Learn about core-satellite investing

Core-satellite investing combines the low-cost benefits of index funds with actively managed funds that offer the potential for outperformance. The appeal of this approach is that it shields the bulk of a portfolio in index investments with lower volatility while allowing for the possibility that an active fund manager might deliver higher-than-market returns.

What is core-satellite investing?
The core-satellite concept of portfolio construction combines the best of portfolio theory and a real-world, market-tested approach.

Common sense is at the foundation of core-satellite investing, combining the benefits of index funds and ETFs – lower cost, broader diversification, tax efficiency1 and lower volatility – with actively managed funds or other direct investments offering potential for outperformance.

Core-satellite brings greater discipline and stability to an investment portfolio by:
• Lessening reliance on picking winning investments or chasing fund-manager returns
• Providing greater portfolio diversification

• Potentially improving after-tax returns by taking maximum advantage of capital gains discounts
• Reducing overall fund-management and transaction costs

Blending the benefits of index and active management
The core-satellite concept acknowledges the fundamental differences between index and active fund management and integrates the best aspects of both approaches.

The index approach
The primary aim of an index fund or ETF is to track market performance, or beta, at a low cost to investors.

Index funds achieve this by holding a broad spread of securities within an index with the aim of tracking the index’s performance. An index fund or ETF doesn’t require

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1 Through lower portfolio turnover.
the same level of research and security analysis that active management requires (at substantially higher cost) and will tend to buy and hold securities with very low levels of portfolio turnover. Lower portfolio turnover results in lower fees to investors and generally more favourable tax outcomes.

The active approach
The primary aim of an actively managed fund is to seek outperformance of the index, or alpha, through security selection and/or market timing.

Active funds often hold fewer securities than index funds. Active funds require more initial and ongoing analysis and rely more heavily on the skill of portfolio managers to pick the right stocks. Active funds tend to transact more often, resulting in higher portfolio turnover, which may lead to higher realized tax gains and higher costs to investors in the pursuit of returns.

The core-satellite approach
Core-satellite delivers the best of both worlds. Using broad-market index funds or ETFs as the portfolio’s “core,” indexing gives investors a low-cost, more tax-efficient and diversified portfolio. Carefully selected actively managed “satellites” can complement the core while providing the potential to outperform the market. Active managers use their knowledge and skill to analyze the market and invest in securities that they believe have the potential to deliver superior investment returns over time. (Figure 1 illustrates the core-satellite approach.)

The benefits of indexing the portfolio’s core

Low costs
Indexing has a cost advantage because of lower management fees and transaction costs. Index funds in Canada cost about half the industry average.²

Management fees
Index funds have lower ongoing fees than most active funds investing in similar assets. In other words, it costs less to manage and operate an index fund or ETF than an actively managed fund.

Transaction costs
Index funds and ETFs generally have lower portfolio turnover than most active funds, resulting in lower ongoing trading costs.

Tax efficiency
Funds that trade more often generally create greater capital gains tax liabilities for investors than funds with lower turnover. Generally, the lower the portfolio turnover, the more tax efficient the portfolio will be. Index funds tend to have low portfolio turnover because they follow a buy-and-hold strategy. This strategy reduces realized capital gains on which tax is payable, and thus maximizes the compounding effect of investing.

Competitive long-term performance
Indexing has historically delivered competitive long-term performance at low cost.³ Few active managers have been able to sustain consistent above-index returns after costs and taxes over the long term.

Portfolio diversification
Indexing gives investors a well-diversified portfolio through an extensive range of investments within an index.

Broad portfolio diversification means less exposure to fluctuations in the performance of individual shares or securities. The overall effect can moderate the volatility of a portfolio and smooth out investment returns over time. Index funds invest in a wide selection of securities in the relevant index, thereby minimizing stock-specific risk.

² Source: Vanguard calculations, using data from Morningstar, Inc. For more information, see the Vanguard research paper The case for index-fund investing for Canadian investors, available in the research and commentary section of vanguardcanada.ca.
³ Past performance is not an indicator of future performance.
Reduced key person risk
Index funds automatically weight a portfolio to track a broad-based index, while actively managed funds rely more heavily on the skill of portfolio managers.

By reducing dependence on key individuals, index funds and ETFs are less prone to human error and can deliver more stable results.

Core-satellite methodology
Conventional wisdom often suggests that indexing works best in the most efficient segments of the market where stocks trade at their fair value and that active management works best in the inefficient market segments where stocks trade at undervalued or inflated prices. Such an approach assumes that in the most efficient markets, information is readily available. Thus, all market participants can price securities effectively, which provides little opportunity for one to gain an advantage.

On the other hand, it is often assumed that, in inefficient markets, information is less readily available. As a result, greater opportunities may exist for individual managers to outperform their market benchmarks. This leads many financial-sector practitioners to conclude that the relatively more-efficient large-capitalization portion of their portfolios should be indexed in the core, while the less-efficient market areas, such as small-cap or emerging markets, are better served with active strategies in those satellites. (See the illustration in Figure 2.)

At Vanguard, we believe that the active vs. index decision should be based on an advisor’s ability to identify low-cost, expert managers, rather than on the assumed efficiency or inefficiency of the market. (See the illustration in Figure 3.) Although indexing has historically outperformed active management in the aggregate over the long run, some active managers may outperform in all market segments. Regardless of the market segment, talented managers with reasonable costs are by definition more likely to add value to a portfolio than active managers selected indiscriminately from a presumably inefficient market where data isn’t readily available.

Conclusion
The basic tenet of core-satellite methodology is that investors should choose an asset allocation that matches their investment objectives primarily by using index funds for the major portion of their portfolio. Then, they should select appropriate actively managed funds to add the potential for market outperformance to the baseline portfolio.

At Vanguard, we believe that indexing is a powerful investment strategy in all market segments. As a result, we propose that the active decision should depend on an advisor’s ability to identify low-cost, talented managers. Skill in selecting managers can enhance the success of a core-satellite portfolio.
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