

What do index funds really hold?

Passive index funds generally have lower management fees because they are not actively managed. Index fund managers maintain appropriate stock weightings to match index holdings. But many advisors don't consider carefully the composition of the indexes.

In general, companies within a stock index are not equally weighted. Because most indexes are market-cap weighted, a handful of the largest stocks in the Standard & Poor's 500 Index hold a great deal of influence on benchmark performance. For example, if all 500 stocks in the S&P 500 Index were equal-weighted, which they are not, Exxon Mobil Corporation would make up 0.20 percent of the index, but with a 3.54 percent position as of June 30, it is actually overweight by about 18 times. Do you have enough research to advise your clients to actively overweight Exxon in their portfolios?

The largest market cap stocks control the index. As of June 30, the 10 largest stocks in the S&P 500 (based on market capitalization weighting) made up 19.29 percent of the index, with 490 stocks



making up the other 80.71 percent. Furthermore, based on market capitalization, the 50 largest stocks in the S&P 500 made up 48.49 percent of the index, meaning approximately half of an investment in an S&P 500 index fund would be in only 50 stocks. Do your clients realize indexes can be so concentrated?

Indexes are not equally weighted by sector or industries. Some industries, such as technology distributors, had absolutely no representation in the S&P 500 Index as of June 30. When reviewing sector representation of the top 20 stocks in the index, there was not a single company from the Consumer Discretionary, Materials or Utilities sectors. Should your clients' portfolios ignore entire sectors of the economy?

AN UNCONSCIOUS STYLE BET

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investors may unwittingly assume a style of investing over which they have no control.

Core holdings should be in the hands of active managers who use a disciplined system to invest in select stocks, sectors and industries. Going with the herd by investing in indexes may allow some investors to sleep soundly at night, but I believe it's a strategy that may be inconsistent with many investors' long-term goals.

Our research supports the notion that investment managers should have the freedom to invest anywhere in the market and not be subject to the vagaries of a passive index.

Craig Callahan is founder and president of ICON Advisers in Greenwood Village, Colo. For more information on the subject, call (800) 828-4881 to request ICON's full study titled, "Relying on a system: An active discipline can complement passive investing strategies."

Index fund – What to watch out for

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Past performance does not guarantee future results.

The unmanaged Standard & Poor's (S&P) 500 Index is a market value-weighted index of large-cap common stocks considered representative of the broad market. Individuals cannot invest directly in an index.

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