Alternative Indexing

I typically recommend smaller investors utilize passive investment techniques. That is, investing in open-ended no-load index mutual or exchange traded funds.

I have not mentioned that there are different ways to construct market indices. There are.

The normal market index is weighted by market capitalization. The bigger the company, the higher the weight in the index. The vast majority of index funds you consider will be this type.

But there are alternative indexing options out there too. I want to touch on them today.

Weighted Average Market Capitalization

The normal index methodology is the market cap index.

This index provides a realistic representation of the market. The big firms that drive the market and economy have weightings that reflect their stature. Key industries are strongly represented. This is a positive.

However, its biggest drawback is that it is a representative representation of the market.

What?

Consider perhaps the most famous index, the S&P 500. 500 key U.S. companies representing 80% of the U.S. equity markets. Good representation of the U.S. But under a weighted average system, the larger companies have bigger pieces of the index holdings. Exxon and Apple alone make up 5% of the index. And the 10 largest companies comprise 18% of the index.

A drawback, but not what I consider a deal-breaker. In fact, on the whole, I want larger companies to have more impact on the portfolio. Perhaps not to the extreme as South Korea (unless you want a pure play on Samsung), but I do want the bigger companies to dominate my weightings (unless I am seeking a small-cap or similar strategy, but then I am investing differently anyway).

For my money, this is a good methodology for smaller investors who seek well-diversified portfolios. Not that a market cap index guarantees strong diversification. But it is fine when building portfolios.

Equal Weight Market Capitalization

Each company in the index is given equal importance. With the S&P 500, the top 10 companies would only warrant a 2% share of the index. Not their current 18% under the weighted method.

If you want to get more bang for your investment dollar from smaller stocks, then this may be of interest. But there tends to be higher fund expenses due to typically higher turnover, rebalancing, pricing discrepancies, and trading costs with respect to holding higher proportions of smaller companies.

Also, smaller companies that may be less established than the mega-cap firms, like Exxon and Apple, may have higher stock volatility. By increasing their weights, you may be raising the risk level of your portfolio.

If I wish to strategically or tactically invest in smaller companies, I personally prefer to add small-cap funds (or stocks) to my overall portfolio (or weighted average index funds). Not invest in equal weighted indices.

Fundamentally Weighted Indices

This type of index fund is becoming more prevalent. I use them with my clients as they can satisfy a strategic niche or investment objective on a relatively low cost basis.

For example, perhaps you want to focus on dividend income to generate decent cash flow. Yet you also want to participate in the upside (capital gains) if the company does well. A generic index will include both dividend and non-dividend paying companies. What to do?

Well, how about investing in the S&P500 Dividend Aristocrats Index? This is a sub-index of the S&P 500 Index, but only includes companies from that index which have increased dividend payments annually for the last 25 years. Problem solved. Note as well that there are similar Dividend Aristocrats Indices for Canada, United Kingdom, and Europe.

You can find many fundamentally constructed indices that meet a multitude of criteria. I personally find them useful. But, as I always say, the more complex a fund, the greater the expense ratio will be. Always keep an eye on your cost structure.

Alternative Index Comparisons

Investopedia

Investopedia compares the above methodologies in, "3 Types of Indexing for ETF Success".

I am not sure I agree with the conclusions as it is more an apples to oranges comparison. The apples being mega-cap stocks that dominate weighted average indices versus small and mid-cap stocks (oranges) that are higher weighted in equal weight or many fundamental indices.

That said, for long term investing, I personally like smaller cap, value companies (yes, based on historic research results), so it does not surprise me to see those conclusions. Just be aware it is not apples to apples. And that the risk profiles between large, established companies may be significantly different from small, relatively young businesses.

Vanguard

I also recommend Vanguard's, "It's Not Your Father's Indexing" and the "Alternative Equity Approaches to Indexing: Buyer Beware" that is linked in the initial article. Maybe a tad (just a tad) technical, but some excellent points made. Note specifically:

> *Unlike a market-capitalization-weighted approach, none of these strategies will enable you to "own the market." Instead, they will either do better than the market or worse. The trick in deviating from a market-cap-weighted index is to find the investment manager or the rule that puts you on the winning side. The risk is ending up a loser relative to the index or having a poor outcome given the portfolio's specific exposures. The cost is whether you pay more than you would if you were in the (cap-weighted) index fund.*
>
> *We believe that what investors expect when they buy an index is that they will own the market. However, a rules-based, non-cap-weighted strategy doesn't give you that kind of exposure. You are, in fact, making a bet against the market or some segment of the market.*

Using non-weighted indices is more a tactical play than a long-term strategy. I agree with that. And there is nothing wrong with that if you can consistently time market movements. But that is difficult.

In the "Alternative Equity Approaches to Indexing" analysis, Vanguard adjusts various factors to try and create an apples to apples comparison. Their finding?

> *Our research shows that alternative weighted indexes tend to tilt toward the smaller and value stocks in the targeted market. The chart above shows that, after controlling for these factors, there was no consistent significant excess return associated with these strategies.*

> *We believe a better, lower-cost implementation option is for you to use cap-weighted indexes to get the risk-factor exposures inherent to these alternative strategies.*

So on an apples to apples basis, “no consistent significant excess return” to invest in alternative indices. I agree, although if you are willing to increase your risk, you may see higher expected returns over the long term by increasing your share of smaller companies.