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Index Funds Get a Makeover

Here's how the new varieties work— and when they make more sense than the traditional ones

By CAROLYN GEER

Like many financial advisers, Jason Gunkel had always invested much of his clients' money in passively managed funds that track the popular market indexes.

Journal Report

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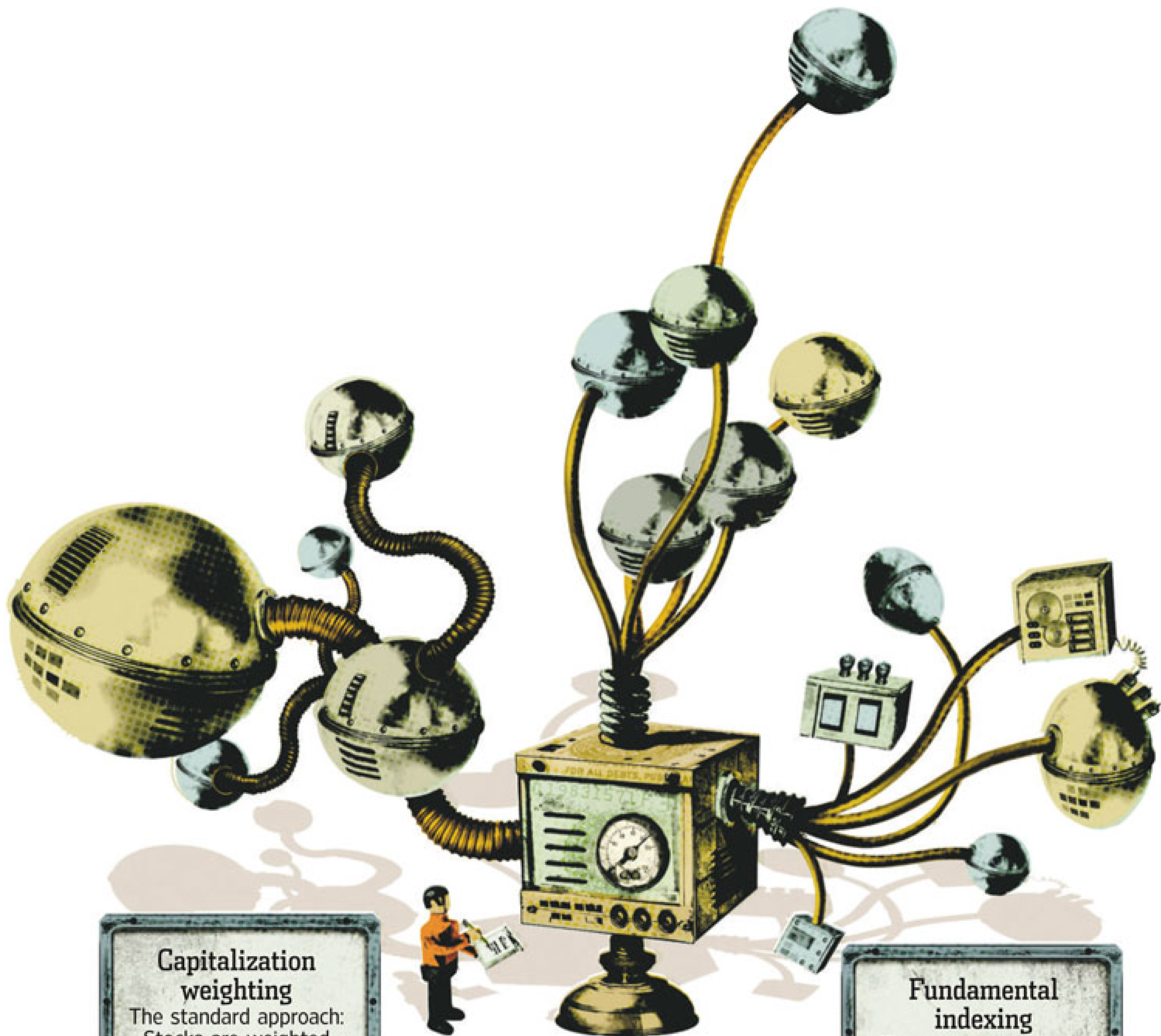
But after surveying the wreckage from the financial crisis of 2008, when the Standard & Poor's 500-stock index dropped 37%, Mr. Gunkel and his colleagues at Syverson Strege & Co. in West Des Moines, Iowa, went back to the drawing board. "We started re-evaluating our whole investment process to see where we could make improvements," he says.

