

Indexing: An Alternative Approach



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Indexing An Alternative Approach

An economics professor and his student are leisurely walking on campus when they notice \$20 lying on the ground. Instead of picking up the money, the professor strolls past, telling his protégé: “The effort to pick up the bill is not worthwhile. If there was worth in picking up the money, someone would have already picked it up.”

This anecdote exemplifies the efficient market hypothesis (“EMH”), which stipulates that the stock market is entirely efficient because participants have access to all relevant information. This concept, along with the ideas of modern portfolio theory and the capital asset pricing model, suggest that investors should be content with average market returns. Thus a new investment concept, called relative return investing — or benchmarking — was born. However there remains a disagreement over the optimal benchmarking strategy. This report will discuss the historical dominance of market capitalization weighting, elaborate on the improvements offered by fundamental indexing, and provide investors and their advisors with ideas on how to incorporate both in their portfolios.

MARKET CAPITALIZATION

Major factions of the investment and academic communities believe investors should aim to simply replicate market returns. This belief stems from Harry Markowitz's and William Sharpe's respective creations of Modern Portfolio Theory and Capital Asset Pricing Model. Both concepts indicate that only systematic (general market) risks are worth accepting because non-systematic (individual equity) risks can be reduced with diversification. These ideas, coupled with Eugene Fama's Efficient Market Hypothesis, support relative return investing or benefitting from general market movements.

Passive investment was extremely successful during the 1982-2000 bull market, as the price to earnings ratio of the S&P 500, rose from 7 to 42.¹ This increase in measure of the market's valuation led to a lengthy duration of above average returns for investors. Furthermore, this passive approach provided investors the benefits of low costs and minimal equity turnover, thus limiting tax implications. This sharply differs from traditional active management, which increases costs in an attempt to deliver higher returns than the market averages. In addition, investors need not worry about a lack of diversification or selecting the wrong manager since passive instruments offer wide market exposure and full transparency.

¹ Easterling, Ed. *Unexpected Returns*. Cypress House. 2005.

Investment products that are based on indexes have roughly doubled in market share from 2000-2013 from 9.5% to 18.5%, with market capitalization weighted indexes leading the way.² Market Capitalization indexes weigh their constituent components according to their valuation size. In other words, the companies with the largest valuations, such as Apple (AAPL) and ExxonMobil (XOM) represent large weightings in many indexes such as the S&P 500. This allows market cap portfolios to almost perfectly mirror the main market indices less a small tracking error. As a security's price appreciates, its percentage or "weight" within the portfolio increases, while the opposite occurs when its price declines. Because market cap weighted indexes adjust daily based on market movements and constituent components are added or subtracted over time, many argue that they allow investors to enjoy the rewards of efficient market exposure. They suggest that patient investment saves on expenses and allows for improved returns. However, market capitalization indexes have recently been attacked for their introduction of a momentum tilt within the portfolio.

A DIFFERENT APPROACH

Believing that capital markets were not entirely efficient and that market capitalization weighting strategies hindered investors' performance, Rob Arnott and his firm Research Affiliates introduced the concept of Smart Beta. (Beta measures of portfolio's

² Wathen, Jordan, "A Billionaire's Warning on Index Funds", CNN Money 2015.

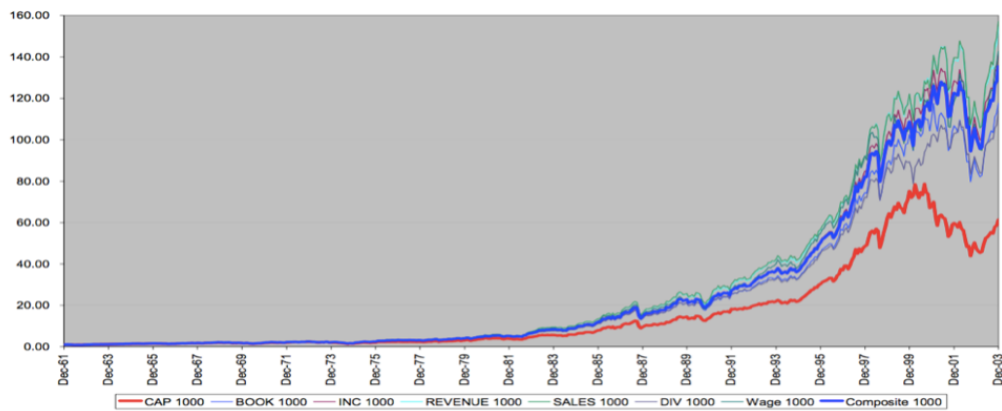
volatility relative to its benchmark. A beta greater than 1.00 suggests the portfolio has historically been more volatile than its benchmark. A beta less than 1.00 suggest the portfolio has historically been less volatile than its benchmark.) The genesis of their conviction arose from the 1992 Eugene Fama and Kenneth French research paper which indicated that certain factors may potentially allow for outperformance. This absolute return investment strategy differs from a relative return strategy due to its acceptance of non-systematic risk as a source of potential investment returns. Instead, it focuses on reducing systematic or market risk through factor based investments. "Smart Beta" weighted portfolios could be constructed based on fundamental, equal weighted, or risk cluster factors.

