ETFS 101, Part 7 - FUNDAMENTAL INDEXING

We've previously discussed how traditional "market capitalization weighted" indexes (such as the S&P 500 index), result in the predominance of larger companies in the index. For example, the 50 largest companies in the 500 stock S&P 500 Index account for about 46% of the total index. This can lead to companies with large market valuations (but perhaps not-so-large revenue or profit) occupying too prominent a position in the index, at least until their market valuations settle back down to something more reasonable (see ETFs 101 – Opportunities & Traps).

In contrast to market capitalization weighting, a number of alternative approaches have emerged, redefining what the "market return" actually means and how to best capture that market return, which is also referred to as "Beta." These alternative indexing approaches go by many names, but "smart beta" is a common moniker applied to them. (See ETFs 101 - Smart Beta).

One of these smart beta approaches – and the topic of this month's article - is the "fundamental index" developed by Rob Arnott.

In contrast to the teachings of "modern portfolio theory" and traditional market-capitalization weighting enthusiasts, Arnott observes that our financial markets are sometimes not so efficient.

From the tech-stock bubble in the late 1990s to the collapse of banking stocks during the more recent financial crisis, market-capitalization indexes overweighted expensive stocks and underweighted cheaper stocks. He believes this institutionalized inefficiency, over the long-term, results in a drag on the returns of potentially 2% per year!

Instead of looking at market capitalization – which might be thought of as a daily popularity contest – Arnott focuses on what he once termed a company's "economic footprint" – the most important real-world factors that determine a company's current financial significance and also foreshadow its potential.

Arnott and his firm, Research Affiliates, studied many different indicators before finally selecting four that appeared to carry the most weight: sales, cash flow, dividends, and book value.

Sales represent the gross revenue a company generates. A company's net income or profit may be temporarily hurt by a one-time event, but if gross revenue continues to grow, then it is deemed healthy.

Cash flow refers to net cash flow *after*expenses. Unlike net income, which is affected by the accounting treatment of various items, net cash flow is a better measure of a company's ability to generate surplus cash.

Dividends are the payments a company makes, out of its profits, to shareholders. Not only do many investors need income and seek companies that pay steady and growing dividends, but historically, nearly half of the total return the stock market generates comes in the form of dividends.

Book value is the net equity of a company as reflected on their financial statements. It is the total assets of a company minus their total liabilities.

Using these four measures, fundamental indexes are developed that have, imbedded in their design, a tilt toward "value" and towards "smaller capitalization" than traditional indexes. These are dynamic tilts, so when a stock is cheaper (a "value stock") it has a smaller market capitalization and the fundamental index may increase its allocation to the stock, whereas traditional indexing would be reducing its allocation to the same stock. Assuming the sales, cash flow, dividends, and book value are unaffected, or less affected than the change in market capitalization, it would become a more attractive investment candidate in the fundamental indexing approach.

There are a number of open-end mutual funds and exchange-traded funds (ETFs) that track the fundamental indexes of Research Affiliates. We'll continue to explore the complexities and opportunities inherent in ETFs in the months ahead.

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