Stock Market Perspective: Better Ways to Index Revisited

A year ago I wrote about alternatives to traditional index funds that have exposure to each component of the index is in accordance with its market capitalization. For example, 3.4% of the assets of the standard S&P Index fund are in ExxonMobil and 2.9% are in GE because those are the percentages of the total market capitalization of the 500 stocks in the index of the two largest components. There are those who argue that weighting by capitalization is not a good idea because too much weight will be given to those components that are "overvalued" and not enough to the "undervalued" ones. (The determination of those categories is another issue that I won't get into. It is the subject of numerous books on the analysis of stocks.)

In recent years, several exchange traded funds (ETFs) has come on the scene that weight the index components using methods other than market capitalization. The Rydex S&P Equal Weight ETF (ticker symbol RSP) has existed for a little over four years. It gives equal weight to each of the 500 stocks in the index, so each is 0.2% of the index subject to fluctuations between the quarterly rebalancings. Standard and Poors has created theoretical values of the equal weight index back to 1990. I have used those to compare my trading methods on an equal weight fund and a traditional S&P fund. I found that the equal weight fund had an advantage during strong markets, but was a little riskier in weak markets. Overall, I concluded that RSP was a better trading vehicle for the signals I use for Tactical Asset Allocation. I have purchased that fund in client and personal accounts.

Professor Jeremy Siegel of the Wharton School and a well known author has been an advocate of "fundamental" indexing. That means basing the weight of each of the components on factors such as revenues or dividends. In a *Wall Street Journal* column in June of last year, he said the new methods would be a "paradigm shift" in investment management I discussed his work in my perspective a year ago. You can read it at "www.pankin.com/persp062.pdf'.

Siegel is an advisor to Wisdom Tree Investments, which offers ETFs implementing his approach. Their first offerings were in June of last year. Later, I will look at how some of them have done in comparison to traditional index funds and the Rydex equal weight ETF.

▶**Counter arguments:** Perhaps the most outspoken and well known advocate of traditional index funds is John Bogle. He founded Vanguard mutual funds in 1974 and introduced the first index fund, the Vanguard Index 500 fund, in 1975. He has written a new book, *The Little Book of Common Sense Investing*, which argues against "fundamental indexing" and using other than market capitalization to weight an index fund portfolio.

His basic argument is that "you can't beat the market" so you are best off getting the market return less a very low cost of running an index fund. In effect, he is a believer in the efficient market hypothesis, which I have discussed in previous perspectives. Once anyone takes that position, no alternative approaches are as good as traditional indexing.

> *Wisdom Tree's dividend weighted funds have not been stellar performers. Siegel's "paradigm shift" has yet to happen.*

Bogle has additional reasons why fundamental indexing is not going to work as well as the traditional approach. One is that the costs of implementation are higher. In addition the slightly higher management fees/expense ratios (typically 0.3-0.4% vs. 0.1-0.2% for the lowest cost providers), there are the transaction costs involved in the periodic rebalancing of any but a capitalization weighted portfolio. Some of the ETFs have significantly higher fees than those shown above.

Bogle and others claim that fundamental indexing is really active management in disguise. Since a large proportion, typically 8o to 90 percent, of actively managed funds fails to beat their relevant indices, active management is to be shunned. The reasons are that all of the funds taken as a whole pretty much are "the market" so collectively they can't do better than the market's return less their expenses. However, that does not say that fundamental indexing can't beat the market. This argument seems to me more like an attempt at guilt by association.

Harvard professor and head of the investment committee for a Boston-based private equity management firm Andre Perold has performed academic studies of the indexing issues. An article in the May 7 *Investment News* discusses some of his work and the reaction to it. His key point is that the determination of the "fair value" of a stock is not at all well defined so any stock is as likely to be overvalued as undervalued. This is a weaker form of the efficient market hypothesis, and it implies that alternative index weightings are not going to produce consistently better returns than a capitalization weighted index. In other words, you can't beat the market.

▶**Performance comparison:** The Wisdom Tree funds have been in existence for a little over a year, so the comparisons are going to be limited and not necessarily meaningful, but they do provide a first look at the value of the methods. I will look at the performance over the last year of four ETFs. The S&P "spiders" (ticker SPY) own the S&P 500 index, and its total return is the index plus dividends less a minimal expense ratio of 0.08%. It is the benchmark for comparison of alternative index funds. The Rydex S&P Equal Weight (RSP) has a 0.40% expense ratio, so it starts with a disadvantage of about a third of a percent. Wisdom Tree does not have a dividend weighted S&P index fund (which would have fewer than 500 stocks in it since some do not pay dividends), but it does have two dividend based funds of interest, each of which has a 0.28% expense ratio. They are the LargeCap Dividend Fund (DLN) and the Total Dividend Fund (DTD). DLN holds about 300 stocks, and DTD, which covers the total U.S. market, owns about 1450.

(In February Wisdom Tree started its "Earnings 500 Fund" ETF. It will own about 500 stocks, but some won't be components of the S&P 500 Index. Most likely, those will comprise a fairly small proportion of the ETF's holdings. I plan to include it in the comparisons once it has been going for at least a year.)

For the one year period through the end of June, the performance of the four funds is similar. The total returns are SPY: 20.4%, RSP: 20.7%, DLN: 20.1%, and DTD: 19.5%. Holding any one of these for the year would have been pleasing as stocks have done quite well. However, the Wisdom Tree funds are not yet living up to Siegel's "paradigm shift" hype.

I don't believe buy and hope, which is usually called "buy and hold," is a good way to invest as I have discussed many times in prior issues. Consequently, the above returns are not my primary area of interest. I want to see how the funds have done when the model I use for buying index funds as part of the TAA managed account program says we should own stocks. In the past year there has been essentially one buy signal, which is still in effect. It called for buying on August 28. (To simplify the discussion I am ignoring a one week whipsaw sell signal in late January.) The total returns from August 28 through June 29 are SPY: 17.4%, RSP: 20.0%, DLN: 14.8%, and DTD: 15.1%.

The above figures support my research that RSP is likely to outperform the market when it is in a strong up trend. A year ago, I said I had no plans to put the Wisdom Tree funds in my clients' or personal portfolios. Now I have some evidence that the Rydex Equal Weight fund is a better choice for what I do.