

## Risks of Equity Indexing – The Lost Decade

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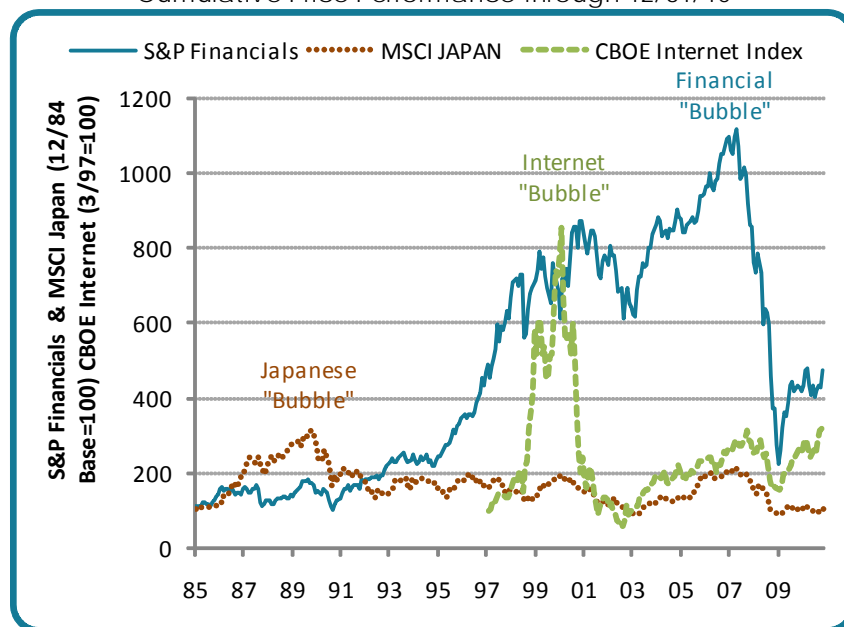
The last decade has been disappointing for many equity investors. The total annualized return for the S&P 500 Index during the past decade, ending on December 31, 2010, was 1.4 percent. However, if an investor had managed a portfolio consisting of all 500 companies in the index on an equal-weighted basis (.2 percent each) rather than a cap-weighted basis; the average annualized return would have been 6.3 percent over the past 10 years. <sup>1</sup>

The inconsistency in performance of stock indexes compared to the average stock can be attributed to the common index methodology of weighting stocks by market capitalization. Companies with larger market capitalizations are given greater weight in indexes. Although market capitalization-based indexes represent a reasonable measure of the stock market's overall performance, there are significant risks one should consider when investing in market index funds.

### 1. Market Index Funds are Subject to "Irrational Exuberance"

Investors are influenced by greed, fear of losing, rumors, herd behavior and/or the latest investment "fads". Often irrational, this behavior can manifest itself in equity markets in the form of overvaluations of specific stocks, sectors or the overall market, which eventually lead to corrections or crashes. History provides numerous examples of this, including the stock market crash of October 1929, the "Nifty 50" of the 1970's, the Japanese "Bubble" of the 1980's, the Internet "Bubble" of the 1990s and most recently, the Financial "Bubble."

**S&P Financials, CBOE Internet and MSCI Japan**  
Cumulative Price Performance Through 12/31/10



Sources: Glenmede Investment Research and FactSet

It is impossible to imagine that all investors were rational in the bidding up of Internet stocks to stratospheric prices in early 2000. The rising prices of technology and internet-related stocks had a significant effect in boosting the performance of market index funds relative to "rational" portfolio managers during the 1990s. And in the mid-2000s, financial stocks soared high with the housing markets.

<sup>1</sup> Sources: S&P Indices via FactSet (S&P 500 Index and S&P 500 Equal Weight Index returns)

## **2. Index Funds Favor Stocks with the Largest Market Capitalizations**

Stocks with the largest capitalizations are weighted the heaviest in market index funds. With that in mind, will the future earnings growth of Exxon Mobil, Microsoft and Procter & Gamble, currently three of the largest stocks, be superior relative to other companies? A historical review of the ten largest stocks in the S&P 500 Index suggests that few companies consistently maintain their relative top ten ranking for an extended time period. Only three of the ten largest stocks from 2000 remained in the top ten ranking by the end of 2010. Similarly, technology stocks accounted for six of the top ten at year-end 1999, yet only one remained by the end of December 2005. Despite this turnover, a market index fund will always more heavily weight the prevailing top ten stocks relative to other stocks.

