

Blind Faith?

BY EDWARD VON DER LINDE

With index fixation fraught with investing misconceptions, cash-stuffed ETFs magnify passive risk.

While index investing and its younger cousin, the exchange traded fund (ETF), may be more popular than ever, we believe it's time for investors to examine their faith in this trend. After all, these products don't truly invest; they "participate." They also are not the passive market-tracking instruments that their makers claim. In most cases, index investing involves throwing money at a basket of stocks that has been performing well lately. But buyers don't realize that they're getting a product of human design and judgment that is specifically designed to draw money and generate a large volume of trades.

Take Standard & Poor's, creator of the popular S&P 500® Index,¹ among others, which has attracted more than \$1.2 trillion in direct investment and, in our opinion, exerts inordinate influence on the market. Like most other indexes, the S&P indexes are designed, constructed, and maintained by people making a series of subjective judgments. Furthermore, the decisions they make to include or exclude a company's stock from one of their indexes has an immediate impact across a broad swath of the market.

The trouble is, this process demolishes the notion that index products are true market representations. Any index must be constructed, thereby emphasizing some aspect of the market over another. The most popular methodology today is capitalization-weighted equity indexes—a trend that belies the primary objective of those who create and sponsor indexes, which is to create the most efficient asset-gathering mechanism possible. Their objective is not, however, to generate wealth for their investors.

Index investing grew significantly during the 1990s, accelerated by the bull run in U.S. stocks. Retirement savers saw index funds as a way to potentially capture the market's upside, attracted also by the product's low cost and relative simplicity. In addition, much of the media, as well as quite a few academics, were very strong and vocal proponents of indexing.

But stocks don't go up forever—a painful lesson many investors learned in 2001. It was an especially rude awakening to index fund investors, whose investments had zero flexibility to take shelter from any substantial market correction. Some newer investors had never before lost significant money in the markets. In general, mutual fund investors who had the benefit of real live people actively managing a portfolio of securities fared better than index fund investors in the 2001-2004 time period.

EXCHANGE TRADED FUNDS GAIN PROMINENCE

Despite those difficult lessons, the indexing strategy continues to flourish. Savers still pour billions of dollars into traditional index mutual funds, and increasingly are turning to exchange traded funds, which invest similarly to index funds, but can be traded intra-day, like stocks or closed-end funds. Between January 1, 2004, and the end of May 2006, \$131.7 billion flowed into ETFs, according to Lipper, Inc.

Exchange traded funds and other index-like vehicles have become so prominent that they hold significant influence over large portions of the market. As investors flood these products with new cash, they are driving up the securities within the index. This creates something of a self-fulfilling cycle, whereby some outperformance results in index products inundated with new cash, and the influx of buyers keeps driving higher the securities in the index.

But this is the same type of scenario that led investors off a cliff about five years ago. The problem with a "me too" mentality in financial markets is that, historically, when people keep piling into a particular investment theme, it drives up prices, setting the stage for an ugly reversal that can't be seen until it is too late.

ETFs, perhaps even more so than traditional index funds, stand in stark contrast to the principles of fundamental investing. Rapid money flows have also skewed market valuations in some instances, and the instruments are very popular among the market-timing set.



This is partially true because ETFs can be shorted, even on a downtick, which is something that can't happen to a traditional mutual fund. In their design and construction, ETFs are backward-looking rather than an attempt to predict future results. ETFs can't perform analysis, such as assessing management's plan for improving profitability. In general, ETFs involve no investing insight.

CREATED BY EXCHANGES, FOR EXCHANGES

Setting aside the critique for a moment, an overlooked truth about exchange traded funds is that they greatly benefit the stock exchanges that design or sponsor them. AMEX designed the first ETF in 1993 with its SPDR (which tracks the S&P 500), stating that the idea was to give people exposure to a large part of the market in a single investment. But because they can be traded intra-day, and often focus on one slice of the market, they facilitate frequent trading, which generates revenue for the exchanges that built them. In addition, ETF trading triggers transactions in the securities that comprise the index the ETF tracks, creating a second payday for the exchange and the brokers and dealers who facilitate the instrument. AMEX isn't paid by long-term, buy-and-hold investors—it is paid when people make trades.

