Stock Market Perspective: Better Ways to Index?

Keeping in mind the old saying about the potential benefits of devising a better method of capturing rodents, it is not surprising that some investment gurus have been trying to improve on the ways of investing in traditional indices such as the S&P 500. One drawback to some of the theoretical "improvements" was that there was no practical way for an ordinary, non-institutional investor, to implement them. Recently, a practical way to invest in these approaches has become available in the form of ETFs (exchange traded funds). After a bit of background, I will discuss one getting a fair amount of publicity to see if it is the panacea that its promoters would like us to think it is.

Most of the indices that measure the market or a segment of it are capitalization weighted. That means the changes in the index are due to a great extent to the stocks with the largest market capitalizations, the total value of their shares. Some indices may adjust the capitalization by removing shares that are not available for general trading because they are held by corporate insiders. That adjustment does not affect the "problem" with cap weighted indices that we will get to shortly.

A capitalization weighted index has too much in "overvalued" components and too little in the "undervalued" ones.

(In contrast, the Dow Jones averages, including the widely quoted Industrials, are price weighted. The stocks with the highest share prices have more influence on the Dow than those that sell for less. That introduces some complications due to stock splits and other events that we won't worry about for the time being. It is not clear to what extent the problem to be discussed affects the Dow, and we won't consider the Dow further here.)

▶The "problem" with cap weighted indices: By definition, the total value of the stock market as a whole is capitalization weighted, so it is natural to use that type of index to quantify stock values and market performance. Moreover, there are some practical advantages to tracking a cap weighted index in a mutual fund. In the mid-1970s, Vanguard introduced the first index fund, the Vanguard Index 500 that closely tracks the capitalization weighted S&P 500. The thinking behind investing in such a fund is that it will have extremely low expenses, which has proved to be the case, so investors can obtain returns close to those of the index with dividends invested. Taken as a whole, all of the trading in stocks must perform worse than the market due to transaction and management costs. Getting the return of the market will outperform most mutual funds over time. This idea has proved to be valid and has attracted a substantial amount of investment.

The "problem" with this approach stems from some stocks being "overvalued" and others being "undervalued" at any given point in time[1]. For practical purposes, we can say under and overvalued mean stocks that will perform better or worse, respectively, than the market as a whole. A capitalization weighted index must give too much weight to the overvalued components and too little to the undervalued ones. That is the crux of the problem.

If we could identify the issues that were not "correctly" valued, the solution to the problem would be easy. An aggressive approach would be to own those we think are undervalued. Since they may fall when the market as a whole drops, a more conservative method would call for also being short the overvalued issues. Those who believe they can accurately make

[1] That statement contradicts the strongest form of Efficient Markets Hypothesis, which I discussed in a prior issue. My thinking is that over time stock prices converge on their "correct" values (another complex issue), but in the short-term may diverge quite a bit. Accordingly, I have no problem with this idea.

the identifications with sufficient accuracy need not worry about better ways of indexing. Others, which I think includes most of us, will admit that we don't have a clear crystal ball, so a better type of index fund becomes a worthwhile pursuit.

▶**Alternatives to cap weighting:** One of the first ideas was to give equal weight to each component of the index. That means an equal dollar investment in the largest stocks (ExxonMobil and GE were the top two as of the end of June) to the very smallest (Gateway and Cooper Tire were the bottom two in the S&P 500, less than 1/500th the capitalization of the top two) and all the ones in between. Since April 2003, Rydex has offered an ETF (ticker symbol RSP) that holds the S&P 500 stocks with equal weights and is rebalanced quarterly. So far it has outperformed the index by a considerable margin. Over the three years ended this past June 30, RSP had a compounded annual return of 16.2% as compared to 11.1% for the Vanguard Index 500 fund. However, we have been in a cyclical bull market that started about a month before the fund, and smaller stocks tend to do better than large ones during uptrends. In the decline since mid-May, RSP has dropped more (8.9%) than the index (6.0%), which is also to be expected. Until we have a sustained down period, we won't be able to evaluate RSP as a longer term, possibly "buy and hold" investment. It has shown its value in the most recent cyclical bull market.

Has Professor Siegel come up with what will be a forthcoming "huge paradigm shift" in index investing?

