
Tracking Down the Right Index Fund

The Morningstar Approach

Morningstar Manager Research

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Executive Summary

- ▶ The popularity of passive funds is on the rise across Europe, and particularly in the UK where the Retail Distribution Review has spurred investors' search for less expensive funds, while providers have responded by slashing costs.
- ▶ In 2013, Morningstar analysts initiated coverage of index funds in the UK, and to date, we have rated 28 of the most popular trackers available to UK investors.
- ▶ In this report, we re-iterate the approach we use to analyse and rate index funds. Within the Morningstar Analyst Rating framework, index funds are put on a level pitch with their active counterparts so investors can select the most suitable option within a given asset class.
- ▶ We explain how our approach may differ from others' in the industry. We rate index funds in the context of their category, which includes not only other passive options but also active funds. By doing so, we take a more holistic approach than those who rate passive funds based exclusively on their ability to track their underlying indices.
- ▶ We believe this is the best way to help retail investors and advisers with their fund selection as they need to understand the merits of all types of strategies, active, passive, or somewhere in between (e.g. strategic beta), and irrespective of the type of vehicle used (fund, ETF, etc.). This is also in keeping with Morningstar's vehicle-, and strategy-agnostic view of the investment world.
- ▶ In this report, we also examine the key quantitative and qualitative factors investors should consider when comparing index funds, and discuss the data-related challenges investors are likely to face when trying to make like-for-like comparisons.
- ▶ And finally, to cement all of this with real examples, we put the current crop of FTSE 100 and FTSE All Share index funds through their paces and demonstrate that identifying the best one on a purely quantitative basis is unlikely to provide us with a definitive answer. That said, deciding between the very different exposures of these two benchmarks is a far more straightforward exercise, and it is a decision that yields more meaningful results for investors.

Foreword

The popularity of passive investing is on the rise, with assets in index trackers and ETFs in Europe reaching record highs of €760bn in 2014, according to Morningstar data. This represents growth of 140% since 2009.

The growth in passive funds is driven by many factors, including increased focus on costs, greater emphasis on asset allocation, general dissatisfaction with active managers, and wider product choice.

In the UK, the Retail Distribution Review (RDR), introduced in 2013, has also played a role in boosting the uptake of passive investments. The Investment Association data shows that assets in UK index funds (not including ETFs) now account for about 11% of total UK-domiciled funds' assets under management, almost double the market share registered five years ago.

In light of this growth, Morningstar analysts initiated coverage of index funds in the UK in 2013. And to date, we have rated 28 of the most popular trackers available to UK investors.

The main purpose of this paper is to explain how we analyse and rate index funds in order to help investors and their advisers with their index fund selection process.

First, we will re-iterate what Morningstar's Analyst Rating for index funds is, and what it is not. Then, we will examine the key factors to consider and challenges to tackle when comparing index funds. And finally, to cement all of this with real examples, we will put the current crop of FTSE 100 and FTSE All Share index funds through their paces and see if we can answer the question: What is the best UK equity tracker?

We hope the insights you gain from this paper will help you with your selection process. The Morningstar Analyst Ratings and research for passive funds are available to individual investors on www.morningstar.co.uk, to financial advisers through Morningstar Adviser Workstation™, and to institutional investors through Morningstar Direct™.

Morningstar's Analyst Rating for Index Funds: What it is, and What it is Not

The Morningstar Analyst Rating was created in 2011 as a complement to the Morningstar Rating, often referred to as the "Star Rating". As is the case with all of our research efforts, the overarching objective of the Morningstar Analyst Rating is to help investors make better investment decisions.

Unlike the Star Rating, which is an assessment of a fund's past risk-adjusted performance versus category peers, the Analyst Rating is the summary expression of Morningstar's forward-looking opinion of a fund's investment merit relative to its peers.

The Analyst Rating is based on our analyst's conviction in the fund's ability to deliver superior risk-adjusted performance relative to its peer group over the long term.

Analyst Ratings are assigned on a five-tier scale, with three positive ratings of Gold, Silver, and Bronze, a Neutral rating, and a Negative rating.

