Index-Based Investments as a Foundation for Asset Allocation

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Index-based investment strategies have grown in scale and scope in recent years, increasing the level of choice for Canadian financial advisors. And index-based investment products bring a number of strengths to the asset allocation process:

- **Efficiency.** Indexes are a very straightforward way to gain broad exposure to an asset class, investment style or company characteristic. Indexes use consistent, rules-based methodologies replicate the performance of whatever market they are tracking and regularly recalibrate and rebalance to ensure they are adhering to their methodology.

- **Predictability.** Because indexes are designed to follow a predetermined set of rules, they are quite predictable. Unlike an active manager, indexes are not able to stray from the rules they have laid out in their methodology. When viewing asset allocation as a "team" where all the players have a certain role to serve, players with predictable performance carry a premium.

- **Modularity.** Index-based investments with distinct strategies and efficient ways of gaining market exposure can be easily implemented within the context of an asset allocation portfolio. For example, if your target exposure calls for 40% Canadian equities and 60% international equities, you can fill your two buckets with distinct yet complementary index-based investments providing broad exposure to these asset classes, then easily readjusting periodically based on market performance.

- **Liquidity.** Index-based investments can also lower your implementation and liquidity risk. Indexes provide access to liquidity across asset classes, making it easier to build exposure for your asset allocation scheme versus buying securities directly.

And while index-based investment strategies do offer many benefits, not all indexes adhere to the same set of standards. As a financial advisor, you should understand the differences among indexes and know what to look for when evaluating potential approaches. Some things to watch out for:

- **Comprehensiveness.** The index must deliver an accurate and comprehensive representation of its intended market segment. This is particularly important for Advisors as they use ETFs to gain access to a market or market segment. Omitting eligible securities from an index can lead to unintended consequences such as errors in the asset allocation structure of the total portfolio.

- **Transparency.** A transparent and objective approach to index constituent selection provides a more accurate, unbiased representation of the market it is designed to measure/represent rather than a subjective, committee-based method. You should make sure that the indexes underlying your investments have publicly available rules which allow investors to understand and potentially anticipate why and when changes are made to the index. Index providers should also to have a formal governance system in place so that the indexes are proactively evaluated to ensure they reflect and adapt to the evolving market.

- **Investability.** Advisors should also make sure that underlying indexes of ETFs in their portfolio limit their holdings to those readily available to the investor. If shares not available to public investors are included in the underlying index, replicating the exposure can be difficult, causing tracking error. Additionally, the demand for shares from investment funds replicating the index could cause unnatural stock price spikes. Index weights should be calculated using float-adjusted market cap, meaning the index should only account for the shares that are freely available for purchase by the average investor, rather than those held by employees or other investors that are restricted from selling their shares.

- **Cost Efficiency.** Advisors, similar to other investors, are very sensitive to transaction costs. For this reason, they also evaluate rebalance methodologies of the underlying indexes tracked by their ETFs. When indexes rebalance constituents and weights in order to keep them representative of their respective index strategy, passively managed investments incur in transaction costs. Advisors typically evaluate index methodologies to ensure that the index adequately represents and aligns to the market, while keeping turnover costs manageable.

In my role with global index provider FTSE Russell I have the pleasure of working with several major ETF providers in Canada, and they all stress the importance of education on index benefits to financial advisors. According to Scott Johnston, CFA and Head of Portfolio Review for the Americas at Vanguard Investments Canada, "We're seeing financial advisors in Canada using index-based investment products such as ETFs more and more as key building blocks in their clients' portfolios. Selecting low-cost ETFs built on high quality indices allows advisors to spend more time on what matters most for good investment outcomes, including asset allocation and rebalancing."

Indexes can be powerful tools for asset allocation, in many ways due to their simplicity and the straightforward nature of their design. Canadian financial advisors, however, should not confuse simplicity with consistency and it is necessary to perform proper due diligence to ensure the indexes you utilize perform as expected. This means evaluating the indexes underlying your asset allocation process just as you would any other investment to ensure they are designed to meet the needs of your clients.