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John Bogle and his revolutionary S&P 500 index fund used to be the king. But upstart ETFs want to grab the crown.

The New Indexing

by Reshma Kapadia

Index investing is in the midst of an identity crisis. When John Bogle launched the first index fund 38 years ago, it was intended as a common-sense, cheap way for individuals to invest in stocks. The Vanguard 500 Index was not intended to beat the market, but simply ensure investors didn't get left behind.

A lot has changed since the mid-1970s, and index investing has morphed from an oft-criticized novelty to the strategy of choice for countless individual investors, financial advisors, and institutions. Index funds themselves have undergone an even more radical change—so much so that the meaning of "index" has been stretched to the point of incomprehension.

Indeed, index investing has become so popular that an entire industry has emerged, borrowing the term "index" and its accompanying halo of investor-friendliness as an umbrella term for a variety of strategies that have much in common with active management. Call it clever marketing, dismiss it as semantics, or express outrage at the word's corruption, but the term "indexing" simply doesn't mean what it once did. So much so that this renaissance of so-called indexing sets up investors with a complicated array of products, many of which carry higher costs and aggressive bets, and require a lot more scrutiny.

The first indexes—the Dow and the S&P 500—were designed to measure and represent the broad market more than 50 years before they became investible via mutual funds. Over time, other indexes were created to represent more specific parts of the market—particular sectors, companies of a certain size, other asset classes, and foreign markets.

Today, though, indexes are not so much about measuring the market, as they are about beating it. Most new indexes these days are created with the sole purpose of building an investment product around it. "Now it's about doing better than the market," says Ben Johnson, director of passive funds research at Morningstar. "We have gone from the realm of benchmark creation to the realm of fabricating investible strategies."

Small wonder, given the money at stake: As of the end of February, 372 index funds managed nearly $1.8 trillion in assets, more than double what was invested in 2008, according to the Investment Company Institute. That doesn't even include the rise of exchange-traded funds in that time—an industry that now commands $1.7 trillion in nearly 1,300 funds linked to some kind of index, more than three times 2008 levels.

All index funds, by definition, are passive investments. There's no manager making trading decisions; all buying and selling is done according to a strict set of rules. Traditional indexes were designed to represent the market and serve as a benchmark, and as such they typically weighted stocks or other securities by size—the stocks with the biggest market value or the largest amount of debt made up a larger portion of the index. These new index funds—called smart beta, strategic beta, fundamental, alternative, advanced, enhanced, and probably a few other monikers—veer from the market-value orientation. And that doesn't sit well with purists. "Market capitalization is the market consensus; if you believe you can do better by not following that view, that's a judgment call," says Joel Dickson, senior investment strategist at Vanguard. These funds are "blurring the lines by putting active bets into the index construct. It's the co-opting of the term indexing."

Most of these new indexes are packaged as exchange-traded funds—some 350 ETFs versus just 47 mutual funds—but this is not a product war. It's a matter of strategy, and, to an extent, semantics. But whatever you call this new breed of indexing, they all have one thing in common—they turn the conventional wisdom of indexing on its head.

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Going Boldly Forth Into the New (Alternative) Universe

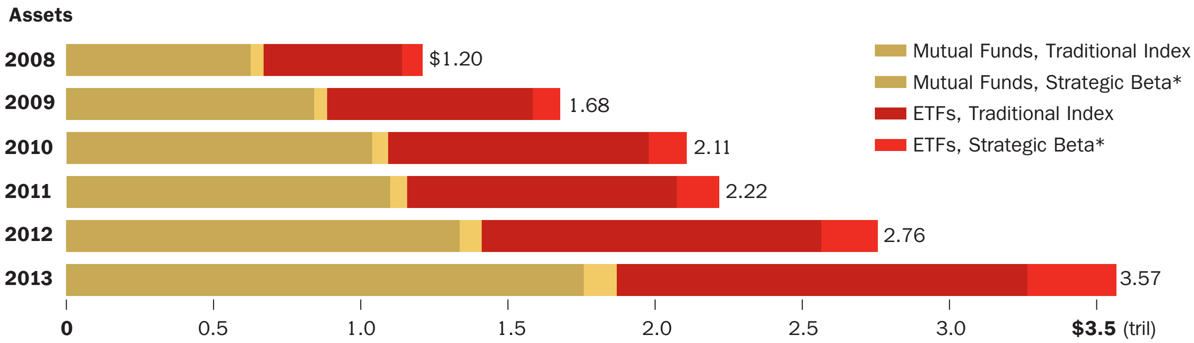
Investors can choose among multiple strategies in this realm. Here are six to consider.

