Passive Investing Choices

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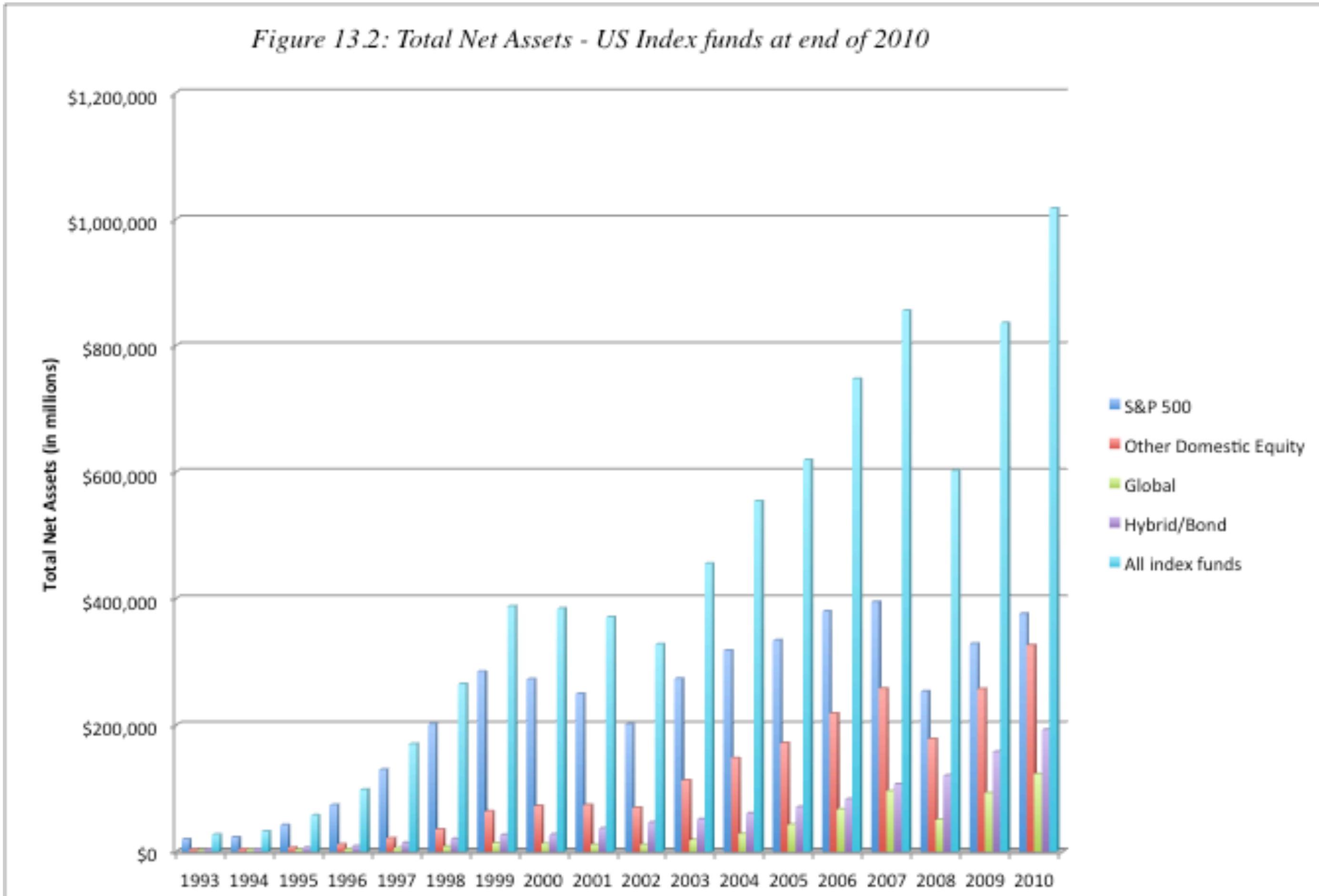
Choices on passive investing