For more detail on the general methodology, [click here](#).

How the Morningstar Analyst Rating Applies to Index Funds

Within the Morningstar Analyst Rating framework, index funds are put on a level pitch with their active counterparts so investors can select the most suitable option within a given category.

Just like active funds, index funds are analysed and compared in the context of their Morningstar categories, which include active funds as well as index funds and ETFs. This means that index funds are compared not only against their passive peers but also against their active ones.

In our view, putting index funds into a broad context is important, as investors need to understand the merits of all the different strategies within the context of a given asset class or category, irrespective of the type of vehicle used. This is in keeping with Morningstar's vehicle-, and strategy-agnostic view of the investment world.

What the Morningstar Analyst Rating is Not: It is Not the Be-All and End-All

As important as it is to understand what the Analyst Rating is, understanding what it is not is paramount.

The Analyst Rating for index funds is not designed to help investors and their advisers identify the best index fund in a specific asset class or, for that matter, the best index fund tracking a specific index.

Nor is the Analyst Rating for index funds exclusively a "tracking performance" rating. It doesn't solely reflect how well an index fund tracks its benchmark, though tracking performance is taken into account as part of our more holistic assessment. In other words, an index fund may track its benchmark very closely but still receive a 'Neutral' rating, based on a more comprehensive assessment of its investment merit.

Rather, the Analyst Rating for index funds reflects our conviction that a particular tracker's strategy is an interesting investment proposition for someone who wants to invest in a specific asset class, as defined by its particular Morningstar Category. We aim to look at the higher-level.

With that in mind, we acknowledge that the Analyst Rating might be of limited help to those investors who have already made the decision that they want to gain passive exposure to a specific

asset class or have already chosen a particular index to track. For further guidance, these investors would have to go beyond the rating and read the full Analyst report, where we discuss tracker-specific features (e.g. tracking accuracy).

The Five Pillar Framework

All Morningstar Analyst Ratings are accompanied by an Analyst report that explains the rating decision and evaluates five pillars –Process, Price, Performance, Parent, and People.

As previously discussed, the framework we apply to analyse and rate index funds is no different from that used for active funds, so our index fund reports cover the same five pillars, although with varying emphasis.

Price and Process are paramount for index funds.

Price. Obviously, keeping costs—both explicit ones, such as the expense ratio, as well as implicit ones, like the cost of portfolio turnover—at a minimum is paramount in running an effective index-tracking fund. As such, it should come as no surprise that the top-rated funds that we analyse are amongst the lowest cost investment options, not just versus their actively-managed peers in their Morningstar Categories but also relative to comparable index funds and ETFs.

In **Process**, we examine the replication method and various techniques used by the fund to minimise costs and tracking error. Additionally, we carefully analyse the composition and rules of construction of the underlying index since these can significantly influence the way the fund behaves. We also assess whether the underlying index has any limitations or flaws and whether it is representative of the opportunity set available to active managers in its category.

In **Performance**, we scrutinise the fund's tracking accuracy—looking at metrics such as tracking difference and tracking error—but we also closely examine the fund's performance relative to its category peers.

Finally, the **Parent** pillar plays a vital role in our analysis of index funds, while we de-emphasise the **People** pillar. The capabilities of the parent organisation can often have a bigger impact than the named managers because much of the portfolio-management process for these funds is automated. The parent firm's infrastructure, scale, risk-management, and trading capabilities can give a fund a competitive edge.

Considerations When Comparing Index Funds

As previously discussed, the Morningstar Analyst Rating for index funds is not aimed at answering the question “What is the best index fund?” in a specific asset class or tracking a specific index.

To answer this question, investors need to conduct further due diligence and make far more granular comparisons, as wins and losses in tracking like benchmarks are typically decided by a few basis points of performance.

In this section, we examine the key factors—both quantitative and qualitative—that investors need to consider when comparing index funds in isolation. We also discuss some of the challenges they face when trying to make like-for-like comparisons.

Key Quantitative Factors

Fees are one of the most important factors to consider. Fees are a drag on long-term performance, and it is fair to assume that funds with the lowest ongoing charges (or TER) have a greater probability of being among the best-performing ones.

