

Watson Wyatt urges funds to diversify indices for added value

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UK – Fundamental and risk-weighted indices can offer different beta to a portfolio, consultants Watson Wyatt has advised pension funds.

Paul Trickett, European head of investment consulting at Watson Wyatt, named "superior risk-adjusted returns, mispricing opportunities relative to traditional portfolios and improved resilience" as main advantages of non-cap-weighted indices, when speaking at a press conference.

"Managers benchmarking against fundamental or risk-adjusted indices did not suffer as strongly from the market turbulences as those using cap-weighted indices," added Craig Baker, global head of manager research at the consultants.

Having coined the term 'beta prime' for briefs benchmarked against indices other than cap-weighted, Watson Wyatt believes this could bring about "the biggest revolution the index world has seen".

Trickett admitted these alternative indices were a bit more expensive than traditional ones, but still cheaper than active management fees.

According to Watson Wyatt figures, 68% of equity mandates in the UK are actively managed versus index benchmarks virtually all of which use cap-weighted indices.

However, "the vast majority are managed to low tracking error where more than 90% of the risk comes from market exposure not skill," Trickett noted. "People are paying a hell of a lot of money for beta."

The growth of passive mandates versus active mandates continued in recent years, but slowed down in 2006, said Roger Urwin, global head of investment consulting.

"But most active managers would tell you they still do not feel pressure and therefore are not considering lowering their fees, especially in the alternative space," Baker explained.

Therefore cheap beta and beta prime should be considered as alternatives to active management. Baker also announced Watson Wyatt will increase pressure on active managers to lower fees.

More about fundamental indices will be available in the November issue of Investment & Pensions Europe.

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