

## Index Funds: Does Active Management Add Value?

Hardly a month goes by without an article in one of the financial magazines lauding the benefits of index mutual funds. Index funds do not hire active managers; instead they attempt to track as closely as possible a selected benchmark index. The logic of index funds is to avoid the costs of paying an active manager to try and outperform “the market.” In addition, index funds almost always have lower portfolio turnover than actively managed funds, incurring lower brokerage commissions and generating fewer taxable fund distributions.

Unfortunately, discussions of index funds often generate more heat than light. The investment management and brokerage industries, whose livelihood depends on investment management contracts and brokerage commissions, understandably regard index funds as a threat to their existence and tend to argue against them in all cases. Proponents of index funds may treat them as a panacea and dismiss any notion that active managers can add value to a portfolio. Sigma owns both indexed and actively managed funds in client portfolios. We believe two questions can help investors understand the uses and abuses of index funds.

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**1. What are you trying to index, and why?** Most discussions of index funds are limited to funds that attempt to track the Standard & Poor’s 500 index of large company, U.S. stocks. While there are a large number of index funds that use the S&P 500 index as their benchmark, many of the more than 100 index funds in our database attempt to track bond indices, small company stock indices, foreign stock indices and industry sector indices. Many index funds attempt to track indices that are simply made up by the fund itself, sometimes without much disclosure on how the index is formulated. One fund attempts to provide a return that is inversely correlated to the S&P 500, going up when the index goes down and vice versa. Some index funds purchase all the stocks or bonds in their benchmark index, while others purchase only a statistical sample of the index. Some index funds purchase the stocks or bonds included in their index, while others purchase or sell derivatives to simulate the performance of the index.

**2. Does active management add value?** By blindly arguing either for or against index funds in general, many pundits fail to differentiate among index funds in different market sectors. Sigma has completed a study of the value of active management for both large and small U.S. companies over each of the last 10 years. The average U.S. large company fund manager outperformed the large company benchmark S&P 500 index in only three out of the past 10 years. In contrast, the average U.S. small company manager outperformed the small

company benchmark Russell 2000 index in seven out of the past 10 years. Large companies, such as IBM or General Motors, have hundreds of analysts following them. It is unlikely that anyone investing in these companies will have information that is not already reflected in the market price of the stocks. On the other hand, smaller companies may have few or no analysts following them, so the market for their stocks may be less “efficient,” creating opportunities for portfolio managers. Indexing makes more sense in some market sectors than in others. Sigma considers index funds as simply another tool for investors. We use index funds in those areas of the market where the cost of active management is unlikely to add value.

*The average small company fund outperformed the small company benchmark index in seven out of 10 years.*

So what is the future of indexing? The indexing of U.S. large company stock portfolios has gained wide acceptance among institutional investors such as large pension plans and public retirement funds. On the other hand, index funds account for only a tiny percentage of individual investor holdings. The widespread institutional move toward indexing may have created something of a self fulfilling prophecy in the last decade. When the S&P 500 outperforms the average large company manager, certain institutional investors make the decision to index their portfolio. This means that they sell stocks that are not in the index (forcing those prices down), while purchasing stocks that are in the index (forcing those prices up). This added supply of non-index stocks and added demand for index stocks helps the index to outperform active managers, leading additional investors to make the indexing decision in the next period. We will discuss the potential dangers of this circular logic by institutional investors in a future study.

**The Lesson:** Indexing is just one of many tools available to mutual fund investors. If you are interested in learning more about how index funds can fit into your portfolio, contact us.

Data Source: Morningstar OnDisc, February 1996