Journal of Indexes

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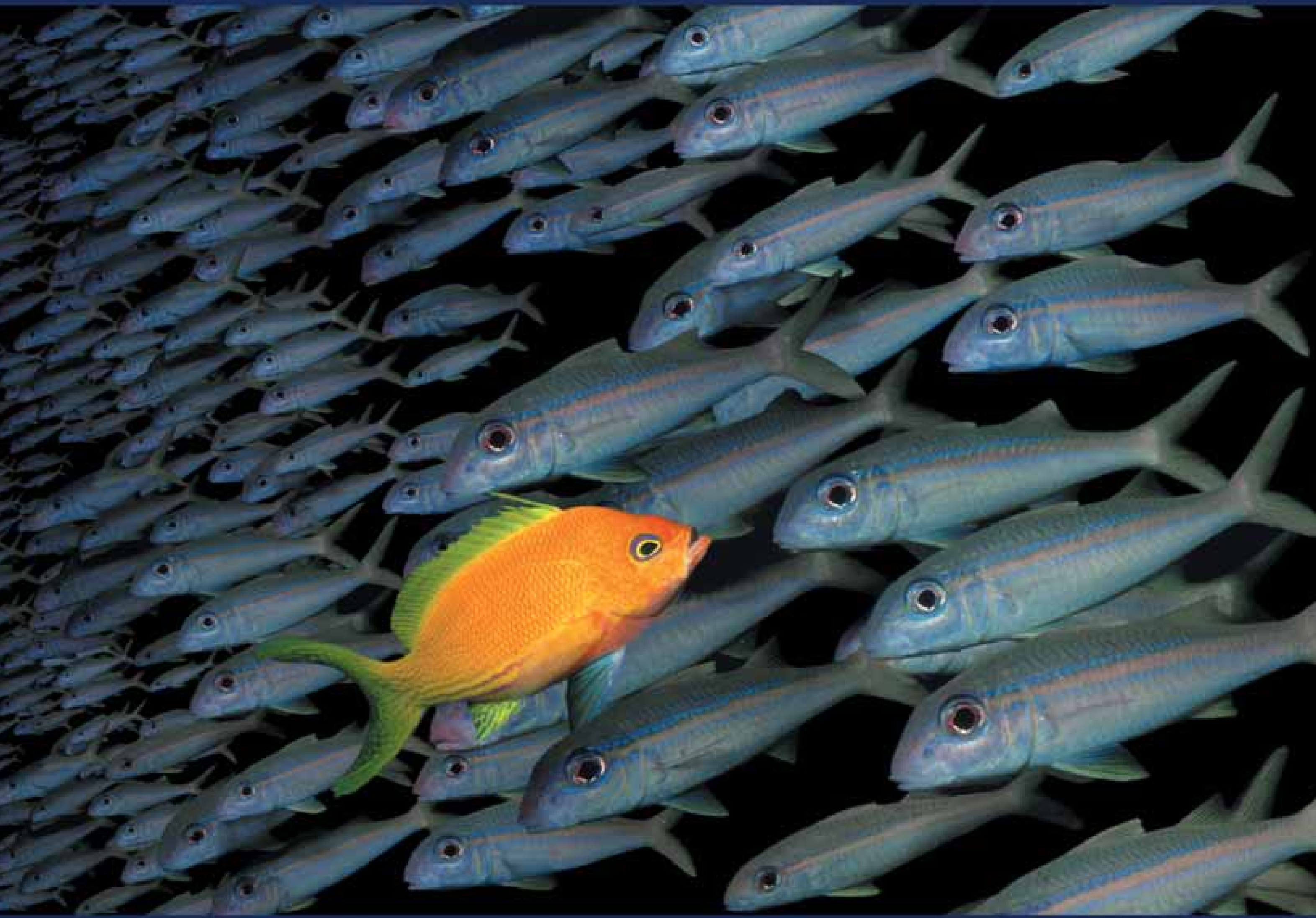
index innovators

September/October 2006



The Innovators Speak
Industry Leaders ... In Their Own Words

Fundamental? Or Just A Fad?
Bogle, Malkiel, Arnott and Siegel Weigh In

Style Purity Unleashed
Paul Lenz and Michael Dellapa

A More Stylish Fit
Robert Waid

Plus Haughton on Style, Special BNY Feature and Blitzer

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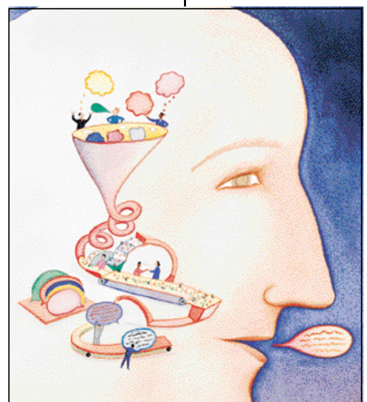

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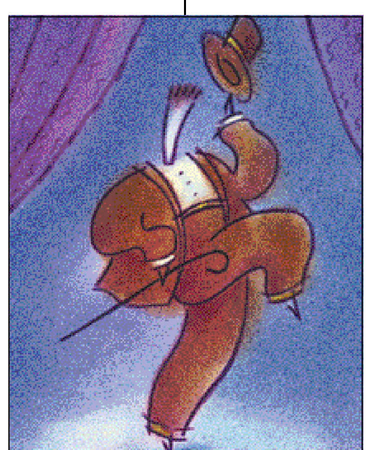

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David Blitzer is the chairman of the S&P 500 Index Committee and a member of Standard & Poor's Investment Policy Committee and Economic Forecast Council. He previously served as corporate economist at McGraw-Hill and as senior economic analyst with National Economic Research Associates. Blitzer is often quoted in the national business press and is the author of *Outpacing the Pros: Using Indices to Beat Wall Street's Savviest Money Managers,* McGraw-Hill, 2001.

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Paul Lenz is a portfolio manager at Rydex Investments, where he co-manages the Rydex Nova, Energy, Energy Services and Utilities funds. He is also responsible for the development of quantitative stock selection models. Prior to joining Rydex, Paul spent six years as a quantitative manager at Brown Brothers Harriman in New York. He holds a Ph.D. in economics from the University of Wisconsin-Madison, a master's degree in economics from the University of Oregon.

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Of Innovators And Fundamentalists

Jim Wiandt
Editor

When we started to put this issue together, we'd planned to prominently feature the transcript from our editorial board meeting. This summer's meeting, held at the American Stock Exchange, had a "Thrilla' in Manila" feel to it, with all the leading innovators in the index and ETF business duking it out over the most contentious issues facing the industry today: weighting schemes, coverage, expense ratios, etc.

We figured it would make good copy. In fact, we *knew* it would make good copy. But it quickly became evident that once the lawyers got their hands on the material and the editing pens came out, our publication would be … delayed.

All was not lost, though. The meeting served as the inspiration for the theme of this issue and our lead article: Innovation. We figured: Why not let all of the innovators and "the establishment" (whatever that is, since the major players are often driving much of the innovation) respond in their own words to (we hope) probing questions from us? That way, we figured the lawyers could have a go before we even got the material, and by asking the whole industry, we'd have good balance. The result is an extremely interesting series of interviews, some by phone or in person and others in writing, of most of the major players in the index (and index-like) industry.

Following the Innovator feature is a reprise of probably the biggest story in index innovation over the past year—alternative index weighting, and in particular, weighting by fundamental factors. We've provided a sort of Cliff's Notes version of the current debate, with ample quotes from the likes of John Bogle, Burton Malkiel, Jeremy Siegel and Rob Arnott. And as you'll see, if you have not already, it's been a hum-dinger of a debate.

Most of the rest of the September/October 2006 *JoI* is all about style, perhaps the most contentious area for the "establishment" part of the index industry. Style has become a real hot button issue because the various growth and value indexes are remarkably different from one another, and there's been a lot of change in how we define style. First, Paul Lenz and Michael Dellapa discuss S&P's latest innovation, their "pure style" indexes, which aim to provide targeted style exposure. Next, the erstwhile Bob Waid discusses how the Dow Jones Wilshire style indexes stack up to some of the other offerings on the market, and Kelly Haughton follows up with a witty and insightful review of Russell's index philosophy.

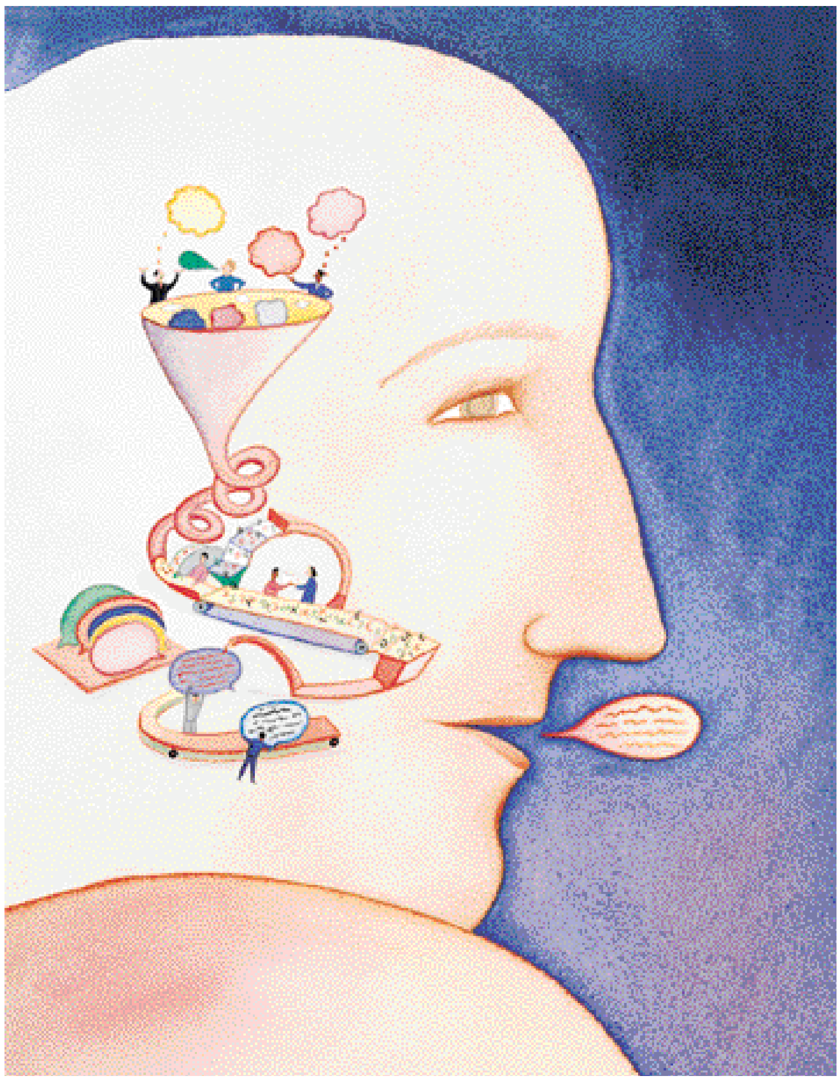
Meanwhile, David Blitzer illuminates an area of index investing that has been one of the touchstones of all of the recent debate: investability. We also introduce something new this issue: a paid feature brought to you by The Bank of New York. It includes an interview with Joe Keenan and a significant excerpt from a very strong ETF panel I recently moderated at The Bank of New York Client Advisory Meeting. The feature includes some great quotes from Jonathan Steinberg of WisdomTree, Cliff Weber of the AMEX, Lisa Chen of BGI and the always-entertaining Kevin Ireland from ALPS. Finally … bringing us home is our own Matt Hougan with a hilariously devastating swipe at Domini for abandoning indexing.

For an index-focused publication, this issue is almost pulsing with controversy. But at its core … after your tears and your laughter … it's really just about good times. OK, maybe, you'll learn something too.

Jim Wiandt
Editor

Index Industry Leaders … In Their Own Words

The innovators—and the establishment—speak out on the biggest issues facing the industry



Things are heating up in the index industry. Every day seems to bring a new innovation, a new way of doing things, and new competition. To capture this unique moment in the industry—and to lay out the groundwork for the discussions we'll be having on the pages of this journal over the next twelve months—we invited some of the leading lights of the indexing industry to answer a few questions about the hottest topics du jour. We tried to ask both "establishment" and "innovator" indexers, although in truth, that is a false divide, as some of the most innovative developments these days are coming from the most established names. Some indexers responded by writing, some by phone, and others not at all. The sample is utterly unscientific, but we hope, insightful and thought provoking nonetheless.

Gus Sauter, Vanguard

George U. "Gus" Sauter is the chief investment officer and a managing director of The Vanguard Group. As chief investment officer, he is responsible for the oversight of approximately $680 billion managed by Vanguard's Fixed Income and Quantitative Equity Groups.

Journal of Indexes: What are your thoughts on what the dividing line between indexed and active investing is, if you believe there is one?

Gus Sauter: I think there is a very distinct line. Much like being pregnant, you're either pregnant or your not. You're either indexed or your not.

Indexing really is the concept of getting the market rate of return, or the return from a segment of the market. Anything other than that is laying an active bet against the market or against a segment of the market. All these indexes that are not cap-weighted are making bets against the market or a segment of the market, and those are active bets. It is just like any active manager … it's just that they have created a rule to apply the active strategy. Still … they are active bets.

I worry that people are creating very, very volatile indexes, and very, very niche indexes, and that investors could suffer. We believe in broad market indexing and/or using a style-specific index to compliment other holdings. If these highly defined indexes are going to be used as market timing vehicles, I worry that investors will buy near the top and sell near the bottom, as has so frequently happened. It is the Internet craze of this decade.

With the fundamentally weighted indexes, the question is: Do investors really understand what they're getting? They are being told that they are getting an index that will outperform the market. I don't think they understand the potential style bets they're making. They essentially have a value bias and a small-cap bias, and those segments have been running dramatically for the past five or six years. We all know, however, that all styles go out of style, eventually. There's a reason that all the "fundamental indexes" are being introduced today, and not in 1999. Without making a market timing call, my guess is that it is not a good time to be building a position in those indexes. I don't know if we're near the end of the run for small and value, but we're closer to the end than we were in the beginning.

Journal of Indexes: How do you respond to the various challenges to market-cap weighted indexes? Are problems like over-investing in market bubbles and the costs of public reconstitutions/front-running/index effect really problems, or are they blown out of proportion?

Gus Sauter: I think they are largely blown out of proportion. Public reconstitution and front-running could be a bit of an issue in a small cap index, but it is not really much of an issue in a large cap index or a total market index. Some of these articles claiming that billions of dollars a years are lost … I'm not so sure they have their methodology right. Certainly, the less well-known large cap indexes don't suffer. And I don't think even the S&P 500 suffers from this to any major degree.

A lot of the studies claim that this "index effect" exists by looking at historical data. But it was a very different time during the 1990s, a period that is generally included in the studies. Back then, if S&P announced that a stock would be added to their index, you knew that the stock would go up and up and up. The hedge funds were playing games with it.

But now, hedge funds are amassing such huge inventories of stock around these moves that, when they have to turn around and sell it, their supply is frequently swamping the indexers' demand. The game is largely gone. There are many, many index additions these days where we close on the low for the day.

Journal of Indexes: Any general thoughts on the index industry?

Gus Sauter: We think the big products have been created a long time ago. You need a total U.S. market index, a total international index, a total bond index and a money market fund. And that's it. Those are the formulas that have been making money for people for decades, and we think they will still be making money for people two decades from now. Fads come and go, but not that many people make money from them.

Mark Makepeace and Jerry Moskowitz, FTSE

Mark Makepeace founded FTSE Group in 1995, and has led its global expansion from the post of CEO ever since.

Jerry Moskowitz is managing director of FTSE Group where he is responsible for increasing FTSE's profile amongst major asset owners, managers and investment banks.

Journal of Indexes: What is your view on the trend toward more targeted and strategically driven indexes or "indexes" now flooding the market?

Moskowitz and Makepeace: Innovation. Innovation. Innovation. Clients are becoming more demanding and want a wider choice of indexes to meet the way they choose to invest. The index calculators are service providers and the winners of the future will be those who can understand and respond to investors needs in the quickest and best way. FTSE won the (William F. Sharpe) awards last year for innovation, but the index business is a marathon, not a sprint race!

Journal of Indexes: What are your thoughts on what the dividing line between indexed and active investing, if you believe there is one?

Moskowitz and Makepeace: What we are seeing is the first phase of "active indexing." There is a clear line between the cap-weighted measure of the market, on which traditional passive index funds will continue to be offered, and a range of indexes that seek to weight stocks on their "true" value. The cap-weighted approach remains the best measure of the valuation the market places on stocks on any given day, but we all know that the market has many pricing anomalies. If it didn't, active management would make no sense!

Now, take the human judgment out of the active management process and select and weight stocks in a structured and systematic way which, in cycles, can outperform the underlying market, and which investors can buy into without the high active management fees. That's "active indexing." It is here to stay and will get stronger and stronger.

Journal of Indexes: How do you respond to the various challenges to market-cap weighted indexes? Are problems like over-investing in market bubbles and the costs of public reconstitutions/front-running/index effect really problems, or are they blown out of proportion?

Moskowitz and Makepeace: They ARE real problems, but like everything new, the alternatives will have their own drawbacks. Investors need to be cautious in adopting new approaches. Roger Urwin of Watson Wyatts Worldwide suggests to asset owners that they consider dividing their index funds into 50 percent cap-weighted and 50 percent fundamental-weighted. It is good advice.

Steven Schoenfeld, Northern Trust

Steven Schoenfeld is the Chief Investment Officer of the Global Quantitative Management group of Northern Trust Global Investments, which manages over $210 billion in index, enhanced index and quantitative-active equity and fixed-income strategies worldwide.

Journal of Indexes: What is your view on the trend toward more targeted and strategically driven indexes or "indexes" now flooding the market? And what are your thoughts on what the dividing line between indexed and active investing, if you believe there is one?

Schoenfeld: As I've stated both in print and in conferences, I strongly believe in innovation in the world of indexing (and in the final chapter of my book, Active Index Investing, I discussed/predicted a range of areas for robust innovation).

However, as noted in Chapter 15 (Enhanced Indexing), the industry is desperately in need of clearer "definition of terms" and not further "blurring of the lines" between index, enhanced index and active management. Unfortunately, the proliferation of narrowly targeted sector/style and micro-sector indexes and the simultaneous development of what I call "quasi-active indexes" are serving to blur—rather than to clarify—the dividing lines.

Targeted indexes serve specific strategic—and more often tactical—allocation purposes. As I wrote in the May/June issue of the *Journal of Indexes,* they are very useful for "active indexing," i.e., active (mostly tactical) allocation between sectors, styles, cap-ranges and countries/regions. But targeted indexes are a world away from the broad, diversified, "indexing at the core" approach that lies at the heart of the basic premise of indexing, as supported by years of research by luminaries such as Malkiel, Sharpe, Bogle and others.

Regarding the growing range of what I call "quasi-active" indexes, they can serve a purpose as "investment strategies," but as I've stated numerous times, I do not consider them indexes. Rather, they are essentially active "tilts" toward identifiable factors that are "baked into" an index construction methodology. There is nothing inherently wrong with this, but I believe that we in the industry—as well as our clients—have a fiduciary responsibility to clearly make the distinction between cap-weighted indexes, which aim to represent a market or sub-set of a market, and the ever-growing range of alternatively weighted indexes, which ultimately are aiming to outperform the market (or beat the market indexes)

What is often lost in much of this "debate" is the important role of *genuine* enhanced indexing. Enhanced index approaches have been available in the institutional marketplace for more than 20 years, and have been growing dramatically since the start of this decade. They aim to outperform standard market benchmarks through carefully risk-controlled "bets"—either within a stock or bond portfolio that is very close to the index constituents, or via "portable alpha" from another asset class, which is ported into the portfolio via index futures. The key distinction is that, with genuine, securities-based enhanced index strategies (i.e., not synthetic/portable alpha enhanced strategies), managers can and *must* fully explain their various stock, sector, size and style bets versus the benchmark, and are thus both transparent and accountable for their active bets within the portfolio. Furthermore, successful enhanced index managers are continually researching and revising their factor models to ensure consistent delivery of performance. In contrast, most of the "quasi-active" indexes are relatively static in their construction methodology, and dependent on a fixed number of factors/tilts.

Journal of Indexes: How do you respond to the various challenges to market-cap weighted indexes? Are problems like over-investing in market bubbles and the costs of public reconstitutions/front-running/index effect really problems, or are they blown out of proportion?

Schoenfeld: From a practical standpoint, float adjustment of all of the major benchmark indexes has attenuated this concern, as has the adoption of "best practices" like the pre-announcement of changes and the availability of "provisional" indexes for major reconstitutions. Furthermore, with the proliferation of "index families" and the resulting fierce competition between many different "complete" float-adjusted capitalization-weighted index families, index fund managers like Northern (and our clients) have a range of alternatives to the "most popular" indexes, which may be more susceptible to front-running or the "index effect."

Rob Arnott, Research Affiliates

Rob Arnott serves as chairman of Research Affiliates, LLC, and as editor of the Financial Analysts Journal. *He has authored of over 70 refereed articles for journals such as the Financial Analysts Journal, the* Journal of Portfolio Management *and the* Harvard Business Review.

Journal of Indexes: Do you think your work has the potential to fundamentally alter the way that investors view the stock market?

Rob Arnott: Absolutely. We've been in the thrall of a "cult of cap-weighting" for fifty years. The dominance of cap-weighting hinges on the notion that, when a stock's price rises or falls, its prospective return is unaltered. If we make the sensible assumption that prices are the market's best estimate of an unknowable "true fair value," and that prices are noisy but revert towards that true fair value in the very long run, then two key things happen. First, an index that is cap-weighted will structurally overweight the overvalued and underweight the undervalued companies, creating a performance drag relative to valuation-indifferent indexes. Second, as a consequence of this reversion towards fair value, such a market will create a strong value effect and a moderate size effect. The Fama-French factors are caused by the same mechanism that creates the "alpha" for Fundamental Indexes.

This concept is so intuitive, and so powerful, that it is already gaining massive traction in the marketplace. Active managers struggle to beat cap-weighted indexes, for an array of reasons well familiar to your readers; winning by 2 percent a year on a long-term basis is exceptional. RAFI adds over 2.5 percent on average within individual countries (adding value in all 23 of the developed world markets, with no exceptions, and in all ten of the S&P sectors), adds an average of 3.5 percent per annum internationally due to the added benefit of country rebalancing, adds over 3 percent in small companies, adds over 5 percent in Emerging Markets … and the list goes on.

Journal of Indexes: What do you say to critics who say that you are simply making a style and/or size tilt to move assets, relatively speaking, into historically higher performing (and more risky) asset classes?

