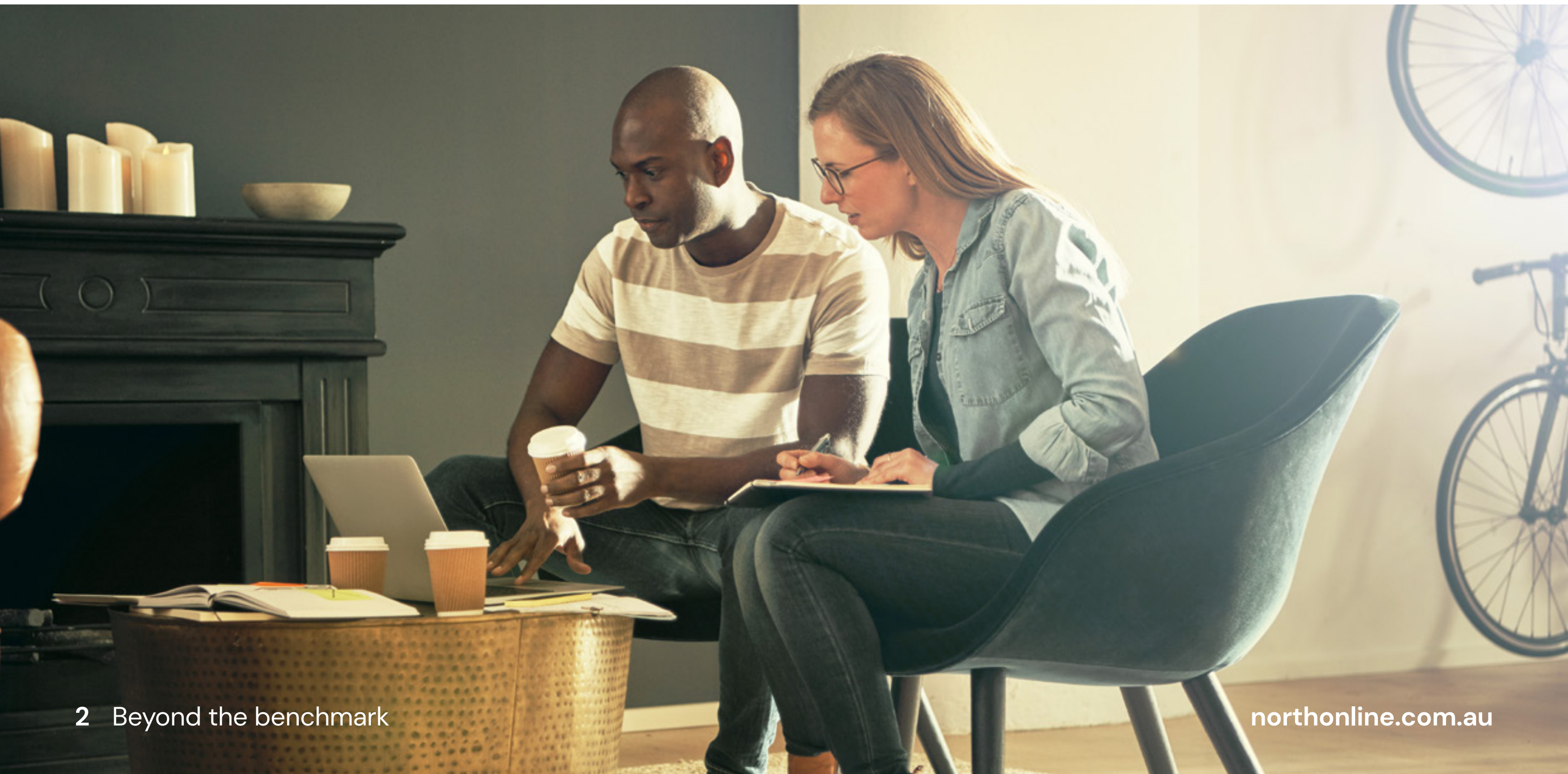
3. ASSET ALLOCATION AND RISK PROFILES

Variation in asset allocation between diversified index funds is the most significant contributor to performance differentials. Investors must therefore carefully evaluate whether a fund is appropriately diversified and offers robust portfolio construction. Investors must also determine the level of growth asset exposure suitable for their financial circumstances. There's currently no widely accepted standard for defining risk profiles or how to classify growth and defensive assets. Investors should be mindful of these details when considering a fund and avoid drawing too many conclusions merely from a fund's label or marketing.