- Once you decide that active investing is not going to pay off for you, you have chosen the path of passive investing.
- The choices on passive investing have grown over time and here are a few:
  – Classic Index Funds
  – Enhanced Index Funds
  – Exchange traded funds

I. Index Funds

- Fully indexed fund: An index fund attempts to replicate a market index. It is relatively simple to create, once the index to be replicated has been identified.
  - Identify the index to be replicated. (Example: S & P 500)
  - Estimate the total market values of equity of all firms in that index.
  - Create a market-value weighted portfolio of stocks in the index. This fund will replicate the index and is self correcting. It will need to be adjusted only if stocks enter or leave the index.
- Sampled Index fund: Here, you sample an index because the index contains too many stocks like the Wilshire 5000 or it is too expensive to index the assets in a fund.

The growth of indexing



Alternatives to Indexing

1. Exchange Traded Funds such as SPDRs provide investors with a way of replicating the index at low cost, while preserving liquidity.
2. Index Futures and Options
3. Enhanced Index Funds that attempt to deliver the low costs of index funds with slightly higher returns.

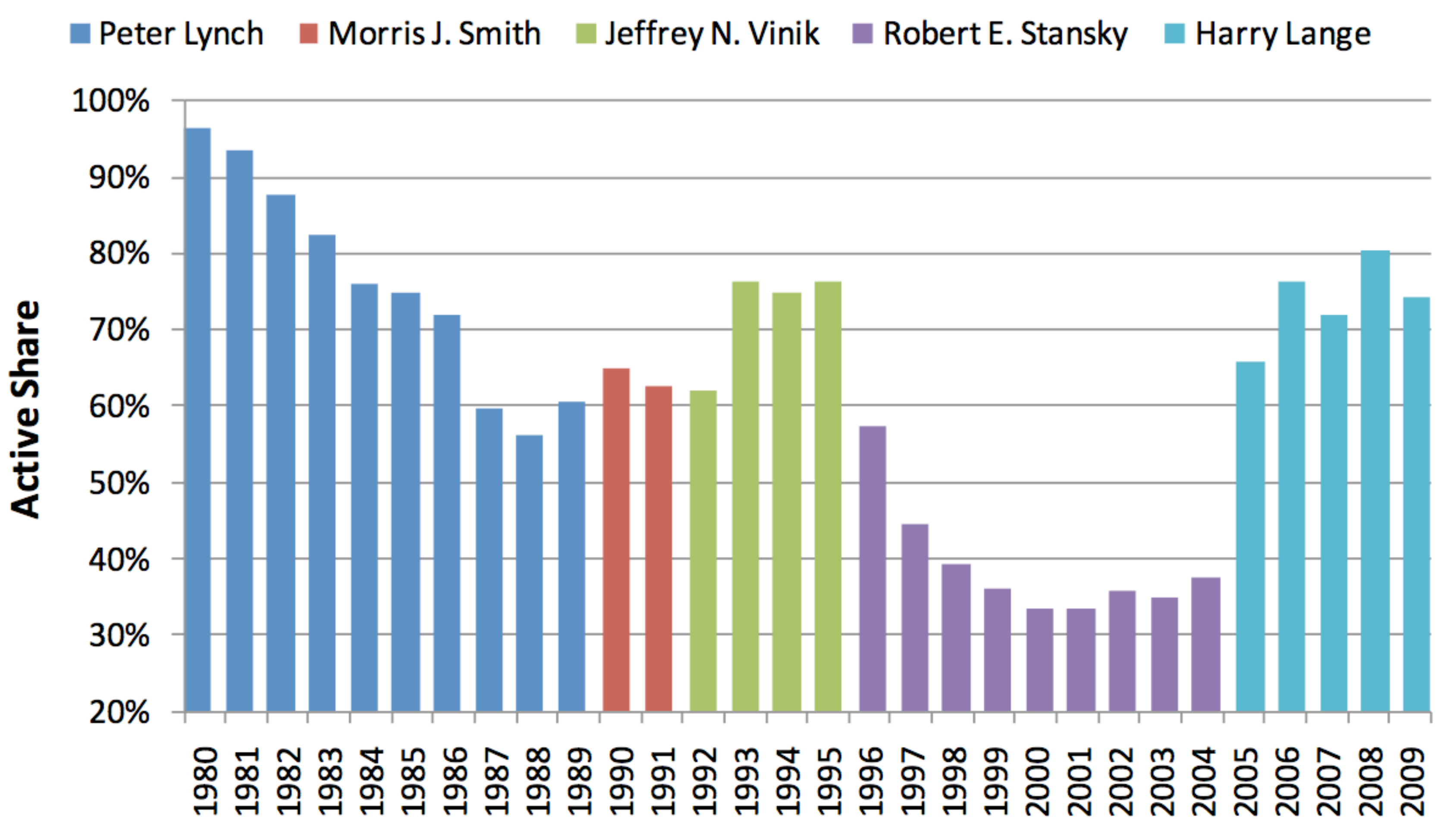