Fundamental Indexing is a contemporary version of Graham-Dodd's value approach. In their seminal book titled "Security Analysis", Benjamin Graham and David Dodd articulated the importance of buying companies with strong financials at measurably low prices. Fundamental indexing incorporates this belief by allocating securities within the portfolio based on certain definable, financial attributes such as operating cash flow, dividend yield, or price to book ratios. A study penned by Arnott, Hsu, and Moore in 2005 introduced the idea of fundamental indexing.³

³ Arnott, Robert D., Hsu, Jason and Moore, Philip. "Fundamental Indexing" *Financial Analyst Journal* Volume 61 Number 2. 2005.

Index Performance by Alternative Weighting Methods (1962-2004)

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Fundamental indexes contain the benefits of market capitalization indexing such as low costs, transparency, and diversification, while avoiding its momentum tilt. Because positions within a market cap index are weighted based on prices, their allocation changes daily and can become disproportionate relative to the rest of the portfolio. In short, overweighting recent winners and underweighting laggards can hinder investors' returns, as they run counter to the powerful concept of mean reversion. With regards to the valuation of asset prices, mean reversion suggests that over time assets significantly above or below their intrinsic value, for whatever short term reason, ultimately converge back to their intrinsic value. Fundamental indexing seeks to benefit from this ongoing process because, unlike market cap indexing, it attempts to overweight this presumed undervaluation and underweight the implied overvaluation.

⁴ Hughes, Ryan A. "The Bull Oak Investment Methodology Backtest Results." *Bull Oak Capital*. 2014.

Licenseses of the Research Affiliates strategy of fundamental indexing now include over \$140 billion in assets under management with outperformance ranging from an annualized ~1.00 to 1.50%.⁵ Smart Beta concepts have steadily grown from \$103 billion in 2008 to \$616 billion in 2015.⁶

CRITICISMS

Fundamental indexing's rapid rise within the investment community has been met with great pushback, with many comparing it to a repackaged value investing approach. Prominent factor analyst and founder of AQR Capital, Cliff Asness evaluated fundamental indexing in a 2006 article in which he argued that weighting positions based on financial factors such as cash flow, dividend growth, and price to book ratio resembles an active value investment decision. This differs from using market cap instruments, whose price market cap participants agree upon. Asness acknowledged that value investing has historically outperformed the leading indices but concluded that after removing fundamental indexing's value approach, the excess returns were nonexistent.⁷

⁵ England, Robert S. "Rob Arnott Reflects on a Decade of Fundamental Indexation." *Institutional Investor*. 17 February 2015.

⁶ Antonacci, Gary. "Smart Beta is Still Just Beta." *Dual Momentum*.

⁷ Asness, Clifford. "The Value of Fundamental Indexing." *Institutional Investor*. 16. Oct. 2006.

Fundamental indexing approaches occasionally “catch a falling knife” or enter a weakening position that continues to depreciate. Its increase in exposure to the maligned energy sector in 2015 stands as a valid example of this criticism. As oil prices collapsed in 2014, the energy sector depreciated 20.8% between July 2014 and March 2015 and seemed undervalued.⁸ Fundamentally weighted portfolios, noting the favorable price, increased their allocation to the sector by 2%, while market cap instruments reduced exposure by 3%. Since this allocation shift, the energy sector has continued its decline, losing another 24%.⁸ It is a reasonable observation that many investors would not be able to stomach such underperformance for a few years even if they considered themselves committed long term investors.

We believe the argument that additional rebalancing brings greater costs for long term investors and reduces compound annual growth rates holds little merit. The average passive investment instrument carries an annual fee of roughly .2%, meaning that investors pay \$2 in fees for every \$1,000 invested.⁹ Fundamental indexes, which additionally rebalance throughout the year, commonly have annual fees of .4%.⁹ For merely a few basis points a year, investors may follow a value oriented strategy which attempts to capture the benefits of mean reversion.

⁸ Invesco Power Shares. “Often Overlooked ... Systematic Rebalancing Key to Smart Beta.” *ETF Trends*. 12. April 2015.