Fees in the realm of passive funds have fallen dramatically in recent years to near rock-bottom levels, often at less than 0.10%. However, wide disparities remain¹.

Tracking difference is another key factor to examine. Tracking difference is the difference in returns between the fund and its benchmark over a period of time. It measures how closely a fund matches its benchmark over time.

Tracking difference² is affected not only by the level of fees, but also by trading costs, taxation (e.g. stamp duty), and the quality of the replication method employed, among other things. Revenue from securities lending³ can help to offset some of these costs.

Tracking error is another useful metric to consider when assessing a fund's tracking quality, although arguably it should matter less than tracking difference for long-term investors. Tracking error is a volatility measure indicating how consistently a fund has tracked its benchmark over time.

The level of tracking error depends to a large extent on the replication method employed by the fund. For instance, funds that use sampling will likely exhibit higher tracking error than those that use full replication, especially during times of high market volatility. But the long-term performance of the former might be the same as (or even superior to) that of the latter because of potentially lower costs.

Footnotes

- 1 For a more detailed examination of fees, see our report [Every Little Helps: Comparing the Costs of Investing in ETPs versus Index Funds](#)
- 2 For more detail on tracking difference and tracking error, see our report [On the Right Track: Measuring Tracking Efficiency in ETFs](#)
- 3 For more detail on securities lending, see our report [Securities Lending in Physical Replication ETFs: A Review of Providers' Practices](#)

Data-Related Challenges

Assessing and comparing the tracking accuracy of multiple funds may seem straightforward, but in reality it can be quite tricky. Here is a list of data-related issues to be aware of:

Differing valuation points

Different funds set their net asset values (NAVs) at different times of the day, depending on the country practices and time zone. A majority of UK index funds are valued at 12 noon, whereas their benchmarks are valued at market close. Market movements between these times can create a valuation discrepancy, which in turn can distort the calculation of both tracking difference and tracking error.

The only way to resolve this mismatch is to request midday index data from either the index vendor or the fund company and align the valuation points.

Different index variants

A fund may track a Gross Total Return Index (dividends are reinvested gross of withholding tax), while rival funds may track a Net Total Return Index (dividends are reinvested net of withholding tax) or a Price Return Index (dividends are not reinvested).

Comparing the tracking performance of funds that use different index variants will inevitably lead to wrong conclusions.

Differences in pricing sources and fair valuation

Differences in pricing sources are an issue mostly affecting fixed income index funds. To value bond portfolios, fund companies may use a host of pricing sources that differ from those used by the index provider. Differences in pricing sources will give an inaccurate picture of how well the fund tracks its benchmark.

Similarly, for foreign equity funds, some managers may choose to make fair value adjustments to reflect events that may affect stock prices in markets that are closed when calculating the value of their fund.

Past Performance Only Tells Part of the Story

While past tracking performance can be a useful guide to predict a fund's future tracking accuracy, it would be a mistake to rely on it in isolation to make comparisons.

A fund's tracking performance can vary over time, influenced by factors such as fee cuts, changes in replication method—for instance as it grows in size, a fund might be able to move from sampling to full replication—, regulatory changes, etc.

Furthermore, there is the *issue of share classes*. To comply with RDR, some fund companies have launched clean share classes, but many didn't launch new share classes at all. Rather, they made existing institutional share classes available to retail investors. This clearly leads to 'unfair' comparisons as institutional share classes will tend to show better performance history—due to their lower fees—than those clean share classes that have had their performance record extended using older classes adjusted for the new fees.

Besides, there are *additional costs* borne by investors that a fund's performance may ignore. Fund companies use a range of pricing mechanisms to account for the 'dilution' effect, i.e. the transaction costs and taxes (e.g. stamp duty) incurred by a fund when investors trade into and out of the fund.

Some use a spread mechanism, with two prices—the one you buy at (the offer price) and the one you sell at (the bid price). Others use a single price mechanism, whereby there is only one price at which you buy and sell and which depends on the flow activity of the fund on any given day. A third option is to charge a dilution levy on subscription and redemption. The proceeds collected go into the fund for the benefit of existing fund holders.

