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EDHEC-Risk Institute Research Highlights the Risk of New Forms of Equity Indices Underperforming Cap-Weighted Indices

In a new research paper published in the prestigious *Journal of Portfolio Management*, entitled "*Diversifying the Diversifiers and Tracking the Tracking Error: Outperforming Cap-Weighted Indices with Limited Risk of Underperformance*," EDHEC-Risk Institute warns of the risk of new forms of alternative-weighted equity indices seriously underperforming traditional cap-weighted indices.

The research shows that the main alternative indices on the market, while superior performers over the long term, have considerable relative drawdowns with regard to their cap-weighted counterparts. These drawdowns can be long (more than two years) and significant (more than 13%). The EDHEC-Risk research identifies two major sources of risk:

1. Risks that stem from a more pronounced "structural" exposure to risk factors, which, through their associated premia, lead to outperformance over cap-weighted indices over the long term, but which, in certain conditions, can negatively affect the performance of these new indices.
2. Every weighting scheme, whether it is qualitative or quantitative, corresponds to a choice of model and therefore contains model risk.

On the basis of this research, EDHEC-Risk Institute makes three recommendations:

- **Diversify beta investment**, because betas are not exposed in the same way to differing market conditions, notably high volatility/low volatility and bull/bear environments.
- Monitor explicit information on **tracking error and extreme tracking error** with respect to the cap-weighted indices that the alternative indices are supposed to be outperforming.
- **Manage this constraint explicitly** because it will ultimately improve the information ratio and risk-adjusted performance of these new indices. The results show that with explicit tracking error constraints, the maximum tracking error of a diversified portfolio of alternative indices declines by 44% while its median relative return is reduced by only 17%. The efficient diversified portfolio, combining the minimum volatility and maximum Sharpe ratio strategies, also **improves the maximum relative drawdown** compared to the stand-alone strategies without relative risk control by 35% and 28.5% respectively.

Commenting on the research, Professor Noël Amenc, Director of EDHEC-Risk Institute, said, "It is surprising that very few alternative equity indices which set a target of beating their cap-weighted equivalent benchmark include explicit tracking error constraints in their construction methodology, or provide information on the extreme tracking error risks that they contain. It is time to develop a genuine culture of relative risk management around alternative indices before the tracking error of these promising offerings leads to their demise."

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About EDHEC Risk Institute

Since 2001, EDHEC has been pursuing an ambitious policy in terms of international research. This policy, known as “Research for Business”, aims to make EDHEC an academic institution of reference for the industry in a small number of areas in which the school has reached critical mass in terms of expertise and research results. Among these areas, asset and risk management have occupied privileged positions, leading to the creation in 2001 of a major research facility: EDHEC-Risk Institute. This institute now boasts a team of 85 permanent professors, engineers and support staff, as well as 19 research associates from the financial industry and 26 affiliate professors.

EDHEC-Risk Institute is located at campuses in Singapore, which was established at the invitation of the Monetary Authority of Singapore (MAS), the City of London in the United Kingdom, and Nice, France. In addition, it has a research team located in the United States. The philosophy of the institute is to validate its work by publication in prestigious academic journals, but also to make it available to professionals and to participate in industry debate through its Position Papers, published studies and conferences. Each year, EDHEC-Risk organises two conferences for professionals in order to present the results of its research, one in London (EDHEC-Risk Days Europe) and one in Singapore (EDHEC-Risk Days Asia), attracting more than 2,000 professional delegates.

To ensure the distribution of its research to the industry, EDHEC-Risk also provides professionals with access to its website, www.edhec-risk.com, which is entirely devoted to international risk and asset management research. The website, which has more than 50,000 regular visitors, is aimed at professionals who wish to benefit from EDHEC-Risk’s analysis and expertise in the area of applied portfolio management research. Its monthly newsletter is distributed to more than 1,250,000 readers.

EDHEC-Risk Institute also has highly significant executive education activities for professionals. In partnership with CFA Institute, it has developed advanced seminars based on its research which are available to CFA charterholders and have been taking place since 2008 in New York, Singapore and London. EDHEC-Risk Institute has an original PhD in Finance programme which, in addition to its highly selective residential track for young talents worldwide, has an executive track for high level professionals who already have master’s degrees from prestigious universities and significant industry experience. Complementing the core faculty, this unique PhD in Finance programme has highly prestigious affiliate faculty from universities such as Princeton, Wharton, Oxford, Chicago and CalTech.

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