Their investigation led them to a radical decision: dump traditional index funds and replace them with a newer breed of funds tracking alternative indexes.

Sure, traditional index funds are cheap and tax-efficient, and they generally outperform actively managed funds after fees. But most of them track indexes that weight securities according to their market capitalization.

That means companies with the largest market capitalizations end up dominating the performance of those indexes and the funds that track them. So big swings in the prices of those securities can lead to periods of boom and bust. Critics say cap-weighted indexes also end up systematically overweighting overvalued securities and underweighting undervalued securities—because a stock's weighting tends to increase as its price goes up and decrease as its price goes down.

Alternative-index funds keep at least some of the cost and tax advantages of traditional index funds, but they aim to outperform them by addressing those perceived flaws.



The alternative indexes they track come in two basic flavors: "Equal weight" benchmarks track the same stocks cap-weighted indexes do, but give every stock equal weighting. Then, there are indexes that select and/or weight stocks by measures other than market capitalization, such as dividends, earnings or a combination of such factors—sometimes called "fundamental" indexes.

How have they done so far? In the roughly five years since they came on the scene, alternatively weighted indexes have often outperformed traditional, cap-weighted indexes—but not always—says Matt Hougan, president of analytics for exchange-traded funds at IndexUniverse.com, a news, commentary and research site.

And while the alternative funds are designed in part to avoid the big swings of cap-weighted indexes, they have been more volatile in many cases, he says, and as a group they failed to protect investors from the full fury of the latest major market downturn.

Mr. Hougan's conclusion: "There is no free lunch at the alternative-indexing buffet."

Expanding Menu

In the past, alternative-index strategies were primarily available to big, institutional investors. Today there is approximately $40 billion in exchange-traded funds alone tracking alternative indexes, according to IndexUniverse. That's still a tiny fraction of the $1.868 trillion in traditional index products tracked by Morningstar Inc., but it is a growing piece of the pie.

In less than five years, the number of ETFs tracking equal-weight and fundamental indexes has risen more than sixfold, to some 140 funds. Rydex S&P Equal Weight, which in 2003 became the first ETF to use equal weighting, collected more than $1 billion in net new investments last year, up from $550 million in 2009. PowerShares FTSE RAFI US 1000, which in 2005 became the first ETF to use fundamental indexation, saw a net inflow of $277 million last year, versus a net outflow of $31 million in 2009.

Morningstar doesn't consider alternatively weighted index funds to be passive, strictly speaking. Yes, they passively mimic their benchmark indexes. But the indexes themselves are constructed in a more active way than most, and the funds sometimes require managers to buy and sell shares to stay in line with the indexes.

That means the alternative funds usually have higher fees than cap-weighted funds, whose weightings automatically change along with the market prices of the constituent stocks.

Think of ETFs on a continuum. At one end are market-cap-weighted index funds, with expense ratios of 0.07% to 0.28%, according to IndexUniverse. At the opposite end are actively managed funds, whose expenses range from 0.30% to more than 2%. In between is a spectrum of alternative-index funds, with expenses of 0.23% to 0.88%.

No Favorites

The most basic of the alternative funds track equal-weight indexes, which Mr. Hougan calls the "simplest retort" to the perceived problems of market-cap strategies.

If weighting by market capitalization has a propensity to overweight overvalued securities and underweight undervalued ones, a system that equalizes weightings "offers the purest fix," he says.

Take Rydex S&P Equal Weight. It holds all the same stocks as a standard S&P 500 index fund, but instead of weighting them by market cap, each stock is allocated a weight of 0.2% (or 1/500th) of the portfolio.

The result: Whereas the S&P 500 is dominated by a small concentration of giant-cap companies—Exxon Mobil Corp. is the largest, at about 3.5% of the index, and the top 10 holdings make up nearly 20%—the Rydex fund has a higher exposure to smaller-cap firms.

As stock prices move, that changes the weightings of the fund's holdings, so the fund is rebalanced quarterly. One of the theoretical advantages of equal-weight funds is that in order to keep all of their holdings equally weighted they are forced to buy low and sell high—that is, to buy shares of stocks that have fallen in price and sell shares of those that have risen.

Morningstar analyst Mike Rawson notes that Rydex S&P Equal Weight is more volatile than the S&P 500 index, with monthly returns that bounce around more like those of the S&P MidCap 400 index. But over the past five years, the Rydex fund returned an average 4.2% a year, besting the 2.3% gain of the S&P 500.