Fund Name/Ticker	AUM (bil)	5-Yr Return	Expense Ratio	Comment
Invesco Equally-Weighted S&P 500 /VADAX*	$2.4	24.0%	0.57%	Beaten S&P 500 by four percentage points a year over last 15 years.
GreenHaven Continuous Commodity/GCC	0.35	4.6	0.85	Invests in 17 commodities equally, rebalances daily.
Schwab Fundamental US Large Company/SFLNX	3.6	23.8	0.35	Beaten S&P by almost four percentage points over last five years.
PowerShares Fundamental High Yield Corporate Bond/PHB	0.65	12.2	0.50	Has lagged other high-yield funds recently, but favored by those wary of rising rates and high-yield euphoria.
PowerShares S&P 500 Low Volatility/SPLV	3.8	13.2**	0.25	No constraints, more sector bets;nearly three years old.
iShares MSCI USA Minimum Volatility/USMV	2.5	13.6**	0.15	Sector constraints, hews closer to the S&P 500 than SPLV, just two years old.

* Charges 5.5% front-load charge. **One-year returns.

Source: Morningstar

Index funds have grown steadily, with ETFs and alternative index funds taking up a bigger and bigger chunk of assets.



*Morningstar defines strategic beta as anything that is not a traditional capitalization-weighted index.

Source: Morningstar

Today's alternative index funds apportion their holdings according to a host of factors other than market value in an effort to beat the market and boost diversification. Many take fundamental metrics such as cash flow and dividends into account; others look at volatility, some use a combination.

Some of these funds have beaten traditional index funds in recent years. But most have yet to be tested through a full economic cycle, and all require more effort in determining how to use them in a portfolio. "You have to be willing to be contrarian and underperform for periods of time—sometimes years," says Chris Brightman, head of investment management at Research Affiliates, a pioneer in alternative indexing.

The argument for alternative indexing is compelling: By weighting securities by market value, the index tends to overweight larger stocks, which may be overvalued, and slight those that are smaller and have lagged. It also can result in a concentrated portfolio—like when Apple got so big in 2012 that it made up 5% of the S&P 500. "You think you are holding something neutral but are instead holding a tilt to large-cap and growth stocks," says Lionel Martellini, a finance professor at European business school EDHEC. "Research has shown that it is the wrong tilt; value and small-cap stocks have a higher return."

That resonates with investors. Fund consultant Towers Watson's institutional clients doubled investments in these alternative index strategies last year to about $11 billion. Advisors say they are using these alternative index funds as a complement to traditional index funds, often using them to replace actively managed funds. Retail investors are pouring money in, with $82 billion—or a quarter of all flows into ETFs and index funds last year—going into funds that Morningstar identifies as strategic beta. In total, there is $563 billion in what Morningstar loosely calls strategic beta.

The most popular alternative index funds come in three iterations—those that equal-weight securities, those focused on volatility in hopes of a smoother market ride, and fundamental indexing, which chooses companies according to their financial strength, using metrics such as sales, cash flow, book value, and dividends.

Towers Watson consultant Fabio Cecutto favors broad versions of these strategies—a low volatility fund for all U.S. stocks, for instance, or a fundamental strategy that uses multiple metrics, since each has its shortcomings. Perhaps the most important trait, however, is cost—transaction costs can be higher since alternative index funds trade more than traditional ones. And annual expenses can be higher, too: The average expense ratio for strategic beta ETFs was 0.49%, according to Morningstar, five times higher than some of the biggest broad-market index funds, though less than active management. Yet some ETFs charge double that.

To sort through the pros and cons of alternative indexing, Barron's talked to analysts and fund consultants to find funds that represent the still-evolving alternative indexing world.

The simplest version of alternative indexing is equal weighting, an approach EDHEC's Martellini describes as "a very safe and natural starting point" for better diversification. It works just as its name implies; every member represents the same percentage of the index. An equal-weighted S&P 500 fund, such as the Guggenheim S&P 500 Equal-Weight ETF (ticker: RSP) or the Invesco Equally-Weighted S&P 500 fund (VADAX), dramatically reduces the impact of the 50 largest stocks, which have a 97% correlation with the S&P 500's returns. An equal-weight approach has an 84% correlation with the S&P 500. These funds typically have more smaller companies and tend to be more volatile than the benchmark indexes, moving higher when the market is on a tear, and falling further when it is tumbling.

As a result, the Guggenheim S&P 500 Equal-Weighted ETF's turnover is four times that of the S&P 500, but over the past decade it has beaten the index by two percentage points annually. While the $2.4 billion Invesco fund has a distressing 5.5% front-end fee, it's an option for those who prefer a mutual fund; it has beaten the S&P 500 by an average of four percentage points annually over the last 15 years, according to Morningstar.

The same approach can work with commodities. Most market-weighted indexes rank commodities by economic size, leading to a heavy helping of energy. For a more diversified fund, Michael Conway, head of Conway Wealth Group at Summit Financial Resources, favors the $350 million GreenHaven Continuous Commodity exchange-traded product (GCC), which allocates equal amounts of money to 17 commodities. The result is one of the biggest allocations to agriculture among diversified funds and lighter oil exposure, which can damp volatility. The fund is structured as a commodity pool, which triggers extra tax steps, and it rebalances daily, which adds to trading costs. But over the past five years, the fund has beaten its equal-weight benchmark by 1.4 percentage points a year and ranks in the top 40% among all of commodity funds.

