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INDEXING

Indexing involves maintaining a portfolio of all of the securities in a market index in the same proportions as they are weighted in the index and, thereby, enabling one's own portfolio precisely to track that index. The most common index that investors seek to track is the *Standard & Poor's* 500.

Investors often ask, how can I make sure that I track the S&P 500, if my portfolio is not large enough to hold 500 stocks, and in the proportions held by the index?

The answer, of course, is that one cannot exactly track the S&P 500, if one does not own exactly the S&P 500 portfolio. There seems to be a pessimistic, but erroneous, supposition by indexers, however, that, if they do not index, they will necessarily underperform the market in which they invest. But not tracking the S&P 500 exactly is not the same as doing worse than the S&P 500. If one has a cross-section of the S&P 500, the odds are exactly as good that he will do better than the S&P 500 as that he will do worse than the S&P 500.

Tracking the S&P 500 with precision can hardly be a worthwhile investment objective in itself. As an analogy, let us assume we want to drive from New York to Los Angeles but do not want to get lost. We might chose to follow somebody else who is making the same trip and knows his way. If asked what our "objective" was, we would say "to get to LA," not "to follow another driver." Clearly, if there were some better way not to get lost, it would be worthy of investigation.

If one does, nevertheless, see emulating the S&P 500 as a goal, and he can approximate its performance, with no greater chance of doing worse than of doing better, then he had ought to be content. This, however, is an objective easily attainable with far fewer than 500 stocks. Historically, for example, the Dow-Jones Industrial Average, made up of only 30 stocks, has served as an excellent proxy for the S&P 500. In fact, the coefficient of correlation between the Dow-Jones-Industrial Average and the S&P 500, over the 73-year period between 1926 and 1998, is 99.7%; and the coefficient of correlation between the total returns (meaning dividends reinvested) on the two indices is 99.8%.

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THE PURSUIT OF PORTFOLIO QUALITY

One of the ways of hedging some of the risk in common stock investing is to own high-quality common stocks. The presumption is that, if we have a catastrophic economy and a catastrophic stock market, larger companies with strong balance sheets and in less cyclical industries will be more apt to survive than small companies with weak balance sheets and in highly cyclical industries.

In financially catastrophic times, it also goes without saying that the bonds of any individual company would also prove a more viable investment than the common stock of that same company. In addition to the relative safety of bonds over stocks, however, bond investors usually give considerable consideration to the quality of the individual bonds they own. Great deference is shown among bond investors to the ratings accorded bonds by the rating services. If bonds are rated AAA, AA, or A by *Standard & Poor's*, they are considered of high quality; if they are rated BBB, they are considered of medium quality; and, if they are rated BB or lower, they are regarded as "junk" bonds.

With so much attention given by bond investors to the quality of the specific bonds in their bond portfolios, in spite of the fact that the bonds of any company are always safer than the common stock of the same company, it intrigues me that more attention is not given by common stock investors to the quality of the specific stocks in their stock portfolios.

Standard & Poor's quality ratings for common stocks are as easily obtained as are its bond ratings for bonds; and its scale of letter grades is similar. Common stocks of above-average quality receive letter grades of A+, A, or A-; stocks of average quality receive a B+; and stocks of "junk" quality receive a grade of B or lower.

Getting back to indexing: By definition, the quality of half the stocks in the *Standard & Poor's* 500 are above the average quality of the stocks in the index, and half are below the average quality of the index. In fact, at any given time, about 40% of the stocks in the index are rated A+, A, or A-; about 20% are rated B+; and the remaining 40% either are rated B or lower or are not rated at all.

Furthermore, as indicated above, given that the common stock of any company is always less safe than the lowest quality bonds of that same company, it would seem even more important to

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be concerned about the quality of the common stocks in one's common stock portfolio than the quality of the bonds in one's bond portfolio.

If, then, one wants to maintain a portfolio of stocks of above-average quality, he must cast out from consideration about 60% of the stocks in the S&P 500.

THE POTENTIAL FOR PORTFOLIO PERFORMANCE

The same argument against indexing can be used if one attempts to discriminate, as most investors do, among common stocks on the basis of their ability to perform in the marketplace. Again, by definition, for any period in the future, as they have for all periods in the past, half the stocks in the index deliver an above-average performance, while the other half deliver a below-average performance.

Though there can be no disagreement about which stocks were above average and which were below average in the past, there is always considerable debate over which will be above-average performers and which will be below-average performers in the future.

To address this question, however, here are at least two useful guidelines:

1. Generally, the common stocks of companies which have enjoyed high rates of return on equity and which have retained a high proportion of their earnings for reinvestment in their own operations have shown higher total returns in the marketplace than have the stocks of companies with low returns on equity and which, in addition, have paid out in dividends a larger part of what they earned.

   Again, by definition, half the companies in the S&P 500 Index fall into each of these two groups; hence, if one wanted to own those in the former group only, he would need summarily to cast out half the stocks in the index.

