

The Sound Investor Series #37

Equity Indexes – In Even More Detail

By Ed Hynes, CFA

February 15, 2006

A reader sent me an e-mail expressing some thoughts about equity indexes, so let's discuss them further.

What should an investor look for when buying an index fund? A few years ago, this was very simple but today, there is a growing multitude of indexes, each promising better results.

When constructing an index one of the most important decisions is determining the weights of individual stocks. You would be surprised at how many weighting choices there are. For instance, should every stock have an equal weight, sort of like the Dow Jones Industrial Average? Or do you think stocks of larger companies should have more weight than those of smaller companies? If so, what are the appropriate criteria for weighting the stocks?

Which index an investor chooses should flow from how they plan to use that index. If they are just curious about how the market performed today, the Dow Jones index works fine. However, as a benchmark index, the Dow does not work very well.

For benchmarking purposes, capitalization-weighted indexes have to be used. With this method, stocks are weighted by the amount of money invested in each of them. Therefore, cap-weighted indexes are the only indexes that actually measure the performance of every dollar and truly capture the full range of investment opportunities available to portfolio managers.

What kind of index is best for investing? The easy answer could be an index of all publicly listed stocks, but that is not always right. First, it is important to analyze if the publicly listed stocks accurately reflect a country's economy. In the U.S., this is not a problem since publicly listed companies make up most of our economy. The only remaining task for investors in U.S. is to weight the companies in the market and I will get to that in a moment.

However, in many emerging markets the stocks available for purchase do not fairly or even remotely reflect the national economy. My favorite example is the group of stocks listed on the Shanghai Exchange when it first opened. I visited the exchange in 1987 and one of the few listed stocks was Shanghai Vacuum. At first, I foolishly thought this was a large vacuum cleaner company but in fact, it was a manufacturer of vacuum tubes for TV sets. For an investor looking for exposure to the Chinese economy, investing in an old state-run company making obsolete TV tubes was not the way to go! I am not sure if a vacuum cleaner manufacturer would have been better, but at least it might have grown as people put electricity and floors into their homes.

This is still a huge problem in China where the market of publicly listed stocks does not accurately reflect the economy. Although China's economy continues to grow, the stock market has been down for 7 or 8 years in a row.

Let's return to the discussion of how to weight stocks in an index. We have already discussed cap-weighted indexes and how they measure the average dollar invested in the market.

There are other weighting schemes and Mr. Robert Arnott, Chairman of Research Affiliates, has reinvented one. He and his colleagues published a detailed article about his new "Fundamental Indexes" in the March/April 2005 addition of Financial Analysts Journal.

Mr. Arnott believes portfolios that weight companies by a number of "fundamental" criteria such as sales or number of employees rather than by capitalization can generate better performance. To me, the re-weighting of stocks in a portfolio to beat the market is the essence of active management, not passive index investing. Here are a few additional observations.

First, do not confuse these "Fundamental Indexes" with benchmarks. They do not even attempt to measure the performance of the money invested in these stocks.

Second, while I applaud the goal of having an index that reflects the economy, Mr. Arnott did not attempt this. Rather his method starts by examining the publicly listed companies and using "fundamental" data to determine their weight in the index.

I suggest a better but more difficult method that starts with economy, not the set of listed companies. In other words, if utilities produced 10% of a county's GDP, 10% of a "Real Fundamental Index" would be utilities. Arnott's approach unfortunately never looks at the underlying economy and goes straight to publicly listed companies. This skews the approach from the get go, especially in emerging markets.

Arnott's article presents information on how his fundamental indexes outperform cap-weighted indexes. This strikes me as interesting, but not revolutionary. I have seen many active quantitative managers detail how they have beaten the market. For years, I also presented data on the superior performance of a quantitative strategy called the Dogs of the Dow. Unfortunately, like most active strategies, it worked until it didn't.

The bottom line is that investors are attracted to index investing because they are confident they will not under-perform the market. So in countries where the stock market reflects the economy, cap-weighted index funds are an index investors best bet. In other markets, where the available stocks do not reflect the economy, indexing makes no sense, no matter what the weighting methodology.

Ed Hynes, CFA, is President of Farm Creek Securities, LLC based in Rowayton, CT. (203) 838-1025. This series of articles is available at farmcreeksecurities.com. Before putting money in any investment, you should carefully consider your investment objectives; and the risks, charges and expenses of any investment. Past performance is not an indication of future performance and there are risks to investing including the loss of principal.