Indexing Goes Hollywood

Gone are the days of only stodgy indexes, but are investors really better off?

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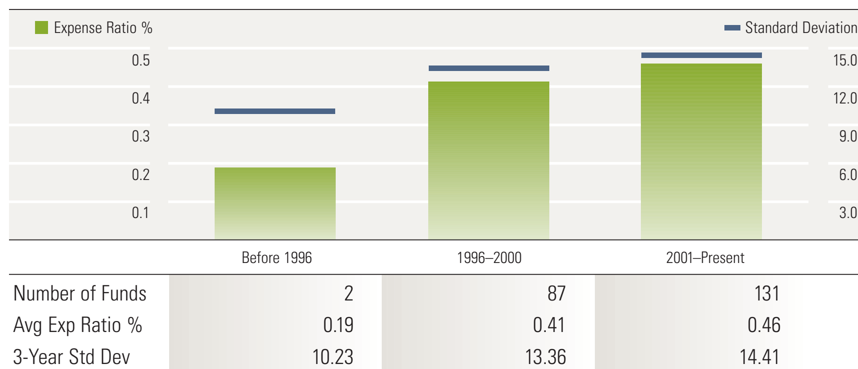
The benefits of indexing have been well-publicized in recent years. Lower costs, greater tax and trading efficiencies, and the precision of a disciplined and consistently applied approach have combined to make indexed investments a hugely popular choice among both professional and individual investors.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

By definition, if one uses market-cap weighted indexes, 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 them 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's simply a more efficient way of producing a bad experience, what's the point?

Rising Costs, Increasing Risk in ETFs



	Before 1996	1996–2000	2001–Present
Number of Funds	2	87	131
Avg Exp Ratio %	0.19	0.41	0.46
3-Year Std Dev	10.23	13.36	14.41

Source: Morningstar® Principia® January 2006

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 chart at the bottom of the page, ETFs have progressively become more volatile and more costly over the past decade.

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, but in the wrong ones, they can do great damage. Indeed, Vanguard founder Jack Bogle once compared ETFs to a finely honed shotgun that could be used for survival or for suicide. Unfortunately, the evidence suggests that investors don't use more volatile investments well. They pile in at the top and lose faith at the bottom. As seen in the chart at the top of the next page, investors have had much greater success with the lowest volatility funds than they have had with the highest. By going down a path of increased specialization, the index world may be positioning itself to do much damage to investors.

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

Higher Risk Funds Haven't Served Investors Well

	10-Year Dollar-Weighted Return %	10-Year Total Return %	Success Ratio (DWR/TR) %
Low Standard Deviation Funds	8.53	8.70	98
High Standard Deviation Funds	5.11	8.25	62

High and low standard deviation defined as relative to a fund's category. Group results based on weighted average of the dollar-weighted returns and total returns for each fund, using average assets for the period as the weights. Ten-year period ending 12-31-2005.

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 Capital Research, Vanguard, and Fidelity, who resisted the temptation to launch such funds. Firms that create a bad investor experience eventually pay a price for doing so. Firms that contribute to a better experience ultimately win.

While some members of the index community may 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.

More Education, Higher Returns

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

Consider the success Dimensional Fund Advisors (DFA) has had in selling its funds through advisors who undergo training on the merits of passive investing and in portfolio construction theory. Consider that over the past decade the dollar-weighted return of all index funds was just 82% of the time-weighted return investors could have gotten with those funds. Yet, the figures for DFA are much better. In fact, the dollar-weighted returns of DFA funds over the past 10 years are actually higher than their time-weighted returns. Suggesting advisors who use DFA encourage very smart behavior among their clients, even buying more out-of-favor segments of the market and riding them up, rather than buying at the peak and riding the trend down, which is usually the case with fund investors.

There's also room for improvement on product development. One way to avoid overexposure to overheated parts of the market that increase index fund volatility is to choose factors other than market cap to weight indexes. There has been much talk about fundamental weighting schemes in recent months, but almost all of it has centered on how to enhance return. An alternative approach would be to use these approaches to dampen volatility and thus produce a smoother ride and one more likely to keep investors on board.

In addition, the ETF industry could take a page from the fund industry's playbook and focus more on creating diversified packages of ETFs, like the life-cycle or target-date funds so popular in the mutual fund world these days. By combining uncorrelated funds, 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 aspects of portfolio-based ETFs could improve the investor experience.

The bottom line is this; the index community is at 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.