

Visit **Benefits and Pensions Monitor** magazine online at: <http://www.bpmmagazine.com>

Fundamental Indexes: Investing More Intelligently

By: Jerry Moskowitz

In December of 1975, John Bogle, at Vanguard, established the First Index **Investment** Trust, a mutual fund that tracked the performance of the Standard & Poor's 500 Common Stock Price Index. The fund was nicknamed 'Bogle's Folly' by his critics and it was labelled 'un-American' for its passive **investment** strategy. Unconventional as this strategy was, the fund turned out to be a great success. Later renamed the 'Vanguard 500,' Bogle's so-called 'folly' grew to become one of the two largest mutual funds of all time with more than \$100 billion in assets under management. In the process, an entire industry was launched.

Some 30-odd years later, index **investing** is widely used by both institutional and individual **investors** as a tool for broad market exposure and is praised for its transparency, low fees, and low turnover. Tracking indexes offers **investors** a simple way to diversify their portfolios and research has also shown that indexes outperform active managers 75 per cent of the time. In the U.S. alone, index funds have more than \$1 trillion in assets under management. They are used as benchmarks and in the construction of options, futures, exchange-traded funds, and structured notes.

Today, the landscape of indexing and index investing is quickly changing. Investors are finding that they have a choice as to what kind of indexes they want to track. In addition to traditional equity indexes as we think of them – large and small cap, industrial, U.S.-centric indexes – we are now seeing innovative indexes that give investors exposure to global markets, developing markets, the real estate industry, infrastructure, socially responsible investment, and more. Along with the proliferation of new sectors and asset classes, the very foundation of how indexes are calculated is beginning to shift as well.

Market-Capitalization Weighting

Until recently, almost all indexes were based on market-capitalization weightings, meaning that a company's weight in an index is based on the price of its stock multiplied by the number of shares it has outstanding. Simply put, the more shares a company has outstanding and the higher its stock value, the greater its weight within the index. This method hinges on the Efficient Markets Hypothesis, which predicates that price equals true value and suggests that because markets are efficient, a cap-weighted index is an efficient equity investment.

The problem is that this hypothesis is not always true. In the open market, prices do not always reflect true value and they do move. Furthermore, as demonstrated by the technology bubble of 1998 to 2000, markets are sometimes emotionally driven rather than economically valued.

As a result of using the market-cap approach, over-valued stocks in an index become overweighted while under-valued stocks remain underweighted until market prices adjust themselves. Until this happens, investors are left overexposed to assets trading above their true fair value and underexposed to those trading below their true fair value. This phenomenon is called 'return drag' and can be particularly problematic during market bubbles.

Drawing another example from the recent technology bubble, the tech sector made up about 25 per cent of most market-cap weighted indexes at that time, up from about only eight per cent in 1995. The reason for the change in weighting was that during this period, the stock prices of technology companies were driven up by investor emotion and market noise, and the companies were grossly overvalued and over-weighted. When prices eventually adjusted themselves, the bubble burst and many investors suffered significant losses.

Is There An Alternative To Market-Cap Weighting?

Having established that market-cap weighting can lead to over- and undervaluation problems, causing return drag, the question is how to go about breaking this link. In 2002, Robert Arnott and his team at Research Affiliates came up with the idea of creating an index that measures profits rather than market-capitalization, taking stock price out of the equation. A very simple idea, the concept is to measure company weight within an index by Main Street's standards of size rather than Wall Street's. In other words, company size and performance are determined by four fundamental factors – sales, cash flows, book values, and dividends. These four factors were selected based on their differences. What one factor did not account for, another would, thereby mitigating the vulnerability of any given factor. The result is a fundamental index, an index showing more stability in stock weighting and less volatility overall, which in more than 60 years of back-testing outperforms capweighted models.

Bringing An Alternative To Market

In mid-2005, the first fundamental indexes came to market. The first fundamental index series went live in November of 2005, beginning with 24 indexes covering global markets.

Thus far, these indexes have outperformed their market-cap counterparts in various economic and market conditions including bull and bear markets, rising and falling interest rates, economic expansions and contractions. In bear markets, fundamental indexes provided a five per cent value add and almost four per cent in recessions. In bull markets, they tend to perform as well, if not better than capweighted indexes. Tests of fundamental index concepts using market data go back as far as 1962, before which point there is not enough market information to support this type of research. These show an annualized return of 12.5 per cent, compared with 10.4 per cent for the S&P 500. (Chart 1)

Performance data also demonstrates that in the Canadian market, these indexes have historically outperformed the S&P/TSX 60. For example, a \$10,000 investment in 1999 would have grown to \$25,726 by year's end, 2006. Conversely, the same \$10,000 investment tracking the S&P/TSX 60 would have only been worth about \$17,011 at that time. (Chart 2)

Controversial Concept

Early adopters of this approach included plan sponsors and financial services providers who recognized that this was an important advance in equity management and that the idea would likely attract substantial assets. Among these plan sponsors were the California Public Employee Retirement System (CalPERS) and the South Dakota Investment Council who began using fundamental indexes to compliment their traditional passive investments.

It is no secret that fundamental indexes are a new and controversial concept. Academics and financial industry heavyweights alike have claimed that fundamental indexes are based on backward-looking data, while others say that they are simply value indexes that favor small cap and value stocks, which historically tend to have better performance than large cap and growth stocks. Some critics even say that fundamental indexes are not indexes at all, but rather an active strategy.

Despite skepticism, with assets under management now exceeding \$12 billion, the concept is rapidly gaining in popularity. Proponents argue they eliminate the return drag inherent in cap-weighted indexes and, furthermore, outperform cap-weighted indexes equivalents by two per cent per annum in the United States and 3.5 per cent globally.

Given the performance data, it makes for a very strong alternative and compliment to any portfolio.

Jerry Moskowitz is president of FTSE Americas.