With various degrees of transparency and fairness, all these methods have pros and cons. They will also affect fund performance and investors' end return differently over time.

Finally, as most UK retail investors buy and sell funds on platforms, it would be a mistake to ignore platform charges. Fees and offerings vary greatly from platform to platform, and these two factors will also have a significant influence on an investor's selection process.

Conclusion

As we have seen, numerous quantitative factors can make the process of comparing index funds, and ultimately selecting the 'best of breed', extremely challenging. That said, using measures like fees or tracking difference can be a straightforward way to 'narrow the field' to a select group of superior funds—as measured by their low fees and benchmark-relative, or tracking, performance.

Now let's look at the qualitative factors that can also be used to differentiate between funds.

Key Qualitative Factors

Process: Portfolio

At Morningstar, we will never tire of saying that the most important factor when selecting a passive fund is the underlying index. Picking the right benchmark is key.

Investors must have a thorough understanding of the index's construction methodology since it can significantly influence the way the fund behaves. Differences in composition between two indices will ultimately cause their performance to diverge.

Unlike ETFs, most index funds don't include their benchmark index in their names, which may lead to confusion. For instance, the [Vanguard US Equity Index fund](#) and the [L&G US Index Trust](#) may have very similar names but they track different indices. The former tracks the broad S&P US Total Market Index (about 3,900 stocks), while the latter tracks the FTSE USA (about 650 stocks). The difference in composition resulted in a 0.28% annualised outperformance by the former over the five-year period ending in January 2015, albeit with a slightly higher level of volatility (standard deviation of 13.52% versus 13.01%).

Process: Approach

The key to successful indexing is minimising tracking deviations, and the manager's approach plays a determinant role in this endeavour. When deciding which method to use, managers consider several factors such as the size and liquidity of the index's constituents, the size of the fund, operational efficiencies, ownership restrictions, cost, tax, tracking error tolerance, and client demand.

The most commonly used replication methods for UK index funds are full replication, optimisation, and sampling. Each method may lead to different results in terms of tracking performance.

There is always a trade-off between minimising costs and minimising tracking error. While full replication works well for highly liquid indices (e.g. FTSE 100), it may not be possible or efficient when the index being tracked references a high number of securities or contains small and relatively illiquid components (e.g. MSCI World with over 1,600 constituents, MSCI Emerging Markets, Barclays Global Aggregate with over 10,000). To replicate these indices, a fund may use sampling or optimisation techniques. These methods may minimise costs but may also introduce tracking error.

Index funds may also use derivatives (e.g. futures) and securities lending to optimise returns.

Parent

We believe the parent organisation is of utmost importance in evaluating index funds. Although other factors may have more immediate impact, they would not be sustainable without backing from the fund firm. The firm's infrastructure, scale, risk-management, and trading capabilities can give a fund a competitive edge. We tend to favour firms that have made indexing a core business and dedicated substantial resources to their indexing team.

Analysis—What is the Best UK Equity Tracker?

We saw in the previous part of the report that there are many factors impeding investors from making meaningful comparisons between index funds. In this final part, we will attempt to meet the challenge. We will put the current crop of FTSE 100 and FTSE All Share index funds through their paces and see if we can answer the question: What is the best UK equity tracker?

First, let's look at those funds that track the UK's most popular large cap benchmark, the FTSE 100.

What is the Best FTSE 100 Tracker?

The following table shows the returns from a sample of the largest FTSE 100 trackers available to UK retail investors and the index. We have calculated valuation point-aligned tracking differences.