II. Exchange Traded Funds…

- With exchange traded funds, you get many of the benefits of being invested in an index, with the added allure of liquidity and more choices.
- The costs of exchange traded funds are slightly higher than index funds over the long term, but the trade off may still work in their favor, especially for more obscure indices.

III. Enhanced Index Funds

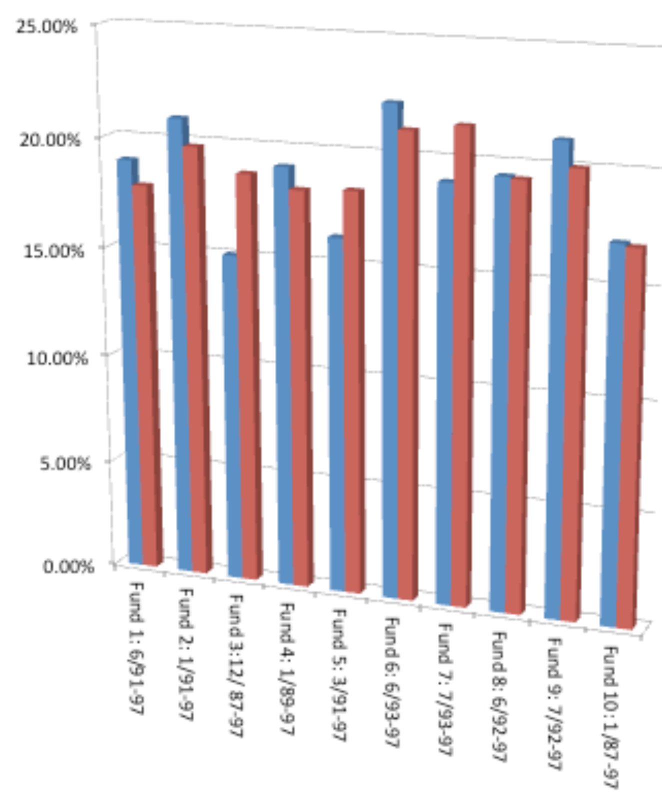
- In synthetic enhancement strategies, you build on the derivatives strategies that we described in the last section. Using the whole range of derivatives – futures, options and swaps- that may be available at any time on an index, you look for mispricing that you can use to replicate the index and generate additional returns.
- In stock-based enhancement strategies, you adopt a more conventional active strategy using either stock selection or allocation to generate the excess returns.
- In quantitative enhancement strategies, you use the mean-variance framework that is the foundation of modern portfolio theory to determine the optimal portfolio in terms of the trade-off between risk and return.

And many active funds are really enhanced index funds..



Enhanced Index Funds… The Returns Promise..

Figure 13.21: Enhanced Index funds vs. S&P 500



Enhanced Index Funds…The Risk