INDEX INVESTING

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Indexes as Benchmarks

You can use indexes and averages as yardsticks to measure the performance of an investment or portfolio.

Investors use indexes and averages as **benchmarks**, or yardsticks of investment return. These benchmarks can help you evaluate the performance of the overall market, particular market sectors and industries, individual securities, mutual funds, and ETFs.

For example, you can measure the performance of a large-cap stock fund against the S&P 500—the standard benchmark for large-cap equity performance because it includes many of the stocks that this type of fund holds in its portfolio. You can also measure the fund against one of the Lipper large-cap mutual fund indexes—Growth, Core, or Value, depending on the fund's investment objective—and against a number of other indexes, including those provided by Morgan Stanley Capital International (MSCI) and Morningstar, Inc. Of course, the fund's return can also be measured directly against the performance of funds that are its primary competitors.

DIFFERENT BENCHMARKS

Not all benchmarks are indexes or averages. Long-term bond yields, for instance, are commonly measured against the yield of the 30-year US Treasury bond. Similarly, the benchmark for cash equivalent investments is the return on the 13-week US Treasury bill.

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WHAT A BENCHMARK SHOWS

Since there's no absolute measure of investment performance, comparing your investments to benchmarks is really the only way to evaluate your results. For example, suppose your portfolio of large-cap stocks gained 8% in a particular year. That might seem fine. But if the S&P 500 gained 15%, that means your portfolio of large-cap stocks underperformed its benchmark by a wide margin.

Of course, you may want to give your large-cap portfolio a year or two to live up to your expectations. But if your investment mix underperforms its benchmark year after year, it may be time to rethink your strategy. On the other hand, if your portfolio of mid-sized company stocks held steady in a year that the S&P MidCap 400 lost 10%, you might decide that you've done well under the circumstances, even though your portfolio didn't realize any gains.

APPLES TO APPLES

One thing you want to avoid is measuring the performance of one **asset class** or **subclass** against the benchmark of another. For instance, let's say you are trying to evaluate the performance of your small-cap portfolio. In that case, an index that tracks small-company stocks, such as the S&P 600 or the Russell 2000, would be a much more accurate yardstick than a large-cap benchmark, such as the S&P 500.

From one year to the next, large-cap and small-cap stocks may report significantly different returns. That's also true with growth and value stocks. And, if you invest in an ETF tracking a low-volatility or high-dividend index, its return will vary significantly from the return on the major index from which the more narrowly focused index is derived.

The same caution applies when you evaluate bond performance against a benchmark. For example, the annual return on long-term US Treasury bonds tracked by a one-bond portfolio is likely to be very different from the return reported for high-yield corporate bonds or 12- to 22-year general obligation (GO) municipal bonds.

THE BIGGER PICTURE

Just because an investment outperforms its benchmark in a particular year doesn't necessarily mean it's right for your portfolio. You still want to evaluate each investment in light of your risk tolerance, time horizon, and overall investment strategy. Similarly, an investment that misses its benchmark from time to time may still be a smart addition to your portfolio if it helps you diversify.

A TWO-WAY STREET

Just as you use benchmarks to measure performance, you can use them to evaluate the suitability of an asset class or subclass you're considering adding to your portfolio.

Let's say you want to diversify a stock portfolio that contains predominately large-cap stocks and you're considering adding a small-cap mutual fund or ETF. As part of your research, you can compare the performance of the individual small-cap funds you're investigating to the historical performance of this class overall as recorded by the S&P 600 or the Russell 2000. The benchmark will show where a particular fund fits in the universe of similar funds. (Keep in mind, however, that past performance is no guarantee of future results.)

You can also gauge how the particular characteristics of small-caps—for instance, their **risk-return profile** and **volatility**—compare to the behavior of equities included in a broader index, such as the Russell 3000 or S&P Composite 1500. Those indexes track a combination of small and large caps. The Russell 2000 is part of the Russell 3000 and the S&P 600 is included in the S&P Composite 1500.

