

The New York Times

FUNDAMENTALLY

Money and Business/Financial Desk; SECT3

If You're Playing 'Beat the Benchmark,' Don't Expect to Win

By PAUL J. LIM

1152 words

29 October 2006

[The New York Times](#)

Late Edition - Final

5

English

Copyright 2006 The New York Times Company. All Rights Reserved.

GOOD old-fashioned indexing -- the plain-vanilla strategy of buying and holding all the stocks in a broad market benchmark like the Standard & Poor's 500 -- became popular in the late 1990s, when the major stock indexes were returning more than 20 percent a year.

But investors who've recently turned their back on this strategy are probably regretting their decisions.

This year through September, only 28.5 percent of actively managed large-capitalization funds -- which try to beat the market through stock selection -- were able to outpace the S. & P. 500 **index** of large-cap stocks, according to a new study by S. & P. In the third quarter alone, it was even worse, with only one in five actively managed large-capitalization funds beating the **index**.

That isn't terribly surprising, said Rosanne Pane, mutual fund strategist at S. & P., because active managers tend to have difficulty beating indexes when market leadership changes. And in the third quarter, many stocks that had paced the market for much of this decade began to fall behind. Small-company stocks were finally beaten by shares of big, blue-chip companies; sectors like energy also started to lose ground.

Still, such transitional periods aren't the only good times for indexing. S. & P. research shows that while active management fared poorly in the third quarter, it has actually been lagging behind the indexes for a considerable period.

Over the five years through the end of the third quarter -- a span that included both bull and bear markets -- only 29.1 percent of large-cap funds managed to beat the S. & P. 500. What's more, only 16.4 percent of mid-cap funds beat the S. & P. 400 **index** of mid-cap stocks, and 19.5 percent of small-cap funds outpaced the S. & P. 600 **index** of small-company shares. "The long term does seem to favor the indexes," Ms. Pane said.

So does the near term. That's because corporate earnings are finally expected to decelerate meaningfully over the next several quarters, said Richard Bernstein, chief investment strategist at Merrill Lynch. And in a period of slowing profit growth, stock market leadership typically narrows.

You would think that active fund managers would thrive during such periods -- because, in theory, they could select the winning stocks from the market's losers. But choosing the winners actually becomes that much harder, Mr. Bernstein said.

"In the past few years, when we saw unprecedented breadth in the stock market, it was a stock picker's paradise," he said. "Even if you were a poor stock picker, your chances of outperforming the broad market were quite high."

But as it becomes more difficult to find stocks generating sizable gains, "we'll begin to uncover who truly has the stock-picking ability out there," he said.

For John C. Bogle, founder of the Vanguard Group, which started the first retail stock **index** fund 30 years ago,

the recent success of indexing is self-evident.

"The reality is, fads come and go and styles of investing come and go," he said. "The only things that go on forever are costs and taxes." And by simply buying all the stocks in an equity benchmark and holding them for the long run, traditional **index** funds minimize the transaction costs and capital gains taxes associated with investing, he said.

Mr. Bogle argued that while indexing grew in popularity in the late 1990s -- when the Vanguard 500 **Index** fund, which tracks the S.& P. 500, was consistently returning more than 20 percent a year -- the strategy is even more valuable in a period of modest returns. If equities gain only 6 or 7 percent annually in the coming years, the higher investment management fees, transaction costs and taxes associated with actively managed portfolios will take a disproportionate bite out of a fund's gross returns, he said.

Yet it's precisely during these stretches of modest returns when individual investors tend to take indexing for granted. After all, there's nothing sexy about earning mid-single-digit returns through an **index** fund.

Mr. Bernstein said that in recent years, "I don't recall getting any questions about indexing." But in the late '90s, he said, "everybody felt they had to **index**."

That's probably because brand-name large-cap stocks like Microsoft and Cisco Systems were driving **index** funds to huge gains back then -- just before the technology stock bubble burst in early 2000.

This is precisely the problem that some proponents of indexing have with traditional **index** funds. In a traditional fund that mimics a market-capitalization-weighted benchmark like the S.& P. 500, rising market values often force portfolios to add to positions in their biggest stocks, even if those shares are grossly overvalued by conventional measures like price-to-earnings ratios.

SO-CALLED fundamental indexers believe that this violates a core principle of buy-and-hold investing: buy low and sell high. And they say that there's a better way.

Research Affiliates, an asset management firm in Pasadena, Calif., has built its own set of indexes that get around the problem of market-cap weightings.

The Research Affiliates Fundamental Indexes, or RAFI, instead weigh stocks on other factors such as sales, book value, free cash flow and dividends.

Jason Hsu, director of research and investment management at Research Affiliates, says that this prevents an **index** from becoming too oriented toward the fastest-growing and largest-capitalization stocks, for example, just because of market momentum.

But while fundamental indexing may be gaining some traction among investors, its timing may be off. That's because the very force that led to the huge success of traditional indexing in the late '90s -- the dominance of large-cap stocks -- appears to be returning.

In the second and third quarters this year, the Russell Top 50 **Index** of the nation's largest blue-chip stocks rose 6.7 percent. By comparison, the Russell 2000 **index** of small-company shares fell 4.3 percent.

Mr. Hsu conceded that "if we go through a sustained period where large-cap stocks outperform dramatically and unreasonably, as we did in the late '90s, then RAFI might not keep up in that environment" with a traditional **index** like the S.& P. 500.

If that's the case, you have another argument not to turn your back on traditional indexing just yet.

Chart: "Often, It Pays to **Index**"

Graph tracks percent of Actively Managed Large-Cap Funds that Beat the S.&P. 500 from 2000 through Sept. 30, 2006.

(Source by Standard & Poor's)

Paul J. Lim is a financial writer at U.S. News & World Report. E-mail: fund@nytimes.com.

Document NYTF000020061029e2at0008q

© 2006 Dow Jones Reuters Business Interactive LLC (trading as Factiva). All rights reserved.