HOW NORTH INDEX DOES IT

The North Index range offers five distinct risk profiles: Conservative (35% growth), Moderately Conservative (55% growth), Balanced (70% growth), Growth (85% growth) and High Growth (97% growth). Shares, property, and infrastructure assets are classified as growth, while fixed income and cash are defensive.

The North Index portfolios are constructed and managed by a team of experienced multi-asset and single sector portfolio managers who work closely with Shane Oliver's investment strategy team. This collaborative approach ensures that each portfolio's SAA is specifically tailored to achieve its individual investment objectives. A comprehensive list of each fund's SAA can be found in the North Index PDS.



4. CURRENCY HEDGING

After share market movements, currency exposures typically represent the second largest source of absolute risk in a diversified index fund. So currency hedging practices – which vary widely between managers – can drive performance differences. Investors must be confident that any fund in which they invest includes a well-considered currency hedging policy that aligns with their investment objectives, manages risks appropriately and achieves low transaction costs.

HOW NORTH INDEX DOES IT

FX exposures within global property, infrastructure and fixed income positions are fully hedged back to the Australian dollar (AUD). Emerging market share exposures are typically unhedged, and global developed market shares are partially hedged.

The North Index portfolios target a specific total FX exposures for each risk profile: Conservative 10% FX, Moderately Conservative 13% FX, Balanced 20% FX, Growth 25% FX, High Growth 30% FX. These exposures are strategically calibrated to manage currency risk (FX is seen to be able to play a defensive role in a diversified portfolio) while ensuring the portfolios remain well-diversified (we want portfolios which are exposed to a various currencies – not just the Australian Dollar).

5. SELECTION OF UNDERLYING ASSET CLASS INDICES

Selecting the appropriate underlying index for each asset class to track can be complex. While the largest traditional asset classes, such as Australian and global shares and fixed income, have common underlying indices, there's much more choice across asset classes like property and infrastructure. Investors should ask the following questions when choosing a fund.

- Is the index broadly diversified and able to provide a comprehensive representation of the asset class?
- Is the index commonly used by other investors and stakeholders, such as regulators? Being accepted by more stakeholders is often a sign of an index's quality.
- Are there actively traded futures contracts for the index? This is important to facilitate efficient trading and rebalancing.
- Can the index be effectively tracked without compromising on liquidity? This requires evaluation of the liquidity profile of the underlying securities.
- Do the rules governing the index promote the long-term interests of investors?
- Are the index provider's fees and costs fair and competitive?

HOW NORTH INDEX DOES IT

North Index funds employ the following indices in each asset class:

- **Australian shares** – S&P/ASX 300 Accumulation Index
- **International shares** – MSCI World ex Australia ex Tobacco Index (partially hedged)
- **Emerging market shares** – MSCI World Emerging Markets Index (AUD)
- **Global listed infrastructure** – FTSE Developed Core Infrastructure Index (AUD hedged)
- **Global listed property** – FTSE EPRA NAREIT Developed ex Australia Rental Net Total Return Index (AUD hedged)
- **Australian listed property** – S&P/ASX 300 A-REIT Accumulation Index
- **Australian fixed income** – Bloomberg AusBond Composite 0+ Yr Index
- **Global fixed income** – Bloomberg Barclays Global Aggregate Index (AUD hedged)
- **Cash** – Bloomberg AusBond Bank Bill Index

Our process for considering indices is extremely thorough. All North Index benchmarks meet the standards of index selection listed above. In fact, entire asset classes have excluded from the funds where the relevant indices have fallen short of our tests, including global and Australian smaller companies shares (due to integrity and liquidity issues) and high yield credit (due to concerns about how indices weight constituents).