Fundamental indexing is what's most commonly meant when talking about alternative indexing. Much of their popularity stems from the success of the fundamental indexes created by Wisdom Tree and Research Affiliates. The latter manages $121 billion, with firms such as Pimco, Schwab, and PowerShares licensing its indexes, and its founder, Robert Arnott, has emerged as the new face of indexing. Executives at Research Affiliates have kind words for Bogle, but call the old definition of indexing "antiquated."

Research Affiliates' funds often have a small-company or value tilt, but can look very different than their actively managed counterparts. The $3.6 billion Schwab Fundamental US Large Company Index (SFLNX), for instance, weights securities based on cash flow, sales, dividends, and stock buybacks, which means it tends to hold more technology companies than traditional large-company value funds. The fund also adjusts sales downward for debt-laden companies, which means fewer financial-services companies than the average value fund.

Over the last five years, it has returned an average of 24% a year, putting it in the top 2% of Morningstar's large-value category, and besting the S&P 500 by about four percentage points. It's more volatile than a capitalization-weighted index, but less than most equal-weighted funds.

While not yet as common, fixed-income fundamental indexes make a lot of sense, as many people—Bogle included—believe the existing bond indexes are flawed and not representative of the investing opportunity, since the government owns so many of the bonds in the index. Plus, in a traditional bond index, the most indebted countries and companies—often those in a weaker financial state—get larger weightings. Fundamental indexes instead weight bonds based on economic measures, such as the ability of the country or company to pay its debt.

The biggest fundamental bond fund is the $648 million PowerShares Fundamental High Yield Corporate Bond fund (PHB). It takes less credit risk than funds tracking a traditional index, which means a lower yield and missing out on some of the upside. Over the last five years, it has returned an average of 12%, two percentage points less than the high-yield bond average, as lower-credit companies have done well in recent years.

Low volatility funds now have $11 billion in assets, thanks to investors' postcrisis skittishness coupled with a desire not to miss out on the bull market.

Though they've outperformed recently, investors should expect equal or slightly lower-than-market returns, but with less volatility, over the long run, Cecutto says.

As with all these funds, analysts stress the importance of looking past the broad concept to examine how the fund is rebalanced, according to what criteria, and whether there are any parameters. For example, the $3.8 billion PowerShares S&P 500 Low Volatility (SPLV) fund has no constraints limiting its sector bets, which can lead to heavy concentrations at times. Every quarter the index identifies the 100 lowest-volatility stocks based on the previous 12 months, and weights them accordingly. Its lack of sector constraints, says John Feyerer, vice president of ETF product management at PowerShares, makes the fund more agile and avoids areas that become too volatile. Over the past year, the nearly three-year-old fund has captured 68% of the market's rise and fallen about 10% less when it's declined, with a total gain of 13%.

If you're looking for a fund with more diversification, the iShares MSCI USA Minimum Volatility (USMV) does not allow for more than a 5% under- or overweight in a sector versus the benchmark index. The iShares fund has 8% in utilities while PowerShares has three times that. Its approach is a bit more complicated than PowerShares' fund, taking into account stock correlations, rather than just targeting those with the lowest volatility. "If it's a replacement for a core equity exposure, you probably don't want the sector risk, and would want a fund with constraints," says ETF.com's Paul Britt, stressing that it really depends on what investors are using the fund for.

Over the past year, the fund has returned 13.6% compared with the S&P 500's 24.2% and 20.3% gain for Morningstar's large-value category. During the past year, the fund captured about 68% of the market's upside and acted as a buffer by falling 12% less than the market during declines.

When investors crowd into low-volatility stocks, as they've been doing in the past year, it can push valuations in some sectors, such as telecommunications, utilities, and consumer staples, to the point they become more volatile than usual.

That's a good reminder these alternative index funds still carry their share of risk, particularly when prices are higher. But Britt says overcrowding is less of an issue for long-term investors.

So it seems even these alternative index funds work best when investors buy and hold. Sound familiar? ■

The information contained to this letter represents opinions and should not be construed as personalized or individualized investment advice.

GreenHaven Continuous Commodity Index Fund (GCC)

The GreenHaven Continuous Commodity Index Fund is an Exchange-Traded Fund (ETF) that provides diversified commodity exposure. It aims to achieve this by using futures contracts to track the Thomson Reuters Equal Weight Continuous Commodity Total Return Index. The index equally weights 17 commodities which include significant exposures to grains, livestock, metals, and soft commodities and a lower energy weighting than many of its peers. In addition, the fund is rebalanced every day in order to maintain each commodity's weight as close to 1/17th of the total as possible. Equal weighting among the components ensures individual holdings are not excessively overweight due to aberrations in market movements. In contrast to other funds, tax reporting is via schedule K-1 as opposed to form 1099 due to its status as a commodity pool partnership."