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Getting Over Index Investing With A Better Way

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Passive investing is a major improvement over actively managed techniques. Index funds have long been the standard for passive investing. More recently, exchange traded funds have emerged to challenge index funds with some advantages, particularly in cost. However, there is still room for significant enhancement.

[Securities](#) markets, even in emerging economies, are generally efficient. It's hard to fool Mother Market, and the chances of consistently winning are slim indeed. So, index funds reliably turn in top quartile performance. Reduced expenses, wider diversification, and limited trading provide for effective, low cost, low risk, low tax exposure solutions for capturing the world's asset class returns.

Another reason for the popularity of index funds, especially in the institutional market, is that comparison to widely available benchmarks makes performance measurement so easy. Index funds mean never having to say you are sorry. Investors in index funds expect to get exactly the performance of the index (less any expense of the fund).

The expectation that an index fund will get EXACTLY the return of the target index sets the stage for an interesting problem: Zero tracking error is achievable, but it comes at a very high price. In order to achieve zero tracking error, the fund manager must hold exactly the index for every second of the day. This task is complicated by daily redemptions and additions to the fund which are beyond the manager's ability to control.

In a world dominated by unknown and unmanageable cash flows on a daily basis the fund manager must make many trades to exactly replicate the index. The manager can buy and sell futures contracts to in part manage his cash flows, but sooner rather than later he must adjust his portfolio to exactly match the index. Given that the world's most popular index contains 500 stocks, and that it is replicated by hundreds of managers for funds and institutional separate accounts, you can see that there is a whole lot of trading going on. The managers must do these trades NOW, which deprive them of any kind of negotiation power. The cumulative costs of these many trades are not trivial, and will be born by the fund's shareholders.

It's important to understand that these costs are not reflected in the fund's expense ratio. They would occur even if the fund's expense ratio were zero. Thus they cannot be avoided by switching to exchange traded funds ([ETFs](#)) or an index fund with lower disclosed expenses. These expenses are generated in direct proportion to the fund's trading, and include commissions, bid-ask spreads, and market impact effects.

The index fund manager's problem is that anything less than perfect index

replication will result in random tracking errors. The demand from consultants and clients for zero tracking error drives him to a sub-optimal solution. Zero tracking error trumps total return as the performance standard. While it meets the standard of mindless simplicity, in the greater scheme of things this isn't a particularly rational approach.

Reconstitution

It gets worse. Suppose some committee decides to revise the index (reconstitution). Now it really hits the fan. [Stocks](#) that are leaving the index will be under enormous sell pressure, while stocks being added to the index suddenly become widely sought after. The whole world knows the exact time the substitution must take place. Prices around the trading date go strangely haywire as not only fund managers but speculators place huge orders. None of this is good for the shareholder. They are almost guaranteed to lose money on shares leaving the index, while they must buy shares at high prices to replace them.

This reconstitution effect is widely documented, and a glaring exception to an otherwise efficient market. Speculators routinely make huge virtually riskless profits at the expense of index fund shareholders. The S&P 500 is particularly notorious for reconstitution “drag” but it happens in indexes around the world, sometimes to even greater cost.

Relaxing the definition

So, what's the alternative, and what might the benefits be? Suppose we relaxed the zero tracking error requirements in favor of avoiding reconstitution drag? A few years ago DFA (Dimensional Funds) made the decision to avoid trading in affected stocks on the S&P 500 for a fourteen day window around reconstitution date. They believe that over time the cost savings will swamp any small tracking error.

Here is an example of how this small trading policy change can impact performance: A few years ago DFA noticed that they were consistently outperforming a foreign index with one of their funds. On examination, they found that they had benefited from simply reconstituting their fund on different dates than the index.

Asset Class [Investing](#)

An even better solution is to drop the more restrictive index definition in favor of an “asset class” structure. Instead of perfectly replicating an arbitrary index like the Russell 2000, we could have an investment policy of providing exposure to the universe of U.S. small company stocks. On a temporary basis we could accept being overweight or underweight on any particular stock in our universe.

By accepting that we will not perfectly match an index, we will obtain significant trading economies just because we will have to execute far fewer trades. This will generate random tracking error that must be explained to both consultants and clients. Sometimes these random errors will be significant. For instance, there may be considerable difference between DFA’s institutional funds and the tax managed funds because of the different composition. Over the long haul they should balance out. Human nature being what it is, investors will only notice and complain when the error is negative. However, the cumulative benefits should be substantial.

DFA takes pains to explain that this value added trading strategy is not active management in the traditional sense. While their fund managers have discretion to deviate from the strict index, no market forecast, sector selection or individual security selection judgment is made.

Conclusion: A better mousetrap

Asset class investing is distinct from index fund investing, and distinctly

better. Index funds are expected to earn index returns less expenses. Asset class funds greatly reduce trading costs and allow for opportunistic value added trading strategies. While both are passive investment strategies, asset class investing accepts tracking error in favor of lower trading costs and higher potential returns. Clients and consultants will have to be educated that accepting some tracking error should yield incremental long term non-trivial benefits.

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