Rob Arnott: This is not accurate. RAFI shows almost an insignificant size tilt. For example, the current weighted average market cap of RAFI US 1000 Index is $81 billion, versus $79 billion for Russell 1000 Index. That's a large-cap tilt, not small-cap!

RAFI does have a noticeable, but dynamic, value tilt by construction. In markets where valuation multiples are stretched in the cross-section and the cap-weighted index is dominated by the high multiple growth stocks, RAFI will take on a greater value tilt, which empirically leads to large value-added as the growth cycle gives way to a value cycle. Since inception, Russell 1000 Value outpaced Russell 1000 by 100 basis points (bps or 1.00%) per annum. But, with less than half as much average value tilt over that same span, RAFI outperformed Russell 1000 by an additional 140 bps per annum!

To address academics who believe that RAFI is no more than the Fama-French ideas executed in a low turnover, passive portfolio, they're right and they're wrong. From our own research, the same mechanism that creates the Fama-French size and value effects also create the alpha for Fundamental Indexes. So while our CAPM alpha is immense, our alpha is slender net of the Fama-French factors.

If that mechanism is a better representation of the way markets truly behave—as, intuitively, it clearly is—then the cap-weighted indexes are the tilted indexes. By giving a company with twice the market multiple a double loading in the index, cap-weighted indexes are structurally tilted to heavily emphasize "growth" and deemphasize "value." Because fundamental indexes are utterly indifferent to price, valuation multiples and market cap, they are utterly neutral—except relative to cap-weighting!

Viewed in this context, it's easy to understand why Fundamental Indexes are *less* risky, not more risky, than the biased cap-weighted indexes. Indeed, we see the dynamic value exposure as risk reducing, lowering *ex ante* portfolio volatility in an environment of high valuation levels and prior to increases in market volatility level.

Journal of Indexes: Do you consider the RAFI indexes to be "benchmark indexes" "quantitatively-driven" indexes, "enhanced" indexes or something else?

Rob Arnott: I leave the marketplace to make this decision. Should people benchmark to Fundamental Indexes? Maybe. The market is cap-weighted, so I don't see RAFI as a substitute for cap-weighting. But one can earn the Fundamental Index return for a very low cost. So, if one's active managers can't beat RAFI, what good are they? Ironically, active managers should be the least threatened by the advent of Fundamental Indexes. If they are skilled enough to beat an index, why not shift their frame of reference and make their active stock bets relative to RAFI, rather than relative to a cap-weighted benchmark.

As for whether investors see RAFI as a new passive portfolio, a new approach to enhanced indexing, or an active management technique, we've seen people embrace the idea in all three contexts. If they like the idea, they should use it, and call it whatever they choose.

Journal of Indexes: What's the advantage of the RAFI approach against other fundamental approaches, such as a focus on dividends?

Rob Arnott: Dividend-based indexes have three vulnerabilities: 1) They raise your tax burden; 2) They offer inferior pretax performance; and, 3) They provide selective coverage of the market.

The best thing about dividend-weighted indexes is that, as they gain traction in the marketplace, they encourage companies to pay dividends. Far too many companies view earnings as a discretionary spending kitty, rather than as the property of the shareholders. Arnott/Asness 2003 showed that the higher the economy-wide payout ratios, the faster earnings grow. Other articles have taken the idea down to the individual stock level, and into international markets, with the same result. Miller-Modigliani is dead: Great theory, but bears little resemblance to the real world.

The worst thing about dividend-based indexes is that they incur the worst tax consequences of any of the new breed of indexes. I've been shocked that press reports haven't picked up on this basic nuance. They also exclude nearly half the companies in the market. These companies exist. They have economic scale and relevance and include the fastest-growing growth names in the market. By using multiple factors in RAFI, the only companies we would exclude are companies with negative net worth, negative profits, zero sales, and zero dividends.

A third drawback for dividend-based indexes is that they empirically add less value than any other fundamentals-based index that we tested, with higher tracking error relative to cap-weighting than most. In the past one-, three- and ten-year periods, a dividend-weighted top 1000 index would have underperformed RAFI by a cumulative 100 basis points (bps), 660 bps and 1900 bps, respectively. On the other hand, they do provide the lowest risk and lowest beta of any of the primary fundamental approaches. So, while—alone among the fundamental-based indexes that we tested, they do not beat cap-weighting in bull markets, they do afford the risk-averse equity investor the best downside protection in bear markets.

Journal of Indexes: How did you choose the four fundamental weighting factors?

Rob Arnott: If one were to poll investment professionals to list how one might measure company size, apart from market cap or float, most lists would include variations on profits (cash flow, earnings, EBITDA, and so forth), book value (or net operating assets), sales (or revenues), dividends and the number of employees. We chose one from each category, selecting the one that was least subject to "gaming" by company management (sales instead of revenues, cash flow instead of earnings). We also left out the number of employees—even though it performs admirably as an index—because it's a bit screwy. McDonalds and Kelly Services wind up with huge weight, even though we know that the average employee at McDonalds is not the same as the average employee at Goldman Sachs or Amgen.

By using multiple factors, we also mitigate our vulnerability to excesses and peculiarities associated with each individual factor. Do we really want to exclude all companies that don't currently pay a dividend? How much exposure do we want to sales, when that concept is not well defined for financial services? If a company has a non-recurring gain from the sale of an operating unit, or a large write-off, do we want the exceptional high or low profits weighting to materially affect the weight in the index? How about good will, or the impact of a history of aggressive or conservative accounting, in the book value? Any single-factor approach is vulnerable to these problems. A multi-factor approach—especially one that's smoothed over several years—sharply mitigates our exposure to these problems and sharply reduces turnover, and hence, trading costs.

Jeremy Siegel, WisdomTree Investments

Jeremy Siegel is the Russell E. Palmer Professor of Finance at The Wharton School of the University of Pennsylvania. His bestselling book, Stocks for the Long Run, *was named by the* Washington Post *as one of the ten-best investment books of all time. Siegel currently serves as senior investment strategy advisor to WisdomTree, consulting the firm on its proprietary stock indexes. He is also member of its board of directors.*

Journal of Indexes: Do you believe the markets are efficient?

Jeremy Siegel: If one defines "efficient market" as one where quoted prices represent the best, unbiased estimate of the value of the underlying security, the answer is "No." Prices of securities are subject to *temporary* shocks, which I call "noise," which obscures their true value. These temporary shocks may last for days or for years and their unpredictability makes it difficult to design a strategy for trading an individual security that could consistently produces superior returns. However, I believe there is an opportunity to earn excess returns by forming an indexed-portfolio of securities whose weights are some fundamental metric of firm valuation, such as sales, earnings, or dividends, instead of market capitalization.

Journal of Indexes: Assuming there is a premium to higher dividend-paying stocks (and possibly small and value stocks), what are the prospects this effect could be priced out of the market?

Jeremy Siegel: Historical analysis has shown that the excess return to value stocks over growth stocks has persisted since 1925 and shows no sign of disappearing. In fact, the last decade we witnessed the largest bubble and over-valuation of growth stocks ever measured. Human nature favors gambling in the new, fast-growing technologies, and I believe this is likely to continue to create opportunities for investors following a value-based strategy.

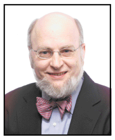
Journal of Indexes: What is your reaction to John Bogle and Burton Malkiel's recent piece in the* Wall Street Journal *showing an overestimation of the market cap drag effect?

Jeremy Siegel: Bogle and Malkiel claim that fundamentally weighted indexes place too much weight on small stocks. I believe they fail to realize that market-cap-weighted indexes place too much weight in the large cap stocks whose returns fall short of the market. For example, the largest stock by market value has returned under 3 percent per year from 1964 through 2005, whereas the S&P 500 returned 10.5 percent. Very large stocks can impose a serious drag on market-cap-weighted indexes.

Journal of Indexes: If investors following your strategies win, who loses?

Jeremy Siegel: If weighting firms by dividends can prove to be a way to outperform the market, there are two groups of investors who I believe may fall short. The first group consists of speculators, momentum traders, and investors who buy fast-growing companies irrespective of the price that they pay for that growth. The second group that falls behind are those who trade stocks for reasons unrelated to fundamental value, such as taxes, liquidity and diversification, and must take a concession in the price to facilitate their trade.

David Blitzer, Standard and Poo r's



David Blitzer is chairman of the S&P 500 Index Committee and a member of Standard and Poor's Investment PolicyCouncil and Economist Forecast Council. He previouslyserved as corporate econo mist at McGraw-Hill and as senior economic analyst with National Economic Research Associates.

Journal of Indexes: What is your view on the trend toward more targeted and strategically driven indexes or "indexes" now flooding the market?

David Blitzer: In the U.S., this seems to be driven by opportunities for ETFs. There are a number of factors boosting ETFs. There are lots of new players entering the market, hoping to replicate the success and profits of the pioneers like BGI and SSGA; ETFs are challenging mutual funds with lower fees; the SEC seems to approve index ETFs with reasonable speed and so far hasn't supported any active ETFs, etc. This is more about ETFs vs. Mutual Funds than about indices. As to why specialized indices? There aren't many places left for broad-based total market ETFs.

Journal of Indexes: What are your thoughts on what the dividing line between indexed and active investing is, if you believe there is one?

David Blitzer: It is a continuum, not a sharp dividing line. Choosing stocks once or twice a year based on size (Russell), Dividends (S&P, Dow, others), growth/value (numerous index providers) is indexing. But picking stocks based on analysis and intuition only once a year is active management.

Journal of Indexes: How do you respond to the various challenges to market-cap weighted indexes? Are problems like over-investing in market bubbles and the costs of public reconstitutions/front-running/index effect really problems, or are they blown out of proportion?

David Blitzer: Most of the problems of front-running, index effect, reconstitutions, etc are blown out of proportion—few people who actual manage large index funds have been asked about these issues, yet they are the ones who would know. From our off the record discussions with index fund managers, things are very much under control. Without getting into a debate about efficient market hypotheses and such, a few things can be agreed on and remembered:

1) A cap-weighted index has the same statistical properties (return, risk, skewness, etc.) as the market. That's what makes the cap-weighted index a benchmark and a fair test of a manager's skill.

2) In the real world of real markets, some stocks are overvalued and some are undervalued at any moment. Which ones are over- or undervalued, and how long they will remain over- or undervalued, is very difficult to determine and probably changes all the time. Buying the under-valued ones is profitable providing they move toward being overvalued fast enough. (They might become more under-valued instead!) All this is true in bull markets, bear markets, bubbles and any other kind of market. Alternative weighting schemes are attempts to identify the undervalued stocks from the rest. Time will tell if they work, and time will tell if they keep working or if the market changes. After all, at times growth beats value and at other times value beats growth.

Journal of Indexes: If indeed we are in a real estate bubble, would consequences be only to individuals or could their be further reaching economic effects?

David Blitzer: The economic effects would reach beyond individuals. That's why figuring out how people can insure their homes against economic downturns with things like the S&P/Case-Shiller Home Price Indices is important.

Bruce Bond, PowerShares

Bruce Bond is the president and CEO of PowerShares Capital Management. Before found ing PowerShares, Mr. Bond served as managing director and vice president of Nuveen Investments, overseeing Exchange Traded Funds, Closed End Funds, and Unit Investment Trusts.

Journal of Indexes: What do you think of the flood of new issuers entering the exchange-traded product market hoping to replicate the PowerShares model?

Bruce Bond: We are not surprised. We expect, as more and more opportunities develop in the ETF space, there will be more and more competition to go with it. At the same time, we think advisors and investors are very discriminating, and that they are going to see through products that are sub-par.

Journal of Indexes: What do you say to critics who say that PowerShares' strategy is focused on the pursuit of "hot money" asset classes and sub-asset classes that have historically been subject to buy-high, sell-low investor underperformance.

Bruce Bond: I don't agree with that, whatsoever. We have introduced a couple of niche products to the market that have been tremendously welcomed by investors, and we think that's a testament to the value of the products.

Typically, we hear responses about "hot money" when our products initially come out. But as our products are duplicated by other fund companies, and embraced by investors, those calls are drowned out.

Journal of Indexes: Where do you think there are still opportunities in the exchange-traded product space, not only for PowerShares, but in other areas PowerShares might not get involved in as well?

Bruce Bond: PowerShares is committed to growing a full line of ETF offerings that include everything across the board, all the way from stocks to other asset classes. Our goal is to be the leading ETF provider in the marketplace in the value-added space. We'll continue to evaluate and introduce products whenever we see an opportunity.

Journal of Indexes: Does competition help or hurt?

Bruce Bond: We believe ETFs will be a core investment holding in the future. In order for the industry to get there, it is necessary for there to be several ETF providers, to elevate the credibility of the product line. Although it increases competition, it also creates more awareness within the financial industry and among investors and advisors. We believe that the most reputable and the largest offerings or brands within the marketplace ultimately will be the ones that benefit investors the most.

Journal of Indexes: How much of your own personal wealth is invested in PowerShares products (not the company) versus other funds?

Bruce Bond: 100 percent.

John Prestbo, Dow Jones Indexes

John Prestbo is editor and executive director of the Dow Jones Global Indexes and is responsible for the development of new indexes for Dow Jones & Company. He is also markets editor of The Wall Street Journal.

Journal of Indexes: What is your view on the trend toward more targeted and strategically driven indexes or "indexes" now flooding the market?

John Prestbo: You mean the move to get thinner and thinner? I think some of that is very good. It gives investors the opportunity to use index products to execute their strategies. For example, we started out at Dow Jones Indexes with 10 economic sectors, which are now 10 industries under the ICB classification benchmark. BGI uses these indexes as the basis for iShares.

This spring, BGI came out with ETFs on 14 narrower slices—areas of the market such as pharmaceuticals. So now, if an investor wants to, they can go long the healthcare sector and short pharmaceuticals, or vice-versa, to gain their desired exposure to that industry. I think that narrow/niche stuff is pretty good. It's not for everybody, obviously, but as long as the products are there, some investors will be able to make intelligent use of them.

As for strategy-driven indexes, some of those are good, too. The problem is that some of them get quite convoluted and dubious in terms of investor merit. If this trend were extended infinitely, we'd end up with an index of small cap stocks run by left-handed CEOs, and that doesn't have any investment merit in my mind. So, somewhere down the line, we could slip down a slippery slope of "indexes for indexes sake," rather than indexes designed for intelligent investment purposes.

Journal of Indexes: What are your thoughts on what the dividing line between indexed and active investing, if you believe there is one?

John Prestbo: To me, indexes mean rules … rules-driven. All of these indexes that are coming out, including some that I am dubious about, have rules. And as long as the rules are followed, whether or not the market is catering to those rules, I'm fine with it. In the end, the investor has to make the choice about whether or not the index is appropriate.

Active investing to me is complete freedom from rules. You may have a vaguely worded investment objective, but an active manager can react largely at will and do things that aren't planned out or specified in advance.

Journal of Indexes: How do you respond to the various challenges to market-cap weighted indexes? Are problems like over-investing in market bubbles and the costs of public reconstitutions/front-running/index effect really problems, or are they blown out of proportion?

John Prestbo: They are legitimate problems or potential problems. Lately I've heard a lot of people cite these problems as reasons for attacking market-cap-weighted indexes. In that regard, I think it is probably a little out of proportion. But it is true that a market cap index does accentuate bubbles—there is no doubt about that. It's just a fact of life. I don't think anybody has devised an index that avoids all market problems, be it on the upside or the downside

I don't pay much attention to the attack on market cap indexes because they are the most reasonable representation of the market, which consists of the sum total of the prices that people are willing to pay for stocks. Those stocks can be overbought or oversold at any given point … but collectively, they are the market. These other approaches—fundamentally weighted, dividend-weighted, or what-have-you weighted—are simply investment strategies. They are approaches to finding your way through the market-cap-weighted market and coming out the other side, perhaps better off than if you just floated there. But then again, perhaps not. People choosing those kinds of indexes have to be prepared for the fact that sometimes they are going to do less well than the market, as represented by cap-weighted indexes.

Journal of Indexes: Is that message getting out?

John Prestbo: Hell no. Partly because no body's marketing material makes a big deal about it, and partly because a lot of investors don't pay a lot of attention to that stuff anyway.

There are a lot of so-called investment truths—starting with buy low/sell high—which have accumulated over time. A lot of these index products, particularly the ETFs, are just too new to have given people the chance to accumulate wisdom about how to use them.

We always try to tell people that all indexes are not alike, and that you have to understand how they operate, what their methodology is, etc. Whether or not anybody is listening is another matter.

Warren Schmalenberger, Dorchester Capital

Warren F. Schmalenberger is the founder and chief executive officer of Dorchester Capital Management a Houston-based company focused on and improving techniques for measuring and managing risk in the investment community. Mr. Schmalenberger is responsible for the company's strategic direction, as well as product development.

Journal of Indexes: What hole does the CPMTKS fill in the index universe?

Warren Schmalenberger: The first hole it fills is that it presents the only market neutral portfolio, because it is the only index of the total investment-grade market.

Second, the CPMTKS index and all of its accompanying indexes and sister indexes represent the only index system that will be able to look at asset allocation as the market does it. I'm not talking asset allocation between large cap and small caps, or between growth and value. I'm talking about asset allocation between Treasury securities and mortgage securities and common stocks and preferred stocks, etc.

It also fills a hole informationally by providing observers and market participants with four real-time indexes that can measure the relative activity between stocks, bonds, liquidity and the total market. There was no easy way to do that on a minute-by-minute basis before.

Journal of Indexes: When will we see investable products tied to the CPMTKS?

Warren Schmalenberger: Obviously, I'm not in control of that train. If I were, we'd already have them. But we are currently talking with several people about that.

Journal of Indexes: How should investors use the CPTMKS index to shape their investment decisions?

The second thing is it gives people, or would give them as an investable product, is the ability to create a market neutral portfolio. From there, you would be able to systematically add risk or subtract risk, which is what academics have talked about for years.

Another important feature is that this would be a one-stop portfolio to provide true diversification. On a more complex level, for consultants, the array of indexes provides a way to look at asset allocation on a complete scale.

Journal of Indexes: Why stop at the stocks, bonds and liquidity - what about commodities, real estate, and other measures of wealth?

Warren Schmalenberger: This is the capital markets series. It is not a capital assets series. The thing about capital markets is that they tend to be priced very often, and they tend to be there for a long duration of time. They involve securities that are freely traded, and you have many potential buyers of the same thing, and most of these securities are registered with the SEC.

We do have a commodities index in the works, which will be a separate module, and we have worked on real estate and a few other intriguing and esoteric indexes as well. Those are part of capital assets, of which capital markets are just a part.

Joanne Hill, Goldman Sachs

Joanne M. Hill is a managing director and leads Equity Products Strategy at Goldman Sachs, where she advises institutional investors on investment strategies and market developments for equity derivative products, ETFs and portfolio trading.

Journal of Indexes: What is your view on the trend toward more targeted and strategically driven indexes or "indexes" now flooding the market?

Joanne Hill: [These indexes] offer retail investors (as they are commercialized through ETFs and mutual fund products) the benefits investment strategies based on quantitative screening and portfolio construction tools in a low-cost, easily accessible product. These are "quantitatively-driven active products" because they are built around the idea that a factor or theme (fundamental selection, dividend tilts, etc.) will deliver superior returns in the long run. The best results, in my view, come from quantitative tools combined with portfolio management that uses human judgment to incorporate dynamic and qualitative factors that the quant tools cannot. These enhanced index strategies can be built around the new indexes and offered in both institutional and retail fund management products—but not easily in the ETF format.

Journal of Indexes: How do you respond to the various challenges to market-cap weighted indexes? Are problems like over-investing in market bubbles and the costs of public reconstitutions/front-running/index effect really problems, or are they blown out of proportion?

Joanne Hill: For any strategy, be it cap-weighted, fundamentally weighted, small cap, tech stocks, etc., we can see periods where superior returns attract funds at an aggressive pace, which leads to prices overshooting economic value for a period that can last months or even a few years. (This can also occur on the negative return side as well, where groups of stocks can move out of favor and be under-priced for a time after particularly weak performance).

Market forces correct these distortions eventually, as competing strategies begin to appeal on a cost basis, first to a narrow and then to a broader group of investors. In the late-1990s for example, the superior returns of cap-weighted indexes attracted investors for return reasons, more than for their feature of representing a capital market segment. We should not let these factors influence our core belief about how to construct a passively managed index covering a segment of publicly traded securities.

As for index effect issues around changes and reconstitutions, the market has proven repeatedly that these are temporary and eventually arbitraged away.

Gus Fleites, ProShares

Gus Fleites is chief investment officer for both the ProShares ETFs and the more than 100 mutual funds managed by ProFund Advisors LLC. He also is responsible for leading the ProShares ETF initiatives. Prior to joining ProFunds in 2005, Mr. Fleites was a Senior Principal at State Street Global Advisors (SSgA), where he led the ETF practice.

Journal of Indexes: You've just made it through the end of six years of waiting at the SEC with your ETFs. What are you going to do now?

Gus Fleites: There are two parts to my answer. The first is that we will continue to get the word out from an educational perspective on the uses and applications of the products we just introduced (the first 12 ProShares ETFs). The second is that we will continue to pursue opportunities to round out our offerings with other leveraged and inverse products tied to other major benchmarks. Our initial exemptive filing covered a broad array of indexes.

Journal of Indexes: Does it make any sense for a buy-and-hold investor to have ProFunds leverage in their portfolios?

Gus Fleites: It could. It depends on what they are looking to do. People who are trying to pursue "Portable Alpha" strategies may be well served by the leveraged ProShares. One of the interesting possibilities that ProShares offers is the ability for investors to maintain 100 percent exposure to the market using less than 100 percent of their cash. Using a 2X leverage fund, investors can gain their market exposure with 50 percent of their funds, and then take the remaining 50 percent and pursue more aggressive strategies.

We would not encourage people to use the ETFs as speculative tools, but rather, to use them to structure a portfolio. The ETFs allow investors to do things they otherwise would not be able to do without access to a professional margin account.

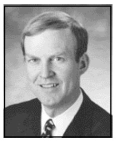
Journal of Indexes: Who do you see as the primary current and potential users of the leveraged and inverse products?

Gus Fleites: This is a story that rings true with many ETFs, but the users of ProShares are going to come from very different walks of life. We're definitely going to see interest from the trading community, from brokers, and from hedge funds. We're also seeing a fair amount of interest from retail investors—for instance, the inverse funds are going to be a great hedging tool for retail investors. And we believe there will be some institutional players as well, as well as pension and other investors who are excluded from going short by their investment guidelines, but who can now use the ETFs to gain hedging exposure.

Journal of Indexes: Will the new ETFs cannibalize ProFunds mutual funds, or will they grow the broader opportunity?

Gus Fleites: I think that they will grow the opportunity. The mutual funds have been targeted primarily at the Registered Investment Advisor marketplace. We believe that introducing the ETFs will allow us to market in channels that we haven't been present in up to this point. Our goal is to broaden the scope of our reach.

