All investors, whether they are individuals or institutions, face familiar questions when creating an appropriate investment policy and selecting investments:

- What is the minimum return requirement?
- What is risk – absolute loss, relative underperformance or opportunity cost?
- What is the level of risk tolerance?
- What diversification is required?
- What liquidity is needed to meet liabilities?
- How can tax be minimised to generate the highest economic return?
- What is the investment horizon – year-to-year or long-term?

Fiduciaries, whether advisers or trustees, are required by law to pursue a prudent strategy that is consistent with an investor’s objectives and financial circumstances. Investors and their advisers use various methods – from “rule of thumb” through to statistics such as past performance or industry averages – to determine the spread between various asset sectors such as shares, bonds and cash. Investors’ past experience may lead to exclusions from the investment “opportunity set”; for example, unlisted property, development capital or high-yielding securities.

For most investors, Australian shares are a key component of their overall strategy. Therefore, after the decision to buy shares has been made, it is necessary to create a portfolio that is consistent with the answers to the familiar questions posed above. At this point, most investors would be unlikely to buy stocks solely on the basis that they were large.

**FUNDAMENTAL ANALYSIS AND INVESTOR JUDGMENT**

By definition, an indexed portfolio will aim to replicate the market (as defined by its construction methodology) regardless of its investment merit and risk.

A managed portfolio, on the other hand, can evolve according to investor insights – that is, desired investment characteristics, industry sectors and companies. A managed portfolio that considers financial and business fundamentals can enable some control to be exerted over common investment risks such as:

- leverage – excessive debt within market sectors or individual stocks;
- unsustainable growth expectations – stock valuations may be at odds with economic realities and long-term trends;
- momentum – buying and selling stocks according to price movements;
- skewness – under-representing evolving companies that are too small to be included in an index; and
- inadequate diversification – excessive individual security exposure, or limited sector exposure.

None of these factors is considered in an indexed portfolio, which simply follows the market.
***PORTFOLIO MANAGEMENT***

**THE MISMATCH BETWEEN INDEX COMPILERS AND INVESTORS**

An index is a valueless basket of securities that is compiled to give users an objective measurement of market size and performance. Indexes are designed to give users desirable characteristics such as broad sector coverage, issue liquidity and ease of replication.

An index is not a measure of fundamental investment merit; indexing, rather than representing a self-contained strategy, means buying a market measure. Stock selections for most managed strategies are not driven by market size alone. A mismatch therefore exists between a portfolio created to meet the needs of those investing discriminately within the market and one that mimics the market. This mismatch is illustrated in Figure 1.

To use a simple analogy, if you were “index shopping” at the greengrocer, you would buy produce in the proportion that it was available and would change your purchases according to the seasons. In practice, shoppers do not usually purchase all items offered, nor in the proportions that they are available. Most shoppers will buy staple items at their lowest cost and make other purchases according to specific taste preferences or fashion.

Similarly, it would seem an unlikely strategy for rational investors to simply buy the “market” at any point in time without considering the attributes of the individual stocks, macroeconomic or microeconomic trends, and fads.

**COMPOSITION AND PARAMETERS**

Since an indexing approach mimics an index, its characteristics are dependent on the index construction methodology.

Commonly used capitalisation (or size-weighted) indexes reflect the average movement of securities allowing for their value. Indexing therefore skews portfolios to the largest companies, and returns reflect both actual information and speculative changes in the earnings multiples of these companies. Changes in the market value of companies will alter the composition of the index portfolio and cause stock additions or deletions. Are these changes a function of long-term equity returns or short-term speculation?

**Table 1**

<table>
<thead>
<tr>
<th>Issuer</th>
<th>Index weight</th>
<th>Cumulative</th>
<th>Issuer</th>
<th>Index weight</th>
<th>Cumulative</th>
</tr>
</thead>
<tbody>
<tr>
<td>News Corp</td>
<td>14.8</td>
<td>14.8</td>
<td>General Electric</td>
<td>4.4</td>
<td>4.4</td>
</tr>
<tr>
<td>Telstra</td>
<td>7.1</td>
<td>21.9</td>
<td>Intel Corp</td>
<td>3.8</td>
<td>8.2</td>
</tr>
<tr>
<td>NAB</td>
<td>6.9</td>
<td>28.8</td>
<td>Cisco Systems</td>
<td>3.7</td>
<td>11.8</td>
</tr>
<tr>
<td>CBA</td>
<td>5.7</td>
<td>34.5</td>
<td>Microsoft Corp</td>
<td>2.8</td>
<td>14.6</td>
</tr>
<tr>
<td>BHP</td>
<td>5.7</td>
<td>40.2</td>
<td>Exxon Mobil</td>
<td>2.2</td>
<td>16.8</td>
</tr>
<tr>
<td>Westpac</td>
<td>3.6</td>
<td>43.8</td>
<td>Pfizer Inc</td>
<td>2.1</td>
<td>18.8</td>
</tr>
<tr>
<td>ANZ</td>
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<td>47.0</td>
<td>Citigroup</td>
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</tr>
<tr>
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<td>50.1</td>
<td>Oracle Corp</td>
<td>2.0</td>
<td>22.8</td>
</tr>
<tr>
<td>AMP</td>
<td>3.0</td>
<td>53.1</td>
<td>Nortel Networks</td>
<td>1.8</td>
<td>24.6</td>
</tr>
<tr>
<td>Rio Tinto</td>
<td>2.2</td>
<td>55.3</td>
<td>IBM</td>
<td>1.8</td>
<td>26.3</td>
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<tr>
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<td>40.2</td>
<td>Top 5</td>
<td>16.8</td>
<td>16.8</td>
</tr>
<tr>
<td>Top 10</td>
<td>55.3</td>
<td>55.3</td>
<td>Top 10</td>
<td>26.3</td>
<td>26.3</td>
</tr>
</tbody>
</table>

Table 1 shows the structures of the S&P/ASX200, Australia’s leading stockmarket proxy, and the S&P500.

At 31 August 2000, the S&P/ASX200 index comprised the big four banks (19%), News Corp (15%), Telstra and Cable & Wireless Optus (10%). The stocks of the five largest issuers were worth more than 40% of the market. Compared with the S&P500, the Australian index is highly concentrated in terms of stocks and industries. It is questionable whether all investors would hold this portfolio to meet their objectives.

**CONCLUSION**

There is no rule that says investors or their advisers must use an index as the basis for portfolio construction, and index compilers do not sell indexes as investment strategies in themselves. Because indexing is solely concerned with tracking a market index, no judgment is made about the quality or appropriateness of stocks or the composition of the investment portfolio.

While indexes are designed to provide a recognised performance benchmark, investors and fiduciaries should invest for reasons other than market size alone. Simply put, indexes are designed to keep score rather than be the game itself.