6. REBALANCING

Efficient rebalancing is crucial for diversified portfolios to maintain their asset class targets and meet investment objectives. Poorly executed rebalancing can lead to unintended tracking error and high transaction costs, which can negatively impact investor returns. Effective rebalancing demands a specialist team, a clear implementation strategy and access to a range of instruments such as futures, forwards and swaps. The ability to directly cross trades with other investors can further enhance rebalancing efficiency and reduce costs.

HOW NORTH INDEX DOES IT

We employ a blend of quantitative rules and qualitative judgement in rebalancing the North Index funds, and continually seek ways to optimise and improve efficiency. The funds' exposures rarely deviate more than 1% from their benchmark target allocations and rebalancing is often executed via crossing exposures with other diversified portfolios managed by AMP Investments or by using futures to reduce transaction costs.

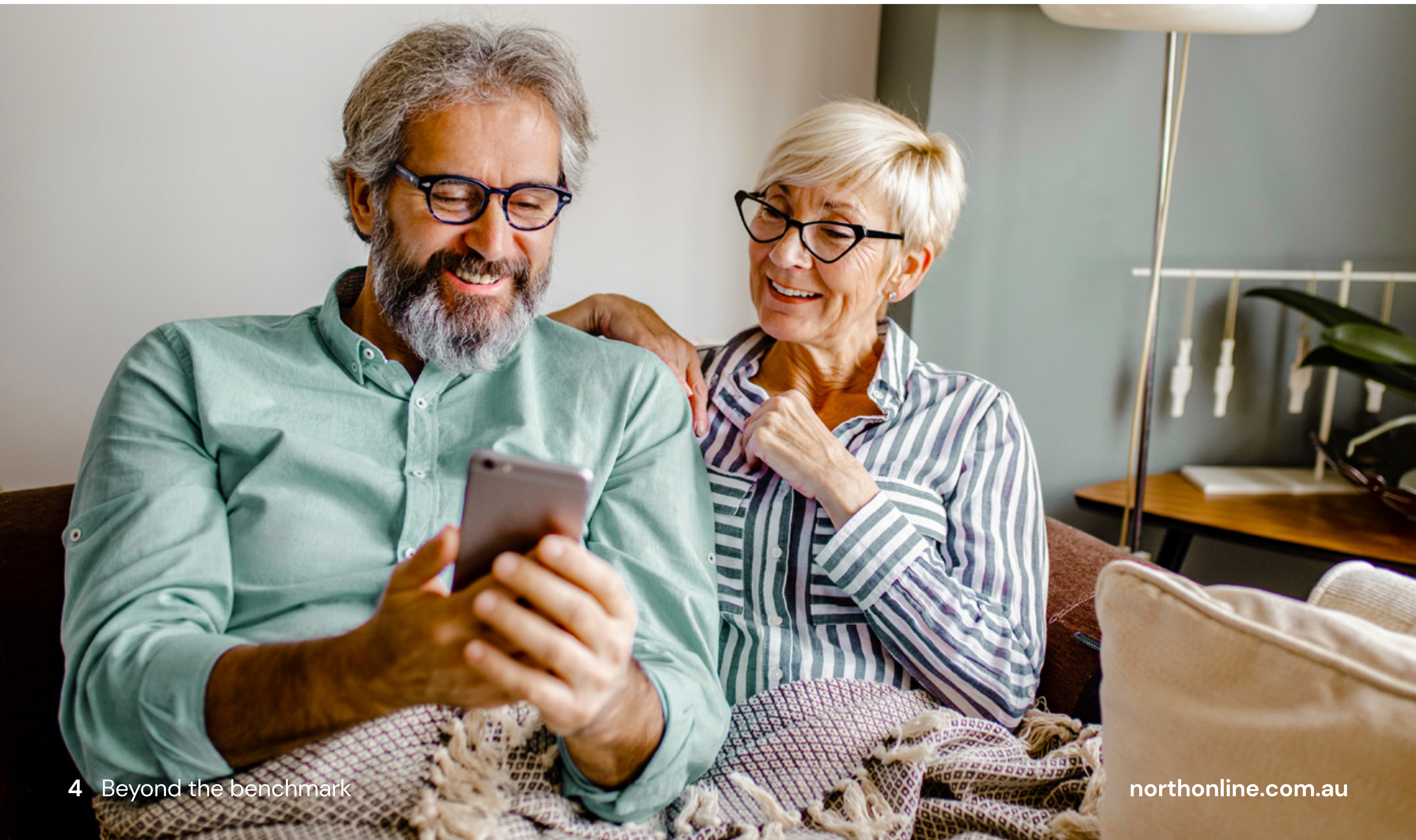
7. UNDERLYING STRUCTURES

Diversified index funds invest in trust vehicles, direct holdings of physical securities and derivatives such as futures and swaps. The choice of underlying structures and asset type is important as it can meaningfully affect transaction costs, tax impacts and risk management outcomes.