Exhibit 1 FTSE 100 Tracker Comparison

Fund Name	Fund Size GBP (million)	Valuation Point	Ongoing Charge (%)	Annualised Return (%)			Annual Return (%)				
				1-Year	2-Year	3-Year	2014	2013	2012	2011	2010
L&G UK 100 Index I Acc	287	Midday	0.10	0.23	8.81	9.29	0.23	18.14	10.26	-3.63	13.11
BlackRock 100 UK Equity Tracker D Acc	663	Midday	0.16	0.24	8.90	—	0.24	18.31	—	—	—
HSBC FTSE 100 Index Accumulation C	745	Midday	0.17	0.23	8.80	9.32	0.23	18.11	10.36	-3.68	13.04
Marks & Spencer UK 100 Comp Acc	295	End of Day	0.60	0.00	7.93	8.42	0.00	16.48	9.42	-4.32	13.05
Scottish Widows UK Tracker G Acc	220	End of Day	1.00	-0.25	7.90	—	-0.25	16.71	—	—	—
FTSE 100 TR GBP—End of Day				0.74	9.33	9.55	0.74	18.66	9.97	-2.18	12.62
FTSE 100 TR GBP—Midday				0.43	9.08	9.63	0.43	18.48	10.72	-3.30	13.49

Fund Name	Morningstar Analyst Rating	Ongoing Charge (%)	Annualised Tracking Difference (%)			Annual Tracking Difference (%)				
			1-Year	2-Year	3-Year	2014	2013	2012	2011	2010
L&G UK 100 Index I Acc	Neutral	0.10	-0.20	-0.27	-0.33	-0.20	-0.34	-0.46	-0.32	-0.37
BlackRock 100 UK Equity Tracker D Acc	Not Rated	0.16	-0.19	-0.19	—	-0.19	-0.17	—	—	—
HSBC FTSE 100 Index Accumulation C	Neutral	0.17	-0.20	-0.28	-0.31	-0.20	-0.37	-0.36	-0.38	-0.45
Marks & Spencer UK 100 Comp Acc	Not Rated	0.60	-0.74	-1.41	-1.12	-0.74	-2.18	-0.55	-2.14	0.42
Scottish Widows UK Tracker G Acc	Not Rated	1.00	-0.99	-1.43	—	-0.99	-1.34	—	—	—

Source: Morningstar Direct at 31/12/2014; FTSE 100 TR GB—Midday data from BlackRock.

From this table, three trackers stand out for their low fees (ranging from 0.10% to 0.17%) and tight tracking differences, namely [L&G UK 100 Index](#), [HSBC FTSE 100 Index](#), and [BlackRock 100 UK Equity Tracker](#). This, however, comes as little surprise as these funds are managed by companies committed to offering the highest quality trackers. The same can certainly not be said about Marks & Spencer and Scottish Widows, both of which charge unjustifiably high fees (0.60% and 1.00%, respectively).

We've winnowed the field down to three finalists based on tracking difference and fees, but at this point judging best of breed becomes increasingly difficult. The L&G and HSBC offerings show almost identical 1-, 2- and 3-year annualised returns, while the BlackRock fund has delivered higher returns

over the last couple of years. At the same time, we expect the L&G fund to track its benchmark more closely in the future than it did in the past on the back of its fee cut in November 2014, from 0.18% to 0.10%.

So which is the winner out of the three? From a strictly quantitative perspective, given the uncertain and/or case specific (e.g. platform fees and preferential pricing arrangements) nature of many of the variables in question, a clear winner cannot be defined --And, were we able to do so, the winner would only be expected to best its closest rivals by just a handful of basis points.

With this in mind, perhaps it's best to step back from our original question and take a broader view, asking ourselves whether or not the FTSE 100 really is the best bet for investors looking for broad UK equity exposure via an index fund.

After all, the FTSE 100 is very heavy in giant- and large-cap UK companies that derive only a small portion of their revenues from the UK. Also, with a quarter of its weighting in resources companies like Royal Dutch Shell and Rio Tinto, the index is acutely exposed to the fortunes of the broader global economy, and less to the health of the UK economy.

Would the FTSE All Share be a better index to track UK equity exposure then?

The FTSE All Share represents about 98% of the UK's market capitalisation, with about 80% of its value allocated to large caps and 20% to mid- and small caps. As such, it provides broader exposure to the UK equity market.

In our view, the more comprehensive exposure of the FTSE All Share is preferable to the targeted strategy of the FTSE 100 which will ultimately leave long-term investors underexposed to certain segments of the UK equity market. Moreover, the FTSE All Share is also more representative of the opportunity set available to managers of active UK equity funds.