Index products also feed off a herd mentality among investors. Whatever the "hot" trend, someone always seems to roll out a new ETF that lets traders ride the wave. Essentially, ETFs are a way to track emotional movement in the marketplace.

ETFs STUFF SMALLER CAP INDEXES WITH CASH

Over the past few years, the influence of ETFs has spread from the larger capitalization indexes, such as the S&P 500 or the Dow Jones Industrials, to the smaller

capitalization parts of the market. Frank Russell & Associates (owned by Northwestern Mutual Life) designed a number of ETFs to mimic their benchmarks, as has Morningstar. And in contrast to their larger capacity brethren, large inflows of money can have an exaggerated effect on many of these newer products because small cap and mid cap stocks are less liquid than large caps.

As new cash inflows boost the securities in the index, they also make ETFs an increasingly difficult benchmark for active managers to beat. If much of the new cash coming into a part of the market goes into an index, it becomes harder to buy stocks outside of the index that investors would typically award a higher price multiple.

Perhaps even more important, as money flows into ETFs, it will drive performance, encouraging even greater flows. Ultimately, as has happened many times before, these inflows will bloat whichever sector of the market is "hot," with the smaller parts of the market even more prone to exaggerated performance. Unfortunately, index designers have shown no inclination to close a product due to capacity or the need to maintain investment integrity (remember, these are not investment vehicles; they are only a way to "participate" in the market). Index makers, exchanges, and other players in the ETF marketplace won't shut these products because they're too lucrative.

The ETF trend also has the potential to distort how companies raise capital. Stocks within a "hot" index product can easily raise capital at low cost because, if they were to issue more stock, the index products and money managers trying to mimic them would be compelled to participate in the offering. Companies held widely in indexes would have an unusually large, built-in audience for new stock issuance.

THE COMPUTER AGE INTRODUCES INDEXING

The advent of computers is what actually made index investing possible. The S&P 500 Index, for instance, had existed for some time before it became a buyable product, but it couldn't be bought because no one could effectively capture and package the index. Index returns were only calculated weekly, while companies' weightings were adjusted just once a month. But computer technology changed that by making it possible to replicate and price daily a variety of indexes.

One misconception, among others, about indexes is that they represent "the market." An index such as the S&P 500 Index does not come close to representing the entire U.S. market; it merely is (S&P parent) McGraw Hill's take on the market and a way of defining an investment concept, which McGraw Hill licenses to money managers for a fee. Subsequently, it is much more of an arbitrary piece of the market than the market itself. There is no agreement on what constitutes "the market," so when academics say an active manager who charges a fee can't beat the market, they are at best partially correct, because they fail to define the market. No current index fund or ETF truly represents the market.

The S&P 500 is a market cap-weighted index of 500 large U.S. companies. The companies in the index are selected by a committee based on a set of fairly vague and unspecific parameters, but specifically, according to Standard & Poor's, "are not chosen because they are the largest companies in terms of market value, sales, or profit. Rather, they tend to be the leading companies in leading industries within the U.S. economy." As stated, the benchmark is market capitalization weighted, which means that the impact of each stock within the index is proportional to the total market value of



its shares. As a percentage of the total, the index includes only 70 percent of the market. That is hardly an accurate representation of “the market.”

FINANCIAL INDUSTRY EXPLOSION AIDED BY INDEXING

Perhaps a more significant development in the indexing culture than the computer replication of indexes has been the explosion of the financial services industry in the past three decades. In the 1970s and part of the 1980s, financial services companies were something of a backwater—sleepy companies that were closely held by family ownership. But bank disintermediation and the rise of 401(k) plans and other savings-friendly trends sent trillions into financial institutions.

Clearly, the resourceful people at these financial companies needed ways to capture assets, so index funds were positioned as a low-cost, efficient way of getting market exposure. What’s more, they are blame-free: if the investment loses money, it’s not the financial institution’s fault; it’s the market’s fault, since these passive investments merely track the market.