Jeremy Siegel, who is a professor at the Wharton School and has written insightful books on investing, has developed methods that he describes as indexing by fundamentals. These, he says, are also improvements over cap weighted indices, and he is now an advisor to WisdomTree Asset Management that offers ETFs based on his research. He discusses two fundamental measures in a June 14 article in the *Wall Street Journal*. One is revenues and the other is dividends. He prefers dividends because they are definite once paid and not subject to accounting procedures, which can be tinkered with by management (Enron being an extreme example), or revisions to correct "errors.". The ETFs run by WisdomTree are based on dividends.

To get an idea of the differences in indexing, the top ten market capitalization stocks in the S&P 500 (and in the U.S. stock market) as of June 30 are ExxonMobil, GE, Citigroup, Bank of America, Microsoft, Proctor and Gamble, Johnson and Johnson, Pfizer, American International Group (AIG), and Altria (formerly Philip Morris). The top ten based on revenues are ExxonMobil, Wal-Mart, GM, ChevronTexaco, Ford, ConocoPhillips, GE, Citigroup, AIG, and IBM. Based on total dividends (not the yield) to be paid based on the current rate, the top ten are Bank of America, Citigroup, GE, ExxonMobil, Altria, Pfizer, AT&T (formerly SBC, which took over the old "Ma Bell"), JP Morgan, ChevronTexaco, and Verizon. A few stocks are common to two or three of the lists, but the emphasis is different. In particular, the dividend based list and the entire fund give a lot of weight to companies in the financial sector, about 1/3 of the assets of the ETF.

WisdomTree's ETFs started this past June, so there is hardly any real data for evaluation. Their literature provides some comparisons loaded with required disclaimers about backtested and hypothetical data comparing the theoretical performance of the fundamental indices with capitalization weighted market indices over 1964-2005 and 1980-2005. They show annualized performance a percent or two higher, which the literature says is essentially the difference in dividend yields. I don't consider that particularly impressive. Unfortunately, they do not provide yearly data, which would allow comparisons over good and bad stock market periods. They do say they are

less volatile, which is generally the case for stocks with significant dividends. While the dividend weighted ETFs may prove to be better investments, particularly for buying and holding than the capitalization weighted indices, I don't think they are all that exciting.

▶**Potential drawbacks:** One reason I am not impressed is that the long-term returns shown do not include management fees, which will be modest, and transaction costs, so they overstate the comparisons. Those costs likely will erode most of the advantages shown in the literature.

An ETF based on a factor other than market capitalization has to be rebalanced periodically. The Rydex fund is rebalanced quarterly. It looks like the dividend based funds will be rebalanced whenever there is a change in dividend by one of its components and at other times. In addition, once a year WisdomTree will reconstitute their funds' holdings based on their updated analysis.

Those actions will result in purchases and sales of stocks not resulting from fund inflows and outflows. In contrast, a capitalization weighted index remains that way by definition once it is established until there is a change in components. A fund based on such an index will have far fewer transaction costs and should have lower management fees.

Another possible drawback is that the transactions can result in taxable distributions due to capital gains to fund holders who don't have the shares in IRAs and similar accounts. Over the years, the Vanguard index fund has distributions consisting mainly of income rather than capital gains. So far, the distributions of the Rydex equally weighted fund have been modest, but that could change. However, I suspect neither it nor the WisdomTree funds will have substantial capital gains distributions.

▶**The "bottom line":** As I indicated above, I am not impressed by Jeremy Siegel's claim that fundamental indices are going to be a "huge paradigm shift." Time will tell if their real-time performance is much better than index tracking funds from Vanguard, Fidelity, other fund companies, or the popular ETF that owns the S&P 500 called "spiders." I have no intention of owning dividend weighted funds.

On the other hand, the impressive performance of the Rydex equally weighted fund during the recent cyclical bull market means that I will quite likely buy that fund when my models for stocks used for TAA managed accounts give buy signals instead of funds that track the S&P fairly closely.

However, I don't think any of these alternative indexing funds should be just bought and held. As I have discussed frequently, no matter how a diversified fund compares to a measure of the market, I think the way to reduce risks and achieve better long-term returns is not to be heavily invested when markets are trending down.