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.

How Much to Invest Abroad?

Individual investors may reap diversification benefits by investing internationally.

The level of benefit is based on many factors – cross-country correlations, major industries, domestic companies that operate globally, etc. Over time, global diversification benefits have fallen. However, investing outside your home country is still worthwhile.

The question then, how much should you invest abroad?

This question was asked of a panel in The Wall Street Journal. Some good responses. I will comment on a few and include my own view of the world.

My Thoughts (Since No One Asked)

The global market is 100%. Your domestic market is a piece of the pie. The U.S. is the largest financial market with about 33% (plus or minus – you actually may see some claim it as high as 46%, but that is too high) of global market capitalization. Canada has only about 4% of the global market share.

Some experts recommend investing in line with relative global weightings. So roughly 33% in U.S. equities, 4% Canada, etc. Fine by me. An easy way to do this is to simply purchase a global equity fund. For example, the Vanguard Total World Stock ETF (VT) or iShares MSCI All Country World Index (ACWI) ETF (ACWI).

Both are extremely inexpensive and do an excellent job of replicating the global equity markets in reasonable weightings. I use "reasonable" as global equity funds tend to overweight U.S. equities. In this case, both Vanguard and iShares invest about 48% in U.S. equities. The higher weighting in funds versus actual real world weightings has to do with investable assets and a slight U.S. bias. Not a huge issue if you are looking for one single fund to invest in. Canada's weighting sits at its proper 4%.

Some experts recommend home country bias when investing. If you live in Canada, instead of 4%, you might want to invest between 10 and 20% in Canadian equities.

Why? Your life is tied to your domestic financial markets. If you live in Canada, you are paid salary in Canadian dollars (CAD). Your debt is in CAD. Interest rates, inflation, unemployment, are all tied to Canadian-centric events. What goes on in Canada impacts Canadians disproportionately to world events. As a result, you may want to have greater exposure to Canadian equity markets.

I might add that some experts make the exact counter-arguement. That you should underweight your home market because of all the other impacts.

Me? I do not mind using either relative global weightings or home country bias. I think you need to consider other factors (what is your home market, debt load, other investments, cash flow requirements, etc.) before choosing one or the other. For many individuals who do not want currency and interest rate impact, a home country bias may be preferable. For younger investors, relative global weightings may prove better.

So what do the experts from The Wall Street Journal say? And bear in mind these folks are speaking as U.S. based investors. What might make sense for Americans may not be optimal for Aussies, Channel Islanders, or Malaysians.

Gus Sauter: Keep a Home Country Bias

> *In my view, investors should have a home-country bias because they face risks that are peculiar to their home country.*
>
> *So, an investor should invest a significant portion in their home country, but invest enough internationally to take advantage of diversification.*

Gus does not provide a suggestion for Aussies. But at 3% global weighting, a home country bias would probably put Australian equities at 10 to 20%. But some would say that more like 30 to 50% is suitable. Too high for me, but just letting you know.

As an aside, I have heard Gus speak a couple of times. Sharp guy.

Manisha Thakor: Don't Think About Where a Company is Based

> *As the consumer class around the globe continues to blossom, growth rates in emerging markets continue to eclipse those at home.*

Good advice. You need to consider the prospects for your home market versus foreign markets.

Also the region in which you live. If you live in Argentina, what goes on in Chile has more significance in your home market than what is happening in Germany. Conversely, Poles need to monitor the German market very closely given physical proximity and trade partnerships.

> *So the real question I think is: What is a non-U.S. investment?*
>
> *To date, corporate domicile has typically been the litmus test for the categorization of an investment as domestic or international. Going forward, I think it's important to pay attention to the source of revenue and profit generation*

So, so true.

Is Apple an American company? Much of its manufacturing is in China. Its customers surround the globe.

Is Nestle a Swiss company? Is Samsung only South Korean? HSBC solely British? Obviously not. These companies operate globally and derive much of their revenue outside their domestic markets. Yet if you look at each country's main indices, Nestle, Samsung, and HSBC dominate the domestic weightings.

As an aside, you can actually create an internationally diversified portfolio by strategically choosing domestic companies.

Frank Holmes: Anticipate Before You Participate

> *when you combine non-U.S. stocks, U.S. stocks, real-estate securities and commodity-linked securities, the resulting portfolio historically outpaced any individual asset class with less volatility.*
>
> *understand the typical price movements of an asset class before you invest.*

Not quite sure what Frank’s point is here. Whenever you prepare a portfolio you must consider historic returns and volatility (i.e., risk). That really is the whole point of diversification. Adding non-correlated assets to try and enhance overall portfolio returns while maintaining the risk level. Or reducing portfolio risk while maintaining the existing expected return levels.

Charles Rotblut: No Crystal Ball? Then Best Diversify

> *unless a person has a working crystal ball, it is impossible to predict where one should invest right now to maximize returns for the next 10 years. By mixing domestic equities with foreign equities, an investor increases the odds of being allocated to the right geographic region at the right time.*

Diversification spreads out the risks. Unless you are certain of the future, hedge your bets.

