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Emerging vs. Developed Countries: A Comparison of Alternative Passive Investment Strategies

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In the last years, the volume of passive investment instruments increased a lot, and many consultancy firms expect a further massive increase in the interest of investors for index trackers products (see, for instance, EY 2017). Given this potential background, we decide to employ in our study a methodology that differs from the traditional index trackers: enhanced indexation (EI) is an investment strategy that aims at mimicking the behaviour of a given benchmark as well as yielding moderate and consistent excess returns over the out-of-sample period. The literature proposes several approaches and methods to achieve the goal. In this talk, we follow the most recent trend in the field and analyze the benefits of using parameter-dependent performance ratios as objective functions to determine the weights of the optimal EI portfolios.

We consider five standard investor prototypes characterized by loss aversion and aggressiveness, namely, defensive, conservative, moderate, growth and aggressive investors. The attitudes of these different investor profiles toward the upside and downside deviations from the benchmark, are captured by a proper parameter balancing.

We present an empirical study, which analyses the effectiveness of such strategies. At first, we check whether the risk allocation is coherent with the investor profile over time. Then, a comparison with a set of index-tracking models is stressed. We employ three different indexes that represent the performance of the full opportunity set of large- and mid-cap stocks. The first is the MSCI ACWI Index, which includes 23 developed and 26 emerging markets, with more than 3.000 constituents across 11 sectors and approximately 85% of the free float-adjusted market capitalization in each market. The second is MSCI World Index, which represents the 23 developed markets countries, and the third is MSCI Emerging Markets Index, covering more than 800 securities across large and mid-cap size segments in 26 emerging markets. We employ these indexes as a benchmark for the different portfolios we create to "beat the market", starting from the local markets indexes used to build the benchmarks themselves.

The goal of this study is to find strategies for passive portfolios management, able to produce excess returns for different prototypes of investors, focusing either on worldwide based portfolios or on developed markets or emerging markets.

Keywords: enhanced index tracking, emerging markets, developed countries, performance measure, investment style

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