Remember, too, that when you're evaluating a specific mutual fund, it's smart to compare its past performance to its target index over a number of years, rather than focusing on a single year in which the fund might have fared significantly better or worse than its benchmark.

INSTITUTIONAL BENCHMARKS

Institutional investors use benchmarks as well: When an actively managed mutual fund aims to "beat the market," its goal is to outperform the index that best matches its investment portfolio.

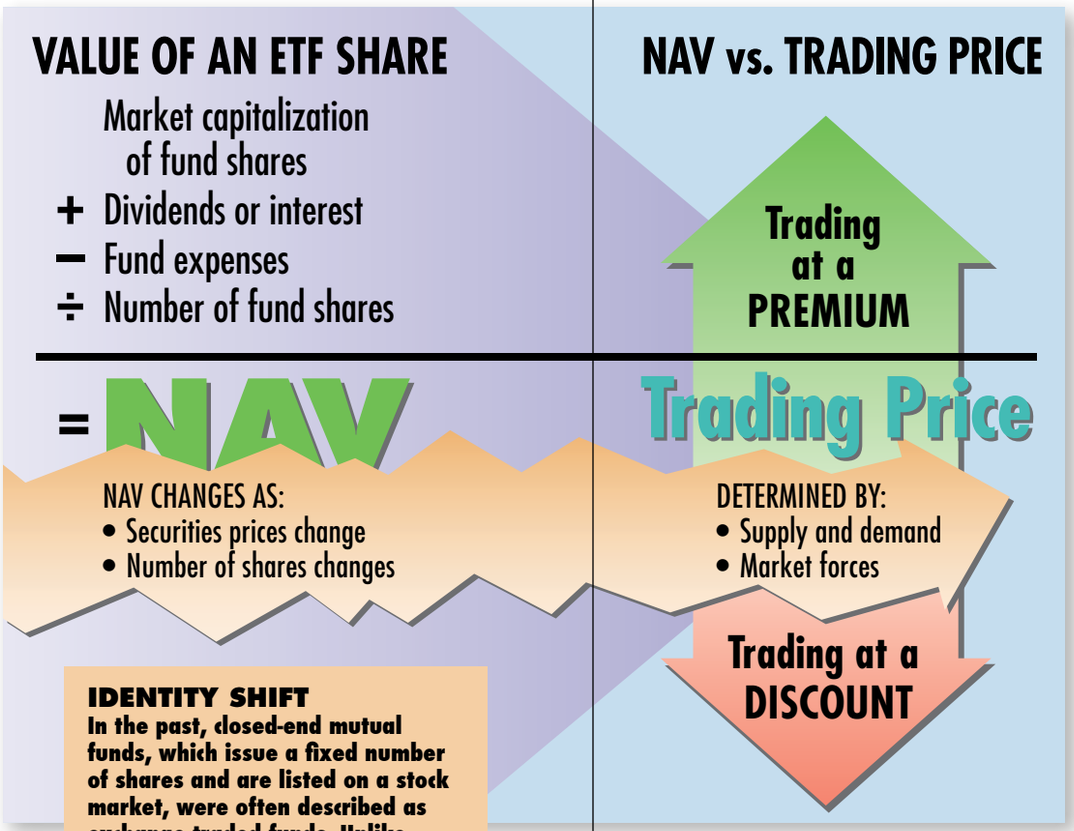
Some benchmarks are designed specifically for institutional investors, who use them to compare international markets, evaluate asset allocation models, determine standards for returns-based style analysis, and perform a number of other analyses. These indexes are governed by a strict set of rules that cover, among other things, the market capitalization of the stocks that may be included in a particular index.

The Ins and Outs of ETFs

The more you know about ETFs, the more you may want to know.

Like mutual funds, each ETF has a **net asset value (NAV)** that reports what a single share is worth at a particular point in time.

The NAV is determined by the total market capitalization of the securities the ETF holds, plus dividends or interest minus fund expenses, divided by the number of fund shares. In other words, the NAV is not a fixed value, and moves up or down as the price of the underlying investments change and the number of outstanding shares increases or decreases.