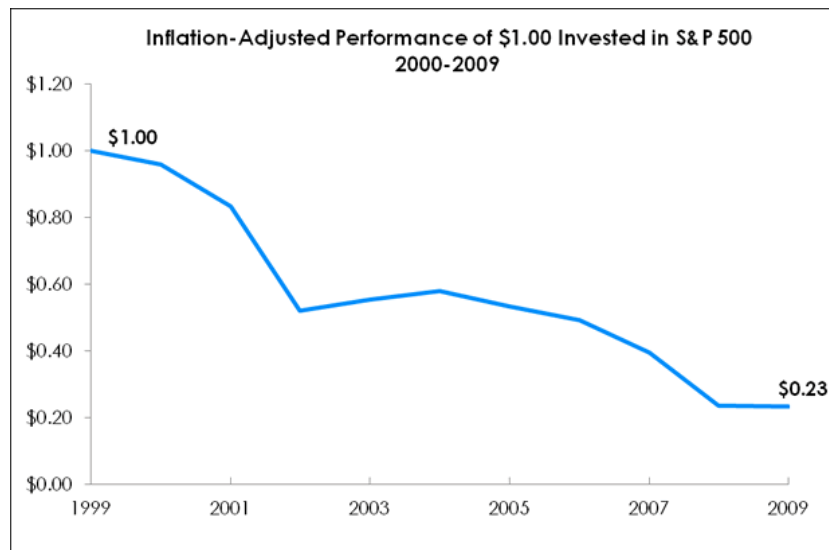
⁹ Anderson, Tom. “Has Rob Arnott Built A Better Index Fund?” *Forbes*. 5 June 2013.

USES FOR INVESTORS

Financial advisors using a 60/40 core and satellite approach can remain conservative, value oriented, and cost efficient by implementing fundamental indexing strategies into the core portion of their portfolio. This approach would allow them the opportunity to potentially create excess alpha from satellite positions, where they could tolerate greater volatility. (Alpha measures the difference between a portfolio's actual returns and its expected performance, given its level of risk as measured by Beta. A positive / negative Alpha indicates the portfolio has performed better / worse than its Beta would predict.) Fundamental indexing strategies also allow portfolio managers the ability to diversify into emerging markets where, as Rob Arnott argues, the price dislocations and subsequent mean reversions are even greater than those in domestic markets. Furthermore, the cost savings of fundamentally weighted portfolios may potentially accrue to both financial advisors and self-directed, individual investors.

Fundamental indexers would argue that most investment strategies contain a certain bias. Market capitalization weighted indexes, for example, introduce a momentum bias as price changes create portfolio imbalance. Investments into market capitalization instruments carry predetermined factors: as investors' believe that mirroring market indices will reward them most favorably with the least amount of risk. Market movements after the peak of the "dot com" bubble until the end of the Great

Recession highlight the occasional ineffectiveness of market cap weighted strategies. The S&P 500 index returned roughly -25% during that time, leaving investors, who were dependent on the capital markets for funding financial goals as a reliable source of retirement income, in a difficult financial situation.¹⁰ Furthermore, remaining invested in market capitalization instruments versus fundamentally weighted alternatives, would have compounded the deficiency of their original decision, as they have lagged fundamental indexes by 1-2% annually since 2006.¹¹



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¹⁰ Weidner, David. "The Lost Decade of Stock Investing." *The Wall Street Journal*. 15 Oct. 2009.

¹¹ England, Robert S. "Rob Arnott Reflects on a Decade of Fundamental Indexation." *Institutional Investor*. 17 February 2015.

¹² Image from Victor Wendl. "Inflation-Adjusted Return Of Deep Value Stocks In Comparison To Gold." *Safe Haven*. 7 July 2014.

CONCLUSION

Because today's market valuations and economic conditions appear similar to those in the late 1990s and early 2000's, investors must carefully consider their current strategies. For those that wish to remain invested and avoid "timing the market", fundamental indexing provides an interesting alternative to market capitalization indexing. With similarly low costs, liquidity, transparency, and broad market exposure, investors may seek to enjoy the benefits of mean reversion in certain sectors or individual companies. Investors should analyze whether it is appropriate to incorporate fundamentally-weighted investment strategies within their own portfolios by examining these items:

1. Review your current allocation between actively managed and passive, indexed approaches. This would provide an important insight into the underlying cost structure of your portfolio and the specific manager risk you are assuming.
2. Within the passive instruments, is the index you are attempting to replicate market capitalization weighted (like the S&P 500), price-weighted (similar to the Dow Jones Industrial Average), or fundamentally weighted. You should also determine which asset classes are represented and conversely, which are possibly under-represented or excluded altogether.

3. Examine all of the holdings within your portfolio to determine additional areas of concentration in specific companies, countries, or sectors. In many cases, holdings within your portfolio are duplicated across different formats such as indexed instruments, actively managed accounts, and direct holdings. You may find more concentration in specific companies or sectors than is appropriate, along with bias', within the overall strategy which may lead to a structural deficiency in your approach.

In short, in addition to developing an appropriate portfolio for your time frame, risk tolerance, and personal preference, you must identify and overcome the potential sources of underperformance so that your assets may pursue their full potential. We have identified two common culprits: the higher costs of active management and the deficiencies of market capitalization weighted indexing strategies.

It is important to note that making significant changes to your overall investment strategy could involve tax implications. We would suggest that you consult with a competent investment professional and/or tax advisor before making any such changes. If you would like to learn more about how these strategies could be employed for your portfolio or would benefit from a complimentary portfolio review, please do not hesitate to contact us.



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