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## FUND OF INFORMATION

## Better Benchmark?

*A value-oriented index's approach sets it apart from the S&P 500*

By LAWRENCE C. STRAUSS

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**WHEN IT COMES TO INDEXING**, most mutual funds hew to benchmarks weighted by stock-market value -- notably the Standard & Poor's 500 Index and the Russell 2000. Late last week, the largest stock in the S&P was [General Electric](#), with a 3.4% weighting.

But Robert Arnott, an investor who is also editor of the Financial Analysts Journal, is working on an alternative. With the help of several colleagues at Research Affiliates, a Pasadena, Calif., firm that runs about \$5.1 billion of institutional assets, he's crafted a new set of indexes, none of which rely on market capitalizations.

Why?

"The problem with cap-weighted indexes is structural," Arnott asserts. "It's not that cap-weighted indexes just happen to underperform." He maintains that the key problem with cap-based indexes is that they overweight overvalued stocks and underweight undervalued stocks.

Research Affiliates, of which Arnott is chairman, has developed a series of indexes whose criteria include trailing five-year average operating income, trailing average sales, trailing average gross dividends and total employment. The Fundamental 1000 Composite, as his signature index is known, reflects sales, cash flow, book value and dividends (if applicable). At least 400 of the companies in the S&P 500 overlap with the new index, Arnott estimates.

The index was rolled out only last fall, but Arnott checked returns going back to 1962, and it has good performance precedents. As of Dec. 31, it was up 8.76% on a three-year annualized basis, versus 3.59% for the S&P 500. Over five years, it was up 7.59%, versus a 2.30% loss for the S&P. And, over 10 years, it gained 15.69%, compared with a 12.07% advance for the S&P.

From 1962 to 2004, the new index notched a 12.47% annual return, compared with 10.39% for the S&P. Every basis point counts, and the outperformance could be a strong selling point down the road, although indexes like the S&P 500 and Russell 2000 are very well entrenched in the \$1 trillion-plus U.S. indexing business.

Not surprisingly, some big differences exist between the composite index and the S&P 500. As of Dec. 31, for example, [Microsoft](#), which has the third-largest weighting in the S&P, ranked 11th in the alternative benchmark. [Ford Motor](#), No. 96 in the S&P, ranked 12th in Arnott's index, and [General Motors](#), No. 112 in the S&P, placed ninth in the alternative index.

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There were some similarities as well. Four of the S&P's top five weightings -- [General Electric](#), [Exxon Mobil](#), [Citigroup](#) and [Wal-Mart](#) -- placed in the top five of Arnott's index.

Whether the newfangled benchmark becomes an indexing staple is uncertain, given the tough competition. Research Affiliates has landed one institutional account so far -- \$100 million from the South Dakota Retirement System, and the firm is in negotiations with other institutional investors. "We thought it would outperform traditional capital-weighted indexes over time," explains Matt Clark, state investment officer in South Dakota. "We thought the idea would attract other investors, which might give a little boost to early adopters."

The retirement system pays an annual management fee of 0.18%, plus 20% of the outperformance of the new index versus the S&P 500; it began using the fundamental index late last year. (Note: The recent switch to Arnott's index represents a tiny fraction of the South Dakota system's roughly \$5.8 billion of assets.)

Not everyone is sold on the new concept, however. Vanguard, the nation's largest mutual-fund indexing operation, passed on the index.

Rick **Ferri**, president of Portfolio Solutions, a Troy, Mich., investment adviser that oversees about \$500 million of assets, also has doubts. By using sales as a key index criterion, "you start bending the portfolio more toward value and mid-cap value," says **Ferri**, who uses various index products, including exchange-traded funds. "If you reduce the market capitalization of your portfolio and bend it toward value, you're going to outperform the S&P."

To get a value component into a portfolio, it makes more sense to use a value index, he argues.

For his part, Arnott maintains that the new index "captures the average company, while the cap-weighted index captures the average stock. It's not the fundamental index that is skewed. It's the cap-weighted indexes that skew investors with a bias toward high-multiple stocks and companies with high growth expectations, which may or may not be realized."

Gary L. Gastineau, managing director of ETF Consultants in Summit, N.J., has spent considerable time researching passive investing strategies. "I'm not negative" on the new index, he says. "I'm just saying it's not clear-cut that it's a better way to go in the long term."

Arnott concedes that his index is "never going to replace cap-weighted indexes. But if it ended up having a 10% market share in a few years, that would be an important accomplishment."

And a very difficult one.

### **Weak Inflows**

Domestic stock funds have had weak inflows in the year's first month. "Domestic flows are flat to negative," says Robert Adler, president of AMG Data Services, which tracks fund data.

Equity funds had net inflows of about \$1.25 billion in the week ended Jan. 19, but much of that went into international stock funds, Adler says. What's more, the four-week moving average for stock-fund flows shows a weekly outflow of \$333.1 million.

January is typically good for fund flows as investors put new cash to work. In January 2004, with the equity market enjoying a strong resurgence, a net \$43.8 billion poured into stock funds,

according to the Investment Company Institute.

That trend hasn't continued in 2005, however. TrimTabs Investment Research estimates that as of Jan. 19, investors had pulled out a net \$2.6 billion from domestic funds this month. Conversely, about \$2 billion poured into international stock funds.

All of this no doubt reflects the weak performance of stocks recently. The Dow Jones Industrial Average, which traded at north of 10,800 in late December, was at 10,471 late last week, down about 3% over the period.

The only time in recent years when stock portfolios had net January outflows was in 2003, when \$466 million came out. But at least one observer senses a longer-term trend.

"I think it's part of a cyclical slump that started in May of 2004," says Carl Wittenbert, director of research at TrimTabs. From that month through December, net monthly inflows for U.S. stock funds were about \$4.7 billion, down from an average of \$16.5 billion from April 2003 to April of last year, TrimTabs estimates.

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