Performance-wise, the FTSE All Share has also beaten its purely large-cap focused counterpart over the last 3, 5, 10, and 15 years on an annualised risk-adjusted basis, and we expect this outperformance to persist in the future.

Exhibit 2 FTSE All Share versus FTSE 100

Name	Annualised Return (%)				Annualised Standard Deviation (%)				Sharpe Ratio			
	3-Year	5-Year	10-Year	15-Year	3-Year	5-Year	10-Year	15-Year	3-Year	5-Year	10-Year	15-Year
FTSE AllShare TR GBP	11.14	8.70	7.58	3.94	10.31	12.34	13.93	14.36	1.03	0.69	0.42	0.12
FTSE 100 TR GBP	9.55	7.69	6.97	3.09	10.49	12.45	13.74	14.24	0.87	0.61	0.38	0.06

Source: Morningstar Direct at 31/12/2014.

So now let's look at those funds that track the FTSE All Share and see if we can identify the best.

What is the best FTSE All Share Tracker?

The following table shows the returns from a sample of the largest FTSE All Share trackers available to UK investors and the index. We have calculated valuation point-aligned tracking differences.

Exhibit 3 FTSE All Share Tracker Comparison

Fund Name	Fund Size GBP (million)	Valuation Point	Ongoing Charge (%)	Annualised Return (%)			Annual Return (%)				
				1-Year	2-Year	3-Year	2014	2013	2012	2011	2010
Vanguard FTSE U.K. All Shr Idx UT Acc	3,774	End of Day	0.08	1.05	10.48	11.05	1.05	20.79	12.20	-3.59	14.29
Fidelity Index UK W Acc	1,490	Midday	0.09	0.58	9.94	10.67	0.58	20.17	12.15	-5.07	14.54
L&G UK Index I Acc	1,387	Midday	0.10	0.78	10.23	11.03	0.78	20.57	12.64	-4.79	14.70
Royal London UK All Share Tracker Z Acc	495	Midday	0.15	0.78	10.57	11.35	0.78	21.32	12.92	-4.56	15.51
SSgA UK Equity Tracker	289	End of Day	0.15	1.15	10.44	10.78	1.15	20.58	11.49	-4.00	13.79
BlackRock UK Equity Tracker D Acc	8,331	Midday	0.16	0.78	10.23	11.01	0.78	20.58	12.56	-4.90	—
HSBC FTSE All Share Index C Acc	1,091	Midday	0.17	0.72	10.10	10.93	0.72	20.36	12.60	-4.85	14.71
Aviva Investors UK Idx Tracking 3 Acc	773	Midday	0.23	0.96	10.25	10.81	0.96	20.40	11.94	-4.15	14.49
F&C FTSE All-Share Tracker 1 Acc	383	Midday	0.36	0.53	9.92	10.75	0.53	20.19	12.41	-4.88	14.72
M&G Index Tracker A Acc	473	Midday	0.46	-0.31	9.95	10.47	-0.31	21.27	11.51	-3.94	13.89
Virgin UK Idx Tracking Trust	2,721	End of Day	1.00	0.25	9.52	10.00	0.25	19.66	10.97	-4.68	14.01
FTSE All Share TR GBP—End of Day				1.18	10.56	11.14	1.18	20.81	12.30	-3.46	14.51
FTSE All Share TR GBP—Midday				0.93	10.36	11.23	0.93	20.67	12.99	-4.42	15.26