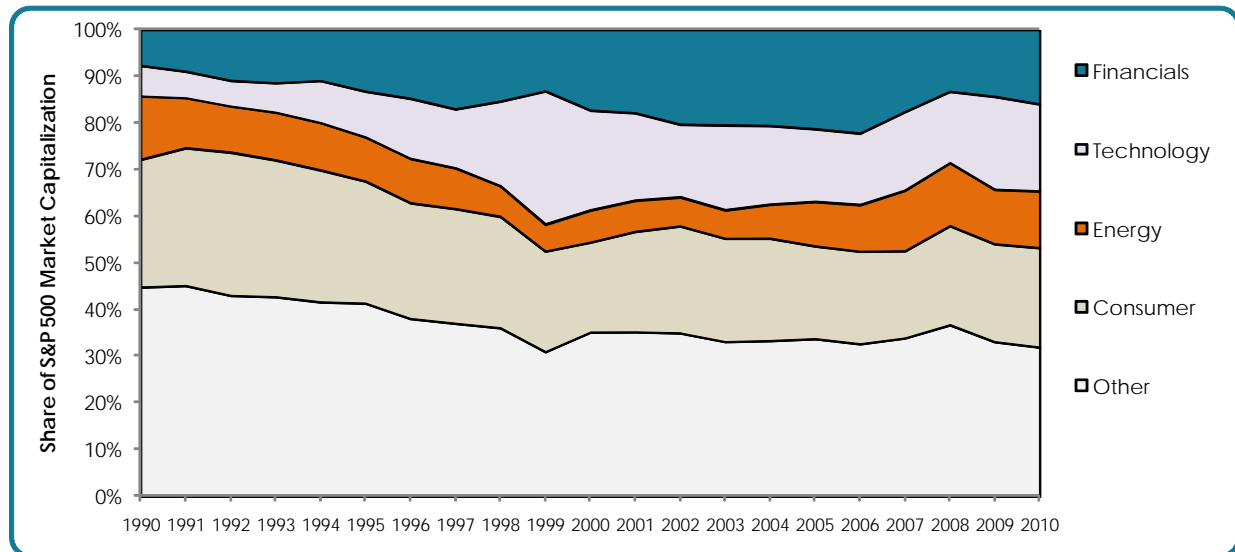
When comparing the annual returns of the market cap-weighted S&P 500 index to an equal-weighted S&P 500 index from 1991 through 2010, an equal-weighted index would have outperformed in 12 of the 20 years (60 percent). The equal-weighted index would have produced a 2.3 percent higher annualized return over this entire twenty year span.<sup>2</sup>

## **3. Index Sector Weightings Are Volatile**

The market has proven time and again that the top index sector leaders constantly change. In the 1980s, energy stocks represented the largest sector in the S&P 500. By early March 2000, at the peak of the internet bubble, technology stocks represented nearly 35 percent of the market capitalization of the S&P 500. By year-end 2000, index fund investors suffered as technology stocks declined to 21 percent of the S&P 500. More recently, in the mid 2000s, the financial sector bubbled up to more than 22% of S&P 500 market capitalization. By year end 2008, the market capitalization of the financial sector dropped to approximately 13% of the S&P 500.

### **S&P 500 Sector Composition**

Year Ends 1990 Through 2010



Sources: Glenmede Investment Research and S&P Indices via FactSet

<sup>2</sup>Data Source: S&P Indices via FactSet

#### **4. Excessive Indexing Can Lead To Inefficient Stock Prices**

Investors' appetite for index funds has grown significantly over the past 15 years. However, as index-based mutual funds and ETFs continue to gain popularity and active managers are increasingly pressured to control their performance tracking error relative to benchmark indexes, the markets could become less efficient. On the extreme side, if investors only invest in index funds, individual equity prices would move solely based on their relative weight in the index. Individual stocks' returns would not be differentiated based on new company releases such as earnings reports, new product developments or management changes. The equity market can only be efficient when active investors and portfolio managers continually adjust security prices based on new information.

#### **Summary**

Market cap-weighted index funds present several risks to the investor. Indexes are vulnerable to irrational market behavior, equity pricing inefficiencies, the index's heavier weightings for the largest companies and sector volatility. An experienced active manager can effectively reduce these risks with quantitative tools, a valuation discipline, fundamental research and portfolio optimization techniques. The portfolio manager can prudently select equities to create a portfolio that is appropriate for the client, rather than selecting a stock simply because of its inclusion in a market index. The characteristics of an equity portfolio can be customized to complement the client's overall asset allocation strategy in meeting long-term return and risk objectives. Additionally, the active manager can manage the individual equity holdings to minimize the investor's tax burden. Looking forward, these advantages should allow a disciplined and experienced equity manager to reward the investor with higher returns and/or lower downside risk compared to market index funds.

Since 2002, Glenmede's quantitative equity strategies have been managed with equally weighted stock positions and a valuation discipline. Additionally, portfolio holdings are subject to downside risk screens (i.e. negative earnings surprise signals, quality of earnings, debt ratings) and use leading industry group indicators to bias sector weightings.

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*The author, Vladimir de Vassal, CFA, is director of quantitative research for Glenmede. He provides proprietary research and analytical support to institutional funds, The Pew Charitable Trusts and high net worth clients of the parent company, The Glenmede Trust Company, N.A. (GTC). Mr. de Vassal and his team manage several quantitatively based equity portfolios, including five mutual funds and 130/30 strategies. The author would like to thank his colleagues Alex Atanasiu, CFA, Paul Sullivan, CFA and Max Young for their contributions and support.*

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