

Indexing Goes Hollywood

Gone are the days of only stodgy indexes, but are investors really better off?
by: Don Phillips



The benefits of indexing have been well publicized in recent years. Lower costs, greater tax and trading efficiencies, and the precision of a disciplined and consistently applied approach have combined to make indexed investments a hugely popular choice among both professional and individual investors. On the whole, indexing has served investors well, but there is a dark side to indexing that investors should not ignore.

By definition, if one uses market-cap-weighted indexes, which the vast majority of indexed investments currently do, one has maximum exposure to the most overheated parts of the market at the worst possible times: Think energy in 1979, Japan in international indexes in 1989, or technology in 1999. Sadly, as these indexes push to their highest points, the investment vehicles based on those indexes attract more and more assets. Technology-heavy, large-cap index funds took in billions of dollars in 1999—just in time for three straight miserable years of losses. Indexing may be a more efficient way to invest, but if it is simply a more efficient way of producing a bad experience, what is the point?

The potential for harm to investors increases as index offerings become more specialized, which is exactly what has happened in the world of exchange-traded funds (ETFs). As seen in the Figure 1, ETFs have progressively become more costly and more volatile over the past

decade.

In terms of costs, ETFs remain an attractive alternative to active management, but it's worth noting that the case for the superiority of indexing was based on lower-cost indexed investments than many investors today are purchasing. With the cost of indexed investments rising at the same time as actively managed mutual funds are experiencing a significant number of fee cuts, it's likely that some of the cost superiority of indexing will erode.

Much more disturbing than the rise in costs, however, is the pronounced increase in risk as ETF offerings become more specialized and explore more exotic areas. Part of this specialization is good; the tools available for investors are becoming more numerous and more precise. In the right hands, precision tools can create great things. In the wrong ones, however, they can do considerable damage. Vanguard founder Jack Bogle once compared ETFs to a finely crafted shotgun that could be used either for survival or for suicide. As ETFs become increasingly more potent, the penalty for their misuse grows more extreme.

Figure 1

Rising Costs, Increasing Risk in ETFs



Source: Morningstar® Principia® January 2006

Unfortunately, evidence suggests that investors don't use more volatile investments well. They pile in at the top and lose faith at the bottom. In the chart below, we've calculated both the dollar-weighted and the time-weighted return for the past 10 years for those funds that fell in either the top or the bottom quartile of their category for standard

deviation. The dollar-weighted returns are calculated using monthly assets for each fund, thus counting the months with greater assets proportionally more than the performance during months when less money was in the fund. For both measures, we aggregate the performance of individual funds by using the average asset total of the fund over the 10-year period as the weighing factor. (Our study looks only at those funds that were in existence for the full 10-year period, so some survivorship bias may be at work. It seems likely, however, that it would be the high standard deviation funds that have the higher probability of being buried to hide bad records. If anything, therefore, this comparison may understate the difficulty investors have with high-risk funds.)

Figure 2

Higher Risk Funds Haven't Served Investors Well			
	10-year Dollar-Weighted Return (DWR)	10-year Total Return (TR)	Success ratio (DWR/TR)
Low Standard Deviation Funds	8.53	8.70	98%
High Standard Deviation Funds	5.11	8.25	62%
<ul style="list-style-type: none"> • High and low standard deviation defined relative to a fund's category. • Group resulted based on the dollar-weighted returns and total returns for each fund, using average assets for the period as the weights. 			

It's clear that investors have had much greater success with funds in the lower quartile of their investment categories in terms of volatility than they have had with funds in the highest quartile of volatility. With lower risk funds, investors realize most of the potential benefits of being in those funds. With higher risk funds, investors capture less than two-thirds of the benefit. The lesson is clear: By going down a path of increased specialization, the ETF world may be making its offerings substantially harder for investors to deploy successfully.