Of course, part of the reason the Rydex fund beat the S&P 500 is that midcap stocks did so well in the past decade, notes Mr. Rawson. While large-cap stocks languished in that stretch, small and midcap stocks posted positive returns. "This is a trend we do not see continuing," warns Mr. Rawson.

The Fundamentals

Edging out Rydex S&P Equal Weight in the five-year return derby is the PowerShares fund tracking the FTSE RAFI US 1000 index.

The index is based on methodology developed by Research Affiliates LLC, an investment-strategy firm based in Newport Beach, Calif. (RAFI stands for Research Affiliates Fundamental Index.) It selects and weights the 1,000 largest U.S. companies based on a combination of sales, cash flow, dividends and book value.

The PowerShares fund, which is slightly more volatile than the Rydex fund, according to Mr. Rawson, has clocked annualized total returns of 4.3% over the past five years, versus 2.6% for the Russell 1000 Index, which tracks the 1,000 largest U.S. companies as measured by market capitalization. The ETF currently charges 0.39%.

Charles Schwab Corp. offers a mutual fund that tracks the same index and currently charges 0.36%, Schwab Fundamental US Large Company Index, which the adviser Mr. Gunkel favors.

Russell Investments is about to introduce a new index series based on Research Affiliates' fundamental-indexing methodology. Meanwhile, indexing firm MSCI Inc. recently launched a family of indexes that reweight the constituents of its standard indexes, including its well-known World, Emerging Markets and EAFE indexes, based on a mix of sales, earnings, cash earnings and book value. There are no funds tracking these new indexes as of yet.

Other funds track indexes that use single fundamental measures to weight holdings.

For example, the WisdomTree Earnings 500 fund charges 0.28% and tracks the WisdomTree Earnings 500 Index, which generally contains most of the same stocks as the S&P 500 but weights them according to earnings rather than capitalization.

Even index-investing giants BlackRock Inc., State Street Corp. and Vanguard Group, which mainly use conventional cap-weighted strategies, offer funds employing fundamental weighting, notes Morningstar's Mr. Rawson.

Take iShares Dow Jones Select Dividend Index, which charges 0.40%. Its benchmark index chooses stocks based on dividend yield after screening for dividend growth and payout. SPDR S&P Dividendcharges 0.35% and follows the S&P High Yield Dividend Aristocrats Index. Vanguard Dividend Appreciation ETF, a Morningstar favorite, charges 0.23% and tracks stocks with a 10-year history of raising dividends.

What's Better When

Mr. Hougan has looked under the hoods of various alternative-index strategies, studying their holdings by sector, size and style.

He found that, relative to the S&P 500, Rydex S&P Equal Weight overweights sectors with a large number of small constituents (such as consumer discretionary) and underweights sectors dominated by a few big players (such as information technology). Its newer cousin, Rydex Russell 1000 Equal Weight, tracks a version of the Russell 1000 that weights all sectors equally, thus underweighting the sectors with the largest market caps and overweighting those with the smallest market caps.

Both equal-weight strategies "tilt" portfolios toward companies with smaller market caps, as compared with cap-weighted and fundamentally weighted indexes.

Fundamental strategies, too, tilt toward smaller-cap companies, though not as much as equal-weight strategies do. They also have a value tilt, favoring stocks that are cheap based on measures such as price/earnings ratios. Rob Arnott, inventor of the RAFI, says the annual rebalancing of the index is what drives the performance of the funds that track it. The rebalancing forces funds to buy more shares of any company whose stock price has decreased more than the company's size, while pruning holdings of those companies whose shares have outperformed the company's fundamentals.

Bottom line: A market-cap-weighted index fund is likely to beat an alternatively weighted index fund when large-cap or growth stocks are in favor. An equal-weight index fund should win when smaller stocks are hot, or certain sectors outperform. And a fundamentally weighted index fund should shine when smaller-cap and especially value stocks are in vogue.

And what about when market bubbles burst?

Turns out, both Rydex S&P Equal Weight and PowerShares FTSE RAFI US 1000 underperformed the market in the most recent crash. From Dec. 31, 2007 to the March 9, 2009 market bottom, the Rydex fund lost 56.4% and the PowerShares fund lost 57.9%, versus the 53.9% loss for the S&P 500.

The market may be irrational, but it is devilishly hard to beat consistently.

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