The Rise of Custom Indexes

by Mike Casciano
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Financial advisors with high-net-worth clients find custom index strategies are low cost and high benefit.

Asset management is big business, generating approximately $300 billion in revenue in 2023 alone. According to the Investment Company Institute, fund assets in the U.S. totaled nearly $34 trillion, with Morningstar tracking over 6,000 actively managed U.S. large-, mid-, and small-cap funds.

The portfolio managers for each of these 6,000 funds charge a fee, creating a hurdle that must be overcome just to match the performance of each respective benchmark. Back in 2000, the average asset-weighted expense ratio for equity mutual funds was 99 basis points (bps). By 2023, this had dropped to 42 bps, driven by the rise of larger, lower-cost funds.

An investor may find themselves paying 50 bps for a fund with the hope that, over the long term, the manager outperforms the benchmark by at least an equivalent amount. But are the odds of selecting a "winner" just as good as betting on red or black at the roulette table? Let's see how active management has performed in the large-cap space over the long term.

Using Morningstar's free research tool, we can compare the performance of actively managed funds against the iShares Core S&P 500 ETF (ticker IVV), as an investable proxy for a large-cap benchmark. As of July 2024, for a management fee of just 3 bps, this ETF ranked in the 9th percentile for 10-year annualized performance and 10th percentile over the past 15 years. Accounting for after-tax performance, it vaults to the 4th percentile over both periods. Out of 895 funds over the last decade, roughly 800 failed to keep pace with the benchmark before taxes, and fewer than 40 delivered better after-tax returns for those in the highest tax brackets.

What Can We Learn?

Investing is undeniably challenging. Portfolio managers are among the most intelligent, well-educated, and well-resourced professional investors globally. They dedicate long hours researching and analyzing securities just to deliver a better outcome in a specific segment of the investment universe. Yet, for the last ten years, only 4% have been able to outperform a low-cost index fund that simply provides market-cap-weighted exposure to the 500 largest U.S. companies, after taxes.

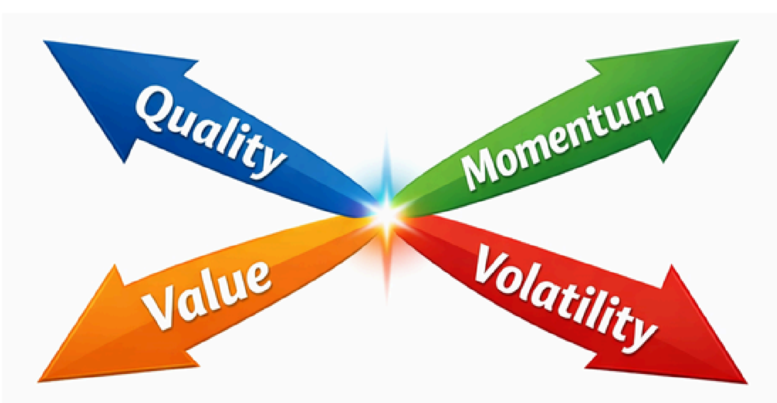
Index-tracking ETFs have two major advantages relative to active management. First, they follow a simple, defined process for selecting and rebalancing holdings. This effectively removes behavioral risks and emotional biases that can negatively impact decision-making. Second, their low cost is a significant advantage. Morningstar research consistently shows that the most reliable predictor of future performance is the management fee — lower fees mean a lower hurdle to keep up with or outperform a benchmark.

In today's highly efficient markets, with supercomputers and complex algorithms, being a great stock picker is far more challenging than it was even a few decades ago.

Rise of Factor Investing

The availability of equity factor analysis has also taken a toll on active management. Factors evaluate the characteristics of investable companies. Some examples of common factors are value, momentum, growth, size, volatility and quality. A rewarded factor is one that historically delivers a favorable experience, compared to a benchmark, over a full market cycle.

Many active managers maintain consistent exposure to one or two rewarded factors as part of their investment process. Think of it as the manager's style. Warren Buffett is perhaps the greatest value investor to ever live. Cathie Wood, the CEO of Ark Invest, looks for companies that can deliver explosive growth.



Improved analytics and quantitative investing have made it extremely easy and efficient to invest in factors. This has arbitraged away a manager's ability to easily generate alpha through simple factor exposure.

Efficiency as an Alternative to Traditional Active Management

The total cost of owning a fund is the combination of both the management fee and the realized tax drag from distributions and capital gains. These costs are ultimately borne by the client. An efficient strategy for advisors can be to maintain exposure to rewarded factors at the lowest possible cost while minimizing tax drag for the client.

Advances in technology have made this approach more accessible and straightforward for advisors to implement. Advisors can now access low-cost custom indexes to invest directly in individual equities from providers like S&P, Morningstar, Russell and VettaFi. They can even create their own proprietary indexes using third-party technology from offerings like Syntax Direct. The index allocations are available daily and account for corporate actions like mergers, acquisitions and spin-offs. These custom or proprietary indexes can often be licensed for less than 10 or 15 bps.

By owning individual stocks, advisors can take advantage of more opportunities to optimally tax manage client portfolios by limiting capital gains, harvesting losses and delivering personalization. Tax alpha is much more predictable and often has a larger positive impact on a client's probability of success than the pursuit of excess returns from investment alpha.

Summarizing the Benefits

Reducing investment costs for client portfolios and reducing tax drag are predictable approaches to delivering a higher probability of successfully achieving financial planning goals. Technology enhancements have made it easy and cost efficient to provide tax optimization and custom index exposure. Most custodians have eliminated trading costs for equities, and wealth technology now exists to automate portfolio management and trading.

For many advisors and clients, actively managed funds remain a great solution. For others, low-cost ETFs for broad market or factor exposure are ideal. However, for advisors managing client accounts with tax-sensitive, non-qualified assets, custom index strategies offer a compelling low cost, benefit-rich solution that is hard to overlook.

Mike Casciano has over two decades of experience in the wealth and asset management industry. He began as a financial advisor in 2005, then worked with BlackRock and Principal Asset Management in various roles including wholesaler, portfolio consulting, model portfolio strategy and wealth technology. In 2023 he founded EVO Wealth Consulting, to help RIA firms implement processes and technology to deliver a differentiated and scalable service model. EVO sits at the intersection of wealth management, asset management and wealth technology. Learn more at www.evo-wealth.com.