Elizabeth Tammaro: “Could you please discuss the pros and cons of market capitalization weighted index funds versus equally weighted index funds?” And, Walter, I’m going to let you take that one.

Walter Lenhard: Sure. No, it’s a very interesting question because most of our indexes are really market-cap weighted, but the first index fund that was ever created was an equal-weighted index. And, conceptually, you could appreciate, the logic with an equal weighted is you’re just buying every single security in the exact same weight.

The challenge is you’ve got to rebalance that. And the frequent rebalancing increases your transaction costs and increases your capital gains. So it’s a lot more challenging to actually incur those expenses and match the performance of the index. And that’s really the beauty of the market-cap weighted index is we own the exact same weight that’s in the portfolio. So Apple is the biggest company these days. It’s about 3.5% of the S&P 500. So we own 3.5% in the portfolio. And if Apple goes up 10% or down 20%, we don’t have to do anything because our portfolio is going to move in perfect lockstep with the index. So we don’t have to trade based on inner movements of those companies.

And if you think about the success for indexing, it’s low cost, diversification, risk control. But the second level there is it’s also low turnover, low transaction costs, and low capital gains realizations. And the market-cap weighted indexing allows you to follow that, to minimize the turnover, minimize the capital gains.

So if you go to any other alternative construction methodology, whether it’s equal weighted or fundamental weighted, you’ve got to have a higher turnover, higher transaction costs, and higher capital gains. That’s the reason we so strongly believe in market-cap weighted.

Elizabeth Tammaro: So then defeating some of the purpose of the indexing, right?

Walter Lenhard: It’s a little bit more of a hybrid between market-cap weighted indexing and active management. It’s a little bit, but it has an active bias to it.

Elizabeth Tammaro: Okay. “What is your opinion of smart beta? Is it still indexing or should it be considered an active strategy?” And before you get into smart beta, I’m just going to have you also describe what beta is.

Walter Lenhard: Well beta really just represents—it’s a fancy academic term that you rank your relative performance versus the stock market. So if the stock market’s up 10% and you have a beta of 1, your portfolio is going to be up the exact same amount.

Elizabeth Tammaro: Okay, so measuring the market.
Walter Lenhard: Yeah, if you’re a higher beta product, you’re going to go up more than the market; if you’re a lower beta product, you’re going to go up a little less than the market.

Elizabeth Tammaro: Okay.

Walter Lenhard: So the market-cap weighted index funds really represent a beta of 1 to these different markets, so we’re just trying to provide the market-like returns. And, as I mentioned, indexing products have taken about a third of all the market share away from active managers. So there’s been a trend recently to come up with the next best thing—better than market-cap weighted indexing—and people are trying to sell this smart beta approach to indexing and they’re implying that it’s better than indexing.

And our view of it is it’s slightly different than indexing and there are some factor exposures associated with these smart beta products, so.

Elizabeth Tammaro: So what do you mean by a factor exposure?

Walter Lenhard: So if you look at the returns, if you segment the stock market, you can segment it by large-cap, mid-cap, small-cap. You can look at growth segments and value segments. And if you look at the performance of the overall stock market for the last 20 or 30 years, you see slight outperformance by two segments. One is small-cap names seem to outperform mid and large, and you also see the value segment seems to outperform the growth segment by a small amount.

So these smart beta products have tilted the construction methodology of the index to give you a little bit of an exposure to small-cap names and value names, more so than the market-cap weighted index.

Elizabeth Tammaro: Okay.

Walter Lenhard: And then they can look at that actual performance over the last 20 years and say, “Look, you get some extra return from smart beta products.” But it’s our belief that that’s just because of the exposure to small-cap and value and you could actually construct market-cap weighted indexes using some of Vanguard’s market-cap weighted small-cap indexes or value indexes to provide the same type of return.

So, in general, what you’re getting with the smart beta product is slightly higher expenses, slightly higher transaction costs, and higher capital gains realizations.

Scott Donaldson: That’s a lot of good points and it’s funny, you know, Walter just mentioned you could possibly, in a way, construct these factor exposures or these tilts to, whether it’s small value or mid value, whatever the case it is, and construct that fundamentally weighted index by using market-cap weighted products. But I also see this occur when people believe in these factors as, again, it’s an active type of a decision to do this, is some investors choose to get this exposure via actual true active funds. They’ll buy a large value manager or a small value active manager at even a higher expense ratio.

So if you’re actually going to try to implement some of these active bets, you know, choosing even a fundamentally weighted index to do it versus a higher cost active fund—again, understanding the risks and the exposures that you’re getting there—you can do it at a much lower cost. So that’s one way that these two types of indexing methodology, so to speak, can work well together.
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