Matt Moran, CBOE



Matthew T. Moran is vice president, Business Development, for the Chicago Board Options Exchange (CBOE), and is responsible for many of the exchange's marketing and educational efforts. He played a leadership role in developing and marketing the CBOE S&P 500 BuyWrite Index (BXM).

Journal of Indexes: Is the surging interest in the BuyWrite strategies crimping returns in that space?

Moran: In the past two years, we have seen increased interest in buy-write strategies, as evidenced by the fact that more than 45 new buy-write products have raised more than $20 billion in assets. A buy-write is a strategy in which an investor buys stocks and writes (or sells) call options for income. Buy-writes often are used to add income and reduce portfolio volatility.

I have not seen strong evidence to suggest that the surging interest in the BuyWrite strategies is crimping the relative returns in that space. In fact, in response to strong customer interest in the BuyWrite strategy, the Chicago Board Options Exchange (CBOE) now has five benchmark indexes designed to track the performance of buy-write strategies that sell index options on the third Friday of every month.

The CBOE BuyWrite Indexes have had positive returns the past three calendar years, despite relatively low volatility levels. In the first half of 2006, many of the CBOE BuyWrite Indexes outperformed key traditional indexes: the CBOE S&P 500 BuyWrite (BXM) and CBOE DJIA BuyWrite Index (BXD) were up 4.9 percent; the CBOE S&P 500 2% OTM BuyWrite (BXY) was up 4.5 percent; the CBOE Russell 2000 BuyWrite (BXR) was up 3.1 percent; and the CBOE NASDAQ-100 BuyWrite Index (BXN) was down 1.7 percent. By comparison, the S&P 500 was up just 2.7 percent, and the Citigroup 30-year Treasury Index was down 8.8 percent.

A key source of returns for buy-write strategies is the level of implied volatility and the amount of call options premiums received. The CBOE Volatility Index (VIX), the key measure of implied volatility in the broad market, was at historically low levels in 2004 and 2005, but it rose in mid-2006. The average daily closing price for VIX from its 1990 inception through June 2006 was 19.3. In 2005, the average price for VIX was 12.8, but by June 2006, the average VIX price rose to 16.9.

For the BXM Index, the average monthly premium received (expressed as a percentage of the underlying) was 1.6 percent for the 16-year period from June 1988 through July 2006, 1.2 percent for the calendar year 2005, and 1.7 percent for May-July 2006.

One could ask: Is interest in buy-writes always higher in times of higher volatility and higher options premiums? My answer would be that interest in a strategy often is dependent on recent relative returns. For example, in the years 1995-1999, implied volatility was at relatively high levels, and the average annual returns were 21 percent for the BXM Index and 29 percent for the S&P 500 Index. There has been more interest in buy-writes in recent years than there was in the late-1990s, however, in part because many stock indexes have had lackluster performance this decade.

The Ibbotson BXM case study noted that another key source of returns for the BXM is the fact that S&P 500 implied volatility has been higher than realized volatility. This phenomenon appears to continue to persist and to continue to help improve the risk-adjusted returns of index options buy-write strategies.

Journal of Indexes: Are you surprised by the size of the interest in the VIX options, so soon after the products launched?

Moran: Options on the CBOE Volatility Index (VIX) began trading February 24, 2006, and these products experienced one of the most successful launches for a cash-settled index option.

VIX options average daily volume was 23,754 from inception through June 2006, and the open interest in June 2006 was 829,616 contracts. The VIX Index is an implied volatility index that measures the market's expectation of 30-day S&P 500 volatility, implicit in the prices of near-term S&P 500 options.

I personally was not surprised by the size of the interest in VIX options. In past years, the CBOE has received several unsolicited requests to list VIX options. Since its introduction in 1993, VIX has been considered by many to be the world's premier barometer of investor sentiment and market volatility. Many individual and institutional investors closely follow the VIX. The OTC market for variance and volatility swaps is estimated at around $10 billion in size.

Wall Street firms have issued many research reports on the VIX Index, with titles such as "Volatility - The Perfect Asset?" "The New VIX as a Market Signal - It Still Works;" and "The Volatility Risk Premium: Sell Volatility?" In an article in The Journal of Investing entitled "Fear and Greed in Global Asset Allocation," the authors from State Street Global Advisors wrote that VIX "is a good indicator of the level of fear or greed in U.S. and global capital markets. When investors are fearful, the VIX level is significantly higher than normal. Market participants require additional compensation in the form of above-average excess returns for riskier assets. ... Using implied volatility as an asset allocation factor would have added significant value over the last thirteen years."

VIX price moves often (but not always) are negatively correlated with the S&P 500: if the S&P 500 falls, the VIX can explode on the upside.

In the future, I believe investors will continue to utilize the VIX Index and VIX futures and options as tools for hedging, asset allocation, and indicators for market sentiment.

Graham Tuckwell, ETF Securities

Graham Tuckwell is the founder and chairman of ETF Securities Limited, whose companies achieved first listings of Exchange Traded Commodities (ETCs). Previously, Mr. Tuckwell was the founder and managing director of Investor Resources Limited, a boutique corporate advisory firm, which specialized in providing financial, technical and strategic advice to the resources industry.

Journal of Indexes: What have been some of the primary challenges you've faced in building and maintaining alternatively structured ETFs, with portfolios including hard assets, derivatives and fixed-income instruments? What unexpected operational issues have you run into?

Graham Tuckwell: As you know, we have been the pioneers in bringing non-share products to market, including hard assets (gold) and futures markets (oil). We will shortly be bringing some more products to market as well. Prior to our initial products being launched, the only ETFs available were those representing baskets of shares (whether whole markets, sub-sectors or other groupings). We changed that by firstly bringing hard assets to market (Gold Bullion Securities, backed by gold bullion stored in a vault) and then by bringing the futures markets to the stock exchange (Oil Securities, backed by oil contracts provided by an oil major, which track the futures market price of oil). These both required enormous hurdles to be overcome because the listing rules, exchange rules, tax law and corporate law were not written with these products in mind. In some cases we had to get regulatory or exchange exemptions, and in other cases, we had to design new corporate and tax structures to enable these vehicles to be flow-through entities with no unintended tax consequences.

Although these products are simple and straightforward for the investor (they just track the price or total return of the commodity), the underlying documentation is new to the market-makers, so it has taken time to get them on board. But that is now happening, and on-exchange trading spreads are tightening and volumes are increasing as a result. Our gold (ticker: GBS) and the oil (ticker: OILB) ETFs are now two of the most liquid ETFs in the whole of Europe.

With regard to operational issues, the administrative side of the products have worked smoothly as expected but, as mentioned, it has taken us longer than hoped to get market-makers and authorized participants to review and sign the underlying documentation.

Journal of Indexes: What do you see as the primary opportunities in the space, both in terms of investment areas and product structures going forward?

Graham Tuckwell: Many investors are realizing that there is more to investment than listed shares, and yet most ETFs still just relate to shares. Although there will be many new share products to come, there will also be a lot more product that gives investors exposure to other asset classes, whether in the form of ETFs, ETCs or other.

For most investors looking for exposure to assets which to date have been difficult for them to access, their primary focus will be beta, i.e., just getting the exposure in an efficient way. There are numerous specialist mutual funds and UCITs funds that seek to provide these exposures, but their fees are very high and it is unclear whether the managers are adding any alpha. This is where ETFs/ETCs will become recognized as the preferred way to gain exposure, because of their perfect or close tracking and low fees.

As for the product structures, they will be determined by the exposures being provided and the countries in which the products are listed. Each country is different and each exchange and regulator needs to be fully briefed and engaged in the process, and that takes time!

Kevin Rich, Deutsche Bank

Kevin Rich is a director in the Currencies and Commodities Complex Risk Group at Deutsche Bank, and is chief executive officer of DB Commodity Services LLC, which is the Managing Owner of the DB Commodity Index Tracking Fund. He is responsible for providing currency and commodity-based investor solutions to the Deutsche Bank sales force in the Americas.

Journal of Indexes: Where do you see opportunities for more innovative ETFs in strategically focused or other investment areas?

Kevin Rich: For asset classes that have been traditionally difficult to reach for investors, a properly structured ETF can provide much needed liquidity and transparency. We have seen this in the commodity and currency space, and I believe it should continue in other investment areas, provided there is adequate market size and liquidity in the underlying asset class.

Journal of Indexes: What are some asset class areas where you think investors are currently still being underserved?

Kevin Rich: Currencies and commodities ETFs are still in the early stages of development, so there will be more demand for more products in this space as investors continue to diversify their portfolios. Enhanced indexes will continue to be developed across many asset classes as well, giving investors more investment alternatives beyond benchmark indexes. The DB structure behind our ETFs holds underlying futures contracts, so we will see opportunities based upon listings in the futures markets.

Journal of Indexes: You have been at the lead of some significant product structure shifts in the ETF industry. Do you think we will continue to see innovation along these lines?

Kevin Rich: Absolutely. The benefits of exchange listing, which ETFs bring when compared to traditional mutual funds and other non-exchange products, will continue to attract new assets into all ETFs.

Journal of Indexes: What do you say to those who believe that commodities and currencies do not have intrinsic growth (or returns) of their own and should therefore not be considered asset classes?

Kevin Rich: I would point them to the independent research, which does validate these as asset classes. For instance, relative to commodities, Gary Gorton of the Wharton School and Geert Rouwenhorst of Yale's School of Management studied commodity futures as an asset class and co-wrote "Facts and Fantasies about Commodity Futures," which shows commodity returns, Sharpe ratios, and correlation compared to equities and bonds. There are numerous academic studies on comparative risks and returns of currencies, including papers from the Bank for International Settlements and the National Bureau of Economic Research, which substantiate the notion of currencies as an asset class.

Journal of Indexes: The negative correlations between commodities and stock prices have not held in recent years. Is that an anomaly or the start of a new trend?

Kevin Rich: At times commodities indexes have been negatively correlated, other times they have exhibited low correlation, and sometimes, for short periods, they have been more correlated. It is very much dependent on the time frame and frequency you are looking at. Over the long run, commodities have shown a low-to-negative correlation to stocks and bonds, so we would not say this is the start of a new trend.

Robert Shiller, Case-Shiller Weiss

Robert Shiller is the co-founder and chief economist of Case-Shiller Weiss, Inc. (now Fiserv CSW, Inc.), a home price research company. He is currently the Stanley B. Resor Professor of Economics at the Cowles Foundation for Research in Economics and International Center for Finance, Yale University.

Journal of Indexes: What do you see as the key failing of the current financial markets, on both a macro and micro level, and how might the landscape shift in the next 20 or 30 years in the way that Modern Portfolio Theory shifted the ways individuals think about investing?

Robert Shiller: As I argued in my 2003 book, *New Financial Order: Risk in the 21st Century,* our improved information technology and improved financial theory will allow a much broader array of risks to be managed. While we may feel very impressed with our risk management devices today, I believe that we are far less than halfway towards optimal risk management. As evidence that risk management has so much further to go, look at the fact that fluctuations in consumption have very low correlations across nations. If people were managing their risks optimally, their consumption should be impacted only by world risk, not idiosyncratic risks, and thus would be highly correlated across countries.

Journal of Indexes: What does the recent streak of record low volatility say about the current market situation? And is that coming to an end?

Robert Shiller: No one completely understands volatility. I would venture a guess that low volatility in the stock market mirrors high volatility in real estate. Mass attention has shifted from the stock market to the real estate market. It will shift back.

Journal of Indexes: If indeed we are in a real estate bubble, would consequences be only to individuals or could their be further reaching economic effects?

Robert Shiller: Real estate is a major asset class, bigger, actually than the stock market. As such, it has to matter one way or another to every sector of the economy. Real estate activity has long been a favored leading indicator of the direction of the economy, and I think that there is every reason to think that will continue in the future. However, as we move to liquid risk markets for real estate, the random character of real estate prices, and their relation to the economy, will be transformed.

Bogle And Malkiel Fight Back

Indexing scions take on fundamentally weighted indexes

Compiled by *Journal of Indexes* Staff

Illustration by Todd Davidson

When WisdomTree Investments launched its first 20 dividend-weighted exchange-traded funds (ETFs) in June, CEO Jonathan Steinberg didn't hold back. Calling market-cap weighted indexes "flawed," Steinberg said that his funds "had the potential to change the way investors think about indexing and investing."

Weighting stocks by dividend, Steinberg said, as opposed to market capitalization, was simply "a better way to index."

Steinberg wasn't the first to attack market-cap-weighted indexes. Far from it: Nouveaux indexers had been openly attacking the indexing establishment for the better part of two years, ever since the March/April 2005 publication of Rob Arnott's paper, "Fundamental Indexation," in the *Financial Analysts Journal.* (And indeed, long before that! Arnott's paper just re-opened an ongoing debate).

Arnott's paper argued that cap-weighted indexes systematically overweight overvalued companies and underweight undervalued companies. He proposed an alternative weighting methodology based on four fundamental factors—book value, dividends, cash flow and revenues—that he claimed would lead to higher returns.

Other index designers, including the folks at Steinberg's WisdomTree Investments, have since proposed using dividends or other fundamental factors to weight stocks. But no matter what metric is used, the goal is the same: To design an index that will outperform traditional cap-weighted benchmarks.

For the most part, traditional indexers haven't felt the need to fight back. After all, index funds have trillions of dollars in assets and a library of supporting academic research that would take a lifetime to consider. But the combination of the WisdomTree launch and a strongly worded editorial by Jeremy Siegel in the *Wall Street Journal* ("The Noisy Market Hypothesis," June 14, 2006) appears to have provoked the traditionalists. On June 27, 2006, they struck back.

Writing on the op-ed pages of the *Wall Street Journal,* John Bogle and Burton Malkiel issued a fiercely worded bromide against "fundamental indexing," calling it little more than a fad made possible by the tremendous outperformance of value stocks in the wake of the Internet bubble. Fundamental indexing's large-scale outperformance, they suggest, is sure to be dashed … perhaps soon … against the rocky shores of reversion-to-the-mean.

"[W]e need to be cautious before accepting any "new paradigm" that implicitly suggests that the "old paradigm"—reflected in more than $3 trillion of capitalization-weighted index investment funds—is in error," they wrote.

Their argument in favor of cap-weighted indexing comes in two parts, and will be familiar to readers of this publication (see Steven Schoenfeld's survey of alternative index weighting methodologies in the May/June issue of the Journal of Indexes). Nonetheless, in light of the continuing debate surrounding this issue, it bears closer examination.

Costs Matter

Bogle and Malkiel start by pointing out the central, tautological truth of capitalization-weighted indexes: Investors as a whole must earn the same return provided by a capitalization-weighted index.

"We can not live in Garrison Keillor's Lake Wobegon, where all the children are above average," they write. "For every investor who outperforms the market, there must be another investor who underperforms."

In fact, the universe of investors in aggregate must underperform the benchmarks because you must deduct the fees and taxes that come with investing in the market. And that, say Bogle and Malkiel, is where fundamental indexes start to suffer.

The pair note that the expense ratios for publicly available fundamental index funds range from 0.49 percent to 1.14 percent. Although the WisdomTree ETFs cost significantly less than that, even their low fees (some as low as 28 basis points) are still significantly higher than traditional index strategies. The FTSE/RAFI U.S. 1000 PowerShare comes in at 60 bps.

Moreover, the pair notes, fundamental indexes will tend to experience higher turnover than cap-weighted indexes, thanks to weighting adjustments mandated by changes in the fundamental factors. In cap-weighted indexes (at least, in total market cap-weighted indexes), those adjustments are made automatically with no cost to investors tracking the index.

Interestingly, the core backtested data published by WisdomTree, Arnott and others do not reflect the impact of fees or taxes.

The fundamental indexers, of course, would say that any talk of expenses is noise compared to the performance enhancements their indexes offer. Both Rob Arnott and WisdomTree say that their strategies have delivered more than 200 basis points of annual outperformance over standard cap-weighted indexes, and have done it over long stretches of time. With that in mind, they suggest, what are a few basis points in fees?

Value Can't Run Forever

The other main criticism of the fundamental indexing argument is that all these fundamental indexers are launching their products in the aftermath of six years of extreme value outperformance. The good times, the traditionalists warn, won't last forever.

"Fundamental indexing will tend to do well in periods when small-cap stocks and "value" stocks tend to outperform," write Bogle and Malkiel. "Thus it is not surprising that most of the long-term excess return attributed to fundamentally weighted portfolios was achieved between 2000 and 2005 alone, one of the best periods in history for the relative returns of dividend-paying stocks, "value" stocks and small-cap stocks."

Will that good run continue? You never know. But the pair note that, since 1937, value and growth funds (as opposed to indexes) have come within a hair's breadth of tracking one another's performance, with average annual returns of 10.62 percent for growth and 10.59 percent for value. (According to Ibbottson data, value indexes have outperformed growth indexes over most timeframes. But the actual funds—with expenses, manager drift, etc.—are another matter.)

"We never know when reversion to the mean will come to the various sectors of the stock market, but we do know that such changes in style invariably occur," Bogle and Malkiel conclude. "Intelligent investors should approach with extreme caution any claim that a 'new paradigm' is here to stay. That's not the way financial markets work."

Throwing Out The Efficient Markets Hypothesis (EMH)

The fundamental indexers, of course, don't want to hear it. They reject the idea that there is always a "reversion-to-the-mean" in the market. They would point out that, as Kenneth French and Eugene Fama have repeatedly shown, small cap and value stocks have outperformed other securities over most significant historical periods … with no obvious reversion to the mean yet. And while EMH diehards will argue that there are hidden risks buried in the small/value exposure, the fundamental indexers say this isn't so: "Current attempts to explain the hidden risks in value stocks remind me of the astronomers in the 16th century who attempted to save the earth-centered Ptolemaic view of the universe," writes Siegel, in his aforementioned June 14 op-ed.

Siegel proposes a "new paradigm" called the "noisy markets hypothesis, by which the prices of stocks "are not always the best estimate of the true underlying value of the firm." Prices, according to this new theory, can be influenced by speculators, insiders and institutions, who may be buying or selling for reasons that are not related to the firms' underlying value (tax selling is but one example). These non-fundamental sales, says Siegel, create "noise," which obscures the true value of stocks.

"If you are a fan of indexing, as I and so many other investors are, you are no longer trapped in capitalization-weighted indexes which overweight overvalued stocks and underweight undervalued stocks," says Siegel. "Fundamentally weighted indexes are the next wave of investing."

[In fact, Siegel responded point-by-point to the Bogle/Malkiel op-ed in a letter published in the *Wall Street Journal* on July 27.]

Irresistible Force Meets Immoveable Object

The argument between the fundamentalists and the traditional indexers is the classic case of an immovable object meeting an irresistible force. The core argument of market cap weighting is tautological: Investors, in total, will earn the cap-weighted return of the market minus fees.

At the same time, the core argument of the fundamental indexers is just as true: Market-cap weighted indexes will, by necessity, overweight companies with the highest market capitalizations … and underweight them at the lowest market capitalization.

You can't escape either conclusion.

One widely held criticism of fundamentally weighted indexes is that they are basically value indexes in disguise. William Bernstein, on his fantastic Web site www.efficientfrontier.com, examines the supposed outperformance of Rob Arnott's "Fundamental Indexes" and finds that two-thirds of the outperformance is explainable by inadvertent factor weightings, while one third is explainable by the fundamental "technique." Unfortunately, that one-third that is attributable to "technique" is not a statistically significant result, suggesting that it could be mined from the data with hindsight.

"Even assuming that fundamental indexation produces returns in excess of its factor exposure, caution should be used in the practical application of this methodology," Bernstein writes. "Differences in the expenses, fees, and transactional costs incurred in the design and execution of real-world portfolios can easily overwhelm the relatively small marginal benefits of any one value-oriented approach. The prospective shareholder needs to consider not only the selection paradigm used, but just who is executing it."

In the end, the final answer will only come when the fundamental indexes and the investable products that track them have 3-, 5-, 10- and even 20-year real-life performance records that we can trace over time. In the interim, though, as the pages of this issue show, the debate will be fun to watch.

Keeping Your Money Inside The Box

Purifying your approach to style investing

by Paul Lenz, Ph.D., and Michael Dellapa, CFA

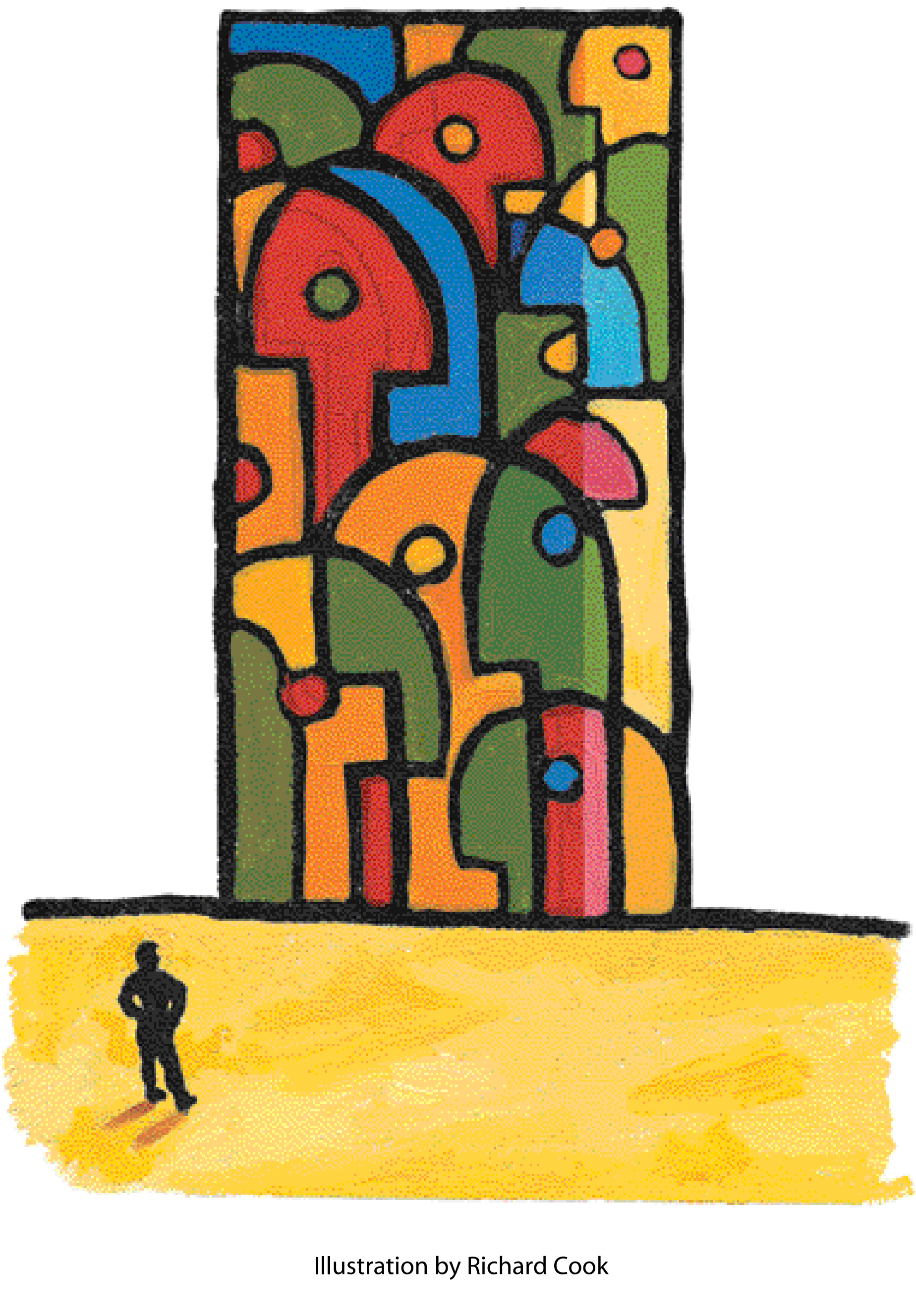


Illustration by Richard Cook

Tactical investors who use style rotation strategies now have a new, genuinely innovative investment tool—the S&P/Citigroup Pure Style Indices. Unlike most other style indexes, which weight stocks based on market capitalization, the new Pure Style indexes are weighted by their growth and value exposures. This gives investors more of a pure play when making style allocation decisions—in essence, helping them keep their style bets more completely focused "inside the box."

