

REVERSEinquiries

Investor Bulletin on Nontraditional Index Funds Covers Issues Familiar to Structured Products Investors

Originally published in REVERSEinquiries Volume 1, Issue 5

The Commission recently published a new Investor Bulletin educating investors about features and potential risks of nontraditional index funds. Nontraditional index funds are index funds that track custom-built indices that are developed based on criteria commonly used by actively managed funds. By combining the benefits of passive investing and the advantages of active investing strategies, nontraditional index funds may seek to outperform the market or achieve alternative investment objectives. The Commission cited examples including smart beta funds, which use factors such as value, dividends or quality in selecting investments; quant funds, which use numerical methods; and environmental, social and governance (ESG) funds, which use environmental, social and governance factors.

Many of the issues related to these nontraditional custom indices are familiar to those who are aware of the regulatory attention paid to complex products over the years. The Investor Bulletin listed some of the risks related to these types of indices:

- Less market correlation;
- Seeking to outperform the market, but with no guarantee of success;
- Complexity;
- Cost – many of these indices have higher expenses than traditional indices; and
- Limited performance histories – these funds tend to be newly created, and it may not be clear to investors how these funds will perform under different market conditions.

With respect to the last bullet point, offering documents for structured products linked to new proprietary indices tend to include hypothetical historical performance data, or “pre-inception performance” (“PIP”) data, which, if used, must be carefully explained, clearly segregated from historical performance data and have associated risk factors explaining how the PIP data was created and if there are any differences from a pure application of the methodology to historical data of the index components.