TOOLS OF THE TRADE – INDEX FUNDS VS ASSET CLASS FUNDS

The first stock index was created in 1884 by publicist Charles Dow as an indicator for investors of how the stock market was performing. Five years later, Dow established the Dow Jones Industrial Average, and in 1923 Standard & Poor's instituted their first index, the S&P 90 Index. In the years that followed, many more indices were established and began to be utilized as tools, or **benchmarks**, for investors when evaluating their own portfolios' performance. An index is simply a collection of investment types held constant, regardless of market conditions, until their governing body deems it appropriate to reconstitute.

While useful as a view of the overall market or specific markets, indices themselves could not be bought or sold until the 1970s. The first index funds, established in 1973 by John McQuown and David Booth at Wells Fargo and Rex Sinquefield at American National Bank, were only available to institutional investors. In 1975, John Bogle at Vanguard changed that by establishing the First Index Investment Trust to track the S&P 500 Index and to be marketed to individuals and institutions. Passive investing was born. The fund, deemed "Bogle's Folly", was derided by professional money managers as "un-American". Edward C. Johnson III, Chairman of Fidelity at that time, was quoted as saying "I can't believe that the great mass of investors are going to be satisfied with just receiving average returns. The name of the game is to be the best." (source: Bogle Financial markets Research Center, 2006) The fund was later re-named the Vanguard 500 Index Fund and by 2001 had more assets under management than Fidelity's Magellan Fund.

"Being the best" was proving an expensive and elusive venture. More and more evidence had been pointing to the fact that the majority of professional money managers were not consistently able to outperform the market. In 1975, Charles D. Ellis, President of Greenwich Associates, wrote, "The investment management business is built upon a simple and basic belief: professional managers can beat the market. That premise appears to be false." Basic arithmetic, wrote Ellis, dictated that an active manager, incurring costs of 2% had to generate annual returns of 11% just to equal the equity market that had historically annualized at 9%. Taking into account capital gains taxes, the math is even more daunting for relatively tax-inefficient active managers.

Index investing has become synonymous with passive investing and has gained in popularity as investors become more aware of how few active managers outperform the market and how inconsistent that outperformance is (source: 2010 Standard & Poor's Persistence Scorecard). Today, approximately 20% of U.S. equity assets are invested passively. The growing interest in passive investing has helped to create a new type of investment vehicle called exchange traded funds or ETFs. Like mutual or index funds, ETFs are baskets of stocks or bonds but they trade throughout the day like stocks do and they can have different tax ramifications.

While using index funds and ETFs is a good strategy for capturing market returns and far better than picking individual stocks or paying high fees to someone else to do it for you, there are certain points an investor should consider:

- **Index investors must be willing to accept market returns.** Traditional thinking, fed by the financial media, would have us believe beating the market consistently is possible as long as you are smart enough, rich enough or know the right people.

- **Index managers must trade in an attempt to mimic their index.** Whenever the governing body of an index deems specific stocks must be removed and others added, index managers must track those changes and therefore may generate trading costs and tax liabilities.

- **Not all segments of the capital markets can be captured with index funds.** For example, there is no index fund for international developed small cap value because the primary index providers have not defined this as a separate asset class.

One of the core tenants in passive investing is **broad diversification** and, in my opinion, this is best achieved by using **asset class funds** rather than index funds. Asset class funds aim to own every stock within a specific segment of the market such as large companies or emerging market companies. They are not obliged to track any arbitrary index. Managers can wait for favorable trading opportunities rather than being forced to buy or sell because an index dictates. This helps to minimize costs, reduce turnover and broaden diversification.

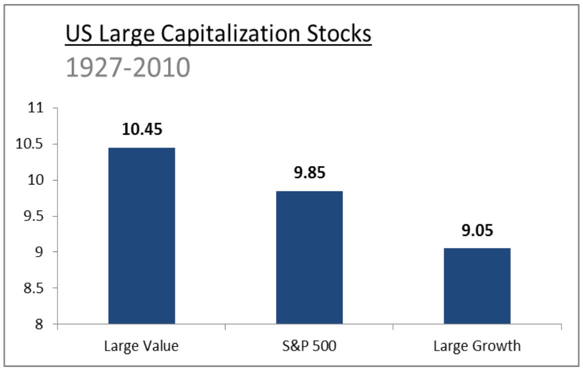
Asset class funds were pioneered in the early 1980s when research by Professor Eugene Fama at the University of Chicago and Professor Kenneth French at Dartmouth identified specific risks that investors are likely, over time, to be rewarded for taking;

