



Factor/Style Investing

The Value of Fundamental Indexing

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Proponents of “fundamental indices” claim that an investment-management revolution is afoot. Traditional indices and the funds based on them are market-capitalization-weighted; they give investors exposure to markets, usually at a very low, all-in cost.

However, Fundamental Indexers contend that because capitalization-weighted indices assign higher weight to higher-priced stocks, they systematically overweight expensive stocks and underweight cheap ones. The Fundamental Indexers contend investors can do better by taking price out of the equation. How? By using new indices based on measures of economic import — such as book value, dividends, earnings or sales — that are not contaminated by the irrationalities of price.

Is this idea anything new? The answer is no. The fundamental indexing “revolution” is driven by nothing we do not already know. We already have a characterization for this in the investment management industry: It is called value investing. More precisely, in this form it is called a quantitative active value tilt.

Fundamental indexing is really just a relabeling of the most debated, and most promising, side bet out there: value investing. As such, it may be an attractive investment product. But fundamental indexing is certainly nothing even remotely new. Instead, it is just a catchy term for a long-established discipline.

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