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PRACTITIONER'S DIGEST

The "Practitioner's Digest" emphasizes the practical significance of manuscripts featured in the "Insights" and "Articles" sections of the journal. Readers who are interested in extracting the practical value of an article, or who are simply looking for a summary, may look to this section.

GROW THE POOL: DIVERSE DIRECTORS ASSOCIATED WITH STRONGER PERFORMANCE, BUT NOT IF THEY ARE TOO BUSY PAGE 4

Mouhamadou M. Ba, Gerald T. Garvey, Brett Z. Miller and Katharina J. Schwaiger

In 2017 less than half of S&P500 firms had multiple minority directors, but now it is more than three-fourths. However, much of this increase represents additional seats for the same directors. To use the jargon, minority directors are nearly twice as likely to be "busy" or "over-boarded". This has implications for the overall pool of director talent as well for individual firms. To illustrate, if no minority directors had more than 3 seats in any S&P 500 corporation, more than 300 new individuals could be added to the director population without changing board sizes.

Our paper documents the value of diverse directors who do not hold too many seats and thereby also represent additions to the pool of board talent. We find that the share of minority directors has a small and insignificant association with future returns, but the effect doubles and becomes significant when we restrict attention to those with 3 or fewer seats.

In addition to the financial benefits, we also find a significant association between Glassdoor ratings and board ethnic diversity if we restrict attention to board members with three or fewer seats. Broadening the pool of director talent seems to be associated with higher employee satisfaction across the organizational hierarchy.

REIMAGINING INDEX FUNDS PAGE 15

Rob Arnott, Chris Brightman, Xi Liu and Que Nguyen

Capitalization weighted indexes and index funds offer many benefits to investors, including lower turnover, lower transaction costs, and diversification spanning much of the publicly-traded macroeconomy. That said, these indices suffer from some largely overlooked weaknesses in practice.

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Cap-weighted indexes are not purely passive. Publishers of commercially available cap-weighted indices typically limit the number of names in an index to improve investability, adding and deleting stocks from the index over time.

The tendency of cap-weighted indexes to add high-flying growth stocks after a recent period of outperformance, and drop feared and loathed deep-discount value stocks after a recent period of underperformance, creates a self-evident drag on performance. That drag on performance goes unnoticed because we are encouraged to compare the index with itself, which means that any shortfall goes unnoticed. Using the mathematics of what Fama and French call "migration," this drag is over 200 bps per annum, which can only be overcome with the businesses of the index additions growing faster than the macroeconomy by a shockingly large margin. In this paper, we explore the possibility of a better-performing broad-market capitalization-weighted index by avoiding this buy-high, sell-low feature in index construction.

Our approach selects companies by fundamentals which are inherently more stable than prices, and then cap weights those companies. We find that the Fundamental-Selection Cap-Weighted (FS-CW) index outperforms popular published cap weighted indexes by 40–50 bps per annum over a 30 year period from 1991–2022, with particularly strong outperformance when the markets are more volatile. The FS-CW index shows minimal exposure to a value bias, and the alpha remains significant after Fama-French style adjustments. Furthermore, the FS-CW index lowers turnover by 20% relative to popular cap weighted indexes. We show that these findings hold across multiple regions and markets. Our hope is that this paper encourages practitioners, index providers, and index fund investors to contemplate and pursue an improved approach to cap weighted indices for the benefit of investors.

THE DIMINISHING ROLE OF ACTIVE MUTUAL FUNDS: FLOWS AND RETURNS PAGE 32

James X. Xiong, Thomas M. Idzorek and Roger G. Ibbotson

U.S. active equity mutual funds have experienced net outflows since around 2006. We estimate that the cumulative net outflows for U.S. active equity mutual funds were about 2.20 trillion dollars from 2006 to 2021. In contrast, index equity mutual funds and exchange traded funds (ETFs) together have enjoyed 1.48 trillion dollars of cumulative net inflows during the same period. What is the impact of this massive outflow on individual active mutual funds and the whole active mutual funds industry?

In this paper, we quantify the flow-impact on fund performance at both individual active mutual funds and aggregated active mutual funds industry level. Inflows/outflows contribute to the over/under performance of individual active funds. We estimate that the flow-impact on annualized alpha for aggregated active funds industry was a positive 0.33% between 1/1991–12/2005, but it was a negative −0.10% between 1/2006–9/2021. If the current flow trend continues, the AUM of active mutual funds will drop to 17% of the total AUM of equity funds after 15 years.

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REALATIVITY IN FINANCE: GOALS AND RISK-BASED ASSET PRICING FOR INVESTORS WITH MULTIPLE STOCHASTIC GOALS AND AGENTS **PAGE 53**

Arun Muralidhar

Investment theory has implications for asset allocation, asset pricing and risk-adjusted performance. The statement in finance that "investors maximize the utility of wealth", is largely incorrect on many levels and assumes that investors are principals with a single deterministic goal. As a result, the resulting recommendations are also incorrect for practical use and are often (blindly) adopted resulting in meaningful systemic risks. Instead, investors delegate to maximize (multiple) goal(s) relative risk-adjusted returns. Investors care about whether their managers are lucky/skilled and their IPSs tell their exact risk specification. This article examines the implications for asset allocation, asset pricing and argues for a relative investment theory paradigm to capture the realities of investing.

The model takes on some interesting characteristics; since there are 3 classes of assets, Absolute risk-free asset; goal-relative risk-free asset, and all other assets (risky), there are three different formulae of each asset in their respective bucket. Unlike traditional finance, it appears that there are no free parameters and the system appears to be closed in that even volatilities and correlations across assets are linked. Also, it is shown that with two goal-replicating asset and the absolute risk-free asset, all assets can be priced with very simple formulae and robust asset allocation recommendations are also derived.

Interestingly, the implications are much easier to apply in practice than traditional theory as Brazil has issued two new (goal-relative risk-free) instruments, RendA+ (January 2023) and EducA+ (August 1 2023) bonds, designed specifically to replicate the cash flows of the (stochastic) retirement and education of a child goal, respectively, as recommended in this paper. The immediate implication for asset allocation is clearly a better portfolio of relative risk-free vs risky assets and better outcomes. The paper also demonstrates how the model easily expands to multiple assets and where the free parameter problem in traditional finance is eliminated. This will present interesting opportunities in futures research and would lead to much better product design, portfolio management and regulation of investment portfolios.

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