The Future for Investors
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Indexing Your Portfolio: The Evolution of Indices

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When investors consider investing in stocks, they think of forming a portfolio of individual companies. That's because most investors become interested in the stock market by following the performance of individual stocks.

It's exciting the see the price of a stock soar when there's good news, like when a company reports high earnings, gains a lucrative contract, or receives a takeover bid.

Even the anticipation of good news can generate substantial stock movements. If you monitor the news constantly, you can try to buy (or sell) these stocks before the price is affected. But there are a lot of short-term investors, particularly day traders, who are trying to do the same thing, so betting on the short-term movements in stocks is no easy task.

Other investors are more patient. They choose their portfolios on the basis of a company's longer-term prospects. These investors spend a lot of time researching stocks to determine which are undervalued relative to their current and future earnings potential.

This route to forming a portfolio requires a good sense of value and a lot of hard work, and even then it may take months or even years before individual stocks pay off. This is frustrating to anyone who wants to reap the fruits of their labors quickly.

Most of us are unwilling or unable to spend all the time and effort it takes to pick individual stocks, which is why the money management business is so large. There are many individuals and organizations that, for a fee, will be happy to manage your money. Money managers are constantly hawking their portfolios, telling you that they are able to outperform the market.

The Truth About Money Management

However, data I analyzed indicates that the vast number of these mangers can't beat the market after fees are subtracted from their portfolio returns. Over the 35-year period from 1971 to 2004, the average annual return on all actively managed equity mutual funds trailed the S&P 500 Index by 87 basis points a year, and the broader-based Wilshire 5000 Index by 105 basis points a year. Over long periods, this difference in return amounted to substantial differences in wealth.

This lagging performance of active managers shouldn't be a surprise; it's a matter of simple arithmetic. For every investor who succeeds in beating the market, someone else has to fall short of matching the market. When the costs (time and money) of actively picking stocks are subtracted from the outcome, those who actively engage in picking stocks must, on average, lag behind the market.

This leads to the somewhat counterintuitive conclusion that if you can form a portfolio that performs exactly "average" -- in other words, identically to the whole market -- you will outperform most actively trading investors.

The Birth of Indexing

This is why most academic and many professional advisors recommend that the best investment strategy is to match the market's performance. You can do this by putting your money in a fund that holds all stocks in proportion to their market value. Since these index funds do no research and little trading, the costs of holding their portfolios are extremely small, some ranging as low as 0.10 percent a year.

The birth of index funds in the 1970s was a natural result of this reasoning, as well as of the documented underperformance of actively managed equity funds. Today, these index funds have attracted literally trillions of investment dollars.

Critics of index funds have pointed out that investors only receive "average" returns for their portfolios. But the average returns in stocks have, on a historical basis, been very good. As I wrote in my March 9 column, "Stocks: The Asset of Choice for the Long Run," the stock market has gained a 6-1/2 to 7 percent after-inflation annual return over long periods of time -- a return that's far superior to fixed income investments.

Today, over 90 percent of all index funds weight individual stocks by the market value of their shares, and are called "capitalization-weighted" indices. Capitalization-weighted indices have the advantage of matching the average return on the market and provide investors with excellent diversification.

Chinks in the Armor

During the 1980s, increasing evidence revealed that certain stocks -- particularly "value stocks," or those that were smaller in size than the S&P 500 Index and/or had low prices relative to such fundamental variables as earnings -- outperformed capitalization-weighted indices.

Small stocks were riskier on average than larger stocks, but they had higher returns even accounting for this risk. Furthermore, it was very easy to form portfolios of small and value stocks, and the costs of holding portfolios of these favored stocks was low.

As a result of these findings, many advisors and academics began to "tilt" their portfolios toward small and value stocks. In fact, index providers such as Standard & Poor's and Russell soon concocted small stock and value stock indices to cater to investors interested in these stocks.

A Strategy for Capturing Extra Returns

Small and value-based indexes had their own distinct problems, however. Speculators hurt small stock indices by buying stocks that were announced (or expected) to be placed in the index, sending the price upward and therefore lowering their future returns.

Value-based indexes suffered from not having a commonly agreed upon definition for "value stock": Is "value" based on earnings, book value, or some other criteria? Moreover, how does an investor tilt his or her portfolio toward these favored sectors?

I'll answer these questions in my next column, and describe a new trend in indexing called "fundamental indexing" that helps investors capture some of the extra returns that small and value stocks provide.