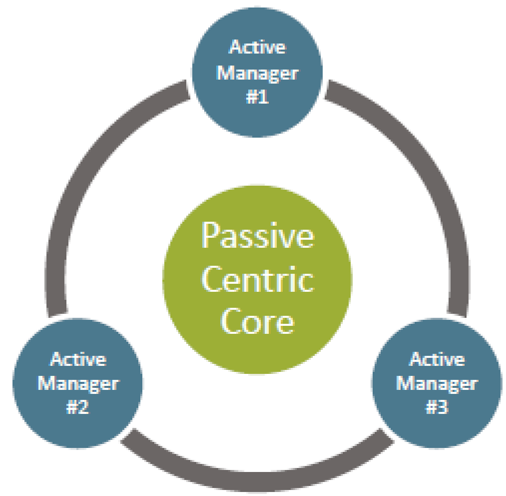
Introducing the Smarter Beta Index: Centric Core

It is not the strongest of the species that survives, nor the most intelligent, but the most responsive to change. Charles Darwin, **The Origin of Species**

What is Centric Core?



According to the Merriam Webster dictionary core is "a **central** and often foundational part usually distinct from the enveloping part by a difference in nature." This makes sense, and conforms to the popular investment use of core as in "core-satellite" portfolios, where active managers are completed by a passive center. However, the version of core that is typically employed in core-satellite investing is not central at all -- it's the entire market, or at least a major portion of the entire market. The S&P500 is the most popular version of core, but it is actually a "Blend" or "Dilutive" "core" because it is not central but rather a blend of all parts of the market, and it dilutes active satellite managers by holding dead-weight stocks they don't want to own. By contrast, Centric Core comprises the stocks in between value and growth. These are securities that active value and growth stock managers generally don't own in order to avoid criticisms of deviating from their style. *The distinction here is important.* Active managers don't reject centric core stocks as unworthy. Rather they never consider these companies because they do not fit the style mandate. Also, so-called active core managers are typically a blend of value and growth stocks rather than the centric definition we have developed.

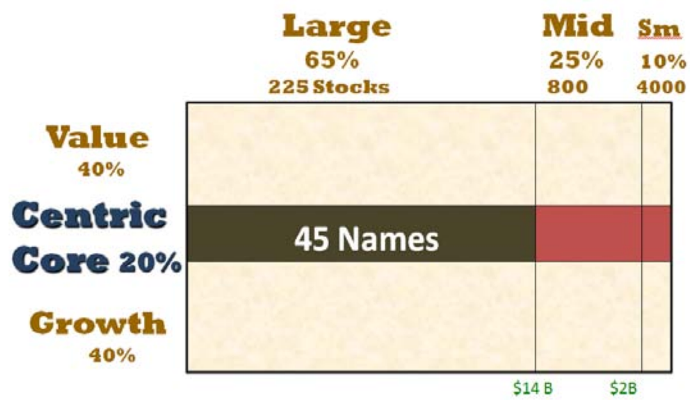
The words "centric" and "core" are redundant, but necessary to differentiate our index from the common misnomer.

How is the index constructed?

1. We define large companies as the top 65% of the Compustat database. In other words, we sort all of stocks in the U.S. by capitalization and add until we reach

65% of the total capitalization. At the time of this writing the line is drawn at about 225 names, the smallest of which has a capitalization of $14 Billion.

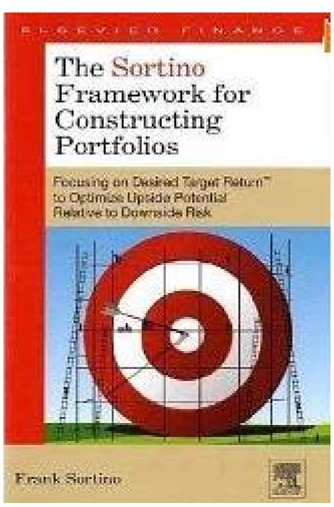
2. Within large companies, we create a value metric that combines earnings yield (the reciprocal of P/E), dividend yield, and a sector-adjusted book/price. We define the 20% in the middle of this metric to be Centric. As shown in the next exhibit, 20% of 225 stocks is just 45 names.
3. Rebalanced quarterly.
4. We allocate to maintain industry/sector neutrality. This creates market-like consistency.
5. We equal weight within sectors. This creates a portfolio that is centric by size, as well as by style.



6. We allow minor drift outside of strict centric in order to keep turnover low.

Benefits

Centric Core improves diversification and increases return in multi-manager U.S. stock portfolios. It is a superior building block in portfolio construction, a cornerstone.



In his recent book, Dr. Frank Sortino describes a framework for constructing multi-manager portfolios using a combination of active and passive management:

1. Look for skill everywhere, not just style corners.
2. Optimize by filling in with passive indexes in parts of the market where no skill is found.

Dr. Sortino's optimizer always calls for Centric Core, indicating that skill is hard to find in the middle of the market because most skillful managers have chosen to be either value or growth. By contrast, Dr. Sortino's optimizer will only use the S&P500 if no skill was found anywhere in the market, which never happens. Skill does exist, even though some practitioners may disagree.

Here's how Centric Core delivers its benefits:

- Improved diversification is achieved by adding stocks that active managers don't hold, namely the stuff in the middle. As little as 15% in Centric Core provides as much diversification as 80% in the S&P500.
- Higher returns are achieved by liberating active managers, so their alpha is delivered to the bottom line. A common belief is that an S&P index fund lowers overall costs because it is cheap, but the fact is that it increases cost by diminishing active manager contributions; it's the dilutive cost of dead-weight stocks that the active managers don't want to hold.

How does Centric Core perform?

Centric is to value and growth as mid-cap is to large and small. Sometimes it outperforms both value and growth and sometimes it underperforms both value and growth. Most times, it's in between value and growth. Over time, Centric delivers return and risk similar to the S&P500, but with much lower correlation to value and growth. It's this lower correlation that makes Centric an important diversifier that smoothes performance. It also increases cumulative performance by not diluting active managers.

Centric Core is Smarter Beta.

Fundamentally-weighted indexes have come to be known as smart betas because the alternative weights are purported to outperform cap-weighted counterparts. Smart beta indexes only make sense for entire markets, like fundamental S&P500, so they dilute active managers. By contrast, Centric Core is a hybrid fundamental index, holding sectors in their market weights, but stocks within sectors are equal weighted. This construct empowers active managers rather than brain-draining them with a smart beta market index. Active managers can invest with conviction knowing that their decisions will not be compromised with dead-weight market indexes, and that a completeness fund will round out the investment program.

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