This article briefly describes the methodology, advantages, disadvantages and applications of the Pure Style indexes, and compares them with their more comprehensive but less focused sister indexes, the S&P/Citigroup Style Indices.

New Scoring and Weighting Methodologies

In May of 2005, Standard and Poor's (S&P) announced plans to retire its S&P/BARRA style index family and replace it with two new sets of indexes: the S&P/Citigroup Style Indices ("Style") and S&P/Citigroup Pure Style Indices ("Pure Style"). As with the old S&P/BARRA style benchmarks, the new Pure Style and Style index families feature six indexes each, broken down into the traditional size (large, mid- and small cap) and style (growth and value) categories.[1]

The new indexes use an objective scoring methodology that incorporates seven common factors characteristic of either growth or value stocks (Figure 1). This is in sharp contrast to the old indexes, which defined growth and value based on a single factor: the book-to-price ratio.

Beyond the more nuanced style scoring methodology, the new indexes also differ from the old S&P/BARRA indexes by implicitly acknowledging that growth and value characteristics are not mutually exclusive. To do this, the indexes determine the growth and value scores for individual components separately. For each stock in the parent index (e.g., the S&P 500), the new methodology calculates a growth score by averaging three standardized growth factors, and separately calculates a value score by averaging four standardized value factors. It then assigns stocks with the highest relative growth ranks to a "Pure Growth" basket, stocks with the highest relative value ranks to a "Pure Value" basket and stocks in between to a "Core" basket.

The Style indexes are then assembled using traditional capitalization weighting. S&P constructs the Growth index by including all of the stocks in the Pure Growth basket at 100 percent of their capitalization, plus all of the stocks in the Core basket at the fraction of their market capitalization that represents growth. The Value index is constructed in a similar fashion.

Figure 1

Standardized Factors Used In Style And Pure Style Indexes	
Growth Factors	**Value Factors**
Five-year historic earnings/share growth	Book-to-price
Five-year historic sales/share growth	Cash flow-to-price
Five-year average internal growth rate*	Sales-to-price
* Internal Growth Rate=Return on Equity (ROE) X (1-Payout Ratio)	Dividend Yield

Source: Standard and Poor's, S&P U.S. Style Indices: Teleconference Presentation, September 20, 2005.

In contrast, the Pure Style indexes are built using style weighting. S&P generates the Pure Growth index by including all of the stocks in the Pure Growth basket that have a minimum growth score, and then weights these stocks by their growth score. The Pure Value index is created in a similar fashion. Core stocks are excluded.[2]

The major differences between the two sets of indexes can be summarized as follows:

- **Universe coverage:** The Style indexes include all stocks from the parent index. By contrast, the Pure Style indexes include only stocks from the Pure Growth and Pure Value Baskets.
- **Overlapping stocks:** While some stocks tracked by the Style indexes appear in both the growth and value style categories, the Pure Style benchmarks do not overlap—stocks are either identified as Pure Growth or Pure Value.
- **Weighting scheme:** The Style indexes are weighted by market cap, while the Pure Style indexes are weighted by style scoring.
- **Breadth:** The Style indexes offer broad coverage of the market, while the Pure Style indexes are narrower and more focused.

Advantages Of The Pure Style Indexes

Because the Pure Style indexes omit stocks in the Core basket, and because the stocks they include are weighted by their growth and value scores, we believe the Pure Style indexes are superior to the Style indexes for use in style rotation strategies. This is primarily attributable to the superior contrast that exists between growth and value. For example, the average monthly return spread is in the 4 percent range for the S&P/Citigroup 500 Pure Style Indices, compared to the 2 percent range for the S&P/Citigroup 500 Style Indices. The Pure Style spreads are consistently larger than the Style spreads for mid- and small-caps as well.

There is also a far lower correlation between growth and value within the Pure Style indexes compared to the Style indexes. This is true for large, mid- and small caps. For tactical asset allocators, this contrast should help magnify the impact of making the "right" decisions based on shifting style movements.

Finally, performance for the Pure Style benchmarks has been demonstrably better. Over the ten years ending December 31, 2005, the S&P/Citigroup 500 Pure Growth Index outperformed the S&P/Citigroup 500 Growth Index by 4.07 percent per year. Similarly, the S&P/Citigroup 500 Pure Value Index outperformed the S&P/Citigroup 500 Value Index by 4.05 percent per year. In the mid- and small-cap arena, the Pure Style indexes outperformed the Style indexes by 1.73 percent to 2.17 percent, except for the S&P/Citigroup 400 Pure Growth Index, which underperformed the S&P/Citigroup 400 Growth Index by 0.70 percent.[3]

Figure 2

Growth Indexes	Volatility (1)	Annual Turnover (2)	Value Indexes	Volatility (1)	Annual Turnover (2)
S&P/Citigroup 500 Pure Growth Index	25.51%	10.42%	**S&P/Citigroup 500 Pure Value Index**	16.86%	14.21%
S&P/Citigroup 500 Growth Index	19.01%	8.82%	**S&P/Citigroup 500 Value Index**	13.93%	10.14%

(1) As measured by standard deviation, for the ten years ending December 31, 2005. (2) Based on three years to December 31, 2005.
Source: Standard and Poor's.

Important Considerations

There are some limitations to keep in mind before employing the Pure Style indexes. As shown in Figure 2 (covering large-caps), the Pure Style indexes are more volatile and have greater turnover than the Style indexes.

For mid- and small-caps, the volatility of the Pure Style indexes was also greater than the Style indexes. In addition, the Pure Style indexes are somewhat less liquid than the Style indexes. Because the Pure Style indexes contain fewer securities, funds tracking the indexes must purchase more of each security. Moreover, because stocks are weighted by their growth and value scores rather than by market capitalizations, the indexes may have more exposure to less liquid stocks.

Broad Applications For The Pure Style Indexes

The features of the Pure Style indexes suggest a number of interesting investment applications. Long-only investors now have a more focused and potentially more profitable way to make growth or value style allocations. Portfolio managers that have the flexibility to take long and short positions may be able to more fully exploit expected spreads between growth and value securities. Finally, for tactical asset allocators, the lower correlation among the Pure Style indexes as compared to their Style index counterparts may make them better suited for use in tactical asset allocation products.

Keeping Assets Inside The Box

The S&P/Citigroup Pure Style Indices offer investors employing active style rotation strategies a much purer play on style investing than formerly available benchmarks. Historically, the Pure Style indexes have demonstrated better contrast between growth and value, lower correlation between growth and value, and better performance characteristics than the S&P/Citigroup Style Indices.

Endnotes

1 These are S&P 500 Growth, S&P 500 Value, S&P MidCap Growth, S&P MidCap Value, S&P SmallCap Growth and S&P SmallCap Value indexes.

2 Blitzer, David M. and Srikant Dash, "Introducing A Comprehensive Style Index Solution: Methodology of Standard & Poor's U.S. Style Indices," May 24, 2005. To access this document via the Internet, go to www.styleindices.standardandpoors.com and click on "Methodology."

3 Historic performance data is based on total returns. Standard & Poor's is the source for all performance characteristics.

A More Stylish Fit

Letting the numbers—and not the name—determine the benchmark

by Robert J. Waid

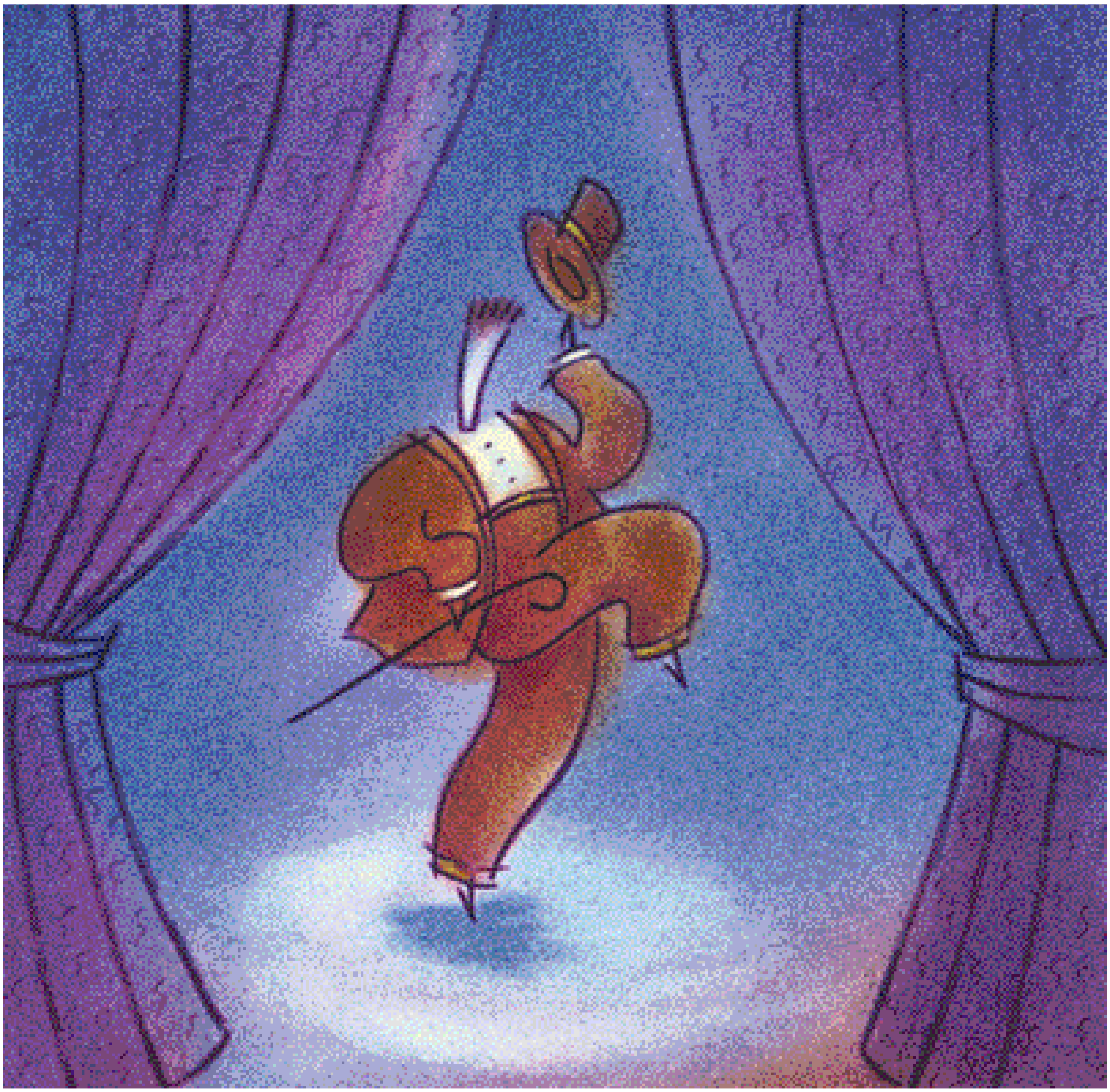


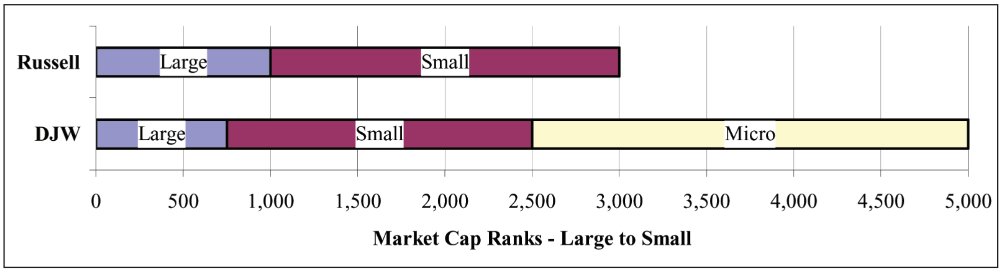
Illustration by Craig Smallish

Choosing the most appropriate benchmark benefits both the investor and the investment manager. The benchmark should be representative of the manager's investment universe, or it should at least have comparable investment risk exposures. When there is a match, the investor receives the desired style exposure and the manager can demonstrate skill.

In this study, we examined self-described Russell style managers to determine whether Russell or Dow Jones Wilshire size indexes better match their portfolios.[1] Despite the names, we found that the Dow Jones Wilshire indexes were a better investment universe and performance match for these managers—especially in the small-cap arena.

Figure 1

Index Size Definitions



Index Differences[2]

This study compares and contrasts two pairs of indexes: the Russell 1000 Index and Dow Jones Wilshire U.S. Large-Cap Index, and the Russell 2000 Index and Dow Jones Wilshire U.S. Small-Cap Index.

All four indexes track U.S. stocks and use market-capitalization rankings to determine which stocks enter which index. The Russell 1000 is a large-cap index consisting of the 1,000 largest U.S. companies as ranked each June by market capitalization.[3] The Russell 2000 is a small-cap index made up of the next 2,000 largest companies. Similarly, the Dow Jones Wilshire U.S. Large-Cap Index consists of the 750 largest U.S. companies as ranked by market capitalization each March and September, while the Dow Jones Wilshire U.S. Small-Cap Index is made up of the next 1,750 largest companies.[4] (See Figure 1)

The main difference between the indexes is that the Russell 1000 includes an additional 250 "smaller" companies when compared with the Dow Jones Wilshire Large-Cap Index.[5] Necessarily, this difference spills over into the capitalization coverage of the small-cap indexes as well, with the 250 companies excluded from the Dow Jones Wilshire U.S. Large-Cap Index entering the Dow Jones Wilshire U.S. Small-Cap Index. These 250 companies have a relatively minimal impact on the large-cap indexes, but they have a striking impact on the small-cap indexes. What accounts for just 4 percent of the Russell 1000 large-cap index accounts for more than 30 percent of the Dow Jones Wilshire Small-Cap Index.

On the small-cap end of the spectrum, the Russell 2000 includes 500 companies that the Dow Jones Wilshire indexing system considers to be microcap stocks. These 500 companies account for a little more than 7 percent of the Russell small-cap index. Thus, both Russell size indexes are larger by count (250) than their corresponding Dow Jones Wilshire size indexes, while the Dow Jones indexes are skewed higher on market capitalization.

On June 30, 2005, for instance, the Russell 2000 had a market-cap range of $182 million to $1,828 million, while the DJ Wilshire Small-Cap Index had a market-cap range of $326 million to $2.8 million.[6]

Manager Data

For this study, June 2005 holdings[7] from the Wilshire Cooperative system were analyzed, where the manager's self-selected benchmark was one of the four Russell style indexes: Russell 1000 Growth, Russell 1000 Value, Russell 2000 Growth and Russell 2000 Value.[8] Using Russell and Dow Jones Wilshire size indexes, manager holdings were divided into three size baskets: 1) holdings that matched the manager's style size; 2) holdings opposite the manager's style size (large vs. small); and 3) holdings in microcap companies (those outside the bounds of the relevant small-cap index).[9]

Results: Large-Cap

Figure 2 shows the large-cap style manager holdings divided using Russell's large-cap and small-cap indexes. The results show that large-cap style managers stayed very close to their size benchmark when measured against the Russell indexes: Less than 1 percent of manager holdings were in small-cap or microcap stocks.

Figure 3 shows these same manager holdings divided into large-, small- and microcap segments using the Dow Jones Wilshire size indexes. These managers had less than 3 percent of their holdings outside of their size benchmark.

Not surprisingly, given the larger universe, the Russell large-cap index provides improved coverage. It is debatable, however, whether the additional 250 companies is worth the 2 percent improvement in large-cap coverage.

Results: Small-Cap

Figure 5 shows how small-cap style manager holdings were invested compared to Russell's large-cap and small-cap indexes.[10] The small-cap Russell value and growth style managers

Figure 2

Holdings Coverage Using Russell Indexes On June 2005

Manager Style	Portfolios	Large	Small	Micro
Large Value	237	99.0%	1.0%	0.0%
Large Growth	204	99.4%	0.6%	0.0%

Figure 3

Holdings Coverage Using Dow Jones Wilshire Indexes On June 2005

Manager Style	Portfolios	Large	Small	Micro
Large Value	237	98.0%	2.0%	0.0%
Large Growth	204	97.4%	2.6%	0.0%

invested 24 percent and 30 percent of their holdings in Russell large-cap stocks, respectively. When using the Dow Jones Wilshire Indexes, this falls to 11 percent and 11 percent, respectively, though the microcap stock allocation increases substantially (see Figure 6).

What is interesting, however, is that even though the Dow Jones Wilshire Small-Cap Index includes 250 fewer stocks than the Russell 2000, it accounts for a larger percentage of actual small-cap style manager holdings. This implies that Russell benchmarked managers believe in—and invest with—a size cutoff closer to the 750th largest company (the Dow Jones standard) than the 1,000th largest company (the Russell standard).

At first glance, it might appear that these data support a separation between small-caps and microcaps closer to the 3,000th largest stock than the 2,500th largest stock. But a more critical look at the data reveals a different answer. As Figure 7 shows, small-cap managers hold roughly the same percentage of their portfolio in stocks larger than the Dow Jones Wilshire U.S. Small-Cap Index as they do in stocks smaller than the index. By comparison, these "missing stocks" are dramatically skewed towards large-caps for the Russell 2000.

Neither index fully covers the breadth of holdings of small-cap managers, suggesting that these managers do not stick strictly to size guidelines. We believe, however, that the even distribution of "missing holdings" around the Dow Jones Wilshire U.S. Small-Cap Index indicates that it more closely approximates the core universe of stocks from which small-cap managers select their holdings.

Explanatory Power: R-Squared And Alpha

A better universe match delivers a significant increase in explanatory power and thus serves as a more useful bench-

Figure 4

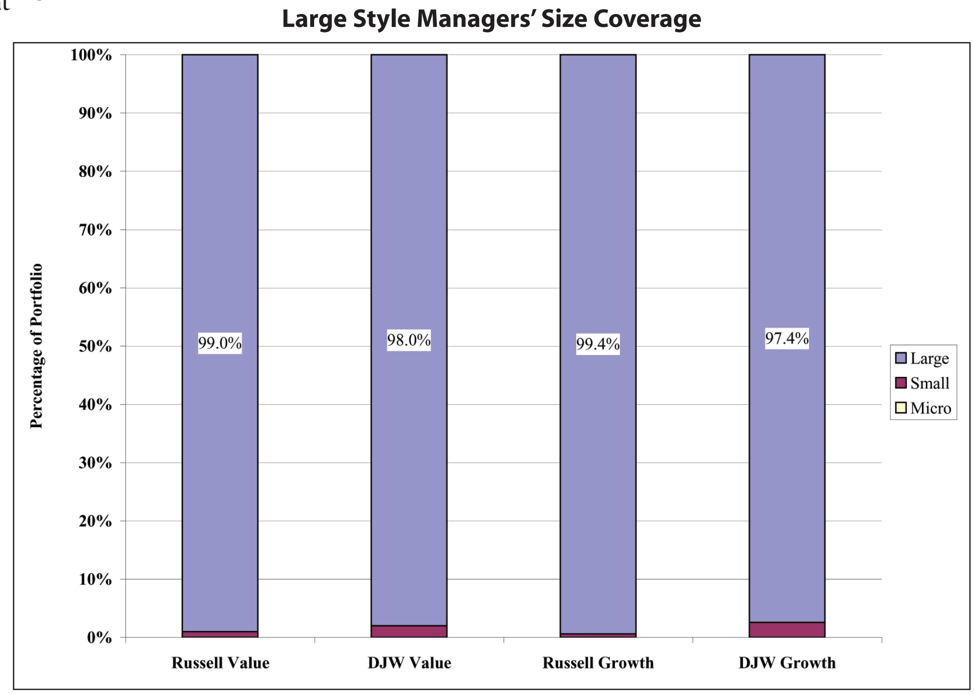


Figure 5

Holdings Coverage Using Russell Indexes On June 2005

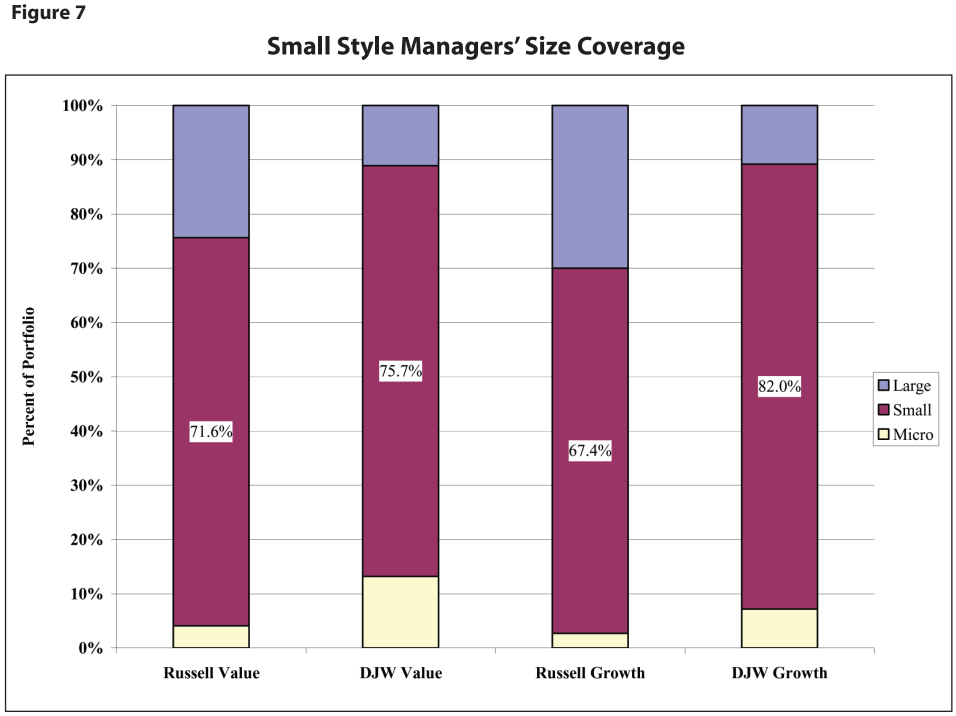
Manager Style	Portfolios	Large	Small	Micro
Small Value	90	24.4%	71.6%	4.1%
Small Growth	82	30.0%	67.4%	2.7%

Figure 6

Holdings Coverage Using Dow Jones Wilshire Indexes On June 2005

Manager Style	Portfolios	Large	Small	Micro
Small Value	90	11.1%	75.7%	13.2%
Small Growth	82	10.8%	82.0%	7.2%

Figure 7



mark. We compared active style manager returns to the style indexes that best matched their self-described investment style using the Wilshire Compass[11] (i.e., a small-cap growth active manager was compared to the Russell 2000 Growth and Dow Jones Wilshire Small-Cap Growth indexes).[12]

R-squared is a common measure of benchmark appropriateness. As Figure 8 demonstrates, based on R-squared (and also correlations), a case can be made for using either index provider's matching named index.