Fund Name	Morningstar Analyst Rating	Ongoing Charge (%)	Annualised Tracking Difference (%)			Annual Tracking Difference (%)				
			1-Year	2-Year	3-Year	2014	2013	2012	2011	2010
Vanguard FTSE U.K. All Shr Idx UT Acc	Silver	0.08	-0.13	-0.08	-0.09	-0.13	-0.02	-0.11	-0.13	-0.22
Fidelity Index UK W Acc	Not Rated	0.09	-0.34	-0.42	-0.56	-0.34	-0.51	-0.84	-0.65	-0.71
L&G UK Index I Acc	Silver	0.10	-0.15	-0.13	-0.20	-0.15	-0.10	-0.35	-0.37	-0.56
Royal London UK All Share Tracker Z Acc	Not Rated	0.15	-0.15	0.21	0.12	-0.15	0.64	-0.07	-0.14	0.26
SSgA UK Equity Tracker	Not Rated	0.15	-0.03	-0.12	-0.36	-0.03	-0.23	-0.82	-0.54	-0.73
BlackRock UK Equity Tracker D Acc	Silver	0.16	-0.15	-0.13	-0.22	-0.15	-0.10	-0.43	-0.48	—
HSBC FTSE All Share Index C Acc	Not Rated	0.17	-0.21	-0.26	-0.30	-0.21	-0.32	-0.39	-0.43	-0.55
Aviva Investors UK Idx Tracking 3 Acc	Not Rated	0.23	0.04	-0.11	-0.42	0.04	-0.27	-1.05	0.27	-0.77
F&C FTSE All-Share Tracker 1 Acc	Not Rated	0.36	-0.40	-0.44	-0.48	-0.40	-0.48	-0.57	-0.46	-0.53
M&G Index Tracker A Acc	Not Rated	0.46	-1.23	-0.41	-0.76	-1.23	0.59	-1.48	0.49	-1.37
Virgin UK Idx Tracking Trust	Not Rated	1.00	-0.93	-1.04	-1.14	-0.93	-1.15	-1.34	-1.22	-0.51

Source: Morningstar Direct at 31/12/2014.

From this table, it's even more difficult to pinpoint a winner. We've identified four FTSE All Share trackers with extremely tight tracking differences over the trailing 2- and 3-year periods, albeit with varying degrees of consistency. These funds also happen to be among the cheapest, with ongoing charges ranging from 0.08% to 0.16%, and be managed by reputable companies that dedicate substantial resources to their indexing business.

However, this table is not enough to draw a definitive conclusion. While we solved the issue of differing valuation points, a few other issues that we raised earlier remain:

- ▶ Some of the tracking differences calculated above may be inflated, while others may be impaired, by the pricing mechanism used by the fund companies to deal with dilution. Each approach affects fund performance differently over time depending on the flow activity within the fund and can result in the fund benefitting or suffering in any given year. For example, the single swing pricing method used by Royal London led to a significant outperformance of its FTSE All Share tracker in 2013. It should be noted that there is no right or wrong approach to dealing with dilution, and although some may look fairer and more transparent than others, it is impossible to predict which one will lead to the highest returns over the long term.
- ▶ Past performance only tells part of the story. We expect some funds' tracking performance to look somewhat better in the future. Such is the case, for example, of [Vanguard FTSE UK All Shr](#), [L&G UK Index](#), as well as Fidelity Index UK, which all saw their fees cut in the last twelve months. A change in portfolio manager and process at Fidelity in March 2014 should also yield better results for the Fidelity Index UK fund going forward, as evidenced by its recent improved performance.

As was the case in the FTSE 100 example, our analysis leaves us without a clear 'best in class' option. It, however, leaves us with a select group of superior funds --which we would define as the most competitively priced and managed by a reputable parent company, two factors that we examine very closely within the Morningstar five Pillar framework.

Conclusion

The Morningstar Analyst Rating for index funds allows investors to see the wood for the trees and prevents them from getting bogged down in the minutiae of tracking performance. To illustrate this point, we have looked at the case of UK equity trackers. The difference in performance between a low-cost FTSE All Share tracker and a low-cost FTSE 100 tracker may be measured in 100s of basis points over long periods of time, whereas the difference in performance between low-cost funds tracking like benchmarks is likely to be measured in 10s of basis points.

Choosing the right benchmark for an investor's need is a far more straightforward exercise and one that yields more meaningful results than identifying the best tracker. It is all the more important to keep this in mind as continued competition between passive fund providers will likely translate into differences in price and performance becoming ever smaller going forward.

It is therefore crucial that investors and their advisers dedicate time and resources to analysing the indices underlying tracker funds and not to focus exclusively on the small differences between top funds, as defined by their low fees, reasonably good tracking performance and managed by companies fully committed to their indexing business.