



How to Index

Indexing is simple, but doing it well is far from easy

The world's two most famous equity indices – the Dow Jones Industrial Average (DJIA) and the S&P 500 – both hit historic peaks in the first quarter of 2000. And then both tumbled when the dot.com bubble burst. The S&P, which fell farther, labored more than seven years to match its 2000 peak level earlier this summer. The Dow, on the other hand, regained its 2000 highpoint by November 2004 – three years faster – and then climbed another 30%¹. Why would two iconic large cap indices – both recognized worldwide as symbols of the American economy – behave so differently?

Different rules, different results

The disparate performance of the S&P and Dow illustrates a crucial lesson for investors: each index dances to its own beat. Risk and return performance is driven not only by the content of the index but also by its construction and management – how securities are selected, weighted, added and replaced.

Every index investment demands careful investigation. For instance, the S&P is designed to include the 500 “biggest” companies in the US. Turnover in the index is significant as companies grow, are acquired, or stumble. Weighted by capitalization, the index tends to overemphasize growth stocks that are rising in value, and underweight others. The DJIA, on the other hand, is price weighted, and its composition is set not by statistical rules, but by editors of the *Wall Street Journal*. According to the Dow Jones website, “A stock typically is added only if it has an excellent reputation, demonstrates sustained growth, is of interest to a large number of investors and accurately represents the sector(s) covered by the average.” Change is infrequent: in ten years, only seven DJIA companies have been replaced.

It's not fair or relevant to say that one of these approaches is better than the other. They are just different. But investors should understand how any index operates before adding it to their portfolio.

¹ Both indexes have retreated from their 2007 highs. As of 8/30/07, the Dow sits at 13238 (versus its 2000 peak of 11723, and the S&P at 1457 (versus its 2000 high of 1527). Since 3/7/00, the Dow is ahead of the S&P by 33%.



The index boom

The popularity of indexing has soared in the last decade, and not just among individuals. Morningstar indicates that the top five US defined benefit plans (California Public Employees, e.g.) include \$730 billion dollars in indexes, an average of 40% of their portfolios.

The desirability of indexing is widely advocated by investment stars, including Yale's David Swensen, as a thoughtfully constructed index provides tax efficiency, low costs and transparency. "Buy indexes" has become something of a mantra among many advisors. We see this as good advice, with a huge disclaimer – that buying indexes without researching their composition is foolhardy and dangerous.

Investor demand has spawned intense competition among providers of index products. There are more than 500 Exchange Traded Funds (ETFs) available, in addition to hundreds of index mutual funds. There are clearly more than enough choices. The trick is picking the right ones.

Many ETFs and mutual funds mirror well known exchange indexes such as the Dow or the Wilshire 5000. But newer indexes are proliferating like mushrooms in a dark forest. Product developers, seeking to stand out in a very crowded marketplace, are creating their own indexes for specific industries, geographies and other market niches.

The proliferation of new products raises some real questions. Do niche indexes provide value to investors? For instance, do we really need a Nanotechnology Index (NNZ)? Are there enough pure play nano firms with real products and revenues to justify an index? I personally believe venture capital is a better way to access nanotechnology. My advice is to tread lightly and research thoroughly in the specialized index field. PHO, a water index, includes any company that focuses on the provision and treatment of water. It's a viable way to invest in an important natural resource. But PHO, like any index, has limitations. For instance, GE is the biggest player in the water market, but is not included because water treatment is only a small percentage of its revenues.

What is "the market?"

The fundamental goal of index investing is generally stated as "matching the performance of the market," or something along those lines. But what is the market? Many commentators use the S&P 500 as a shorthand reference for the broad market, but it contains only a small portion of US stocks. No bonds. No international. No emerging markets. No alternative investments. It is not representative of the very diverse worldwide marketplace. To create a portfolio that *does* replicate broad market



performance means allocating assets across multiple indexes, where each index offers access to different kinds of securities.

Indexes are offered in the three primary investment classes – equities, fixed income, and alternative investments – with five different types of indexes in each asset class:

- *Benchmark indexing* tracks well known standards. For instance, the ETF Dow Jones Diamonds (DIA) seeks to replicate the results of the Dow industrials. The advantage of benchmarking is that there are no surprises, no manager blowups and probably a tiny tax bill
- *Regional indexing* provides access to specific geographic areas, such as China (FXI), without the need to pick specific securities. Regional indexing allows your portfolio to mirror the world as it is, say, by GDP or by market capitalization. For instance, the US represents 31% of world equity value.
- *Sector indexing* allows easy investment in specific economic sectors, such as global energy (IXC) or global healthcare (IXJ). Healthcare is 13% of our domestic GDP, for example, so one could make a portfolio allocation of that amount to participate in the results of that sector.
- *Style indexing* means buying bundles of growth or value stocks, the two most broadly recognized equity investment styles. Over short 5-10 year periods of time, one style typically outperforms the other depending on a complex web of factors. The suggested solution is to index both styles and weight them according to one's emotional investment makeup
- *Capitalization indexing* segments small, medium or large capitalization securities. History shows that small cap stocks have the highest long term returns, but also the highest risk. Indexing provides a simple means to regulate expected risk levels.

Diversify

Using these five indexing methods, one can obviously create an infinite number of portfolio combinations. There's no single "perfect" distribution, but indexes should be selected and weighted to create a highly diversified portfolio that reflects a broad view of the global economy. It is important to remember that just because a single index, such as the S&P 500, contains a large number of stocks, it may not be very diverse. In most indexes, stocks earn entry by being similar, not different. Only by choosing a mix of indexes that represent different elements of the world economy can one construct a truly diverse portfolio.

The OCM Advantage –
Indexing is the benchmark, the standard of any portfolio. We strive to leverage the valuable benefits of indexing – tax efficiency, diversification, transparency and cost control. Indexes are key ingredients in all of our customized client portfolios.



Cross-check

The next step is to cross-check the portfolio as a whole to see if the pieces, when combined, achieve their desired effect. At OCM, we use Bloomberg to check against two fundamental benchmarks – market capitalization and GDP. We look for reasonable relationships here – where market value is proportionate to economic value. After adjusting portfolio allocations accordingly, we next use Morningstar to reveal overlapping contents and for a look at security selection by country of origin. Exxon Mobil, for example, would likely appear in all five types of indexes. We monitor these overlaps to avoid unintended overexposure to individual stocks, sectors or geographies.

Optimize

We use Ian Johnson and Alpha Analytics to complete the last step: optimization. Optimization picks the appropriate mix of indexes based on risk and return guidelines, based on five years of historical price performance. Optimization is the customized part of indexing – every client is different. Although we may consistently use the same broad group of indexes, the individual weightings are unique to each individual.

Invest by design, not default

Index investing has been hailed by many for its simplicity. And yes, it does simplify the creation of a diverse portfolio. In almost all cases, we see it as a favorable alternative to picking individual stocks. However, reaping the full benefits of indexing demands very deliberate allocation of assets to a variety of carefully selected and researched indexes.

How do your investments stack up against a diversified portfolio of indexes? ***Free offer:** OCM will analyze the distribution and performance of your portfolio relative to a mix of the five types of indexes. Contact us today to take a new look at the composition of your portfolio.*

Sample ‘How to Index’ Template: See website/publications for a graphic representation of the five types of indexes we advocate at OCM.

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