2. Generally, companies with above-average *Value Line* "Timeliness" ratings have delivered significantly higher future rates of total return than have companies with below-average *Value Line* "Timeliness" ratings. Because above-average *Value Line* "Timeliness" ratings usually reflect above-average earnings growth in the underlying companies, these ratings are commonly used as a proxy for helping to identify growth companies.

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At any given time, approximately one-quarter of the stocks in the S&P 500 have above-average *Value Line* "Timeliness" ratings (#1 or #2); approximately half have neutral ratings (#3); and about one quarter have below-average ratings (#4 or #5). Hence, if one wants to maintain an above-average portfolio, insofar as *Value Line* "Timeliness" ratings are concerned, one would need, again, to be sure that he excluded from ownership about three-quarters of the issues in the S&P 500.

One measure of the potential for improving portfolio performance by discriminating among the types of stocks owned is provided by Morningstar mutual fund service which provides the following data:

	Average Annual Total Return for Periods Ending December 31, 1998			
	1 Year	3 Years	5 Years	10 Years
Growth Funds	**35.75%/yr.**	**25.91%/yr.**	**20.61%/yr.**	**18.46%/yr.**
Value Funds	**12.34%/yr.**	**19.74%/yr.**	**17.88%/yr.**	**15.53%/yr.**
Difference	**23.41%/yr.**	**6.17%/yr.**	**2.73%/yr.**	**2.93%/yr.**

Clearly, over the past decade, there has been some performance benefit to investing in the "growth" stock sector of the common stock universe.

INDEXING WITH MUTUAL FUNDS

It would appear that indexing with mutual funds or with variable annuity sub-accounts is even less advantageous than indexing with a portfolio of common stocks. Not only is one denied the opportunity to modify either the quality of his portfolio or its potential for growth, but he is also burdened with a built-in performance handicap or "efficiency shortfall," as documented in the following table:

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Series	Average Annual Total Return for Periods Ending December 31, 1998					
	1 Year	3 Years	5 Years	10 Years	15 Years	20 Years
Standard & Poor's 500 Composite	**28.34%/yr.**	**28.15%/yr.**	**24.02%/yr.**	**19.13%/yr.**	**17.78%/yr.**	**17.63%/yr.**
Mutual Funds Indexed to S&P 500	**27.41%/yr.**	**27.12%/yr.**	**23.10%/yr.**	**18.29%/yr.**	**16.45%/yr.**	**15.95%/yr.**
Shortfall	**0.93%/yr.**	**1.03%/yr.**	**0.92%/yr.**	**0.84%/yr.**	**1.33%/yr.**	**1.68%/yr.**
Variable Annuities Indexed to S&P 500	**26.69%/yr.**	**25.88%/yr.**	**21.83%/yr.**	**17.09%/yr.**	**N/A**	**N/A**
Shortfall	**1.65%/yr.**	**2.27%/yr.**	**2.19%/yr.**	**2.04%/yr.**	**N/A**	**N/A**

Source: CDA/Wiesenberger

As can be seen, the average mutual fund indexed to the Standard & Poor's 500 has underperformed its index by about 1 1/2% per year, and the average variable annuity indexed to the S&P 500 has underperformed its index by about 2% per year.

The sources of these shortfalls include the administrative expenses associated with operating the fund, as well as "market impact" costs associated with the buying and selling of securities necessary to track changes in the index and to accommodate investor cash flows into and out of the fund. "Market impact" costs are the price penalties to which institutional investors are subject by virtue of the large blocks of stock they must trade when they buy or sell.

A chronic 1 1/2% or 2% per year performance shortfall may seem less burdensome in a stock market that has delivered average annual rates of return in excess of 20%. If and when the markets revert to their more typical 10% to 12% rates of return, and after adjusting for taxes and inflation, however, 1 1/2% or 2% deducted from one's total return, year-after-year, can detract considerably from the after-tax, inflation-adjusted return one earns on his money over a long span of time.

Another Analogy

Indexing may be compared to trying to duplicate the lifestyle of the Joneses. We might try to do everything the Joneses do - no more, no less. When the Joneses paint their house green, we paint our house green; when they buy a new car, we buy exactly the same kind; and, when they take a trip to the Caribbean, we take one also, at the same time and for the same duration. We forgo the possibility of having an experience more gratifying than any the Joneses have in an effort to minimize the possibility of having an experience less gratifying than any they have. As

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copycats, however, we are never quite able to keep up with the Joneses. They get their house painted and their car purchased before we know what they are up to; and they get a better price on their tickets to the Caribbean because they are able to purchase them farther in advance. Such is the lot of the indexer, as the data in the foregoing table and a mountain of other evidence so clearly demonstrate. In an effort not to underperform, the indexer pursues mediocrity, foregoes the opportunity to outperform, and, in the process, of necessity, underperforms, nevertheless.

By definition, half of all common stock investors who try, will outperform the average. Endeavoring merely to be in the upper half of any competition ought not be regarded as an overly ambitious goal. The indexer, however, even in that modest pursuit, surrenders before he starts.

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