

Fundamental Indexing: The Real Deal?

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For those not following the fundamental indexing phenomenon, here's a brief primer.

Influenced by the 1999 technology stock bubble and its disastrous consequences for investors, Robert D. Arnott, chairman of Research Affiliates, came up with the idea of fundamental indexes. Instead of weighting stocks in an index by their capitalization — the tried and true way acknowledged by people like Vanguard's Jack Bogle as the only way to index — this new indexing strategy weights them according to fundamental factors, such as revenues, or earnings, or a combination of such factors.

Why was the tech bubble an influence? As the thinking goes, when there's a bubble, there are unrealistically high stock prices. When those stocks are a major component of an index, the index then disproportionately represents the value of some of its components. The index still measures the true market value of its stocks, but some of the stocks' prices don't measure the true value of their companies. "Fundamentalists" would say: If the price is wrong, then the weighting in an index is wrong.

Fundamental indexing is the way to get around these ever-changing miscalculations. If stock values aren't reliable, revenues and other fundamental measures of a company's presence in the economy are significantly more stable and representative. Some critics say this shift in valuation will overemphasize value versus growth stocks. Yet, academic research already treats as common wisdom the fact that value stocks outperform growth stocks a majority of the time.

So the debate rages on: Is fundamental indexing real indexing, or is it just another formulaic attempt to beat the market? Let's see what your peers think. (Here's a hint: More dislike it than not).

Reasons to Dislike It

Fundamental indexing is new, unproven and, therefore, uncertain. Dylan Ross with Swan Financial Planning in East Windsor, N.J., puts it this way: "From a financial planning standpoint, there is already a degree of uncertainty in the markets. Investing in fundamental index-tracking investments adds additional uncertainty. If a goal of financial planning is to minimize uncertainty, cap-weighted indexing may be the better option for the individual investor."

High fees wipe out return advantage. Steve Condon of Truepoint Capital in Cincinnati notes: "The management fees charged by fundamental index products are often much higher than those of comparable index or passive funds." Adds Aaron Skloff of Skloff Financial Group in Berkeley Heights, N.J.: "Fundamentally weighted index funds are likely to produce after trading, management, marketing and other costs, returns similar to their respective market-capitalization- and valuation-based indices over multiple market cycles."

Bobbie Munroe of Fraser Financial in Atlanta provides some numbers to back up these claims. "Take the FTSE RAFI 1000/PRF [a fundamentally weighted ETF]. As of July 15, 2008, the top eight out of 1,000 holdings comprised over 18 percent of the fund. And the expenses run 0.6 percent versus 0.15 percent for a cap-weighted ETF. [With this expense structure], PRF has to perform significantly better than its cap-weighted counterpart just to break even."

It's nothing more than value- and small-cap stock investing. Says Pam Poldiak of Fee-Only Financial Planning in Roanoke, Va.: "As just a new way to market an old idea — that value and small-cap stocks perform better than growth and large-cap stocks — fundamentally weighted indexes are just a marketing gimmick. [Theorists Eugene Fama and Kenneth French] came up with this theory a long time ago, and Dimensional Fund Advisors [DFA] has been offering funds targeting small-cap and value stocks for over 25 years. Any investor can create an index portfolio targeting small and value stocks by simply buying ETFs from iShares or Vanguard — all at a much lower cost than the fundamentally weighted funds."

Higher risk, higher return . “ Arnott is going around the country saying that fundamental indexing is better because it outperforms the S&P 500,” says Sean Sebold of Sebold Capital Management in Naperville , Ill. “Gee whiz, do you think small-caps will outperform large-caps over a long period of time? Of course, but the risk profile is different. This is something that is neglected in the marketing materials.”

You get the same thing with equal-weight indexes. Maurizio Piglia , a director at S&I Savings and Investments of Auckland, New Zealand, says: “To beat a cap-weighted index, you just have to equal-weight its components and the bias you obtain versus smaller-cap stocks is enough to pay you a higher return — in exchange for higher risk.”

Summarizing, fundamental indexing’s detractors say it’s just a slickly packaged version of value- and small-cap-stock investing. Investors pay more for the packing than they need to and these indexes haven’t been around long enough to provide certainty of return — in spite of all the back-testing Arnott and others have done.

For the Defense

As the president of RevenueShares Investor Services of Paoli, Pa. , Sean O’Hara is uniquely qualified to discuss the reasons to like fundamental indexing and, more particularly, the ETFs his company offers.

As the company’s name suggests, O’Hara’s offerings are weighted based upon revenues — not earnings, dividends or book value — just revenues. “As I see it, you’ve got market-cap-weighted indexes at one extreme; they’ve been the norm forever, and they’re primarily a price game. For nine basis points, Barclays and State Street will make these available to you. On the other end, you’ve got fundamental indexes and people like PowerShares and WisdomTree creating their own indexes of 300 or 500 or 1,000 stocks — a competitive alternative to traditional capitalization weighting. Where we fit is in between the two. We don’t create our own indexes. We’ll take the S&P 500 and apply a revenue-weighting factor.”

Why just revenues? O’Hara explains: “First, according to our tests, revenue [as the weighting mechanism] produces the highest return over time. Second, if I want to use a known index [like the S&P 500], I have to use a weighting factor that all members of the index have in common. It couldn’t be dividends, for example, and earnings are similarly problematic. Finally, revenue isn’t a number that changes often or can be manipulated easily. Everything else can change on a whim, like dividends, but not revenue.”

And to those who say fundamental index expenses are so high because of the marketing dollars companies must spend to explain and promote these products, O’Hara says: “We don’t spend money on national advertising. We believe in the salesperson’s model, so we have people across the country who call on financial advisors and provide an education as to how these indexes work.”

And he’s getting through to some. Roy Komack of Family Financial Architects in Natick , Mass. , says: “I believe the ‘productizing’ and marketing of fundamental indexation is brilliant. To me, it’s just common sense that securities should be weighted by their economic footprint [e.g., revenues] rather than by what public sentiment ‘believes’ they ought to be worth [i.e., market price]. After all, public sentiment is what creates Extraordinary Popular Delusions and the Madness of Crowds [a reference to the book by Charles Mackay].”

Norm Boone, a veteran advisor and head of Mosaic Financial Partners in San Francisco , agrees: “I happen to think the concept of fundamental indexing is brilliant. There’s nothing terribly new about it, as such, but the way Arnott has put it together — developing four different indices based on different fundamental factors and combining them — is unique and new. The combination moderates the problems of each and becomes a more rational way to determine what belongs in your index than just going on the basis of market-cap.”

Estimates are that \$30 billion has made its way into fundamental index investments. Judging from the above comments, more dollars may have come directly from individual investors than from financial advisors, but that may change with time. Just as mutual funds are a more convenient way to invest in common stocks than is direct stock investing, fundamental indexing may come to be seen as a similarly convenient alternative to value and small-cap funds. And the costs ... well, let’s just say cap-weight indexes were once a lot more expensive than they are now.

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