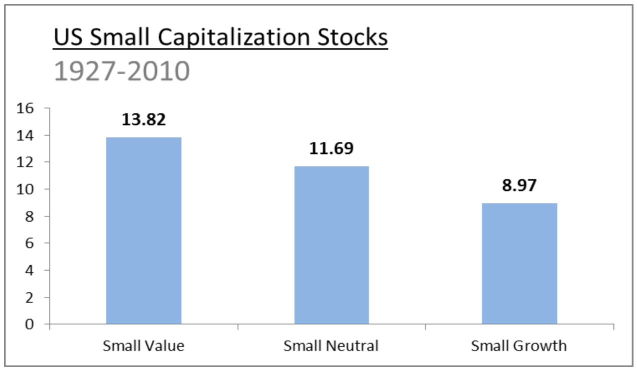
- **Market risk** – stocks are riskier than bonds
- **Size risk** - small companies are riskier than large companies
- **Financial health risk** - value companies are riskier than growth companies

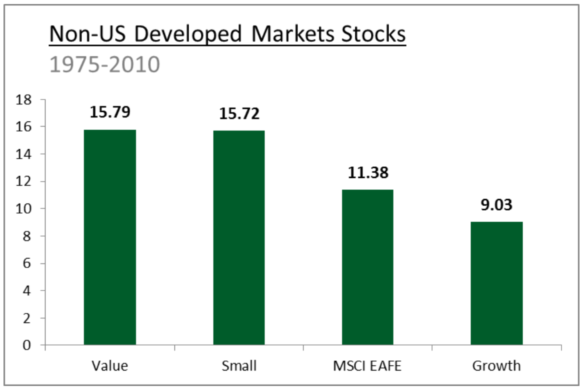
Most people agree that investing in the stock market is riskier than putting your money in a bank or buying bonds. The majority of investors would also agree that investing in small companies carries a greater risk than investing in large, established companies. Financial health risk though is not as easily understood. In a debate about value versus growth, most people, especially those that remember the high-flying internet companies that burst during the tech bubble of 2000 – 2001, would argue that growth companies are riskier than value companies. However, the expected returns of growth companies are already reflected in their share price. Let's think about this another way. If Microsoft and Southwest Airlines both went to their banks for business loans, which company would be charged the higher interest rate? Southwest would have a much higher cost of capital because banks would view them as a higher risk than Microsoft to default on their loan. Risk and reward are inextricably related therefore it's reasonable for investors to expect a higher return from an investment in Southwest because they are assuming higher risk.

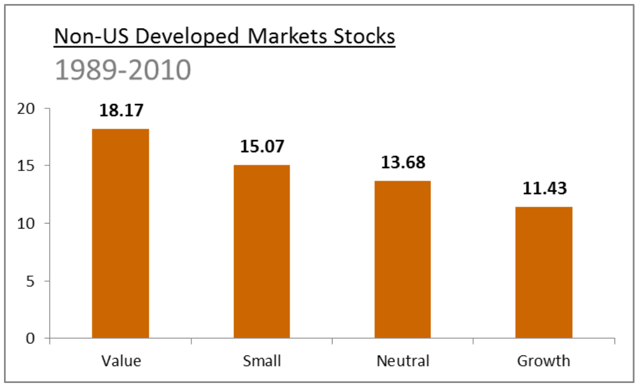
The graphs on the next page (*Source: Dimensional Fund Advisors*) show the historical returns of various equity asset classes around the globe. You can easily see that, over time, small companies generate higher returns than large companies and value companies generate higher returns than growth companies. These higher returns reflect compensation for bearing higher risk.

Understanding how the three risk factors drive returns presents investors with the opportunity to design portfolios specifically within their own appropriate risk/reward framework using asset class funds that offer very targeted exposures to these risks.









Academic research shows that asset allocation is the primary determinant of a portfolio's performance. Using a combination of index funds, exchange traded funds and **asset class funds,** offer investors a strategy to **enhance the returns of index funds alone through broader diversification and more targeted exposures.**

<u>In summary</u>,

Asset Class Investing:

- Believes capital markets work and price securities fairly
- Acknowledges that market timing usually fails
- Structures globally diversified portfolios of passively managed investment tools
- Captures specific dimensions of risk, including the small/value premiums
- Increases returns through portfolio design and reduced trading costs

Index Investing:

- Allows commercial benchmarks to define strategy
- Suffers effects of index reconstitution
- Accepts index returns minus costs

Active Investing:

- Believes markets misprice securities
- Picks stocks or funds and attempts to time the market
- Generates higher expenses, trading costs and excess risk
- May or may not provide market returns.

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