

## OPINION

# The Hidden Costs of Indexing Are Hurting Institutions' Returns

The science of investing has advanced, and institutional investors can get better solutions, argues Joel Schneider of Dimensional.

By Joel Schneider

For many institutional investors, indexing has become a default way to access the broad market, but the time has come to apply real scrutiny to this approach.

For much of the past 50 years, index funds have been a net positive for investors, who moved from expensive and concentrated conventional active strategies to a more diversified and low-cost option.

As trillions of dollars have flown into index funds, though, their limitations have become more apparent. Index funds may not be as passive or as low cost as they appear. Their rigid trading – with the goal of minimizing tracking error (a common measure of performance deviation between a portfolio and a benchmark) – can create a performance drag that is not captured in fees and expenses. The science of investing has advanced, and institutional investors should demand better solutions to meet their needs.

## Indexes are Not “The Market”

Many believe that an index is synonymous with “the market.” A quick glance at indexes that track the same asset category tells a different story.

Let's look at the broad market equity indexes from major providers like MSCI, FTSE, and S&P.

In developed ex US markets over the past two decades, the average annual difference in returns (from best to worst) across these three providers has been 100 basis points. In emerging markets, the average annual difference has been 270 basis points. Those are big differences.

So, which one of the indexes is “the market?” None of them.

Index returns differ because they are designed by people (some sitting on index committees) who make decisions regarding market coverage, security eligibility, and rebalance frequency, among others. These are all active decisions that impact returns.

## An Easy Target

The Achilles' heel of indexing is the publisher-tracker model. An index provider publishes which stocks to track, in which quantities, and at what times, and then separate entities, index managers, buy and sell stocks to match what the index providers published. This means index funds tend to buy and sell the same things at the same time, creating a massive demand for liquidity that can destroy value for investors.

These reconstitution events (a period when stocks are added to or dropped from an index) attract a huge amount of trading. The average daily volume for these stocks tends to rise 20x to 50x higher over the following days and weeks. This puts index managers at a considerable disadvantage, since it can be disadvantageous for professional investors to publicly announce their upcoming trades.

When index providers publicly announce changes ahead of time, sophisticated traders such as hedge funds get ahead of these trades, acting as liquidity providers to the index funds. This typ-



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Joel Schneider, Deputy Head of Portfolio Management, North America at Dimensional Fund Advisors.

ically pushes prices up before index funds buy and down before they sell.

Looking across the decade ending in December 2023, the stocks added and dropped from major indexes had their prices deviate by an average of 3 percent to 4 percent relative to the other stocks in the index.

As a result, index fund managers systematically buy high and sell low. This creates a performance drag for both the index fund and the index itself.

These trading costs, which depend on several factors, such as the particular index and the amount of assets tracking it, may cost you as much as the expense ratio, meaning the cost of an index fund can be up to twice what you think.

If you are using the same index for both your investment and benchmark – which as a historical coincidence most investors do – you will never see this hidden cost. Why?

The trading costs are not in the expense ratio (so you won't see them there) and they affect both your investment and the index (so you won't see them in tracking error). This creates a hidden cost for investors.

Using the same index as both your investment and benchmark is like running a race and only knowing your own time. You might be able to compare your performance to your personal record, but you don't know if your time was good or bad relative to other runners. Professional runners aren't rewarded for beating their PRs; they are rewarded for beating others.

### Style Drift

While concentrated pre-announced trading is a major challenge for indexing, it is not the only challenge that comes with the ri-

gidity of indexing. Rebalancing infrequently also comes with the potential for style drift. Securities' characteristics evolve every day. An index strategy focused on small caps or value stocks can easily miss a strong period of outperformance by holding a stale roster of such names.

Moreover, every new dollar allocated to such a strategy is also going to the stale roster, compounding the problem. And even that next rebalancing might not resolve the problem because many indices these days apply gradual migrations and overlaps to stifle turnover across asset class indexes. Well, that comes with the side effect of even more style drift.

### A Better Approach

Since indexes are not “the market,” is minimizing tracking error to a specific index the right goal for a passive allocation?

The goal should be to make your passive investments work harder for you. Decide how much tracking error is acceptable and then pursue higher returns that fit within the amount of tracking error you can handle.

A systematic yet flexible implementation process can stay within 25 to 75 basis points tracking error versus a broad market index while using up-to-date market information to pursue higher expected returns, manage risks, and control costs.

With tens of trillions of dollars being indexed, more and more institutional investors understand that low management fees are not the same as low cost and that even seemingly small improvements in net returns mean real money.

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