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Understanding index management

At the end of May, the Frank Russell Co. will reconstitute the Russell indexes, which investors, money managers and consultants use as benchmarks in evaluating investment performance. In addition, passive management proponents often use index funds that replicate the Russell benchmarks.

PERSONAL FINANCE

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Many investors don't realize that Russell rebalances its indexes once a year on May 31, at which time some stocks will move totally from one index to the other, and other stocks presently split between growth and value indexes will gain or lose a part of their weightings.

Russell uses a relative price to book method in determining a stock's style. They compare a stock's long-term growth rate with price to book. In other words, "cheap" stocks based on book value relative to price are put in the value camp, and more expensive stocks that have had good earning growth are put in the growth index. Seventy percent of stocks in the major Russell indexes are classified as all-value or all-growth, and 30 percent are weighted a combination of the two. (Yes, this means a stock may appear in both Russell Growth and Value indexes).

Surprising names may be shifting. Those companies that will have the biggest increase or weight gain in the Russell 1000 Growth Index include No. 1 General Electric, No. 3 Exxon Mobil, No. 4 Dow Chemical and No. 6 E:I DuPont de Nemours & Co. These aren't classic growth companies and most investors would think of them as classic value names.

Also very interesting are the new members and increased weighting of the Russell 1000 Value Index. Ranked No. 1 is Pfizer, No. 4 Nextel, No. 5 Motorola, No. 6 Coca Cola, and No. 10 Merck. Although most would consider them growth stocks, their low P/B ratio pushes them into the value index.

We have a few thoughts regarding these shifts:

- Benchmarks are actively managed and can be moving targets.
- Benchmark-sensitive managers are under pressure to make large portfolio adjustments. For example, not owning Pfizer by a value manager which makes up 3.45 percent of the index, is essentially like going "short" Pfizer. Overnight, Pfizer becomes a lesser concern for growth managers and a greater concern for value.
- Emotions of the market cause certain sectors to come into and go out of favor. Benchmarks shift their structure based on those emotions. Investors who don't understand benchmark design can become poorly diversified.

Shifts of traditional growth stocks to the value index probably bodes well for growth. Large-cap growth looks reasonably priced after five years of under-performance.

Gary Black, chief investment officer for Janus, spoke recently at the Rocky Mountain Foundation and Endowment Conference in Denver. Asked if growth was inexpensive, he quipped that although Janus is a growth stock manager, of Janus Capital Group's (JNS) 10 largest investors, seven were "value" managers.

Value managers like growth, too.

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