HOW NORTH INDEX DOES IT

The North Index funds access ten dedicated AMPI trusts that hold physical securities in the nine asset classes in which the funds invest. These underlying trust portfolios are managed via mandates with UBS, one of the world's leading index providers. Directly holding physical securities is an important risk mitigation feature as it maximises our control transparency and flexibility (e.g. if a new stock is entering an index we have the flexibility purchase it a few days in advance before the index providers bid up the price). These holdings are not pooled with other external investors to avoid commingling risk and further enhance control and flexibility.

The North Index funds also hold a small number of derivatives such as futures to facilitate efficient rebalancing and FX forwards for currency hedging.



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8. ENVIRONMENTAL AND SOCIAL GOVERNANCE (ESG)

ESG issues matter to active and passive investors alike. The degree to which funds incorporate ESG considerations into their investment decisions and risk management practices can vary significantly. Some funds may screen out certain types of securities or engage with companies to improve their performance on ESG matters. Investors should carefully consider a fund's ESG policies and approach before investing to ensure alignment with their own values, beliefs and priorities.

HOW NORTH INDEX DOES IT

While North Index funds don't have a specific ESG mandate, they are subject to AMP's Responsible Investment and ESG Statement. The funds seek to avoid investing in tobacco, electronic cigarettes (ENDS) and controversial weapon manufacturers or in companies receiving more than 50% revenue from the distribution or sale of tobacco products and ENDS, and we assess and manage jurisdictional risk when investing offshore. Where possible, the funds took steps to divest and reduce exposure to Russian assets when the Ukraine conflict broke out. For directly held securities, we exercise our rights as shareholders of companies we are invest in. Our fund managers, and our internal ESG team monitors and engages with companies through proxy voting or in collaboration with other investors on relevant issues. The effectiveness of our ESG policies is significantly enhanced by the fund's structure which ensures that the majority of assets are directly held physical securities.

9. SCALE

Diversified index funds vary significantly in the size of their AUM, from just a few million dollars to tens of billions. Larger funds generally boast advantages such as greater cost efficiencies, specialised resources, access to more sophisticated systems and efficient bespoke internal structures (i.e. dedicated mandates).

HOW NORTH INDEX DOES IT

Successful AUM growth has seen the North Index funds become one of Australia's largest diversified index fund ranges with a total portfolio size in excess of $14bn. This allows for a highly cost efficient operation and provides the funds access to dedicated resources including ESG specialists, risk analysts, trading teams, tax experts and dedicated asset class portfolio managers. Their size also means the funds can access a diverse set of asset classes and have dedicated mandates in each.

10. REPLICATION METHODOLOGY

As the passive investing industry has grown to trillions of dollars under management, it has evolved considerably. The methodology for tracking asset class indices has become increasingly sophisticated and various index replication methods have emerged including physical replication, synthetic replication and hybrid approaches. While these different approaches usually yield similar results, there are certain situations where investment outcomes can vary measurably. Put another way, while the returns might look the same the risks can be very different.

HOW NORTH INDEX DOES IT

The North Index funds primarily employ a physical replication approach. This offers benefits such as access to franking credits for Australian shares and lower counterparty risk. However, the portfolios do replicate some small exposures synthetically via futures, typically for rebalancing purposes. This hybrid approach reduces transaction costs while maintaining the benefits of physical replication.

Not all diversified index funds are created equal. Investors should make sure the diversified fund is aligned to their needs and suitable for their circumstances. Equally important is selecting a manager with the expertise, experience and resources to successfully navigate these issues.

Get in touch

If you'd like to know more, we'd suggest having a chat to your financial adviser.