PREMIUMS AND DISCOUNTS

Unlike no-load mutual funds, though, you don't pay the NAV when you buy shares, and you don't receive that value when you sell. Instead, an ETF trades at its market price, which is determined by supply and demand as well as other market forces, as is the case when you're trading individual stocks. If other investors are buying when you buy, creating greater demand, you may pay more than the NAV. And if you buy when the majority is selling, you may pay less than the NAV.

If the price of an ETF is higher than the NAV, you're buying or selling at a **premium**. And if the price is lower than the NAV, you're buying or selling at a **discount**. The amount of the premium or discount is usually very small—and the more popular the ETF is, the lower the spread between the market price and the NAV tends to be. You can find a particular ETF's premium or discount through the exchange on which it trades, from your financial adviser, or online at financial websites.

A unique feature of ETFs is that authorized participants, usually institutional investors or market makers, may buy large blocks of shares at the NAV with in-kind baskets of the fund's securities or redeem shares for a basket of securities. This helps ensure that ETF prices don't deviate significantly from their NAVs and provides a buffer against potentially large premiums and discounts often associated with closed-end mutual funds.

However, as the number of ETFs grows, the roster includes some that are very narrowly focused, some linked to nontraditional fundamental indexes, and others actively managed, you can't be assured that the **liquidity** that characterizes trading in the most popular funds will be true in all funds. Neither are there any guarantees that the market price and the NAV will always be closely aligned.

IDENTITY SHIFT

In the past, closed-end mutual funds, which issue a fixed number of shares and are listed on a stock market, were often described as exchange traded funds. Unlike an index-based ETF, though, a closed-end fund typically includes a portfolio of assets that are not intended to resemble those in a particular index.

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ASSET ALLOCATION MADE EASY

Since the holdings in an ETF's portfolio are made public every day, and since those securities also appear in the index that the fund tracks, the asset class to which the ETF belongs is crystal clear.

The advantage to an investor is that ETFs may simplify the process of building a portfolio that corresponds to a specific asset allocation model.

For example, the SPDR S&P 500 trust owns shares of the 500 large-capitalization stocks in the S&P 500, making it a large-cap equity ETF. You can similarly find mid-cap and small-cap equity ETFs, long- and short-term corporate bond ETFs, and ETFs invested in a specific, sometimes narrow, sector—say companies that manufacture semiconductors.

That is not always the case with actively managed mutual funds. While mutual funds focus on a particular asset class, they may actually shift the makeup of the fund in some circumstances. For example, under certain market conditions, some funds may hold a substantial percentage of their assets in cash. Others may seek to improve their returns by buying securities in different asset classes to take advantage of what's happening in the markets.

While those actions are perfectly legal, they might leave you underweighted in the asset class you have selected, and overweighted in another. For example, if you purchase a small-cap mutual fund that holds 50% of its assets in cash, you have only half the exposure to small-cap stocks that you had anticipated. Of course, you can also buy individual securities in different asset classes as you allocate your portfolio. That requires more research and many more transactions than researching and purchasing an ETF.

GETTING DIVERSIFIED

ETFs, like other funds, may simplify portfolio diversification since you don't have to evaluate individual securities and then buy them in sufficient numbers to protect yourself against portfolio risk.

For example, if you own shares of the Nasdaq 100 ETF (QQQ), made up of the 100 largest nonfinancial companies listed on the Nasdaq Stock Market, you might reasonably anticipate—though nothing is guaranteed—that even if some of the stocks falter as part of the normal market fluctuation, other stocks will gain.

But since ETFs trade throughout the day, an added advantage is the speed with which you can gain exposure to an underlying index and diversify your holdings. If, for example, your research indicates that there might be a surge in a certain sector's performance—particularly a sector in which you might be underweighted—you can make a tactical decision and buy an ETF based on that sector's index.

UNWRAPPING THE BUNDLE

ETFs have a high degree of transparency because the fund's sponsor, or provider, announces the contents of the ETF's portfolio at the beginning of each business day, generally through the National Securities Clearing Corporation (NSCC).