THE WALL STREET JOURNAL.

SATURDAY, NOVEMBER 27, 2010

THE INTELLIGENT INVESTOR

Are Index Funds on Track to Become Even Harder to Beat?

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Investors, like the Pilgrims at the first Thanksgiving, should remember that gratitude can feel sweetest when the skies are bleak and the table is mostly bare.

Financial markets are reeling in Europe, another insider-trading scandal is unfolding on Wall Street, and the Federal Reserve's efforts to drive down interest rates seem to be backfiring. Even so, the Dow Jones U.S. Total Stock Market Index is up 10.3% thus far this year.

More important for the future, index funds continue to make investing cheaper and easier than ever. For investors in these low-cost, autopilot portfolios that dispense with stock pickers and passively replicate the holdings of a broad basket of stocks or bonds, the best is yet to be.

That may not sound right at first. Since they aren't designed to beat the market, but only to match it, these portfolios don't look very appealing after a long period in which stocks have gone nowhere. In a market with low returns, low fees still can't leave you with much.

Over the past decade, Vanguard Total Stock Market Index Fund has gained an annual average of just 1.79%, or less than half the return you could have gotten keeping your money in cash. Then again, according to Morningstar, this autopilot fund outperformed two-thirds of all other stock funds, including those run by managers trying to beat the market.

Until now, index funds have had an Achilles' heel. One factor that makes indexing "a horrendous idea," the renowned value investor Seth Klarman of Baupost Group argued earlier this year, is that hedge funds and others have long beaten the index funds to the punch on trades that the autopilot portfolios are forced to make.

New "investable" indexes, forthcoming early next year from the Center for Research in Security Prices at the University of Chicago, or CRSP, could reduce compulsory trading for any index funds that adopt them as a benchmark. Funds that trade less should have lower brokerage costs, lower tax bills and higher net returns. Better yet, it should be harder for outsiders to "front run" these improved indexes. CRSP, founded in 1960, was a pioneer in calculating long-term returns on assets; it gathers and analyzes massive amounts of data for investment firms and academic researchers.

Consider an index fund that specializes in small stocks. If the shares of a little company in the fund take off, then the stock won't be small anymore – and the fund will have to sell it. Likewise, the firms that compile market benchmarks periodically add or delete stocks, forcing index funds to buy everything that is added and to sell everything that is deleted.

Each June, roughly 200 stocks are replaced in the Russell 2000 index of small companies. This June 25, the stocks that were added to the Russell 2000 outperformed those that were deleted by 2.3%, according to Investment Technology Group. Over the long run, sharp traders getting out in front of these forced portfolio changes have poached at least 0.38 percentage point of annual return away from Russell 2000 index funds, estimates a new study in the Journal of Empirical Finance.

CRSP's new family of indexes will tackle the poaching problem in several ways, says Lubos Pastor, a University of Chicago finance professor who helped design them. The boundaries between small, medium and large stocks will be set as proportions of the value of the total market, rather than as fixed dollar amounts or as an unchanging number of companies. Stocks will be "partially weighted," or shared, across different size indexes – so, as a company grows or shrinks, it doesn't have to be added or eliminated in one fell swoop. Any additions or deletions will be made in "packets," or gradual steps over time, and the days on which the substitutions take effect will be randomized.

These techniques should reduce turnover and poaching by outsiders while preserving the "style purity" of the indexes, argues Mr. Pastor. New screening methods could also enable CRSP to offer investors an index of stocks that rank high in both growth and value. "That's a very interesting idea that I've wanted to be able to index for a long time," says Gus Sauter, chief investment officer at Vanguard Group.

David Barclay, CRSP's chief operating officer, says "a couple of" index-fund providers have expressed interest in the new benchmarks. Mr. Sauter says that "it's something we'll have to consider." CRSP's approach, he adds, is "well thought-out" and "compelling."

There is other good news for index investors. Over the past year, Charles Schwab, Fidelity Investments, TD Ameritrade and Vanguard have eliminated brokerage commissions on selected ETFs. William Koehler, chief investment officer at ETF Portfolio Partners in Leawood, Kan., says he has opened a custodial Roth IRA for both his teenage sons at Schwab, where the minimum opening balance for such accounts is $100. "They mow lawns, and now I can buy ETFs for them with their lawn-mowing money without paying a commission," he says. "When they're in their 20s, they'll thank me."

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