



## **The Power of Indexing** ***Debunking Six Index Myths***

Without question, one of the most important developments in the current generation of investing is the growth of indexing – where investors dedicate assets not to a specific set of securities or money manager but to an index that tracks the performance of a particular market or market segment.

Indexes can be owned through two primary vehicles – index mutual funds or Exchange Traded Funds (ETFs). As the name implies, ETFs are traded like stocks, meaning prices fluctuate throughout the day, and can be held in long or short positions. As of this summer, 287 ETFs were available, with \$360 billion in assets...and rising quickly.

Here's our take on several potential misconceptions about indexing:

**Indexing is lazy.** Buying ETFs and index funds may seem like a shortcut. It is. It is the same kind of shortcut as the interstate highway system, taking people to more destinations more quickly and with less aggravation than by taking the back roads. Indexing is more efficient, reduces risk, and costs less than actively managing a portfolio of individual securities. Who says shortcuts are bad?

**Indexing is mediocre.** Indexing is often criticized for seeking to match rather than beat the market. In truth, by matching the market, indexing actually outperforms most managers and actively managed funds. In his eye-opening book *Unconventional Success*, David Swensen (head of Yale's high performing endowment fund) points out that even an entry-level index, the Vanguard Index 500, beats more than 85% of managed funds over a typical 10 year period. That's before taxes; on an after-tax basis, the margin is even wider. Yes, talented managers can and do beat indexes. But in general it is more important to pick the best markets to own rather than to pick the rare manager who can consistently beat those markets. Indexes make it easy to own diversified positions in many markets with just a few investments.

**Indexing is unimaginative.** There was a time when only the largest, best known equity markets were tracked as indexed securities. Those days are long gone. Index instruments are now available for fixed income, currencies, real



estate, specialized industries, and even continents and countries. Some of the brightest minds in investing now dedicate their efforts to creating innovative and valuable indexes. For instance, investors who appreciate the limitless global demand for clean water can buy PHO, an index of 25 leaders in the acquisition, purification and distribution of that precious liquid asset. State Street has filed for an international real estate fund ETF with holdings in London, Australia and Japan. If you want access to China, just buy the index. There is no limit in sight as to what can and will be indexed.

**Indexing is an “amateur” approach.** Wealthy individuals expect the best, and sometimes express concern that indexing lacks the sophistication their high value portfolios deserve. Interestingly, top professionals have led the charge in index investing. Multi-billion dollar pension and profit-sharing plans are liberal purchasers of indexes. Yale’s Swensen, a vocal index proponent, holds several major ETF positions in the school’s endowment. Leading academics, including Eugene Fama (University of Chicago) and Jeremy Siegel (Wharton) are also index professionals. And Burton Malkiel of Princeton strongly advocates indexes in his seminal book *A Random Walk Down Wall Street*. Furthermore, indexing offers access to some asset classes that would be extremely difficult for individual investors to reach otherwise. Junk bonds, for instance, require huge block purchases, but when bundled in an index fund are accessible to all. Indexing is anything but amateur.

**Indexing is too simple.** No, that’s the beauty of indexing: transparency. While turning over assets to an active manager is something of a leap of faith, indexing is a more predictable, intentional step into the known (or at least the knowable). The daily composition of indexes is readily available. There are no surprises at tax time. And when the index is intelligently designed, there’s no fear of pointless churn.

**Indexing is fool-proof.** If indexing is such a smart investment approach, and indexes are so readily available, why would an individual investor need any guidance at all? This is a crucial question. Yes, an online trader could assemble a massive index portfolio in a few hours, but a do-it-yourself approach is likely to falter in several key areas:

- **Asset allocation** – Choosing appropriate weightings across different asset classes is the critical first step for any investor. It is no less important for index portfolios than for actively managed accounts.



- ***Index composition*** – Once asset allocations are set, the next step is to find low cost, logically constructed ETFs or index funds that provide access to the desired asset classes. The only reliable way to achieve this is to look under the hood – to systematically analyze index composition. Without this scrutiny, one is almost assured to suffer unintended correlations – when the same stocks reside in multiple indexes – or excessive industry or geographic concentrations.
- ***Index mechanics*** – Not all indexes are created equal. Some poorly constructed indexes experience high turnover rates and transaction costs as stocks enter and exit the index on a revolving door basis. More rational index constructs mitigate turnover by softening the buy and sell rules. Further, most ETFs operate at lower costs than mutual funds tracking the same index (due to simpler record keeping). These and other mechanical nuances have very significant effects on performance.

**The OCM difference**

Osbon Capital Management is a registered investment adviser operating as a family investment office. We consider all options for our clients, including index investments and active managers. ETFs are part of all of our current client portfolios. Our specific recommendations are based on the unique needs and goals of our clients.

**Last step, not the first**

With the many appealing characteristics of indexing, and ETFs in particular, it is tempting to think of buying indexes as step one in creating a smart portfolio. Not so. Purchasing specific indexes is actually the *last* step. Only after thorough professional analysis can smart choices be made among the hundreds of available index instruments. Clearly, to make the most of this investing technique, one must buy the right indexes in the right proportions.