

INTERVIEW

For professional investors
September 2016

ROBECO
The Investment Engineers

The future of Enhanced Indexing: Building customized core quant portfolios

Robeco's enhanced index strategies are based on the experience we've gained from over 25 years of quantitative equity research and portfolio management. We spoke to Wilma de Groot and Michael Strating, senior members of our Quantitative Equities team, who explain how they run the strategies and how we can tailor portfolios to meet the needs of individual clients – particularly in terms of their sustainability profile.

What are Robeco's credentials in managing enhanced indexing strategies?

We've been running developed and emerging market quantitative equity portfolios for many years, for a wide variety of clients. We have a large team of researchers and portfolio managers dedicated to quantitative equity management, and our portfolios have consistently outperformed the broader markets over the years. This has helped us to accumulate over EUR 11 billion worth of assets in our core quant equity strategies of which our enhanced index portfolios form an integral part. These assets are managed in a range of funds and mandates, with a large proportion in low-tracking-error portfolios.



Michael Strating

Head of Quantitative
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Wilma de Groot

Portfolio Manager
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How do you manage your enhanced index strategy?

We manage it according to our purely systematic, bottom-up core quant approach. We invest in stocks based on the signals given by our proprietary quantitative stock selection model, which incorporates a broad range of factors, including valuation, momentum. But rather than simply using the generic definitions of valuation and momentum, we use enhanced definitions to strip out unintended risk and maximize return potential.

The upshot is a strategy where the sector and country weights resemble those of the parent index but with slightly higher weights to attractive stocks and lower weights to unattractive ones. This results in a portfolio with a low tracking error. Our core quant approach is also fully scalable – so we can increase or reduce its tracking error according to the preferences of each individual client.

Does your approach work?

Yes, we've built up a compelling track record over the years. As at 30 June 2016, our enhanced index developed market equities composite had outperformed the MSCI World Index by an annualized 121 basis points since its inception in 2004, with a tracking error of just 1.06%. That means its information ratio was well over 1 – something very few other firms can match over this kind of timeframe.

How would it fit in a broad portfolio?

Our clients see our enhanced index strategy as a core equity holding within their overall portfolio, but it could also be an ideal alternative to a passive equity allocation for investors who want to make additional returns on the broad market. But of course as our core quant approach is fully scalable, we can increase its tracking error to the level that each client wants, up to around 5%.

What are Robeco's competitive advantages in managing quant strategies?

First, we have a long history in quantitative investing, having been using our stock selection model to exploit market inefficiencies for over 25 years and published on our pioneering research findings in academic journals. Our thorough research-based approach therefore reduces the chance of disappointing results out-of-sample. And the proof is there, as we are running our enhanced indexing approach since 2002 with a strong track record.

Second, an important part of our success has been our use of enhanced rather than generic definitions of the valuation and momentum factors. For example, we use residualization techniques to ensure we invest in stocks with high stock-specific momentum rather than those that have large negative or positive betas and which depend more on recent market returns, while for the value factor we are able to reduce exposure to distress risk without reducing return potential.

Another important consideration is that we adopt what we call a glass-box approach, which means all the decisions we take are fully transparent, rules-based and explainable. This results in predictable portfolio construction mechanisms, which in turn lead to relatively low turnover and the ability to offer our clients completely customized portfolios and reporting.

What kind of customization do you offer your clients?

Our clients really are in the driving seat when it comes to tailoring a quant portfolio to suit their individual circumstances, and we can adapt it further in the future if their needs change or on the basis of new Robeco insights. We can customize in three main areas.

First, the investment universe. We can use any broad equity index from any region as the starting point for portfolio construction such as all countries, US, Europe, Pacific, emerging markets, and we can exclude individual market segments. Examples of areas we avoid at our clients' request include Russia, European banks, and their own home countries.

Second, the degree of activeness, as measured by tracking error. Our core quant process is fully scalable and our software can build an optimal portfolio for any desired level of risk. Having launched our enhanced indexing strategy for clients in 2002, as a result of client demand we introduced semi-passive (lower tracking error) portfolios in 2006 and active quant (higher tracking error) strategies in 2008. And we've been able to run these higher-tracking-error portfolios without a major reduction in the information ratio.

The final main area is sustainability. In 2010 we became one of the first quant managers to integrate ESG (environmental, social and governance) into our investment processes, and can easily implement client-specific exclusion lists. But we take a more proactive approach too, ensuring our portfolios are overweight companies with good ESG practices relative to the benchmark. We can also implement a range of sustainability overlays, including carbon footprint reduction. RobecoSAM, a leading firm in sustainability investing, provides us with access to an unparalleled source of corporate sustainability data through its annual sustainability assessment of over 3000 firms around the world.

Why is sustainability so important?

Taking sustainability seriously is one of Robeco's key commitments, and it's becoming increasingly important for our clients across the world as well. By integrating ESG criteria into their investment approach today, clients can make their portfolios more 'future proof', better able to withstand risks that may arise down the road. But each investor deals with sustainability in a different way – they all have their own beliefs, so a one-size-fits-all approach doesn't work.

This means we work closely with our clients to develop bespoke sustainability solutions. For example, in 2013 a large European insurance company chose our enhanced index strategy as an alternative to a passive investment and asked us to implement its own specific exclusion list. Within two years the mandate had surpassed USD 1 billion in size. We also implemented a carbon footprint reduction overlay for this mandate.

We have also been applying ESG criteria to enhanced index emerging equities portfolios for many years. In 2006, a large pension fund in Europe asked us to set up a low-tracking-error emerging equities mandate with a non-standard benchmark and customized ESG integration. The mandate has performed in line with expectations and grown considerably in size.

What are your plans for the future?

We're working on different ways of integrating ESG into our portfolios. For example, a client might say they don't just want their portfolio to have a better ESG profile than their benchmark, they want to make sure it has a better 'E' – environmental – score, as that's what's most important to them. We look into the best ways of implementing such a solution without it having a negative impact on the proven risk-return characteristics of our stock selection model.

And we have a busy research agenda, with our quant researchers examining new factors using non-standard datasets that could further enhance our portfolios' return potential. Any factors that we use must be based on a convincing economic rationale, have proven risk-adjusted return potential over time, and be easy to implement.

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