Mutual Funds

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A Skeptic's View of Index Funds

➤ One of the more prevalent discussions in the mutual fund and investing world these days surrounds the strategy of indexing and the use of index funds. Proponents generally focus on a number of common benefits. They point to the degree with which active managers have had difficulty beating the benchmark indices over the last couple of years. This is usually explained, particularly in academic circles, by the "efficiency of the capital markets". They also point to the "low cost" of indexing and index funds. While these are valid points to some degree, there are some major caveats investors should be aware of before using indexing as a strategy and investing in index funds.

➤ First, it is extremely important to realize that the success of indexing, or the relative lack of success of many actively managed funds over the last couple of years, comes from a fairly uncommon convergence of events and circumstances. In particular, 1998 was a year of extreme divergences within the stock markets of Canada and the United States. It was a year in which an extremely narrow number of stocks accounted for the lion's share of the gain of the market indices. These all happened to be the largest of the large companies in both Canada and the US. The weighting of the 500 stocks in the S&P 500 index is based on the size of the company, measured by stock market capitalization. The larger the market cap (ie. the bigger the company), the bigger the weight in the index. The top 30 stocks in the S&P 500 account for 43% of that index's market value, leaving a little over half for the other 470 stocks.

➤ In 1998 and in the beginning of 1999, there were several "flights to quality" due to concerns about international markets and growth in earnings. Earnings growth last year was found primarily in larger companies, and generally flights to quality and liquidity means that investors put their money into the biggest blue chip companies they can find. These and other factors combined resulted in a market in the US where the 30 largest stocks in the S&P 500 index accounted for 46% of the gain in that index. The trend continued in the first quarter of 1999. The top 30 stocks accounted for over 60% of the index's gain of 4.6% in the first quarter, while the average S&P 500 stock only rose 0.3% and 56% of the S&P 500 companies actually saw their share price decline[1] .

➤ Market gains are not usually concentrated in this small a number of stocks. The circumstances over the past year have lent extreme favour to the indexing strategy, while money managers who have done anything a little different simply haven't been able to keep up. This is not always the case. Depending on the market and the time period, we have seen the index fall anywhere from the top 10% of funds to the bottom 10%. Also, remember that recent history has a profound effect on longer-term performance numbers due to the magic of compounding. Does indexing work? Yes, but not always as well as recent history might indicate.

Footnote: [1] *Donaldson, Lufkin & Jenrette*

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- Another argument for indexing and index funds usually involves costs. Compared to the typical Management Expense Ratios (MERs) for most equity mutual funds in Canada in excess of 2%, indexing appears to be a bargain. However, if one takes a close look, numbers on the index fund side are not particularly appealing. The return of an index fund starts with that of its benchmark, less a small difference because of the effects of money flows into or out of the fund (requiring the manager to invest or divest those amounts), less the fund's management fees and expenses, otherwise known as the MER. The impact of the latter is the most significant. The least expensive index fund available to typical retail investors in Canada carries an MER of 0.50%. Most others start at roughly 0.70% and go to upwards of 2%.

- Given that these total expense numbers are still generally less than for actively managed funds, what's the problem? Returns of these funds are essentially "capped" at the index return, without the possibility of exceeding that of the benchmark. By definition, the return of an index fund equals the benchmark index, less error for execution, less the MER of 0.50% or more. As a result, the fund will trail the benchmark by an amount at least equal to and generally greater than its MER. For example, one of the index funds which tracks the TSE carries an MER of 0.80% and has trailed the benchmark by 1.37% on average for the last three years ended May 1999.

- It is for this reason that investors might want to look at exchange traded index units such as TIPs (TSE 35 Index Participation Units), SPDRs (Standard & Poors Depositary Receipts) or WEBS (World Equity Benchmark Shares which track over a dozen individual MSCI country indices). Typical ongoing expenses for these products are a fraction of those found in index funds.

- Finally, many people who use indexing as a strategy often overlook taking risk into consideration. With indexing, you take on full market risk. If the index declines by 20%, an index fund generally declines by at least 20% (plus the MER). Many active managers follow investing strategies which expose investors to far less risk. Whatever investments you own, whether index funds, actively managed funds, individual stocks or bonds, individually and collectively as a portfolio, they should always be tailored to individual goals, objectives and risk tolerances. The "market" aside, investing is about meeting unique personal financial goals, and doing it in a way each investor feels comfortable with. Failing to match the market in a very strong year, and losing far less in a down year is, for many investors, a more positive outcome than "matching the market".

- In conclusion, indexing is a strategy that is gaining more attention and favour. It can be a sensible way to invest. Like every investing strategy it works better at some times than at others, and does not work for everyone. It can be effective as part of a well thought out and balanced investment portfolio or RRSP. For those who would propose it as the ideal investment strategy however, be skeptical, for it is no panacea.