BE ACTIVE WHEN YOU ARE PASSIVE

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Index funds now are 31 years old. They were pioneered for average investors by Vanguard's First Investment Trust in the mid seventies. Passive investing was a novel concept at the time and provided some significant benefits to investors. The biggest benefits were, and still are, transparency, diversification, low cost and usually low turnover.

Investors can now obtain many of these benefits in passive mutual funds, exchange traded funds and closed end funds. There have been significant advances in the way investors can implement a passive approach. The range of choices now numbers in the thousands.

The basic premise for a passive approach is that in a stock market with full disclosure and efficient distribution of information the current stock price would give a reasonable value for the bulk of traded securities. This is considered the "Strong Form" efficient market hypothesis. For the record, we subscribe to the "Weak Form" efficient market hypothesis which states that the market for the most part does a reasonable job at pricing stocks but does have stocks that stray from fair market value. It is possible for some managers (but not all) to add value relative to a passive approach. A similar concept would be that, of the some 600 players in the NHL, very few will make it to the hall of fame (most managers do not beat the market) but it is obvious when talent relative to the crowd is present, Crosby, Orr, Gretzky and many others are such examples. So in our practice we use both active and passive approaches. The decision is based on the ability to add value and confidence in the outcome.

Back to indexing, after 31 years indexing can be excused for showing some wrinkles. There are some important issues with respect to indexing that affect investors. There are four methodologies employed in indexing and each have strengths and weaknesses. The first is price weighted which is the dear old Dow, second is market capitalization weighted which includes the TSX and S&P indexes, equal weighted, and finally a relative new approach called fundamental weighting.

Price weighted indices are constructed by the weighting of the price of the stock within the index. The Dow Jones Industrial Index is such an index and covers 30 stocks. Not a very broad approach and covers only about 20% of total US listed stocks by market capitalization. The advantage is that it is a simple approach, the weakness is that funds then are allocated disproportionately to the stocks with the highest price. Not very rational and few investors or pension funds use this method.

Capitalization weighted indices are employed extensively in pensions and retail funds, both as investment approaches or reference benchmarks to keep track of how the active managers are doing. They are very cost effective, transparent and have been the largest segment by assets for the passive approach. However there are some very significant flaws with capitalization weighted indexes that have vexed investors over the years. The very first problem with them is the implicit assumption that the inclusion of securities is done on a rational basis. For those of us with good memories we will recall the horrendous decision to include Bre-X into the TSE 300 in the mid nineties. Much damage was done to investors and the credibility of the index construct. The S&P 500 suffered similar embarrassment after the growth market meltdown of the tech stocks in 1999 and 2000 and the accounting scandals of Enron and Worldcom. A number of approaches were born out of this period designed to address some of the larger problems.

The second problem with this approach is that the index will weight stocks according to market cap and in essence overweight overvalued stocks. At the height of the Growth bubble the top ten stocks of the S&P 500 made up half of the overall weight. In Canada Nortel was our nemesis with a weight timing of over a 30%. Of course, as the market went up and index funds outperformed active managers added cash to index funds which plowed more money into the larger stocks and continue to drive prices upward. It became a upward spiral and because of the way the index is built there was no sober second thought. The index was buying higher and higher as investors allocated more funds to the cap weighted index funds who bought the stocks driving up the price further, essentially adding fuel to the fire. A legalized ponzi scheme that ended in tears. It took the TSX and S&P over five years to recover the highs. Overpaying for expensive stocks and ignoring or selling undervalued stocks to maintain the index weighting.

The third issue is that the cap weighted indexes are forced to do exactly the opposite of corporate insiders. Historically, a very poor strategy. Companies who have the view that stock is undervalued will undertake share buybacks reducing the number of shares in the cap weighted formula. Conversely if managers think the company stock is at a premium they may be encouraged to issue shares and raise what they see as cheap capital. A corollary of this also occurs for merger's & acquisitions activity where a company may issue stock to aid the purchase. Indexing will subsidize the acquirer and enable the dilution of the existing stock holders.

The frequency of rebalancing can also affect the fund and in particular on severe declines. A longer period between rebalancing means the index rides losers down longer, again a number of securities come to mind, Enron, Worldcom, Bombardier, Nortel and Bre-X.

There is an uncomfortable secret, in my view, with indexing that is beginning to be debated in the pension world but not in the retail market as of yet. While the fees of index funds are attractive, one of the reasons they are able to achieve this is that the funds often undertake securities lending programs. They in essence receive a fee for renting the stocks to others, including hedge funds, to short the very stocks they own! While it may be good for fees it is not good for the underlying securities as shorting stocks does have a negative affect on prices. It is an indelicate balance of interests that merits more discussion but is beyond the scope of this piece. You can look to the prospectus to determine if the fund is undertaking securities lending operations and make your own decision.

A third option is to equal-weight the index which solves many of the issues associated with cap weighted indexes. Very simply equal amounts are placed across all securities and this more evenly distributes investments across over valued and undervalued stocks. A large amount of the damage from a busted blue chip holding is avoided. They retain all of the attractive features of indexing. Low cost, transparency in particular. They can however have problems in implementation in broader indexes as the smaller stocks can be difficult to buy or sell if they are thinly traded. A more frequent balancing model will help alleviate the problem but at a small implementation cost. We do employ these in the practice and will often use closed-end variants given we can often find discounts in the closed end trust relative to the market price of the underlying securities.

A relatively new approach has been developed that addresses most of the flaws with indexing. It is called Fundamental Indexing. Rather than building a portfolio using the previous methods the approach considers either one or a number of characteristics of a company unrelated to its position in the index. There are three common approaches, income statement based, balance sheet based or a combination of them. Income approaches will consider the company's share of revenues, earnings, dividends and free cash flow. Balance sheet approaches may look at book value or various balance sheet ratios. We are beginning to see more offerings of this style of passive investing through mutual funds, Exchange traded funds and finally closed end funds. The biggest advantage is that the bias towards high priced stocks built into the other passive models is avoided. Selection is growing so investors are able to pick a model they feel more comfortable with, be it earnings, dividends or book value. This evolution in passive investing is welcome and overdue.

Investors have the option to augment their investment portfolios with various passive strategies. Passive does not necessarily mean better and research is required to understand the strengths and weakness of various approaches. There has been an explosion of choice in the last few years but a sensible approach is required to have the desired outcomes. Always start with a comprehensive financial plan which outlines your goals, objectives and tolerance for risk before implementing specific investment strategies or solutions.

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