These results are not unexpected, considering that the R-squared between Russell and Dow Jones Wilshire style indexes is between 0.99 and 1.00. However, similar R-squared numbers do not translate into similar measures of skill (alpha). Figure 9 shows how exposures to different sections of the market translate to dramatically different measures of skill.

The importance of the index size cutoff is demonstrated by the fact that all three small-cap style manager categories had higher alphas when benchmarked against the corresponding Russell index than they did using the correspoding Dow Jones Wilshire index. (More than 90 percent of the 611 small-cap managers had better alphas using Russell's small-cap style indexes than they did using Dow Jones Wilshire's.) This confirms that the different index size exposures are material. It also suggests that a majority of the active Wilshire Compass managers invested with size exposures more in line with the Dow Jones Wilshire Indexes than with the Russell Indexes. Figure 10 shows how these different alphas distort the skill message (a manager can claim skill with an alpha greater than 0.0).

Figure 8 Average Five-Year R-Squared Of Active Managers Matched to Appropriate Style Indexes Ending December 2005

Style	Managers	Russell	DJ Wilshire	Difference
Large-Cap Growth	327	0.94	0.94	0.00
Large-Cap Core	207	0.95	0.95	0.00
Large-Cap Value	302	0.95	0.95	0.00
Small-Cap Growth	213	0.95	0.94	0.01
Small-Cap Core	133	0.95	0.96	-0.01
Small-Cap Value	225	0.95	0.95	0.00

Figure 9 Average Five-Year Alpha Of Active Style Managers Matched to Appropriate Style Indexes, Ending December 2005

Style	Managers	Russell	DJ Wilshire	Difference
Large-Cap Growth	327	3.22	2.26	0.96
Large-Cap Core	207	1.37	1.43	-0.06
Large-Cap Value	302	0.87	1.40	-0.53
Small-Cap Growth	213	2.53	-0.56	3.09
Small-Cap Core	133	3.63	2.02	1.61
Small-Cap Value	225	2.12	1.91	0.21

Figure 10 Percentage Of Style Managers With Positive Alpha Matched to Appropriate Style Indexes, Ending December 2005

Style	Managers	Russell	DJ Wilshire	Difference
Large-Cap Growth	327	81.0%	73.4%	7.6%
Large-Cap Core	207	70.0%	72.0%	-2.0%
Large-Cap Value	302	60.6%	67.5%	-6.9%
Small-Cap Growth	213	67.6%	44.6%	23.0%
Small-Cap Core	133	88.0%	76.7%	11.3%
Small-Cap Value	225	68.4%	67.1%	1.3%

Conclusion

Index names and R-squared measurements are not sufficient to determine the appropriateness of a benchmark to measure skill. When matching the holdings of Russell benchmarked style managers, results show that the Dow Jones Wilshire U.S. Large-Cap Style Indexes served large-cap style managers nearly as well as the Russell 1000 Style Indexes, and did so more efficiently. More revealing was the fact that small-cap, Russell-benchmarked style managers invested well above the Russell large/small size cutoff, showing that the Dow Jones Wilshire size cutoffs were more appropriate for small-cap Russell style managers. These points suggest that even self-proclaimed Russell style managers and their clients would be better served with the Dow Jones Wilshire Size and Style Indexes.

Endnotes

1 Growth/value benchmark mismatch—another critical issue—is a topic for a separate article.

2 This comparison highlights general differences only.

3 Russell and Dow Jones Wilshire have different definitions of U.S. companies.

4 Dow Jones Wilshire's use of buffer zones means that the cut-offs are not exact.

5 This is over-simplified because of different rebalance dates, additions, deletions, buffer zones, etc.

6 Russell market-cap ranges use the DJ Wilshire 5000 membership with Russell definitions.

7 Russell's optimal evaluation date, assuming indexes should be closest to their objectives on their rebalance dates.

8 The Wilshire Cooperative is a collaboration between Wilshire Associates and more than 60 independent investment consulting firms to provide performance measurement and analytical services to their plan sponsor clients.

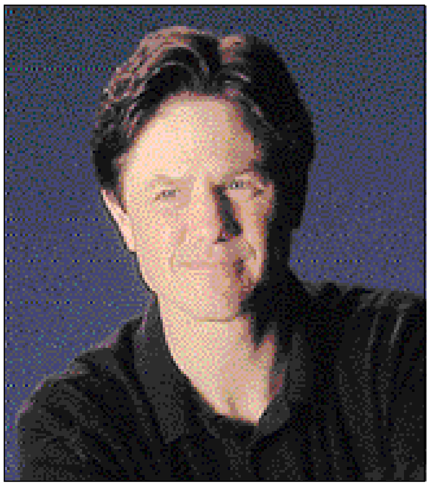
9 Microcap for the Russell is defined as stocks with a market capitalization lower than the 3,000th company.

10 Four "obvious" microcap managers were removed from the sample. These small-cap value managers each had more than 80 percent of their holdings in the DJ Wilshire U.S. Micro-Cap Index.

11 The Wilshire Compass is a PC-based fund management and consulting tool.

12 Active managers in the Wilshire Compass database were defined as U.S. equity managers whose investment philosophy was either "Active Bottom-Up" or "Active Top-Down."

The Russell Index Philosophy



By Kelly Haughton
Strategic Director,
Russell Indexes

There are two ways to construct an index. You can build it from the top down, working from the proverbial "Ivory Tower" to craft an index that fits a preconceived notion of how the equity markets *should* work. Or you can build it from the bottom up, studying investment managers to determine how the equity markets and investors actually *do* work.

Russell's history is steeped in the real-life world of asset management. We pioneered and continue to lead the field of global multimanager investing, putting together portfolios of managers to build and preserve wealth for all types of investors. It is no surprise, then, that our indexing philosophy follows the "bottom-up" approach: We need accurate benchmarks that can help us evaluate managers and separate skill from market performance, or we can't deliver value to clients. Real dollar performance is a cruel taskmaster.

Russell has developed its index family to reflect this need. Our philosophy is that no investment manager should be forced to pick a particular index when their investment approach differs from that index substantially.

The Russell Index Family

While we are best known for our large-cap Russell 1000 and small-cap Russell 2000 indexes, the Russell index family includes six capitalization categories:

- **The Russell 1000 Index** covers the extensive large-cap segment of the U.S. equity universe, representing approximately 92 percent of the total U.S. market capitalization. The index includes the 1,000 largest companies in the U.S. market.
- **The Russell 2000 Index** covers U.S. small caps, representing approximately 6 percent of the total U.S. market. It includes stocks ranked 1,001 through 3,000 by market capitalization.
- **The Russell 3000 Index** is a broad U.S. equity index representing approximately 98 percent of the total U.S. market. It combines the Russell 1000 and Russell 2000 indexes.
- **The Russell 2500 Index** covers the small- and mid-cap segment of the U.S. equity universe, commonly referred to as "smid" caps. It includes the smallest 2,500 securities in the Russell 3000, and is an increasingly important index for Russell (more below).
- **The Russell MidCap Index** offers investors access to the mid-cap segment of the U.S. equity universe. It includes the smallest 800 securities in the Russell 1000 Index.
- **The Russell Microcap Index** includes the smallest 1,000 securities in the Russell 2000 Index, plus the next 1,000 securities. It does not include less-regulated OTC bulletin board securities or so-called "pink sheet" stocks. It represents less than 3 percent of the total U.S. equity market.

Russell also offers style (growth and value) breakdowns on each of these indexes, as well as "megacap" indexes tracking the largest 50 and largest 200 companies in the U.S. Soon, we will be expanding overseas, with a complete set of international indexes that use the same rigorous methodology as our U.S. benchmarks.

Overlap—Or Listening To Managers

When we launched the Russell Microcap Index in June of 2005, we received a fair amount of criticism from the academic arm of indexing for the overlap between the small-cap Russell 2000 and the new Russell Microcap Index. Some observers believed that the indexes should be discrete, and that we were wrong to include the 1,000 smallest members of the Russell 2000 in the new Microcap benchmark.

Our reason for doing so, however, was simple: The research showed that microcap fund managers select from stocks ranked up to about the 2,000th largest security. Meanwhile, small cap managers select stocks as small as the 3,000th largest security. To start the Microcap index at the 3,000th stock—or raise the capitalization cut-off for the Russell 2000—would have meant overlooking the full opportunity set used by small cap and micro-cap portfolio managers, respectively.

Our investment manager research team has been monitoring investment managers for over 30 years, and we have observed that U.S. equity managers specialize across the cap spectrum as well as across the style spectrum. Our indexes are built to match that.

Diversifying The Small-Cap Index Market

A case in point for the importance of closely monitoring U.S. equity managers is the evolution of our small-cap family of indexes. More than a decade ago, our analysts noticed that the Russell 2000 Index did not fit all of the small-cap investment products available in the marketplace. Many managers drew on somewhat larger-cap stocks, while a new (and growing) class of managers focused almost exclusively on the smallest end of the spectrum. As a result, today Russell offers a family of small-cap indexes: the Russell 2000, Russell 2000 Growth, Russell 2000 Value, Russell 2500, Russell 2500 Growth, Russell 2500 Value and Russell Microcap indexes.

As Figure 1 shows, use of the Russell small-cap family has grown over time, thanks largely to growing use of the Russell 2500 and the style versions of the Russell 2000 and Russell 2500. In contrast, use of the regular Russell 2000 Index has remained mostly flat. This reflects the fact that different managers operate in different portions of the market, and with Russell's full slate of indexes, they are able to choose benchmarks that accurately reflect their investing universe.

Over the last few years, the mid-cap segment of the market has delivered solid returns, and the Russell Midcap and Russell 2500 indexes have performed very well. As a result, many managers have had a difficult time outperforming these indexes. Nonetheless, more and more managers are using these indexes as benchmarks, as they accurately reflect their style choices.

Conclusion

The Russell family of indexes does a good job of covering the universe of U.S. equity managers, and this is reflected in the success of the indexes in the marketplace. According to our internal research, 54 percent of institutional investor products and 52 percent of institutional investor assets are now benchmarked against Russell's family of U.S. equity indexes.[1] That percentage has nearly doubled over the past four years. We hold a dominant position in style indexing as well.

As our share of the market has grown, managers have significantly diversified their use of the Russell indexes, particularly in the small-cap area. More and more managers are embracing the Russell 2500 and related style indexes, reflecting their movement into the "smid-cap" space. This more-focused benchmarking has helped clients to better understand what these managers are trying to accomplish, and has improved our ability to identify manager skill.

Figure 1

Most Frequently Used U.S. Equity Benchmarks: Number Of Products

Index	U.S. Institutional Equity Products Benchmarked						
	1996	1998	2002	2003	2004	2005	2006
S&P 500	1,379	1,306	1,009	924	919	901	888
Russell 2000	216	299	289	255	264	275	273
Russell 1000 Growth	23	47	78	128	168	219	264
Russell 1000 Value	25	41	130	177	219	243	252
Russell 2000 Growth	31	81	116	174	194	210	224
Russell 2000 Value	6	17	65	103	136	159	170
Russell 2500TM	23	42	53	55	69	81	108
Russell Midcap Growth	5	25	41	75	90	96	103
Russell Midcap Value	--	--	33	41	67	79	94
Russell 3000	12	23	39	39	52	69	92
S&P MidCap 400	73	89	84	73	63	59	62
Russell Midcap®	12	28	41	50	45	49	53
Russell 1000®	19	20	29	43	43	48	52
S&P/BARRA Value	10	21	37	35	30	30	23
S&P Small Cap 600	5	10	11	12	11	14	13
Wilshire 5000	16	18	16	15	12	12	13
S&P/BARRA Growth	14	18	18	16	16	15	11

** Compiled by Russell Product & Marketing Research using Nelson Information's MarketPlace Web database and* 1998 Survey of Performance Benchmarks. *Products analyzed are primarily institutional-oriented mutual funds, separate accounts, and commingled funds. Only indexes with at least ten products benchmarked to them are included in the study.*

Endnotes

1. Smith, Matthew T., and Deepak, George, "U.S. Equity Index Benchmark Usage," Russell Indexes paper, June 2006.

A Special Bank of New York Sponsored Feature on ETFs

During a recent gathering of senior Bank of New York clients, a panel of ETF industry experts offered an insightful and thought provoking overview of the rapidly evolving ETF marketplace. The following piece is an excerpt of this stimulating panel discussion and concludes with an interview with the Bank of New York's Joe Keenan, who discusses what is driving the growth of ETFs and where they may be headed next.

Excerpts from ETF Panel
The Bank of New York Client Advisory Board Meeting
June 20, 2006, The Palace Hotel, New York City
Moderated by Jim Wiandt, Editor, *Journal of Indexes*

Jim Wiandt: I never thought I'd see the day when indexing became something that everyone wanted to talk about. But it seems like that is what has happened, particularly with exchange-traded funds (ETFs). ETFs have really gotten a lot of attention in the national media, and for good reason. Over the past couple of years, we've seen a lot of very interesting things happen in the industry. We've seen ETFs open up asset classes that weren't really available to a broad array of investors on a cost-effective basis; we've seen the launch of strategy-driven, alternatively weighted, alpha-pursuing strategies wrapped inside ETFs; we've even seen ETFs that have other derivatives inside them, which allow you to manage the ETF to whatever benchmark or pseudo-benchmark you want.

It's just a very exciting time. There have certainly never been as many ETFs in registration as there are now, and I don't think there's ever been as interesting an array of products.

We have a great panel today to discuss these topics. They're amusing, and they tend to know what they're talking about.

I'll just go down the line. Immediately to my left is Lisa Chen, a portfolio manager at BGI [Barclays Global Investors], which is the 800-pound gorilla in the ETF industry with over $200 billion in assets and over 100 products.

To her left is Kevin Ireland. Kevin works at ALPS Distributors and is charged with promoting the Nasdaq-100 ETF (QQQ).

To his left is Jonathan Steinberg, who just last week launched twenty new ETFs, which have been the buzz of the industry, and which definitely fit the spectrum of alternative strategies. The WisdomTree ETFs are dividend-weighted, and I'm sure "Jono" will talk about the advantages of this, and how market capitalization can sometimes overweight stocks at the top end of the spectrum.

To his left is Cliff Weber, who heads up the ETF business at the American Stock Exchange (Amex). The Amex is really the brain trust and the birthplace of ETFs: The first ETF—the Spider [the Standard and Poor's Depository Receipt 1, ticker "SPY"]—came out of the Amex in 1993. And, of course, the Amex is still very active in product development, including the development of indexes and strategies for new products.

Let's start our Q&A with Cliff Weber. Cliff, could you talk about the ETF industry and how it has evolved since the launch of the Spiders?

Cliff Weber, Senior Vice President of the Amex ETF Marketplace: Sure, Jim, thanks. In 1993, we launched the Spider on the AMEX. It was based on the S&P 500, which at the time was certainly the best-established benchmark in terms of broad market exposure, among both institutional and retail investors.

We structured the fund as a unit investment trust. It was essentially a passive vehicle. There's no investment advisor to manage the assets. The trustee has built into the trust the steps to manage the fund so that it tracks an index. From that day in the end of January, 1993, to today … well, Jim already talked about the tremendous growth we've seen.

The initial growth in the product line extended out to more domestic products and international products—both country based funds, regions, sectors, etc. The U.S. market has been sliced and diced fairly well: large-cap, mid-cap, small-cap, growth/value, blend, various sectors. It really is getting down finer and finer in terms of the slicing and dicing of the indexes. Even internationally, there are individual countries, regions and sectors. There's fixed-income, too.

Now the category really is beginning to expand into even more asset classes. The first product based on gold was launched at the end of 2004, and since then, there has been an additional gold-based product filed [and launched]. Combined, I believe that these two funds have something on the order of $7 or $8 billion in assets.

BGI launched a silver trust earlier this year, which very quickly gathered assets. Deutsche Bank launched a product based on the Deutsche Bank Liquid Commodity Index, which is more of an index of commodity exposure.

I think the interesting thing here is that we're starting to see the creation of new product structures, rather than 1940 Act companies. These products are being structured either as commodity pools or limited partnerships. BGI is coming out now with some structured notes. We're getting into individual commodities: There is already an oil-based ETF out there. In short, the ETF structure really is expanding to cover the demands of the marketplace, and is bringing that opportunity to individual as well as institutional investors.

The other thing that's happening in the ETF space—what has been happening over the last couple of years—is that the indexes that are being created are more what we call "strategy-based" or "theme-based" indexes. For example, there's a family of ETFs from PowerShares that are based on what are called Intellidexes, which are indexes that have a certain element of quantitative screening involved to try to capture some opportunity for performance.

There now are other products coming to market that are using alternative weighting schemes and alternative approaches to indexing to try to capture some element of performance. I think ultimately what will happen is that this will merge with the movement into alternative assets, and you'll start to see more quantitative strategies in other asset categories: currencies, other commodities etc.

Out of the gate, ETFs were primarily institutional products for a couple of reasons: One was that the institutional approach is one way to get assets quickly, and ETFs—especially the SPDR, as an S&P-based product—appealed very well to institutions. Over time, more of the early adopter individual investors used Internet-based brokers and they started becoming more involved in the product. More recently, and I think in a large part due to some efforts from BGI, you see a lot more Registered Investment Advisors managing their customer assets with ETFs. You see more wrap accounts; you see firms that are building whole [ETF] programs now. There are enough ETFs on the menu to create real strategies and real asset allocation programs. At this point, the use is really spread out among institutional, retail and managers.

Jim Wiandt: Alright, let's go to question number two, and this will be for Lisa. What are the primary ways that institutional investors and intermediaries use ETFs? I know BGI has really led the charge of marketing to the intermediary group. What are we seeing? How are we seeing the uses change over time? What are some strategies investors are not employing as much as they might be?

Lisa Chen, Senior Portfolio Manager for Barclays Global Investors: Thanks, Jim. Just to give you a little bit of background, BGI actually first entered the exchange-traded fund market way back in 1996 with some single-country WEBS products, which were a joint product with Morgan Stanley. We've actually had about a ten-year history in international ETFs as of this year. It's been a really interesting ride, seeing the assets grow from essentially nothing to about $200 billion.

As Cliff mentioned, actually a lot of the earlier investors were the largest institutions. Over time, though, that's really changed, as BGI has put in a lot of marketing and educational efforts particularly directed at the financial advisor audience. A couple of times a year, we actually go out and have road shows in a number of different cities around the U.S., educating people on ETFs and ETF investing. Today, there are a lot of financial advisors who are embracing the product, along with smaller institutions and intermediaries. The big institutions have been there pretty much all along.

In terms of uses, there are two buckets: short-term, more tactical trading strategies and longer-term strategic uses.

On the short end, we see a lot of institutions extensively using ETFs for cash equitization purposes—to equitize smaller notional amounts of cash and get diversified benchmark exposure. At the same time, we see ETFs being used where there might not be a liquid futures alternative available: for example, with the MSCI EAFE for international developed markets. There is an EAFE futures contract that launched in the end of March, but to date, we haven't seen a lot of trading volume in that contract. The only alternative, really, to equitize cash internationally, is using a basket of futures or the MSCI EAFE ETF.

Secondly, for short-term uses, we have manager transition strategies where ETFs are used when plan sponsors and managers are being hired and fired. For example, if you have fired a manager but haven't yet identified a new manager going forward, you will see an ETF being used in the interim in order to maintain benchmark-specific exposure. We're seeing a lot of these managers generate extra income by lending ETFs out in the interim.

Thirdly, we're just seeing very targeted exposures, tactical plays, for example, in sectors or countries, or overweights and under-weights. It's all about creating the exposure you want. If you look at sector ETFs, for example, they have some of the highest levels of short interest out there.

On a longer-term basis, we see strategies such as portfolio completion. We're seeing a lot of smaller institutions or smaller investors using ETFs in areas where they may feel that the market is more or less efficient, such as large-cap U.S. equities, or in areas that might not be their primary area of expertise, like international. We're seeing people gravitate to using a plug-and-play approach, especially for smaller investors.

Finally, with core-satellite strategies, investors are using an ETF for their core index position and then blending that with an active position. That active position could be funds; it could be managers; it could be underlying securities in separate accounts. The premise is really using a combination of active and passive management in order to build a better portfolio structure.

Jim Wiandt: Maybe Cliff and Kevin will remember how, four or five years ago, if we asked a room of advisors, "does anyone know what an ETF is, and who uses them?" we would get a couple hands in the room of two hundred. Now, you do these financial advisor conferences and there's a room of five hundred and it's ninety percent. I think a good part of that is the work of the BGI sales people. Out of 150,000 advisors, I bet they've met about 140,000 of them. They've been all over the country.

Cliff Weber: I agree with that, Jim, and I think, also, they've filled out the product line, which really made them useful.

Jim Wiandt: Absolutely. That's the other shift. You initially had broad ETFs for the S&P 500 and the MidCap space, and BGI really changed the whole dynamic by having a full product line, across all sectors, styles and size, and then across international and fixed-income, and now into the commodity space, too. You can lay out your whole portfolio across all these ETFs and tilt in one sector, if you want. There's been a real shift in the industry and it's reflected in the assets.

