Index Funds and Index Rebalancing

By Michael Kemp

This is a story of two Americans, one still living and one who died over 100 years ago. It's about what they created and the impact their legacy has had on the way we all invest today.

The World's Oldest Stock Index

The first American was a man called Charles Dow. He might have died back in 1902, but his name is still repeated thousands of times every single day in countries all around the world. Dow created what has become the oldest stock market index still in use, the Dow Jones Transportation Average. The second oldest, also created by Dow, you probably know better. It's the Dow Jones Industrial Average, more affectionately known as *The Dow*. Dow first calculated his industrial index back in 1896. It then stood at 40.94 points!

Dow created his indices so he could study how the whole stock market was travelling at any point in time. To distil disparate share prices into just one "snapshot" figure. And that's pretty much what we use indices for today. Well, there is one other use now, a use which Charles Dow wasn't thinking about. This leads me to the second American in our story.

The Birth of Index Funds

John Bogle was a student at Princeton University back in 1949. Like many students he was faced with a problem - he had to come up with an idea for his University research paper. He decided to study the investment returns being achieved by professional fund managers. He found that, when considered as a group, they failed to outperform the broad index after deducting their fees. He figured that since the index could be reproduced without undertaking any form of financial analysis it would be far simpler to run a fund which aimed to match the index rather than beat it. All John Bogle had to do was buy the same stocks and in the same proportions that made up the stock index he was aiming to match. John Bogle ended up forming the Vanguard Group in 1974 and with it he started the whole game of Index Funds.

Let's now bring the story back to the here and now. And more importantly, back to Australia. We have two popular broad based stock indices of our own: the S&P/ASX 200 Index and the ASX All Ordinaries Index. The S&P/ASX 200 Index contains roughly the 200 largest companies as measured by market capitalization. I say roughly because it is a dynamic number. The ASX All Ordinaries Index contains the largest 500 companies. Both are broad based indices. The S&P/ASX 200 Index covers approximately 80 percent of the Australian stock market by capitalization; while the ASX All Ordinaries Index covers about 95 percent. A portfolio containing the same companies they contain is similar to investing in every company listed on the Australian stock market.

Index Rebalancing

Based on John Bogle's lead there are now plenty of index funds around. It's also spawned the popular index tracking Exchange Traded Funds (ETFs). All provide a *set and forget* form of investing for investors. But it's not that way for the group who actually manages the index-based portfolio. Activity is required from their end to keep the portfolio in sync with the index they're tracking.

That's because the companies included in an index change. Remember Charles Dow's original index?

Today only one of the companies in Dow's first index calculation remains (General Electric). This happens because businesses change. Their share prices can fall if they become less profitable. Some are taken over by other companies. Some just go out of business altogether. Stock indices live and die according to Darwin's guiding principle of survival of the fittest. Only the big and the strong survive, for a while at least.

So both the indices and the portfolios which track them require periodic tweaking. Consider also that the S&P/ASX 200 Index and The ASX All Ordinaries Index are weighted according to market capitalisation. That means they are constructed taking into consideration the size of each constituent company. The bigger the company the bigger the proportion it makes up of the index. Which means a percentage shift in the price of a big company impacts the index more than that of a small one. It makes sense because more investors own and watch more closely the share prices of companies like BHP and CBA than companies like Atlas Iron and Acrux Limited.

This periodic index tweaking has a name – index rebalancing. The frequency with which index rebalancing is undertaken differs for different indices. But for the S&P/ASX 200 Index and the ASX All Ordinaries Index it is four times a year, on the third Friday of March, June, September and December. Announcement of the changes is made a couple of weeks earlier.

Can you profit from Index Rebalancing?

One should never forget why people read these articles; they are looking for an edge. So the question is, can you profit from the index rebalancing process?

Intuitively you'd think so. Think about a company that's sitting at the 201st position by market capitalization. Not big enough to be included in the S&P/ASX 200 Index. So it is a stock which the index funds chasing S&P/ASX 200 Index returns don't own. But this stock is knocking on the door of the big league; a bit like the kid who's aiming to get into the footy team. To make the grade he either needs to start playing better or someone in the team needs to break a leg.

Can you profit from buying this stock in the hope it does eventually make the grade and because the index fund managers are then forced to buy it? After all, you know what happens to a company's share price when there's plenty of dollars chasing a limited amount of stock.

Before you get too excited it is worth remembering that making the grade for one index might mean the stock is getting cut from another. For example when it's finally big enough to become part of a major index no longer will it be included in a small or mid cap index. So it's a bit of a dynamic process. How many small cap funds are there? How many big cap funds? And how will their combined portfolio adjustments impact on each of the stocks concerned?

It's also worth remembering there are professional stock strategists out there playing the same game. The following US job posted on the web last year clearly demonstrates the point. As a key responsibility of the position being advertised it required:

… researching the rules of major indexes, monitoring when those indexes rebalance their constituents and trading any inefficiencies

These guys will be quicker on their feet than *Mum and Dad* investors. They'll also be punting with bigger fistfuls of cash. That all means arbitrage opportunities will be closing up pretty quickly if ever they appear. So it all sounds good in theory but I'm not sure this is something you should be trying at home.

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But if you do it definitely wasn't me who told you about it.

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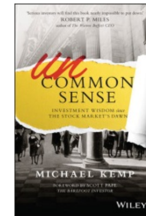

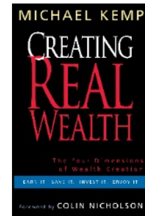

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Michael Kemp is the chief analyst for the Barefoot Blueprint and author of "Uncommon Sense". Published under the Wiley label "Uncommon Sense" delivers a deeply considered and logical approach to the otherwise complex world of investing.