Continuing Bogle's metaphor, some ETF providers may choose to take the stance that they are merely weapons manufacturers who bear little or no responsibility for how investors actually use their products. That's essentially the stance taken by many mutual fund firms that launched Internet funds in the late 1990s; they were simply meeting market demand. Sadly, the celebration surrounding the rapid asset growth of several ETFs launched recently seems eerily similar to the euphoria around fast-selling Internet funds in the 1990s. The real success measure of any investment, however, is not how quickly it raises assets, but how much money it makes for investors over time.

On that score, the jury is still out for most ETFs. Still, there are lessons to be learned from the mutual fund industry. How many fund companies who "won big" in 1999 by launching an Internet fund now wish that they had never done so? Indeed, the biggest inflows in the mutual fund industry today go to firms like American Funds, Vanguard and Fidelity, who resisted the temptation to launch Internet sector funds. The money management business is ultimately a meritocracy: Firms that contribute to a better experience ultimately win; Firms that create a bad investor experience eventually pay the price.

While some members of the index community may choose to divorce themselves from the responsibility for how their products are used, others will seek an alternative to being an arms supplier in constant search of more powerful weapons to sell. Many will embrace educational efforts to promote better use of their tools and, in time, will take strides to make their offerings safer to use and more likely to contribute to better outcomes. While fund companies don't have complete control over how investors use their services, that doesn't mean that they can't exercise any control over their use. Fund companies and ETF providers do control the timing of fund launches, the types of funds they launch and the promotional campaigns supporting them. Choices made in each area can contribute to a better investor experience.

Consider the success that Dimensional Fund Advisors (DFA) has had in selling its funds through advisors who undergo training on the merits of passive investing and the theory of portfolio construction. Over the past decade, the dollar-weighted return of all index funds available to the public was just 82 percent of the time-weighted return investors could have gotten with those same funds. DFA, in contrast, has done much better. In fact, the dollar-weighted returns of DFA funds over the past ten years are actually higher than their time-weighted returns, suggesting that advisors who work with DFA encourage very smart behavior among their clients. Collectively, DFA fund shareholders buy into out-of-favor segments of the market and ride them up rather than buying at the peak and riding the trend down, which is usually the case with fund investors (Figure 3).

Figure 3

	10-Yr DWR	10-Yr TR	+/- Diff	Success %
All No-Load Index Funds	7.07	8.65	-1.58	82%
DFA Funds	10.81	9.90	+0.91	109%

In addition to educational efforts, there's also room for improvement on the product development front. One way to dampen the inherent volatility of market-cap weighted indexes, which, again, by definition, give investors more and more exposure to the most overheated parts of the market, is to choose factors other than market cap on which to weight indexes. There has been much talk in the index community about fundamental weighting schemes in recent months, but almost all of it has centered on how to enhance returns. An alternative approach would be to use such alternative approaches to lessen volatility and thus produce a smoother ride that would be more likely to keep investors on board, which is the key to not getting on the wrong side of the dollar-weighted return equation.

In addition, the ETF industry could take a page from the traditional mutual fund industry's playbook and focus more on creating diversified packages of ETFs, like the lifecycle or target-date funds so popular in the mutual fund world these days. By combining uncorrelated funds into portfolios for less sophisticated investors, one can take some of the rough edges off performance. Such packaging can also make it easier for an investor to select the right offering for their needs. Both lower volatility and the simplification of investor choices can contribute to a better investor outcome. Granted, such modifications may not be necessary for the more traditional institutional users of ETFs, but as the industry's popularity extends to individual investors and programs like 401(k) plans, these steps may be important in protecting both investors and the ETF industry's good reputation.

The bottom line is this: The index community is nearing a crossroads. It's wandered so far from its roots of offering one-stop, broad-based exposure to the market that a return to that simpler approach may not be possible. In creating more complex offerings, the index community has found new revenue sources from hedge funds and other parties seeking very specialized tools, but it has done so at the risk of doing considerable harm to less sophisticated investors. The test of character facing the index community is whether it ignores that risk or steps up and tries to mitigate it. The continued good name of indexing lies in the balance.

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