CASH “SPONGE” COULD FOSTER MARKET MIEDIOCRITY

The indexing and ETF trends have profound implications for the investment management business, as well as for financial markets as a whole. With index products so ubiquitous and now fragmented into so many parts of the market, indexing has become a huge sponge for cash. But having popular indexes so laden with assets could eventually create widespread mediocrity in returns, with no discernable difference between a large cap value and a small cap growth index. If the indexes were stuffed and investors felt they had nowhere else to go, the market would probably stag-

nate because all the money would flow into the same places in the same style.

Imagine the market saturating the indexes, making any significant gains unlikely. In that situation, stock selection based on the underlying company’s business prospects—and management’s willingness to pay out the profits to shareholders in one form or another—would be the primary mode of making money.

LAST INVESTORS STANDING MAY REAP REWARDS

As more and more fundamental investors give up their convictions and buy into the index investing mentality, die-hard value players may still want to buy a stock that is not in any index, has low profitability and cash flow, but has a way to improve these metrics.

With most of the market mired in index products, there wouldn’t be enough buyers for the stock as the company improves. The only thing for the improving company to do to potentially move its stock price would be to pay out dividends or buy back shares. The true-believing shareholders would then be paid by the company they own, but the indexers wouldn’t.

Our investment process is enlivened by the belief that wealth is built by investing in the stocks and bonds of companies that have the possibility and plans to improve their profitability. But how could an investor discover this in an index? How would a “passive” vehicle ever capture the dynamics of human endeavor? Yes, indexes and their ETF cousins are a way to gain exposure within a short period of time, but that should not be a consideration for a thoughtful investor.

The implicit assumption a buyer makes when participating in an index product is that the market will take care of his or her money; there is neither assessment of the future potential of the

underlying companies nor is there even a possibility of evaluating the investment strategy, simply because there is none.

FUNDAMENTAL RESEARCH HAS ENDURING VALUE

At Lord Abbett, we believe investing is a “craft” business. In part, this means providing a time-tested investment discipline practiced by skilled and experienced professionals. But if we were making furniture, for example, the indexing trend would represent a transfer from building pieces by hand to automated mass production. When this happens, money management becomes less about analyzing businesses and much more about money flowing into whatever is “hot” at the moment.

Unlike in indexes, where price moves of a broad range of stocks determine results, in managing the Lord Abbett Mid Cap Value Fund, we invest in companies that try to improve their profitability, improve cash flows, and demonstrate a commitment to pay shareholders through dividends or by buying back shares.

As one of the oldest money management firms in the United States, Lord Abbett strives to build wealth for our investors and clients. We must continue to stand above the fray, avoid becoming involved in trading vehicles, and adhere to our craft of managing money. Our job is to build portfolios using prudent financial analysis and judgment that will serve clients and investors well for the long term. We offer investment vehicles, not products, and believe that the two are not synonymous.

What will continue to drive the popularity of ETFs is similar to what drove the S&P 500: the mentality that you have to be “in it to win it.” That’s actually a lottery mentality, or a trading mentality at best. We’re not traders; we’re investors. ■



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Notes:

Exchange-traded fund (ETF): An investment company, typically a mutual fund or unit investment trust, whose shares are traded intraday on stock exchanges at market-determined prices. Investors may buy or sell ETF shares through a broker, just as they would the shares of any publicly traded company.

Index fund: A mutual fund designed to track the performance of a market index. The fund's portfolio of securities mirrors that of the designated market index.

Mutual fund: An investment company that buys a portfolio of securities selected by a professional investment advisor to meet a specified financial goal. Mutual fund investors buy shares in the fund that represent ownership in all the fund's securities. A mutual fund stands ready to buy back its shares at their current net asset value, which is the total market value of the fund's investment portfolio, minus its liabilities, divided by the number of shares outstanding. Most mutual funds continuously offer new shares to investors.

¹ **S&P 500[®] Index:** Widely regarded as the standard for measuring large cap stock market performance, this popular index includes a representative sample of leading companies in leading industries. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

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