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Real Topics

The Gerstein Fisher Approach vs. Conventional Index Approaches

At Gerstein Fisher, we design portfolios to capture the returns of particular market segments. We believe that markets are generally efficient at setting prices and that active attempts to "outsmart" the market through individual sector or security selection cannot consistently generate excess returns. We aim for well-diversified portfolios and careful cost control.

When clients ask us what separates our asset class-based approach to investing from what index managers do, we can point to several key differences:

More Complete Asset Class Representation

Indexes are designed as a proxy for a given segment of the market, yet they include only a subset of the many securities that actually make up that market segment. For example, the S&P 500 often is used as a barometer for US large cap stocks but contains only a fraction of "representative" names from a market of thousands of companies. There are certain segments of the market for which no representative indexes yet exist, like international fixed income. Gerstein Fisher's "pure" asset class approach to investing accesses a wider opportunity set for more precise and comprehensive asset class exposure than would be available through an indexed approach.

Flexible vs. Rule-based Security Selection

Indexes are created based on specific construction methodologies in which stocks are included because they meet certain criteria for size, style, etc. But because indexes are reconstituted only annually, some stocks may remain in the index even when they no longer meet those criteria. A stock's market capitalization may creep beyond a small cap index's threshold, for instance, well before it actually "graduates" from that index. We are not bound by such rigid rules or portfolio construction formulas and even have the ability to "tilt" a portfolio in favor of characteristics that we know to historically have added value.

Flexible vs. Fixed Weightings

Index funds are designed to mirror a given index, which means they must hold securities in the exact weights of that index at all times to minimize tracking error. If the index weighting in a name increases, an index manager must purchase more of that stock to continue to track the index, regardless of the price it is trading at. At Gerstein Fisher, we are not subject to these rigid weightings. If we do choose to match the new index weight exactly, we have the flexibility to wait to trade at a better price.

The "Reconstitution Effect"

Related to the above point regarding an index manager's obligation to continually mirror the fund's benchmark is the issue of index reconstitutions. Indexes typically are recalibrated once annually. New index components are released to the public in advance of the reconstitution date, and research has shown that the prices of securities to be added to an index actually increase between that announcement and the date of the reconstitution. Purchasing these securities at artificially and temporarily inflated prices can negatively impact the performance of index funds that must purchase them at the reconstitution in order to continue to closely track their benchmark.

Negative Momentum

Empirical research on momentum has shown that stocks that have performed poorly over several months typically continue that trend. Until a stock is removed from an index, an index fund must hold it, even if it is experiencing negative price momentum. Gerstein Fisher's flexible security weights and ability to trade patiently means that we can sell negative-momentum stocks if and when we deem it appropriate to do so.

Conclusion

Gerstein Fisher's approach to investing has many similarities to index-based approaches: a belief in the efficiency of markets, a focus on diversification, the aim of tracking particular market segments. But important conceptual and operational differences exist, allowing investors to benefit from our unique approach (see box). To learn more, call us at (212) 968-0707 or toll-free at (800) 473-1155.

The Benefits of True Asset Class Investing

An asset class fund or portfolio tracks the asset class itself, rather than an index. Any holding that falls within the definition of the asset class is "fair game" for purchase, whether or not it is found within any index. This affords the portfolio manager greater selection and thus greater flexibility for capturing the desired asset class return characteristics. Asset class portfolios are not obligated to trade based upon changes to particular indexes, which helps to reduce trading costs as well.

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