> *by diversifying internationally, an investor’s wealth won’t solely be dependent on the strength or weakness of the U.S. dollar.*

This is a two-edged sword. If your cash needs (living income, debt repayment, etc.) are in your home currency, investments in foreign currency denominated assets might be risky. But if you do not have these concerns, owning assets in a different currency may add value.

The Other Experts

Mostly dross. But you can see that there is no consensus on how much to invest outside your domestic market.

If you have a decent risk appetite and long time horizon, look to higher levels of non-domestic equities. Especially in emergent (and smaller) markets.

If you have substantial liability exposure to your domestic currency or you require income flows in local currency, then focus on a significant home bias.

Market Capitalization

A company's market capitalization (commonly shortened to "cap") is found by multiplying the current share price by the number of shares outstanding.

Market capitalization is useful in comparing companies of similar size.

It is also used as a tool by mutual funds when determining investment style.

So what are the different market capitalization segments?

Market Capitalization Segments

You will always see three market capitalization segments: large-cap, mid-cap, small-cap.

Less common are three additional categories: mega-cap, micro-cap, nano-cap.

All these terms have some flexibility in their usage and in the ranges for each segment. I will provide the common categorizations, but be aware that you may see slightly different terminology and different ranges at times.

Segment Ranges

Over $200 billion are the mega-cap companies. Microsoft (current market capitalization of $208 billion), Apple ($220 billion), and Exxon ($300 billion) are examples of these extremely large companies.

Between $10 billion and $200 billion are large-cap. If mega-cap is not used by the rater, they will be included in the large-cap segment. Cisco Systems ($121 billion), AT&T ($158 billion), and Amazon ($55 billion) would fall into this grouping.

Between $1 billion and $10 billion are mid-cap. Polo Ralph Lauren ($8 billion), H&R Block ($4 billion), and Office Depot ($1 billion) are examples.

Between $300 million and $1 billion are small-cap. K-Swiss ($394 million), Ruby Tuesday ($608 million), and Quicksilver ($471 million) are small-cap stocks.

Between $50 million and $300 million are micro-cap. Arctic Cat ($142 million), THQ ($238 million), and Winnebago ($244 million) are in this category.

Below $50 million are nano-cap. Athersys ($50 million), Aastrom Biosciences ($40 million), and China Logistics ($3 million) are non-cap stocks.

If micro or nano are not utilized, these segments will be part of the small-cap segment.

Ranges May Differ

As I stated above, some investment professionals, mutual fund companies, or ratings agencies may use different terms and/or ranges for the market segments.

For example, Investopedia includes all companies up to $2 billion in size as part of the small-cap segment.

Morningstar utilizes percentages to segment their stocks. Equities are divided into 7 geographic regions. Within each region, the top 70% of stocks are classified as large-cap. The next 20% are mid-cap and the last 10% are deemed small-cap.

Note that with this Morningstar system, internal and external comparisons may be difficult.

Perhaps a stock that is construed as a large-cap in Latin America is only a mid-cap in the Greater Europe region. This makes internal comparisons of global companies within the Morningstar system harder than by using a fixed dollar calculation.

Second, it makes external comparisons between rating organizations difficult. Morningstar has Canada as a unique region, so the bottom 10% of Canadian companies in size are considered small-cap. But unless I know the exact cut-off point, it is hard to compare to someone that uses a threshold of $1 or $2 billion for Canadian firms.

So when assessing stocks as large, mid, or small-cap, do not blindly accept the classification by the organization that segments the equity. Do your own analysis to ensure that, in your own mind, you know what type of company it is.

Market Capitalization Investing Caveats

First, market capitalization may fluctuate over time based on how a company's share price performs, as well as the number of outstanding shares it has. Small-cap companies aspire to increase their share price so as to move up into mid, or even large-cap, segments.

Also, some companies slip over time to lower segments. Being large is not protection from declines in value.

For example, consider the Canadian telecommunications company, Nortel. In September 2000, its market capitalization was CAD 398 billion. In less than two years, Nortel was worth under CAD 5 billion. If you had wanted to invest only in large or mega-cap equities, you would have found yourself owning (almost) a small-cap stock very quickly.

Second, the larger the capitalization, the more shares are outstanding, which normally translates into increased liquidity for investors.

If investing in nano or micro-cap companies, you may find it difficult to buy or sell shares on a timely basis and/or at your target price. This may also be the case for small-cap stocks.

Reduced liquidity can increase the volatility (risk) of an investment. That is why smaller capitalized companies are generally considered riskier than larger companies.

Third, the smaller the companies, the less publicly available information exists. I am not necessarily referring to corporate filings, such as annual reports and statutory documents. More in respect of investing information.

Many small firms are not actively followed by stock analysts, so getting research or recommendations is difficult. This is compounded by the fact that industry peers are also small firms with relatively little investment information.

Fourth, small-cap firms may be closely held by insiders or other persons or groups connected to the company. While one cannot legally trade on inside information, insiders do have better access to company data and tend to do better than non-insiders.

So when considering investments in small-cap or smaller stocks, be careful.

We will see how market capitalization segments are used extensively in mutual funds.