Next up is Jono from WisdomTree. Jono: Which investment areas do you think will see more new ETFs and ETF-like products? Where do you see the opportunities for new product development going forward?

Jonathan Steinberg, CEO of WisdomTree Investments: First, just a quick background. One thing that makes WisdomTree a little bit different is that we have developed our own indexes and are the ETF sponsor as well, and I think that is one of the structural changes that will continue to allow development. In a very real sense, WisdomTree not only competes with iShares (BGI), State Street and Vanguard, but also with MSCI, S&P and Russell.

We're taking a fundamental-weighting approach as an alternative to market-cap weighting. We try to capture all of the best characteristics of index construction: some very broad indexes, fully transparent, low turnover. But we also realize that we're not first to the game. The plan of matching the market … Vanguard and iShares dominate that space and there's no way to take that away from them.

What we tried to do with our index construction was to deliver better returns with less risk. Of the twenty funds we launched, six of them were domestic, broad-based American equity funds (large, mid- and small cap), including two specialty products, a high-yielding fund and a Top 100 fund, which is a high-yielding slice of the large-cap segment. The fourteen remaining funds are international, including EAFE funds (small/mid/large), specific country funds like Japan, and other regions like Europe and the Pacific region excluding Japan.

One thing that we did see is a tremendous opportunity on the international side. BGI dominates the business of ETFs, with a particular strength in the international side. We really added some real choice to the market, including some of the first small-cap ETFs internationally. We tried to add some innovation through index construction.

One of the things that had been spoken about earlier was a consciousness on fees. And just to step back a little: Launching a low-fee firm was the area of greatest resistance for us. Nobody that we met wanted us to launch a low-fee firm. In this audience, there is a tremendous interest in hedge funds and private equity. So we would hear all the time, "I love your methodology: Can we do it as a hedge fund?" And when you combine the economic incentives of a high-fee approach with the SEC process, which really penalizes a low-fee approach and the whole ETF format … well, it's not surprising that Barclays has so little competition. There are just so many barriers to entry.

That's why you're seeing alternative asset classes, alternative weighting structures, and a lot of mixed specialty products that are just filling out the alternatives. Investors, particularly where they are not in a tax-advantaged structure, really embrace the ETF format. Liquidity and convenience are very, very important. Transparency and fees are very important. But for most investors, particularly if you're talking about the retail side, tax efficiency has to be of paramount importance. So I would really say that the traditional mutual fund industry, and in some sense, the hedge fund industry, faces tremendous competition from the ETF format.

We have made a tremendous effort and commitment to the ETF format. We think that the structure is best of breed, and that it slowly but surely is attracting all investors. On the retail side, the online brokerage firms say that some of the most widely held securities are ETFs. I know that a lot of people disdain what the retail investor does, but that's not fair. Where they have the opportunity to make a decision based on their own self-interest, with no influence from anyone else, they are flocking to ETFs.

We've spoken about a $2 trillion number. Internally, we feel that whatever people are investing in, eventually you will see it in the ETF format. We're quite bullish on the opportunities ahead of us. I think it's just the beginning.

Jim Wiandt: Okay, you raise some very interesting issues. Let's turn to Kevin Ireland: Where do you see the ETF industry headed in the next 5 or 10 years?

Kevin Ireland, Regional Sales Director for ALPS: I'll start with the immediate future and work my way out. The immediate future seems like we will see a continued trend in alternative asset classes with ETFs. BGI has done it with gold and silver, there's oil, commodities…I think you'll see continued coverage in different metals and different commodities-type baskets. I think you're going to start to move into less liquid commodities, allowing not just individuals but institutions the first chance to invest directly in these types of products … for better or worse.

You're going to be able to invest directly in natural gas, unleaded gas, regular gasoline, coal, soft commodities, grains. And then you can move on to some less liquid commodities. We can talk about lumber. I know there's some talk about an ETF on real estate. You're going to be able to invest in certain geographic areas of the country in the real estate area. I'm not sure exactly how that works out on a real time pricing basis, but they're working on that, and they're going to be able to do that.

ProFunds recently received exemptive relief on their inverse and leveraged ETFs, too.

What I think is very interesting is that, on a product level, most ETFs have been successful. If you look at most product launches, across anything—I mean, if you talk about cereal, or whatever—how many products are really successful? There's only been a handful of ETFs that have failed so far. Moving down the road, some will work, some won't … but for the most part, success rates run very high. When you compare that to mutual funds or hedge funds … they close and reopen every ten minutes.

There are a lot of naysayers out there who say the market's saturated. But remember, ten years ago, 98 percent of the people were saying, "These things are not going to work." There are several people in this room who sat in front of audiences when we were talking to them, trying to educate the world about ETFs, and it was like we were chasing them through the woods with an ax. And they were afraid: "Run away, run away!"

On the equity side, I think you're going to see continued interest in the quant models, with transparency. I think all investors like to see transparency in the portfolio, and, from the ETF perspective, it also helps pricing a lot.

The other successful thing about ETFs, which no one has mentioned, is the ability to make really tight markets. The QQQs are the most active security in the world, but I think [the tight markets] extend right down the line.

Funds of funds are a thing that could happen a lot more, too—not necessarily for asset allocation, but relative to hedge fund-type strategies: Long/short strategies, market-neutral strategies, correlation strategies. You're laying fees on top of fees, but I can tell you that when hedge funds are charging 2 and 20, they're using ETFs to implement half of their strategies. So you could still be extremely cheap in comparison to a traditional hedge fund. Hedge funds probably won't like that, but that's not a bad thing overall.

Jim Wiandt: That was great, Kevin. There was a lot of food for thought in that. I think first, ETFs have been the driver of sort of a huge shift in the focus of the wider index industry. I think you see a trend toward more focused concentrations, sectors and micro sectors, higher volatility, and quantitatively-driven strategies that drift towards active. And, of course, somewhat higher fees, also. Ironically, I think, in active management, you're seeing the opposite trend, where fees are coming down and they're becoming more risk conscious and more like indexes.

I'm wondering if anyone has any thoughts on that: about ETFs forcing change in the wider actively managed fund business. And also, in terms of ETFs cracking the 401(k) market and other distribution channels.

Jonathan Steinberg: I'll just jump in for a second on the breaking into other channels like the 401(k) market. First, indexing itself hasn't been so pervasive in the 401(k) market. But the regulatory environment has put a lot of pressure on who gets in, and pay-to-play has been something that has been really looked at very carefully. I think it's really been something that is percolating, and I think change is coming from that.

Specifically on the ETF side, there are small firms that are aggregating trades that make it cost-effective to buy ETFs in the 401(k) structure. Though it is only in its infancy, I think this will be something that will continue to develop over time. So I would be optimistic that they will penetrate [the market] and that they have figured out how to do it in a cost-effective way.

I think, basically, you have to realize that ETFs are another distribution channel. When you talk to issuers, no one is blind to the growth of ETFs over the last several years. There's tremendous interest among traditional fund managers with what's happening in the ETF space and how it is affecting them. They have entrenched and established channels of distribution that they're looking at. One of the things about ETFs is that it really opens up distribution in a different way to issuers. The intermediary channel is so much more accessible and so widely used with ETFs. I think there's a lot of interest there.

But the infrastructure has to be there to support it. I think the industry will develop a solution if there's enough of a need for it, and I think we're starting to see that happening. One thing to remember is that one of the big appeals of ETFs—tax efficiency—is not a big deal in the

401(k) channel. But there are certainly cost benefits and flexibility benefits that carry over that still may have some appeal. My opinion is that ETFs are going to grow into the active space. There will be active managers out there with ETFs in the next couple of years.

Question from Patrick Curtin, Executive Vice President of The Bank of New York: What is the view of the panel on the competitive reaction of the behemoths in this space?

Kevin Ireland: I think some of the behemoths are actually looking at this as the model case, and that they're still on the sidelines. But if they see a distribution channel that could bring in $1 trillion, I think they're going to look at it more seriously. I don't think there are too many huge players out there who haven't at least stuck their toe in the water. And once it starts to happen, I think you'll see the big players come in.

Question from Joe Keenan, Managing Director of The Bank of New York: How different would an actively managed ETF be from the existing version of exchange-traded funds that are out there?

Cliff Weber: The key aspect of an exchange-traded fund is the fact that it's open for creations and redemptions at net asset value everyday. So, one of the features should be that there should not be the significant premiums or discounts that you see in the closed-end fund space. Obviously, the issue is how much information needs to be in the marketplace to allow for market participants, specialists, market makers and trading desks to adequately compile portfolios for creation and redemption and feel comfortable that their pricing model works … all without the fund manager completely revealing their holdings. That's something that we've been working on for a long time, and we think we have an approach for that. We're working with some issuers, and hopefully we'll have something we can talk about publicly very soon.

Jim Wiandt: I have a question for Lisa. You talked about strategies for retail and for institutions. The majority of our audience today has an institutional perspective. Where in Barclays have you seen the greatest interest from that perspective?

Lisa Chen: Typically, I think applications for the institutional audience, and particularly the larger institutions, are limited and they tend to be shorter-term in nature. The reality is that, managing internal assets, you can definitely manage them or have us manage them in a commingled-type structure at prices that are cheaper than the ETFs.

I think most of what we've seen recently is plan sponsors realizing the value in having their underlying iShares holdings lent out. We have also seen institutions keep a small portion of cash in ETFs so they can easily use that for cash in- and outflows. Again, I would say that the lending opportunities are very attractive and that's something that institutions are really waking up to now. We've had several inquiries that are almost entirely securities lending-driven, because if you look at particular times during the year and particular iShares, the lending revenues can be very attractive, sometimes even offsetting the management fee.

Joe Keenan: Just one more question, Jim. When we did the audience survey, literally none of the audience felt that transparency and immunity from market-timing were important features to ETFs. How much do you feel the increased scrutiny on the traditional funds business will contribute to the success of ETFs moving forward?

Jonathan Steinberg: Just on a personal note, it was the scrutiny into some of the mutual fund practices that actually allowed us to raise capital for launching ETFs. I think that, prior to that, it was perceived that there really was little demand in the market for some of these innovations. If you look at what's happened, the exchange-traded fund industry has really gone through these changes in the market without any sniff of scandal, or any problems whatsoever. I think they're definitely benefiting from an image standpoint, while on the other side, you're seeing certain older, traditional firms where it has been, in some cases, very meaningfully difficult to earn back the trust of investors.

Cliff Weber: I would also say that some of the interest we hear from more traditional asset managers has been driven by concerns that were raised by market-timing and late-trading issues. Vanguard, in particular, the way they do their ETFs is as a share class of their existing funds. They've said that the reason they did them that way was to accommodate the more active trading customers and have it not impact the ongoing shareholders.

Lisa Chen: I think, just from our perspective, that [the market-timing scandals were] one of the huge tailwinds that helped our asset growth, in combination with a lot of the education that Barclays did on ETFs. People felt comfortable that the ETFs were not subject to timing concerns.

Question from the Audience: I haven't heard in this discussion the issue of social screens in the products that you're offering. Is that at all on your horizon?

Lisa Chen: Absolutely. We actually do already have a KLD Social Select ETF, in partnership with KLD, which has a social screen. We are also looking at possibly expanding that product set down the road.

Pat Curtin: One last question here for some of the larger plan sponsors: With the advent of commodity-based ETFs, why would a plan sponsor who might want to make an asset allocation to commodities consider an ETF structure rather than some other active manager.

Jonathan Steinberg: I think you get the benefits of the ease of trading and the ability to equitize cash in a different segment. Commodities are such a huge asset class. I would say that people around the world are underinvested against that asset class. The ease of use with the ETFs will, I think, take in a lot of assets. I think it will prove to be very exciting. On the currency side, it's a tremendously large market, but it's really been open only to the most sophisticated investors. I think ETFs will democratize that asset class as it continues to develop. We are only in the very early stages.

Jim Wiandt: With the shift of the ETF structures, you've seen ETFs now go to trust structures. There's been a real blurring of the lines of definitions of what an ETF is or what an exchange-traded share is. Closed-ended products are also being marketed as ETFs, and I'm wondering: Is there more risk? If you have a structure like a Limited Partnership, for example, or some of those other structures, does anyone have any thoughts in terms of the potential risk and what that might mean to the larger ETF industry?

Jonathan Steinberg: One reason why sponsors are moving away from the 1940 Act structure is the difficulty to get through the regulatory environment. And so, if the SEC continues to be slow moving, I think you will continue to see issuers embrace the grantor trust structure or many other structures that provide quicker access to the market. I think that if you look at ETFs, there are six hundred some odd ETFs around the world versus nine thousand hedge funds and eight thousand mutual funds. You'll see that, as choice grows, it will be incumbent upon the advisor or the investor to take responsibility. As we get away from just pure vanilla investing, you're going to have to take some responsibility to make sure that you're with a firm that you can trust, or really understand the underlying structure itself or the underlying index. It will require a more proactive approach to choosing these instruments.

Jim Wiandt: On behalf of all of the panel participants, I'd like to thank The Bank of New York for the opportunity to discuss the ETF industry at its semi-annual Client Advisory Board Meeting.

A Word With Joe Keenan

The Journal of Indexes *editorial staff met with Joe Keenan, managing director and head of fund services sales at The Bank of New York, to get his view of where the Bank fits inside the ETF industry and where he thinks that industry is headed.*

Journal of Indexes (JoI): We get the sense that The Bank of New York is really ramping up its efforts focusing on ETFs. What are the Bank's goals in the ETF marketplace?

Joe Keenan, Managing Director and Head of Fund Services Sales, Bank of New York: The Bank of New York has enjoyed its reputation as a leading provider of services to the ETF marketplace since the launch of the MidCap SPDR in 1995. The services required by these products—worldwide custody, fund accounting and administration, transfer agency and basket clearing/settlement—are core capabilities we have offered as a leading services provider to funds and trusts for many decades. In fact, our first clients engaged us even before the 1940 Act was created.

In spite of our long and storied history as a top provider to funds and trusts (the Bank has more than $1.7 trillion in total assets under administration for several thousand portfolios), we have always sought to implement new technologies and services to push the industry forward.

Today, we are the leading third party provider of services to ETFs in the industry, with more than 100 separate funds under administration for 15 separate clients, and total assets under management in excess of $60 billion. It is our goal to continue to capture market share from both new and existing sponsors, and, in turn, to solidify our leadership position in this high-growth segment of the global funds industry.

JoI: We know you've always been a very big proponent of ETFs. What is your personal view on the primary advantages that ETFs bring to investors?

Joe Keenan: We are all aware of the many benefits that ETFs offer in terms of their demonstrated tax and expense efficiency. Securities exchanges have proven to be an optimal mechanism for the delivery of these products, offering the real-time benefits of execution coupled with the trading features of equities. They even provide investors with the ability to purchase the products on margin or to short shares—even on the downtick where specific relief has been granted.

In my personal opinion, the greatest benefits ETFs offer to the ordinary investor are transparency and ease of use. Today, it is more important than ever, as we gain greater control of (and responsibility for) our financial future, to know with pinpoint accuracy whether or not our investments are truly diversified. In turn, there is an ample supply of ETFs in the marketplace, including fixed-income and commodity products, to allow all classes of investors to "slice and dice" their portfolios to minimize risk and maximize the potential for gains.

JoI: Where do you see the major opportunities both for BNY and for the ETF industry as a whole going forward?

Joe Keenan: In the near term, we are very excited about the potential for growth of all of our clients' products—from PowerShares, Rydex and WisdomTree to the Nasdaq, BGI and Deutsche Bank, just to name a few. We are proud of the truly complementary range of products that we support. Because when our customers succeed we succeed too, we are working closely with all of our clients to identify potential distribution opportunities to further augment their success.

Over the longer term, we expect that more products and more sponsors will enter the ETF fray, and we are confident that, based upon our demonstrated ability to partner with clients to bring new and innovative products to market, the Bank will have the opportunity to secure important new mandates in the months and years ahead.

JoI: While The Bank of New York has a history of innovation in the ETF sphere, particularly with QQQ and the first ADR ETFs, there has been an explosion of innovation around exchange-traded products. What are investors to make of all of these new offerings?

Joe Keenan: I think it is important that investors fully understand that the ETF acronym has morphed into a catch-all for fund and trust products that trade just like stocks. While the majority of products still fit the traditional definition of a diversified portfolio designed to replicate the performance of an underlying benchmark, there are now "ETFs" that track the performance of physical commodities like gold, silver and currencies, as well as products structured as notes or grantor trusts that are designed to offer exposure to commodity futures, including oil.

While these products are all important examples of a continuing ETF evolution that include the key features of transparency and ease of trading, it is essential that investors understand how these new products differ from a tax and diversification perspective. As always, the educated investor who fully understands the risks associated with the products he or she buys is inevitably the successful investor.

JoI: What are your thoughts on the array of alternatively weighted products that have hit the market (WisdomTree, the PowerShares RAFI & Intellidex indexes, the iShares DVY ETF and the Morningstar iShares ETFs all come to mind)?

Joe Keenan: With the wide range of products based upon traditional market-cap-weighted indexes already available, ETFs appear to be driving the demand for new products based upon novel benchmarks. There is clearly tremendous potential for innovation within the index arena, whether that appears as razor-thin slices of fast-growing industry segments like nanotechnology, or through alternative methodologies like equal-weighting or dividend-weighting. Today, ETFs offer investors and their advisors an ever-increasing ability to actively manage their portfolios using "passive" products. Quantitative indexes based upon less-than-transparent rules have also emerged as a potential middle ground between traditional passive and active products.

Only time will tell if these new products will deliver on the potential for enhanced returns while minimizing risk. I for one laud these new developments, because if industry innovators like Nate Most didn't embrace the concept that there is always a "better way of doing things," then ETFs themselves wouldn't have seen the light of day. My instincts tell me that the new wave of indexes is simply an extension of the belief in the potential for innovation within our industry.

JoI: In terms of both investment areas and product structure, what are your thoughts on some of the broad areas of product development we'll continue to see in the ETF marketplace in the coming 5 or 10 years?

Joe Keenan: I think we have only touched the surface on the many ways an index can be constructed. More fixed-income products like muni's, junk and broader corporate bond offerings seem to be obvious areas for expansion. I expect we'll also see greater penetration into the 401(k) space—either via products used as wrappers around ETFs, through target portfolios comprised of ETFs, or directly via brokerage window mechanisms. ETFs on illiquid asset classes like hedge funds could also be on the horizon. I also think that ETFs will be among the first products traded on a truly 24/7 basis as the world's stock exchanges rush toward consolidation. Finally, I think there will be continuing investment in the infrastructure that supports the efficiency of ETFs, including the emergence of central clearing networks outside of the U.S. that should further drive down the cost of international products.

JoI: If you were handicapping, where do you think ETF assets will be in 5 years? 10 years? (Globally, ETF assets are at nearly $500 billion now, and over $300 billion in the U.S.)

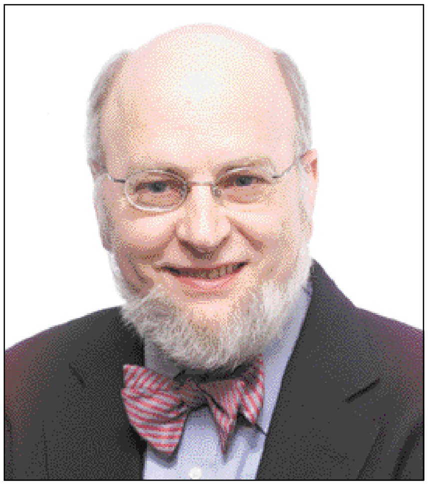
Joe Keenan: 12/31/2010: $ 1,098,453,685,211
12/31/2015: $ 2,411,989,297,987

(If you remember, please let me know how close my guess was, as I am using The Price Is Right rules and trying very hard not to overbid!)

JoI: Are there any potential ETFs you'd really like to see come to market that have not been listed yet?

Joe Keenan: Other than those mentioned in Question 6, or better yet, one guaranteed to only increase in value, I think I'd like to see products offered by sponsors that are already leaders in the traditional fund space (we look forward to the marriage of our clients Amvescap and PowerShares with great anticipation), in recognition of the tremendous asset gathering potential for the ETF market in the years ahead.

The Hunt For Investability



By David M. Blitzer,
Managing Director & Chairman of the Index Committee,
Standard & Poor's

Today, almost every index is called "investable," although little thought is given as to what that actually requires or how to achieve it. At the same time, investability is increasingly important to the way indexes are used for investments and investment products. Liquidity and low tracking errors don't just happen, after all: They must be part of the index design.

The "investability" of indexes has not always been an issue. When Charles Dow launched the Dow Jones Industrial Average in 1896, no one wondered if he or she could invest with an index—the indexes were designed to measure the performance of the market. The same was true some 30 years later when the Standard Statistics Company—a predecessor to Standard and Poor's—introduced the first capitalization-weighted indexes. The belief then was that capitalization weighting was a better way to measure the market, not that it would transform indexes into investment products. Indexes were used strictly to study or gauge market performance, to support attempts to predict the market and to see how well investors did at picking stocks. It would take several decades and a lot of economic and financial theory before the idea of investing in indexes caught on.

While financial theory made progress in the 1940s and 1950s, indexes didn't move much beyond newspapers and stock charting services until the 1960s, when the first serious attempts to see if investors could beat the market were made. Michael Jensen's 1968 article, *The Performance of Mutual Funds in the Period 1945-1964,* both established alpha as the thing to measure and found that mutual funds didn't offer much of it.[1]

Harry Markowitz moved things along with the advent of Modern Portfolio Theory, which outlined the benefits of diversification and laid in place the foundation of the Capital Assets Pricing Model (CAPM) and the trade-off between risk and reward. As tests and debates about Markowitz's work spread, what we now call benchmarking became established. Indexes were used to understand overall market movements, to relate the market to the economy and to evaluate investment managers.

In the 1970s, a new idea appeared: investing with an index. By the end of the 1970s, there were a number of institutional investors doing just that—more often than not tracking the S&P 500 Index. It was around this time that the first (and still the largest) index fund for individual investors, the Vanguard 500 Index Fund, came on the scene. Indexing had moved from the analysts' calculators and the technicians' charts to the trading room. The significance of this move was confirmed at the beginning of the 1980s with the introduction of index futures and options.

New uses placed new demands on the indexes then available. In the early 1980s, there were relatively few indexes compared to today, and most were associated with one or another stock exchange. In the U.S., the leaders were the aforementioned Dow Jones Industrial Average and S&P 500 indexes, while globally, there was the MSCI EAFE Index.

In the benchmark days, an index had to generate performance numbers that didn't contradict what investors were experiencing in the market. A good index might also provide some related statistics like P/E ratios that some felt could warn of the next market pullback. But once funds, futures and options appeared, a new requirement was the ability to buy all, or at least almost all, of the stocks in an index in the correct proportions and with reasonable speed and costs. Otherwise, investors would discover they weren't holding, or hedging, the index—just some vague look-alike portfolio.

