Review Category Equity Portfolio Management (1 & 2)

Done Reviewing

Correct

Correct Answer	Your Answer
A	
B	
C	✓

Confidence Level:
Low

Time Spent:
1 sec

Difficulty Level:
Expert

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Sapphire Bay Foundation Case Scenario

Edward Cullen advises the board of directors of the Sapphire Bay Foundation (Sapphire) regarding all aspects of the investment portfolio of Sapphire's endowment fund. Traditionally, Cullen drove the selection of active investment managers for the various asset classes. Despite historically ranking well among peers, several of the managers have performed below the level of their respective benchmarks in the past few years. Cullen's colleague Paige Stapleton recommends that some passive management should be introduced into Sapphire's investment mix using pooled investments. They agree to introduce the idea to Sapphire's board at its next meeting.

At the next board meeting, Cullen begins by introducing passive investing to Sapphire's board. He states that open-end mutual funds and exchange-traded funds (ETFs) are appropriate approaches. Both alternatives are readily available, offer a broad spectrum of investment choices, and are easy to buy and sell. He makes the following comments comparing the two alternatives.

1. Both mutual funds and ETFs can be purchased on margin.
2. Investors can take short positions in ETFs but not in mutual funds.
3. Both mutual funds and ETFs have the same degree of liquidity.

Stapleton then begins a description of factor-based strategies. These include common equity factors, such as value, size, and quality, and they can be used either in place of or to complement market-cap-weighted indexing. She points out that relative to market-cap weighting, factor-based strategies tend to diversify risk exposures; are transparent in terms of factor selection, weighting, and rebalancing; but can be copied by other investors, which can reduce the advantages of a strategy.

Cullen provides Sapphire's board with an example comparing the performance of the River Valley Fund, a factor-based fund, with its benchmark portfolio (Exhibit 1). The fund uses benchmark segments of four mutually exclusive sub-categories. Cullen calculates the percentage of River Valley's excess return that resulted from active factor-weighting decisions.

Exhibit 1

Attribution Data for River Valley Fund and Benchmark

[redacted]

Growth	0.22	7.9	23	0.25	7.9	23
Value	0.19	5.2	27	0.19	5.2	27
Quality	0.29	6.7	20	0.26	6.7	20
Momentum	0.30	3.9	24	0.30	4.5	30
Total	**1.00**	**5.84**	**94**	**1.00**	**6.06**	**100**

For the large-cap US equity portion of Sapphire's investment portfolio, Cullen believes that there are some existing passive indexed-based funds that track the S&P 500 Index that the foundation should consider. Cullen presents Exhibit 2 to Sapphire's board.

Exhibit 2 S&P

500 Index Funds

	Manager A	Manager B	Manager C
Benchmark	S&P 500	S&P 500	S&P 500
Number of holdings: fund/index	498/500	504/500	475/500
Dividends reinvested	Next day	Same day	Next day
Management fee (in basis points)	12	15	10
Rebalance	Quarterly	Quarterly	Quarterly
Reconstitution	Quarterly	Quarterly	Semi-Annually

For the international portion of the investment portfolio, Stapleton suggests that Sapphire invest in an MSCI EAFE index portfolio specifically tailored for the foundation rather than investing in an existing index fund. Anne Rowland, Sapphire's board chair, asks her how this could be accomplished, given that the initial allocation is only $15 million. Stapleton suggests that Sapphire hire a manager to purchase a portfolio of securities that are a mutually exclusive yet comprehensive subgroup of the index designed to track the index return and risk characteristics.

Q. When comparing factor-based strategies relative to the market-cap weighting of an index, Stapleton's comments are *most likely*:

A. incorrect regarding transparency.
B. correct.
C. incorrect regarding risk exposure.

Solution

C is correct. Stapleton's comment is incorrect regarding risk exposure. Relative to broad-market-cap-weighting, passive factor-based strategies

Correct

Correct Answer	Your Answer
A	
B	
C	✓

Confidence Level:
Low

Time Spent:
1 sec

Difficulty Level:
Expert

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[redacted]

Passive factor-based strategies tend to be transparent in terms of factor selection, weighting, and rebalancing. The strategies can be easily replicated by other investors which can produce overcrowding and reduce the realized advantages of a strategy.

B is incorrect. Stapleton's comment is correct regarding transparency but incorrect regarding risk exposure. Passive factor-based strategies tend to be transparent in terms of factor selection, weighting, and rebalancing. The strategies can be easily replicated by other investors which can produce overcrowding and reduce the realized advantages of a strategy. Relative to broad-market-cap-weighting, passive factor-based strategies tend to concentrate risk exposures, leaving investors exposed during periods when a chosen risk factor is out of favor.

Passive Equity Investing Learning Outcome

b. Compare passive factor-based strategies to market-capitalization-weighted indexing

Correct

Correct Answer	Your Answe
A	
B	
C	✓

Confidence Level:
Low

Time Spent:
1 sec

Difficulty Level:
Expert

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Discussion

DB "relative to market-cap weighting, factor-based strategies... are transparent in..."
How can any strategy be more transparent than market-cap, since the market value data are public and can be calculated with an excel only in 5 min?

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SS I disagree, if you have a index that is heavily skewed to lets say growth factor like the S&P500 and you construct a factor portfolio that equally weights growth, momentum, quality factors etc, it will definitely diversify risk exposure...

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[redacted]