Concepts	Description
	Passive Equity Investing
Characteristics of an equity index	**1. Rules-based** : rules (i.e.: including / excluding stocks, weighting scheme, rebalancing frequency) must be consistent, objective and predictable **2. Transparent** : underlying rules are public, clearly stated and understandable **3. Investable** : Investors can replicate the risk and return of the index
Considerations when choosing a benchmark	**1. Market segment** : broad market vs. focus to certain sectors ; domestic vs. international ; developed vs. emerging vs. frontier markets **2. Capitalisation (size factor)** : Large-cap vs Mid-cap vs. Small-cap (Small-cap has higher risk and expected returns) **3. Growth vs. value (style factor)** : growth stocks (high P/E, P/B) vs. value stocks (low P/E, P/B)
Method for Constructing Index	**1. Stock selection** : - <u>Exhaustive method</u> : every stocks in a defined universe (e.g.: CRSP US Total Market Index) - <u>Selective method</u> : subset of sotcks within a universe (e.g.: S&P 500) **2. Stock weighting** : - <u>Market-cap weighting method</u> : weight each stock in the portfolio as % of its capitalisation / index capitalisation + Large-cap stocks have higher liquidity → can be thought as liquidity-weighted + Free-float weighting : stock market cap exclude closely-held shares not available to market participants (held by insiders, promoters, goverments) - <u>Price weighting method</u> : weight each stock by its price - <u>Equal weighting method</u> : weight each stock equally + Reduce concentration risk + Slow to change sector exposures + Small-cap bias → more volatile + Small-cap bias → lower liquidity → limited investment capacity + Require regular balancing - Fundamental weighting method : weight each stock based on fundamental factors (e.g.: revenue, income, dividends) **3. Stock concentration** : used to calculated the effective number of stocks in the portfolio, in order to replicate the index. Stock concentration is calculated using HHI $HHI = \sum_{i=1}^{n} {w_i}^2$ $effective\ number\ of\ stocks = 1/HHI$ $w_i = weight\ of\ stock\ i$
Method for Maintaining Index	**1. Rebalancing** : update stock weight in the index to reflect chage in market cap **2. Reconstitution** : remove / replace stocks that no longer fit the index market exposure ; add new stocks that fit in
Passive factor-based strategy	**Passive factor-based strategy (smart beta)** : create a portfolio with same exposures to a set of risk factors as the index. Common risk factors include : - <u>Growth factor</u> : stocks with high P/E , P/B , above-average net income growth - <u>Value factor</u> : mature stocks with low P/E , P/B , stable net income , high dividend yield - <u>Size factor</u> : stocks with low market caps - <u>Yield factor</u> : high dividend-yield stocks - <u>Momentum factor</u> : stocks with recent above-average returns - <u>Quality factor</u> : stocks with consistent earnings + dividend growth, high CF-to-earnings, low debt-to-equity - <u>Volatility factor</u> : stocks with low standard deviation of return **Types of passive factor-based strategy** : - <u>Return-oriented</u> : include dividend yield ; momentum ; fundamentally-weighted strategies ; etc. - <u>Risk-oriented</u> : include volatility weighting (weight are inverse of price volatility) ; minimum-variance investing ; etc. + Advantage : simple, provide risk reduction + Disadvantage : based on historical data → may not reflect future conditions - <u>Diversification-oriented</u> : equally-weighted ; maximum diversification ; etc. **Advantages of passive factor-based strategy** : - Less costly than active management - Still offer factor exposure based on investor's view of the market **Disadvantages of passivve factor-based strategy** : - Higher management fees and trade commissions than passive cap-weighted investing

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