In the early days of investability, the S&P 500 was in the right place at the right time. First, it was (and is) a capitalization-weighted index, so rebalancing was only necessary when stocks were added to or deleted from the index, or when there were share issuances or buybacks. Second, the index rules required that each stock have a public float of at least 50 percent, so illiquid, closely held stocks were excluded from the get-go. Third, because the index tracked leading companies in leading industries, it tended to focus on large, well-established companies, which were generally easier to trade in large quantities than their smaller peers. All this made the index liquid and investable, which was especially important in the 1970s and 1980s, when trading was much more costly than it is today. (It was especially important before 1975, when commissions were fixed.)

As indexes evolved with the introduction of futures and options, and then with ETFs about ten years later, the number of indexes expanded rapidly and indexes began to specialize into two classes: benchmarks and investable/tradable indexes.

Benchmarks aimed to be comprehensive and complete. To achieve this while including closely held stocks, float adjustment was introduced with the Salomon Brothers World Equity Indexes, now the S&P/Citigroup Global Equity Indexes, in 1989. Less than two decades later, almost every index—including the MSCI EAFE and S&P 500—were using float adjustments.

At the same time, the demands of investability meant that tradable or investable indexes could not be comprehensive or complete. There were some stocks that were too closely held, too highly priced or too hard to trade to include in an investable index.

Until all stocks are truly liquid and easy to trade, or until trading systems can move a 10,000-share block of Berkshire Hathaway A shares as easily as a round lot of Microsoft, we will face a split between investable and benchmark indexes. The concerns are far greater outside the United States. Most of China's equity markets, for instance, are in A-shares, which are available only to domestic Chinese investors and institutions; meanwhile, most of the world's investors (those outside of China) must be satisfied with B-shares and/or Hong Kong and Nasdaq-listed companies. Similar conditions apply to India and Russia. (These are three of the four "BRIC" countries one hears so much about. The S&P BRIC 40 index is tradable—but only because it includes stocks listed in New York, London or Hong Kong, rather than any of the BRIC home markets.)

The hunt for investability has recently expanded as indexes take on a new role—that of opening formerly uninvestable markets. In May 2006, S&P introduced the S&P/Case-Shiller Metro Area Home Price Indices. This is a series of 11 indexes covering 10 major metropolitan regions and a national composite. The indexes use a repeat sales technique to measure home prices across the United States. The Chicago Mercantile Exchange trades futures based on these indexes. Owner-occupied housing is a major asset class, slightly larger than equities in the U.S, and it is also an asset class that has historically been inaccessible to institutional investors: They can buy rental properties like apartment buildings, but these are not the same as single family homes. Thanks to the new indexes and their related futures, residential housing is now an investable asset class.

The hint to investors is to look carefully at the indexes they use—benchmark indexes make for poor investment vehicles and some tradable indexes don't tell the full story about the market they track. The need to distinguish between benchmark and investable indexes is not a fault of index construction; it is a result of market conditions and investor needs. The results of using the wrong index for the wrong purpose can be seen in high expense ratios for some ETFs, large tracking errors for funds and basis risk in futures.

Endnotes

1 Jensen, Michael, "The Performance of Mutual Funds in the Period 1945-64," 1968, *Journal of Finance.*

Global Finance

The New York Stock Exchange (NYSE) unveiled a bold, $10.2 billion bid for Euronext, in a deal that would create the world's first transatlantic financial exchange. Euronext operates the Amsterdam, Brussels, Lisbon and Paris stock exchanges, as well as the pan-European Euronext.liffe, a large futures and options exchange.

"We believe this will offer really the first truly global exchange marketplace in the world," says NYSE CEO John Thain.

European politicians from Italian Prime Minister Romano Prodi to French President Jacques Chirac have expressed their preference for a pan-European deal, arguing that Euronext should instead partner with the Deutsche Borse (which is definitely interested). Most experts, however, expect the NYSE merger to go through.

Meanwhile, the Nasdaq is expected to launch yet another takeover bid for the London Stock Exchange (LSE) later this year. The Nasdaq's initial bid was rebuffed by the LSE, and under UK takeover law it cannot make a second bid until September 30.

The mergers, assuming one or both go through, will dramatically transform the financial landscape. Down the road, it is easy to imagine these deals leading to a 24-hour trading day, increased cross-border listing, arbitrage opportunities across currencies and time zones, and the migration of listings from the U.S. to Europe and back again, depending on which country has the most favorable regulatory regime. The fate of the exchange-traded fund (ETF) marketplace hangs in the balance as well, as Euronext has a leading position in the European ETF arena.

The deal, of course, will be subject to massive regulatory scrutiny, as it raises issues about who gets to regulate whom … where, when, and why.

Russell Goes Global

Russell announced a major international expansion of its index product line, sketching out plans to launch global and country-specific indexes spanning markets around the globe. The company so far has revealed precious little in the way of details on the new indexes, saying only that it will offer a "comprehensive set of country, region and industry benchmarks, covering small-cap and large-cap companies in developed and emerging markets." Ultimately, Russell plans to launch a complete line of global style and sector indexes as well.

Russell says that the global benchmarks will use the same rigorous methodology as its popular U.S. indexes, including float weighting, multifactor style analysis and broad coverage. The company says the indexes will track over 98 percent of the capitalization of developed and emerging markets alike, and will not use a sampling methodology. Russell believes this deep coverage will create a "better global small-cap benchmark" in particular. Russell is best known in the U.S. for its small-cap benchmark, the Russell 2000.

Finally! We Get Some Leverage!

After nearly a half-decade in development, the SEC gave the go-ahead for 12 leveraged, short and short-leveraged exchange-traded funds (ETFs) from ProShares, the ETF arm of ProFunds.

The new funds provide 2X long, 1X short and 2X short exposure to four major U.S. market indexes: the Dow Jones Industrial Average, Nasdaq-100, S&P MidCap 400 and S&P 500.

The new funds are the:

Dow Jones Industrial Average
- Ultra Dow30 ProShares (DDM)
- Short Dow30 ProShares (DOG)
- UltraShort Dow 30 ProShares (DXD)

Nasdaq-100 Index
- Ultra QQQ ProShares (QLD)
- Short QQQ ProShares PSQ)
- UltraShort QQQ ProShares (QID)

S&P MidCap 400 Index
- Ultra MidCap 400 ProShares (MVV)
- Short MidCap 400 ProShares (SH)
- UltraShort MidCap 400 ProShares (MZZ)

S&P 500 Index
- Ultra S&P 500 ProShares (SSO)
- Short S&P 500 ProShares (SH)
- UltraShort S&P 500 ProShares (SDS)

The ETFs charge 95 basis points in annual expenses. By comparison, ProFunds charges 1.44 percent for their open-end leveraged S&P 500 fund.

ProFunds has huge expectations for these funds, and for good reason. In an ironic twist for an index product, these ETFs could become *the* home for "hot money" on the market. They will also prove useful for hedging, tax management and portable alpha strategies.

Speaking of leverage, Rydex Investments rolled out four new open-end (read: traditional) mutual funds, including the first-ever funds to offer leveraged (2X) long and short exposure to the Russell 2000 Index.

WisdomTree Launches Its First 20 ETFs

After more than a year of hype, WisdomTree Investments launched 20 new dividend-weighted ETFs on the NYSE on June 17, in a move that WisdomTree CEO Jonathan Steinberg said has the “potential to change the way investors think about indexing and investing.”

In a conference call announcing the deal, WisdomTree called traditional market-cap-weighted indexes “flawed,” and WisdomTree’s dividend-weighted approach “a better way to index.”

WisdomTree’s indexes (and the ETFs that track them) weight companies based on the size of their cash dividend stream, rather than their market capitalization. By targeting the dividend stream, WisdomTree believes it can deliver between 100 and 500 basis points of excess annual returns to investors.

WisdomTree is not the first company to launch a dividend-weighted ETF, of course. Barclays Global Investors (BGI) has that honor, thanks to its $6 billion iShares Dow Jones Select Dividend Fund (DVY), which launched in 2003. The WisdomTree filings differ from DVY in many ways, however, including their scope: They are a full suite of indexes designed to substantially replace traditional cap-weighted funds in an investor’s portfolio.

The funds include six domestic ETFs and 14 international ETFs. (Fig. 1)

The WisdomTree weighting methodology differs from other dividend indexes in that it measures the cash value of the dividend stream, i.e., shares outstanding multiplied by cash dividend per share. Other dividend indexes focus on some variant of dividend yield, usually selecting only the highest-yielding components for inclusion. The end result is that the WisdomTree indexes are a bit more diversified than most dividend products, and have more of a large-cap tilt.

The company believes that weighting by dividend stream will help keep the indexes investable by focusing exposure onto large-cap names. By contrast, indexes like the Dow Jones Select Dividend Index include many mid- and (sometimes) small-cap names, which may impact their investability as assets tied to the indexes grow. (Note: The WisdomTree filings do include some yield-ranked funds: The “Top 100” funds select 100 large-cap companies with the highest yields in a given market segment, while the “High-Yielding” funds select the top 30 percent of companies by yield.)

The biggest competition for these ETFs will come from other “fundamentally weighted” ETFs, such as the FTSE RAFI ETFs from PowerShares, which track Rob Arnott’s “Fundamental Indexes.” Those indexes weight components based on four factors—dividend yield, book value, revenues and free cash flow—and have the same goal as the WisdomTree funds: to outperform the market by avoiding the excesses of market-cap-weighted indexes.

One way that the WisdomTree and RAFI indexes differ significantly is in their sector weightings. For instance, the WisdomTree indexes have very little exposure to technology, as technology names rarely pay dividends. Under the RAFI methodology, companies that do not pay dividends simply have that score dropped?they are ranked based on the three other fundamental measures (book value, revenues and free cash flow). The result is a higher technology concentration.

Even putting aside any extra performance from the dividend scheme, a number of the WisdomTree ETFs could become huge hits for investors. For instance, the international small-cap fund is the first of its kind in the U.S., as are the small-cap funds for Japan and Europe.

WisdomTree deserves a great deal of credit for bucking the trend on rising expense ratios and setting its expenses at reasonable levels: 28-38 basis points for U.S. ETFs and 48-58 basis points for its overseas funds.

Figure 1

Fund	Ticker	Expense Ratio	Yield
Domestic Funds			
Total Dividend	DTD	0.28%	3.22%
High-Yielding Equity	DHS	0.38%	4.29%
LargeCap Dividend	DLN	0.28%	3.01%
MidCap Dividend	DON	0.38%	3.73%
SmallCap Dividend	DES	0.38%	5.44%
Dividend Top 100	DTN	0.38%	3.86%
International Funds			
DIEFA (Developed Markets)	DWM	0.48%	3.67%
DIEFA High-Yielding Equity	DTH	0.58%	4.68%
International LargeCap Dividend	DOL	0.48%	3.59%
International MidCap Dividend	DIM	0.58%	3.88%
International SmallCap Dividend	DLS	0.58%	4.01%
International Dividend Top 100	DOO	0.58%	4.41.%
Europe Total Dividend	DEB	0.48%	3.94%
Europe SmallCap Dividend	DFE	0.58%	4.37%
Japan Total Dividend	DXJ	0.48%	1.40%
Japan High-Yielding Equity	DNL	0.58%	1.88%
Japan SmallCap Dividend	DJF	0.58%	1.40%
Pacific ex-Japan Total Dividend	DND	0.48%	4.32%
Pacific ex-Japan High-Yielding Equity	DNH	0.58%	6.29%

Affirmed: Dow Jones vs. ISE

In a stunning development with significant implications for the indexing industry, the U.S. Court of Appeals for the Second Circuit upheld a lower court’s ruling in the case of Dow Jones and McGraw-Hill vs. the International Securities Exchange.

The original ruling found that the International Securities Exchange (ISE) could launch options on index-linked ETFs without paying a licensing fee to the index developers.

Standard and Poor’s (S&P) tried to downplay the significance of the ruling, saying that “it is a narrow ruling that applies only to intellectual property rights associated with ETF-based options. The ruling has no impact on S&P’s broader index business and associated intellectual property rights."

Maybe. But index providers everywhere must be shocked by this result, as the general consensus was that the original ruling would be overturned.

Still Work To Do

Mutual fund fees fell to their lowest levels in more than 25 years in 2005, according to a new study by the Investment Company Institute (ICI). The average stock fund shareholder paid 4 basis points less than in 2004, while the average bond fund shareholder saved 2 basis points.

Before we start popping the (budget) champagne, let's put things in context: The record low expense ratio that has the ICI's PR team doing cartwheels was still 1.13 percent. By comparison, investors in Vanguard's Total Market Index ETF (ticker: VTI) paid just 7 basis points to gain exposure to all the stocks in the United States.

INDEXING DEVELOPMENTS

Russell, Reconstituted

The annual Russell reconstitution went off without an apparent hitch, as $3.8 trillion benchmarked to the U.S. family of Russell indexes adjusted to changes in the underlying benchmark. The Russell indexes are rebalanced at the end of every June, with new companies entering the indexes and companies jumping from the large-cap Russell 1000 to the small-cap Russell 2000, and vice-versa. Many people call it the "biggest day on the indexing calendar."

Only 263 companies entered the Russell 2000 this year, a historic low for the index. By comparison, nearly 700 companies entered the index in 2000.

Both the sector compositions within the indexes and the balance between the growth and value style benchmarks stayed much the same this year, too.

Reflecting rising market values, the market-capitalization cutoffs for the indexes rose markedly: It now takes a market cap of about $2 billion to make it into the large-cap Russell 1000, and a market cap of $225 million to make it into the small-cap 2000. That's up 19 percent and 27 percent, respectively, from year-ago levels.

Wilshire Forms Advisory Board

Dow Jones Indexes and Wilshire Associates announced the creation of a new advisory board to help shepherd the Dow Jones Wilshire Index family as it "goes global" in the second half of 2006. The board features eight members of the "who's who" of indexing, including John Bogle, Steven Schoenfeld and John Prestbo.

Russell Launches U.S. Microcap Styles

Russell Investment Group announced plans to launch growth and value variations of its Microcap Index in June. According to Russell, microcap growth and value stocks have performed very differently recently, and most microcap managers have a pronounced style bias.

A Fidelity To MSCI

Fidelity, which launched the world's first family of sector-based funds 25 years ago, is changing the benchmark on those funds from the Goldman Sachs sector indexes to sector indexes from MSCI. The move will impact most—but not all—of Fidelity's 58 sector funds, and will take place in September, pending shareholder approval. The change aligns Fidelity's funds with the dominant GICS classification benchmark, making it easier for investors to measure and manage their exposure across different asset classes.

Another BRIC In The Wall

The Bank of New York, Dow Jones and S&P all launched new indexes tied to the so-called BRIC countries of Brazil, Russia, India and China in June. The indexes join an existing MSCI benchmark in the U.S., and indexes from Deutsche Bank and others overseas. European investors already enjoy a number of funds tied to BRIC indexes, while in the U.S., Claymore Advisors has filed with the SEC for the right to launch an ETF tied to the Bank of New York BRIC Index.

Global Gold

S&P has joined up with the Toronto Stock Exchange (TSX) to develop a new index that will track the performance of gold mining companies around the globe. Canadian companies will dominate the index?no surprise, considering 60 percent of all gold mining companies are listed in Canada—but it will include companies from around the world.

FTSE Opens The Gulf

FTSE and the Dubai Financial Exchange (DIFX) launched what they are calling the first-ever "GCC country tradable" indexes. The new indexes are designed to support internationally tradable ETFs and other financial products tied to the performance of stocks in the "Gulf Cooperation Council" states. Previously, these states have been off-limits to foreign investors.

For now, the internationally tradable indexes only cover Kuwait and Qatar, the two countries with the most open policy to foreign investment.

Investors looking for energy exposure from these indexes will be disappointed. Oil companies are nationally owned in the region and are thereby excluded from the indexes, which are dominated instead by banks and telecom companies.

Absolute China

MSCI plans to roll out style indexes for the Domestic ("A share") China market.

"Our research has shown that

there are strong style effects in the China A share market, leading to performance differentials which are of interest to investment professionals," says Henry Fernandez, president and CEO of MSCI Barra.

MSCI says it would launch two sets of indexes: traditional "Growth" and "Value" indexes, and, in a first for MSCI, new "Absolute Growth" and "Absolute Value" indexes. The "Absolute" style indexes will exclude stocks that exhibit neither growth nor value characteristics. Furthermore, they will not divide the market capitalization of a single stock exhibiting both growth and value characteristics; instead, that stock will be fully allocated to each index (double-counting is allowed).

In launching "Absolute" indexes, MSCI joins a growing trend in the indexing industry to create "focused" style indexes. Both Morningstar and S&P offer variants on "Absolute" or "Pure Style" indexing.

Merrill Lynch Launches Commodities eXtra Index

Merrill Lynch has joined the commodities indexing party, launching a new index with a novel methodology that it says can add as much as 3.4 percent per year to the performance of its index. The index has two wrinkles that drive that performance.

For one, rather than holding the "front month" contract and rolling it over into the "second month," the Merrill Lynch index holds the "second month" contract and rolls it into the "third month." Merrill Lynch says that this has historically proved more profitable (note that many other commodities indexes also tweak their "roll calendar" to improve returns).

The second wrinkle is more unique: Rather than rolling contracts over a five-day period, as is the norm, the index rolls them little by little over a 15-day session. This "semi-continuous roll," according to the company, contributes to excess returns.

The index includes a nice mix of 18 components, with sector baskets capped at 60 percent of the total weight. Compared to other indexes, the Merrill benchmark has a strong concentration in agricultural commodities.

According to Merrill Lynch, since 1990, an equity portfolio searching for the efficient frontier would have been best positioned with a balance of 45 percent global stocks and 55 percent commodities. In a balanced portfolio, the mix would have been 39 percent stocks, 26 percent fixed income and 35 percent commodities.

"[W]e believe that there is potentially a lot of room to increase exposure to commodities in the average portfolio," the company says

Lehman Joins The Commodities Crew

Just weeks after Merrill Lynch launched its own commodities benchmark, Lehman Brothers jumped onto the commodities indexing bandwagon with the launch of the Lehman Brothers Commodity Index (LBCI). The LBCI tracks a portfolio of 20 U.S.-traded commodities, with the following weights: 52.9 percent energy, 27.2 percent metals, 17.4 percent agriculture and 2.5 percent livestock. The index has the highest exposure to metals of any major commodities index.

Lehman plans to expand its commodities index family to include global benchmarks with commodities that are not listed in the U.S., as well asindexes denominated in currencies besides dollars.

Figure 2

	Energy	Metals	Agriculture	Livestock
Lehman Bros.	52.9%	27.2%	17.4%	2.5%
Deutsche Bank	55.0%	22.5%	22.5%	0.0%
Dow Jones – AIG	33.0%	26.3%	30.2%	10.4%
GSCI	74.1%	11.3%	10.3%	4.3%
Merrill Lynch	60.0%	16.8%	14.9%	5.5%
Reuters CRB	17.6%	23.4%	41.0%	11.8%
Rogers	44.0%	17.0%	31.0%	3.0%

Meet The New REIT

Sometimes it takes an index to vault a new style of investing or a new asset category into the public consciousness. That's the hope behind the new Alerian MLP Index (ticker: AMZ). Created by Alerian Capital Management, the new index tracks the performance of "master limited partnerships," or MLPs, a little known type of security that, according to the index's historical data, has delivered 17 percent compound annual returns over the past decade.

MLPs are the real estate investment trusts (REITs) of the energy world. They own things like pipelines and storage facilities. As a result of their limited operating procedures, MLPs are taxed like REITs—their profits are passed down to shareholders without corporate taxation, creating eye-popping yields in many cases.

Dividends Down Under

Dow Jones Indexes unveiled a new Select Dividend Index—its 15th—as it continues to press its first-mover advantage in the startlingly popular dividend space. The Dow Jones Select Australia Dividend Index tracks the performance of the 30 highest-yielding components traded on the Australian stock market; it yields an impressive 5.04 percent.

Dividend Increases A-Plenty

Standard and Poor's says that 483 of 7,000 publicly traded companies boosted their dividend payouts in the second quarter of 2006. That's up 4.8 percent over the second quarter of 2005, and 24.8 percent over the second quarter of 2004.

Buyback Goggles

Corporate America is buying back stock. By the bushel. And that's got some people worried.

According to S&P, stock buyback activity surged 22.1 percent in the first quarter over year-ago levels. The indexing giant said that 108 companies in the S&P 500 have reduced their diluted shares outstanding by more than 4 percent in the first three months of 2006 alone-which will trickle straight down to their earnings per share number.

Target Date Semiotics

Set it and forget it? Umm … not quite.

Dow Jones Indexes has made a significant change to its popular Target Date Index series, increasing the indexes' exposure to equities over time. The company says it is responding to customer demand.

Historically, Dow Jones has started the indexes at 90 percent equity exposure 35 years before the "target date," and then slowly ratcheted down that exposure to just 20 percent by the time the target date arrives. Dow Jones will now stretch the exposure reduction period an additional ten years. (At the official "target date," the portfolios will hold 28 percent exposure to equities.)

An Index Goes To Its Grave

S&P reluctantly shut down its popular Hedge Fund Index (HFI) series on July 1, after its data provider, PlusFunds, told the Refco bankruptcy judge that it would cease operations by August. The shutdown points to one of the major shortcomings of the investable hedge fund indexing space: The S&P indexes were linked to the performance of just 40 funds, many of which were looped into the Refco scandal.

Party Over?

The Chicago Board Options Exchange's (CBOE) U.S. Exchange Index, or EXQ, sunk to an all-time low on June 14, as the air continued to come out of the stock exchange bubble. Investors appear to be rethinking the dream of unmitigated growth and never-ending profits that sustained the exchange sector over the past year.

AROUND THE WORLD OF ETFS

Exchange-Traded Notes

Barclays Bank PLC, a division of Barclays PLC, won approval from the Securities and Exchange Commission (SEC) to launch a new kind of security that straddles the line between structured debt and ETFs. Dubbed "iPath ETNs," the new products trade like ETFs but use a debt-based structure that changes the tax implications, risks and arbitrage opportunities on the funds.

So far, Barclays has rolled out three ETNs: one tied to the total return version of the Goldman Sachs Commodity Index (ticker: GSP), one tied to the total return version of the Dow Jones AIG Commodity Index (ticker: DJP) and one tied to the Goldman Sachs Oil Total Return Index (ticker: OIL). The funds trade on the NYSE.

In a traditional ETF, shareholders own a stake in the underlying assets, and if you hold enough shares, you can (through an Authorized Participant) redeem those shares directly from the fund for the corresponding value of said assets.

That is decidedly not the case with the iPath ETNs. The iPath ETNs are debt instruments. When you buy an ETN, you are buying a senior debt note from Barclays PLC, whereby Barclays promises to pay you the exact return of the underlying commodity index—minus an expense ratio of 75 basis points per year.

