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THE FUNDAMENTAL INDEXATION CONTROVERSY:

NOT OVER YET

“With the availability of several articles, critiques, and replies...and knowing that we have the benefit of some of the very best thinking on what has proved to be a genuinely interesting finance riddle, each of us can form our own opinion as to the merits of fundamental indexation.”

Richard Ennis
Editor

Financial Analysts Journal

Not Over Yet

Naively, we thought we had laid this issue to rest almost two years ago when we wrote a *Letter* titled “The Index Fund Weighting Controversy: Is Fundamental or Capitalization-Based Better?” (Aug. 2006). Not so, as evidenced by Richard Ennis’ comments in the most recent issue of the *FAJ* (March-April 2008). This ongoing controversy is more than just the continuation of a “genuinely interesting finance riddle”. Billions of dollars of pension fund money has flowed into fundamental indexation strategies over the course of the last few years. Thus it has become a finance riddle with a lot of money riding on it.

The ‘thought-experiments’ we conducted in our August 2006 *Letter* led to four key observations:

1. The ‘market’ is by necessity cap-weighted: thus by definition, market participants in aggregate will earn the cap-weighted market return less costs. If some market participants earn higher-than-market returns, this must be offset by others earning lower-than-market returns.
2. Implementation costs are highly material in evaluating any investment strategy: trading costs, management fees, sales commissions, and taxes all drive wedges between gross returns and net returns. In the end, only net returns matter to investors.

3. Fundamental indexation strategies may lead to portfolios with ‘Value’ and/or ‘Small Cap’ tilts: however, that may not be the whole story.
4. All profitable trading strategies are eventually arbitrated away: although ‘eventually’ may in some cases be periods of many years rather than days or weeks.

The lingering controversy relates to Observation 3: the underlying theory that explains the documented historical success of fundamental indexation strategies over traditional cap-weighted indexation strategies.

The Perold Critique, the Rebuttal, and the Re-Rebuttal

In an *FAJ* article (Nov-Dec. 2007) titled “Fundamentally Flawed Indexing”, Harvard’s Andre Perold characterized fundamental indexing as “a strategy of active security selection through investing in ‘value’ stocks”. It is not, he wrote, a new theory of finance dubbed by some as “the noisy market hypothesis”. The problem with “the noisy market hypothesis”, he argues, is that it anchored on the ‘fair value’ of securities which are unknowable. All one knows is the current market price. If pricing errors are symmetrically distributed around current market prices, capitalization weighting itself cannot entail a performance drag.