

Fundamental indexes: Fixing a problem you didn't know you had

BY JAY HEALY

Robert Arnott and his firm, Research Affiliates, have fixed a problem you didn't know you had. They have taken something that works pretty darn well — index investing — and made it better.

The result is fundamental indexing, and the products resulting from it could reshape a large part of the investment landscape.

INDEXING: A BETTER MOUSE TRAP

Most mutual funds and managed accounts employ a manager to actively choose the investments, hoping to generate market beating returns. Index funds, sometimes called passive investments, instead buy a diversified basket of securities designed only to capture the return of market averages. Passive investments remove the manager from the process along with their associated expenses. Ironically, this often leads to higher returns.

One of the most counterintuitive, hard-to-wrap-your-head-around concepts in investing is the consistent outperformance of indexes versus their actively managed competition. It is almost un-American to think that the hard working, highly paid, smart folks on Wall Street can't get ahead in the investing world. Unfortunately for the 80% or so of you who employ these smart folks to actively manage your accounts, the results are clear.

In almost all market segments, in almost all market cycles and almost all time frames, the great majority (60%-80%) of active managers fail to beat their comparable index.

Yes, at any given time, 20%-40% of managers are outperforming. But before you get too enamored with the idea of picking only winners and avoiding the losers, know this: There is little consistency among the winners. Beating the index one year indicates very little about your likelihood to do it again. Ultimately, it is as hard for investors to pick winning managers as it is for managers to pick winning stocks. Not to say it can't be done, but the average investor's time and efforts are better spent elsewhere.

So, index funds have low fees, are tax efficient and generally trounce the actively managed competition. What's not to love? Robert Arnott asked himself that question and found the following answer.

A CHINK IN THE ARMOR

Indexes are, with only a few exceptions, capitalization weighted (cap-weighted in Wall Street lingo). That means that an individual company's size in the index is directly proportional to its size in the market. Bigger companies — those the market values highly — take up a bigger share of the index, and smaller companies — those with which the market is not as fond — have smaller representation.

The market does a good job of pricing companies on average, but it stands to reason that at any point in time, half the companies will be undervalued and half will be overvalued. A capitalization weighted index structurally overweights every overvalued company while underweighting every undervalued one. Here in lies both the problem and the opportunity.

FUNDAMENTAL INDEXING: A BETTER, BETTER MOUSE TRAP

Arnott studied index compositions from 1926 through 2004 and found that this structural over-weighting of expensive companies was a significant performance drag. Typically, the top 10 names in a capitalization weighted index make up 20%-25% of the total holdings. When measured in 10-year cycles, these same names typically underperform the index as a whole by 25%-30%.

Inspired by this data, Arnott and Research Affiliates developed the RAFI 1000, an index weighted not by market capitalization, but by economic fundamentals. They use a combination of sales, dividends, book value and earning to determine each company's footprint in the economy and, correspondingly, its appropriate footprint in the index. The results are impressive.

Back testing from 1961-2004, the RAFI 1000 compounded at 12.6% per year, while a traditional cap-weighted index of the 1,000 largest U.S. companies compounded at 10.5%. That is the difference between making 73 times your money owning the cap-weighted index or 166 times owning the fundamentally weighted index. This is a powerful performance differential that fund companies have been quick to embrace.

Since Arnott published his findings, several RAFI based products have been introduced. PowerShares has 11 ETFs based on fundamental indexing. Pimco has two RAFI-based funds. Wisdom Tree and State Street Global Advisors have since developed their own versions of fundamental indexing. Since the concept's introduction just over a year ago, billions have been invested in fundamental index products, a trend likely to continue.

TELL ME SOMETHING I DON'T KNOW

Critics argue that fundamental indexes aren't anything new. They are simply tilting the portfolio toward smaller companies and companies with more value characteristics. Ken French and Eugene Fama, in a series of landmark academic papers written in the 1990s, established that any portfolio's returns can be largely explained by the portfolio's exposure to three factors: equities in general, the market cap of those equities and their valuation as evidenced by such variables as price to book or p/e ratio.

When viewed through the filter of this "three factor model," the performance advantage of the

RAFI 1000 index is explained completely away just as Fama and French would have predicted.

Others embrace the concept, but urge investors to proceed with caution for the following reason. Markets move in cycles. During some periods, large growth companies lead the pack, while in other periods, smaller, more value-like companies dominate.

The performance differential between traditional and fundamental indexes is closely tied to these cycles. Because of its size and value tilt, the back-tested fundamental index tended to have the biggest performance advantage during the market's small value cycles, but trailed the traditional index when market performance was dominated by large companies. These style cycles generally last several years and then reverse themselves. 2006 will mark the seventh year of a strong value-driven cycle. Large growth companies could soon have the wind at their backs once again, making this a poor time to embrace fundamental indexing.

CONCLUSION

How can investors use these funds successfully? There are a few obvious situations. In accounts where a one-fund solution is desirable and the time horizon is long — college savings accounts, small IRAs, etc. — a RAFI based product could be an ideal choice.

Investors seeking to enhance performance in a diversified portfolio could replace existing large-cap exposure with a RAFI-based fund. However, investors choosing this path must be fully aware of the value and size tilt they are taking on and the effect it will have on their overall portfolio.

PowerShares has also used the fundamental index concept in the development of industry sector ETFs. Investors who want dedicated exposure to the energy, finance, technology or health care segments of the market can now get it without structurally overweighting the most expensive companies.

This could prove to be the area where fundamental indexing has the most potential.

I am always excited when research and ingenuity make good ideas better. Fundamental indexing is a valid concept and products developed around this research can be powerful tools for investors. In addition, the arrival of fundamental indexes will cause many fund companies and portfolio managers to rethink their own assumptions and practices.



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