The primary functional difference between ETFs and ETNs lies in the different kinds of risk that investors take on when they buy the products. With ETFs, investors take on "tracking risk"—the risk that the underlying assets will not accurately track the intended benchmark. With ETNs, Barclays guarantees that the ETNs will track their benchmarks, so there is no tracking risk. Instead, investors take on "credit risk"—the risk that Barclays won't pay up on its promises.

There are other important differences that investors must consider. For instance, there is no guarantee that there will be a liquid market for the ETNs, although Barclays says it will engage in "limited trading" to support the notes. (Investors should keep a close eye on spreads.)

One further uncertainty for the notes involves their tax status. According to Barclays, "[t]he United States Federal income tax consequences of an investment in the iPath ETNs are uncertain." Barclays believes that investors will only pay capital gains taxes when they sell the funds, with no possibility for distributions in the interim. That would be quite attractive … if it holds up at the IRS.

It's not clear how Barclays plans to separately market its ETNs and ETFs, particularly when they cover the same product. For instance, as we went to press, Barclays received approval for an ETF linked to the Goldman Sachs Commodities Index. It's not clear how Barclays will distinguish that product from the existing ETN linked to the same index.

Baker To SEC: Get Moving

Rep. Richard Baker (R-La.) has a message for the SEC: Get moving on ETFs, or the ETF industry will get moving overseas.

The blunt-speaking congressman, who chairs the Congressional Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, has a history of prodding the SEC on competitive issues. He famously called Regulation NMS "the worst public policy I have seen in my nearly two decades in Congress."

In his latest move, Baker told the SEC that it needed to develop standardized rules on approving ETFs, and to create a dedicated staff whose only focus is on the ETF industry.

Massive PowerShares Expansion

PowerShares Capital Management

filed with the SEC for the right to launch 31 new ETFs, including a full line-up of RAFI-branded "fundamental indexing" ETFs, a host of Intellidex funds and a number of interesting stand-alone portfolios.

The RAFI funds are based on the "fundamental indexing" methodology of Rob Arnott's Research Affiliates (RAFI). PowerShares already sponsors one RAFI fund, the RAFI U.S. 1000 ETF (ticker: PRF), which debuted in December 2005 and has attracted more than $115 million in assets. The new funds include one U.S. small-/mid-cap ETF and nine sector-based funds.

The remaining 21 filings cover a wide range of ETFs tied to a number of different strategies. Among these, the India Tiger Portfolio may prove to be one of the more popular. The fund will track an equal-dollar-weighted index of Indian companies that trade on U.S. exchanges, and will likely be the first India-specific ETF on the U.S. market. A full listing of the funds is available at www.indexuniverse.com.

One concern about the new ETFs is that they will charge 70 basis points in expenses, pushing up the boundaries of expense ratios among ETFs.

Vanguard Embraces Its ETFs

Vanguard has dropped the VIPERs brand name from its rapidly growing family of ETFs. The funds will now be called, simply, "Vanguard ETFs." The move impacts all 24 Vanguard ETFs, which together hold more than $15.4 billion in assets. Many see this move as a tacit acknowledgement by Vanguard that ETFs will play a critical role in the company's future.

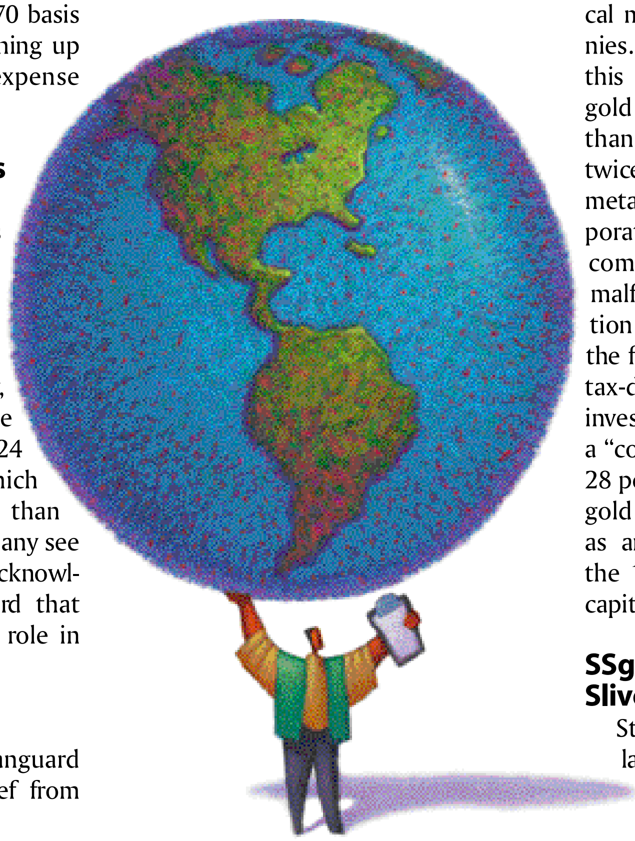
Exemptive Relief

In related news, Vanguard received exemptive relief from the SEC permitting mutual funds to invest in Vanguard ETFs in excess of the limits outlined in section 12(d)(1) of the Investment Company Act of 1940. A number of ETF fund families have received this kind of exemption recently, which allows mutual funds to place more than 5 percent of their assets in a given ETF.

Pounds, And Pesos, And Krona: Oh My!

Following on the remarkable success of its first currency ETF, the Euro Currency Trust (FXE), Rydex Investments launched six new CurrencyShares ETFs:

- CurrencyShares Australian Dollar Trust (FXA)
- CurrencyShares British Pound Sterling Trust (FXB)
- CurrencyShares Canadian Dollar Trust (FXC)
- CurrencyShares Mexican Peso Trust (FXM)
- CurrencyShares Swedish Krona Trust (FXS)
- CurrencyShares Swiss Franc Trust (FXF)



The funds have a beautiful simplicity: They hold the given foreign currency as their sole asset, with the requisite number of pounds (or pesos or krona) deposited at the London branch of J.P. Morgan. The deposits earn interest income based on the home country funds rate. At launch, the peso paid the highest yield, at 6.43 percent, while the Swiss franc offered just 0.78 percent. All of the ETFs charge 40 basis points in annual expenses.

Better Bullion?

Van Eck Associates, an old-line, hard assets securities firm, joined the ETF revolution by launching the new Market Vectors-Gold Miners ETF (ticker: GDX) onto the American Stock Exchange (AMEX). GDX is designed to track the Amex Gold Miners Index, a 44-component, modified cap-weighted index of U.S.-listed gold mining companies.

With GDX trading alongside the wildly popular gold bullion ETFs, the question for investors is whether it is better to gain exposure to the physical metal or to gold mining companies. The arguments could easily fill this magazine. Generally speaking, gold mining shares are more volatile than gold bullion, often moving twice as much as the underlying metal. They also come with the corporate risks involved in owning any company, including executive malfeasance, environmental litigation exposure and other issues. On the flip side, gold bullion is woefully tax-disadvantaged for wealthy investors: Gold bullion is classified as a "collectible," making it subject to a 28 percent tax from the IRS, whereas gold mining companies are classified as an "investment" and subject to the 15 percent maximum long-term capital gains tax.

SSgA Launches Six Sector Slivers

State Street Global Advisors (SSgA) launched six new ETFs onto the Amex in June, as it continued the aggressive expansion of its ETF lineup.

The funds include five SPDR-branded, subindustry ETFs tied to indexes from Standard and Poor's (S&P), and one ETF tied to the Keefe, Bruyette and Wood (KBW) Regional Banking Index. The funds are:

- SPDR Metals & Mining ETF (XME)
- SPDR Oil & Gas Equipment & Services ETF (XES)
- SPDR Oil & Gas Exploration & Production ETF (XOP)
- SPDR Pharmaceuticals ETF (XPH)
- SPDR Retail ETF (XRT)
- streetTRACKS KBW Regional Banking ETF (KRE)

SSgA, like other ETF providers, has moved aggressively into the subindustry space over the past eight months. In November 2005, SSgA launched three ETFs tied to KBW's Banking (ticker: KBE), Capital Markets (ticker: KCE) and Insurance (ticker: KIE) indexes. And according to recent filings, SSgA is planning SPDR-branded sector portfolios tied to ten additional industries, as well.

SSgA funds offer the lowest expense ratios of any subsector funds, at just 35 basis points. By contrast, PowerShares charges 60 basis points, while BGI saddles investors with fees of 48 basis points.

The subindustry space is clearly one area where the choice of index matters ... a lot. The SPDR-branded indexes, for instance, are equal-weighted indexes, offering markedly different exposure from the cap-weighted industry indexes tracked by BGI's iShares.

First Trust Sectors

First Trust Advisors rolled out two new ETFs tied to the Internet and biotechnology sectors, respectively.

The First Trust Dow Jones Internet Index Fund (ticker: FDN) tracks the performance of the Dow Jones Internet Index, which includes the forty largest Internet companies in the U.S. The index includes 25 "Internet Services" companies and 15 "Internet Commerce" companies, and is market-cap-weighted with the usual free-float adjustments.

The First Trust Amex Biotechnology Index Fund (ticker: FTB) tracks the performance of the AMEX Biotech Index, an equal-weighted index of twenty established biotech companies. The index has long been one the most closely followed barometers of the biotech sector, and is actively traded on the options market. It is better known by its ticker symbol, BTK.

Both ETFs charge 60 basis points.

Insider Sentiment Portfolio? Sabrient Stealth?

Claymore Advisors, traditionally a closed-end fund shop, has filed with the SEC for the right to launch five ETFs, including some of the more unusual funds to be proposed so far.

The most anticipated of the five funds is likely the BRIC ETF, featuring a portfolio of American Depository Receipts from companies in Brazil, Russia, India and China.

The other funds include the Claymore-Sabrient Insider Sentiment Portfolio, which chooses 50 stocks that have witnessed both strong corporate insider buying and recent Wall Street analyst upgrades. In a twist, this portfolio will be rebalanced "whenever market conditions warrant," a fact that seems to stray awfully close to active management.

A third fund is the Claymore-Sabrient Stealth Portfolio, which tracks a portfolio of 250 stocks that are "flying under the radar screen of Wall Street's analysts," but that have strong growth prospects. The other funds are the Zacks Sector Rotation Portfolio, following a value-based sector rotation strategy, and the Zacks Yield Hog Portfolio, an index of 125-150 securities that are chosen based on high yields and good growth prospects. The funds will all list on the Amex. As of yet, there's no information on expense ratios.

PWC Earns Five Stars

After 36 months on the market, the PowerShares Dynamic Market Portfolio (ticker: PWC)—one of the two original PowerShares funds—was awarded the maximum of five stars from Morningstar. Morningstar only rates funds with three years of performance data.

Countering Contango

The Deutsche Bank Commodities ETF (ticker: DBC) has adopted a new policy designed to mitigate the impact of "contango" on shareholder returns. DBC's new rules-based strategy will allow it to select the most favorable contract when it rolls over its futures contracts each month. If, for instance, the August aluminum contract is cheaper than the July contract, the fund will purchase the August contract.

"The result will tend to maximize the benefits of rolling in backwardated markets and minimize the loss from rolling in contangoed markets," Deutsche Bank says in a statement.

DBC Also Lowers Fees … Again!

For the second time this year, the team behind DBC has slashed the fees it charges investors.

When DBC launched in February, it charged a gaudy 1.9 percent—somewhat of a disappointment to commodities investors. Just one month later, however, the fund slashed fees by 60 basis points, bringing the "all-in" expense ratio (including brokerage fees, operating expenses, etc.) down to 1.3 percent. Deutsche Bank said at the time that it had essentially overestimated the costs of running the fund.

Now they've done it again, cutting fees a further 43 basis points to bring the "all-in" fee down to just 87 bps. The cuts include a 20 bps reduction in the management fee (from 95 bps to 75 bps), an 8 bps reduction in the estimated brokerage expense, and the assumption of 10 bps in organizational/offering fees and 5 bps in administrative fees.

What's wonderful about the fee reduction is that it is happening for all the right reasons: DBC has now attracted more than $600 million in assets, and the fund is passing along the economies of scale to shareholders. That's what should happen … but so rarely does in the world of ETFs.

DB Files For Seven More

In related news, Deutsche Bank has filed with the SEC for the right to launch an additional seven commodities-based ETFs. The new funds will focus on individual "sectors" within the commodities space, including Energy, Oil, Precious Metals, Gold, Silver, Base Metals and Agriculture. In each case, the funds will gain exposure using futures contracts and will track "optimum yield" indexes from Deutsche Bank, meaning they will have some flexibility in the timing their "rolls" maximize returns.

The Little ETF That Can Beat The Market

First Trust Portfolios launched a new ETF onto the American Stock Exchange (Amex) that puts a new spin on the idea of value investing. The First Trust DB Strategic Value Fund (ticker: FDV) attempts to look beyond the cover story of reported financial metrics and suss out the true, underlying value in the market.

The fund will track something called the Deutsche Bank CROCI US+ Index, which captures 40 stocks from among the 251 largest names in the S&P 500 Index. It chooses stocks with the "lowest positive CROCI Economic Price Earnings Ratio"–which is a fancy way of saying stocks with high operating margins and strong returns on capital.

The methodology uses various assumptions to make reported financial metrics more comparable across sectors and markets. The 40 companies are assigned equal weights in the index.

The result is a "value-based" ETF that reflects firms' underlying profitability … a factor that historically has had a strong tie to performance. Over the past ten years, for instance, the index has delivered returns of 17.94 percent per year, compared to just 9.16 percent for the S&P 500 Value Index.

The fund reminds many of Gotham Capital principal Joel Greenberg's best-selling book, The Little Book That Beats The Market. That book also emphasizes the importance of picking stocks that earn more than their cost of capital, and promises backtested returns of over 30 percent per annum.

The ETF charges 65 basis points in annual expenses.

First India ETF Trades

BGI launched the first India fund to trade outside that country's borders onto the Singapore exchange. The new iShares tracks MSCI's India index, which covers 85 percent of the free float-adjusted market cap of each industry group in the Indian market.

Borsa Italiana Trades Commodity ETFs

The first ETF ever to track the venerable Reuters/Jefferies CRB launched onto the Italian Stock Exchange in June, with Lyxor as the sponsor. In related news, EasyETF debuted its own commodities ETF in Europe, with a new fund tracking an 18-compoment, non-energy subindex of the Goldman Sachs Commodity Index.

Stockholm To Trade Fundamental European ETF

Stockholm-based XACT Fonder AB signed a license agreement to use FTSE's new fundamentally weighted European Index as the basis of a new ETF. The ETF, which is awaiting approval by the Finansinspektionen (the Swedish Financial Supervisory Authority), will be the first to use a fundamental weighting scheme in the Nordic region.

Canadian ETF Trades In Mexico

As international interest in Canadian equities continues to surge, foreign investors are snapping up shares of Canada's natural resource companies. Capitalizing on the trend, BGI launched its Canadian-based iShares S&P/TSX 60 on the Mexican Bolsa.

The Russians Enter Paris

With Russian stocks trading up nearly 30 percent on the year, Lyxor AM launched a new Russian equities ETF onto the Paris Stock Exchange. The ETF tracks the Dow Jones RusIndex Titans 10 Index, a measure of the ten largest Russian stocks on the market. According to Dow Jones, the new ETF is the "first tradeable product focused on Russian equities." More than 50 percent of the index is currently tied to energy-related companies.

Smartshares Adds An ETF

Smartshares, the innovative ETF outfit in New Zealand that allows shareholders to buy ETFs without a commission, has acquired the rights to the Tortis Ozzy ETF, a fund linked to the large-cap Australian S&P/AST 20 Index. It is the fifth Smartshares ETF.

Jim Rogers Is Back … In Europe

ABN Amro became the newest company to enter the ETF market when it launched its first-ever ETF onto the Deutsche Borse's XTF trading platform. The new "Market Access Jim Rogers Commodity Index Fund" (ISIN: LU0249326488) is based on the commodities index created by the Wall Street investing legend of the same name. The index tracks a hugely diversified swathe of commodities ranging from crude oil to live cows, platinum and adzuki beans.

Lyxor Launches

In related news, Lyxor Asset

Management launched an additional six ETFs onto the Deutsche Borse's XTF platform. The new products include five fixed-income ETFs—four covering EuroMTS bonds (one- to three-year maturity, three- to five-year maturity, ten- to 15-year maturity and the global index), one EuroMTS Inflation Linked ETF and one equity ETF tracking the 16 European countries covered by the MSCI Europe Index.

EXPLORING YOUR OPTIONS

A New Option When Window-Dressing

The Chicago Board Options Exchange (CBOE), International Securities Exchange (ISE) and NYSE all launched new "quarterly" options contracts. Unlike most options, which expire on the third Friday of each month, the new "Quarterlies" will instead expire … you guessed it … at the end of each calendar quarter. The options are timed to expire with the traditional fund reporting dates for most products.

Quarterlies are just the latest innovation in the expiration timing of options. Last year, the Chicago Board Options Exchange (CBOE) began trading options that expire on a weekly basis.

Currency Options For The Rest Of Us

In a sign of the rising popularity of currency investments, the Philadelphia Stock Exchange (PHLX) filed with the SEC for the right to launch a new suite of currency options aimed squarely at the retail investing crowd. The new PHLX World Currency Options will offer retail investors the ability to hedge and leverage their portfolios to the value of the Australian dollar, British pound, Canadian dollar, euro, Japanese yen, and Swiss franc.

The new options differ from established currency contracts because they are cash-settled. If you hold traditional currency options to maturity, you take physical delivery of the underlying currency–and that can be unwieldy, considering the size of the contracts (one contract for British pounds equals 31,250 pound sterling). The new options, in contrast, simply cash-settle in your options trading account.

INTO THE FUTURES

Regulators To Allow Debt Index Futures

The SEC and the Commodities Futures Trading Commission (CFTC) announced new rules that pave the way for the launch of futures contracts on bond indexes and individual debt securities. Trading debt index futures has effectively been banned in the past because there was no clear regulatory pathway to approve the products.

ON THE MOVE

ISE Chairman Stepping Down

Ivers Riley, chairman of the fast-moving ISE, stepped down from the exchange in May. He was replaced by ISE vice chairman Frank Jones. Riley had been chairman of the ISE since 2002, helping to lead it through a period of tremendous growth, including its very successful initial public offering.

Lavine To Head WisdomTree

WisdomTree Investments rounded out its A-list executive leadership team by hiring former BGI executive Bruce Lavine as its new president and chief operating executive. Lavine held a variety of senior positions at BGI, including head of iShares Europe and New Global Markets, chief financial officer, and director of New Product Development.

WisdomTree also plucked iShares strategy manager Todd Westby to be its new director of national accounts.

Global Index Data

Selected Major Indexes Sorted By Year-To-Date Returns

Don't cry for Argentina…

	Total Return %			Annualized Total Return %					
Fund Name	**YTD**	**2005**	**2004**	**3-Year**	**5-Year**	**10-Year**	**15-Year**	**P/E Ratio***	**Std Dev***
MSCI Argentina	33.21	59.69	24.57	52.31	15.45	5.81	10.64	-	36.24
MSCI Indonesia	21.63	12.56	44.54	36.50	34.21	-5.87	-2.65	-	27.59
MSCI World Metals & Mining	20.48	33.66	13.88	41.24	22.93	-	-	-	23.38
MSCI Portugal	18.81	-4.50	21.85	21.51	10.78	6.92	6.76	-	15.25
Dow Jones Transportation	18.04	11.65	27.73	28.27	12.98	9.85	11.68	-	14.32
MSCI Spain	16.48	4.41	28.93	25.57	16.06	14.30	12.55	10.32	
MSCI World ex-US	10.06	14.47	20.38	24.25	10.41	6.76	7.77	16.00	10.40
S&P SmallCap 600 Value	9.66	8.36	21.09	21.24	12.00	13.09	-	17.70	14.22
AMEX Composite	9.64	22.64	22.22	25.78	16.01	12.83	11.88	-	11.39
MSCI EAFE Growth	9.29	13.28	16.12	21.05	8.12	-	-	-	10.45
Russell 2000	8.21	4.55	18.33	18.70	8.50	9.05	11.80	19.30	14.60
S&P SmallCap 600	7.70	7.68	22.65	20.46	11.36	11.95	-	18.30	13.67
Russell 1000 Value	6.56	7.05	16.49	15.70	6.90	10.85	12.72	14.30	7.83
S&P 500 Value	6.52	8.71	15.03	16.15	6.68	9.27	-	15.40	8.27
MSCI EAFE Sm-Cap	6.38	26.19	30.78	32.61	18.69	-	-	-	12.88
Russell 2000 Growth	6.07	4.15	14.31	16.27	3.49	4.13	7.93	21.90	16.40
MSCI World	6.06	9.49	14.72	16.86	5.73	6.93	8.58	16.90	8.56
MSCI EM	5.81	30.31	22.45	30.98	18.35	4.08	7.66	13.60	18.15
S&P SmallCap 600 Grwth	5.65	7.07	24.29	19.72	10.09	10.30	-	19.10	13.31
DJ Wilshire 4500	5.51	10.27	18.57	19.05	9.01	9.32	11.84	-	11.63
NYSE Composite	5.35	6.95	12.16	14.06	4.44	7.96	9.30	-	8.51
Dow Jones Industrial	5.23	1.72	5.31	9.88	3.44	9.11	11.82	-	8.59
Dow Jones Target 2040	4.98	10.96	16.36	17.92	8.37	9.00	10.94	-	9.09
S&P MidCap 400	4.24	12.56	16.48	18.14	9.29	13.83	-	19.00	10.92
MSCI Pacific	3.53	22.64	18.98	25.37	9.03	1.19	3.09	20.80	14.17
DJ Wilshire 5000	3.51	6.32	12.62	13.06	4.06	8.47	10.95	-	8.45
Credit Suisse High Yield	3.49	2.26	11.96	8.92	9.66	7.10	9.22	-	4.00
Russell 3000	3.23	6.12	11.95	12.56	3.53	8.52	11.01	16.90	8.33
MSCI Europe	3.06	21.65	9.43	15.90	0.28	7.28	7.96	14.30	9.18
Consumer Price Index	2.90	3.42	3.26	3.30	2.61	2.60	2.69	-	1.42
Russell 1000	2.76	6.27	11.41	12.04	3.12	8.56	11.02	16.70	7.90
Citigroup World Govt Bond	2.75	-6.88	10.35	4.25	8.51	5.43	7.22	-	7.11
Standard & Poor's 500	2.71	4.91	10.88	11.22	2.49	8.32	10.74	16.60	7.74
6-Month CD	2.51	3.72	1.74	2.85	2.46	4.04	4.25	-	0.42
3-Month T-Bill	2.40	3.34	1.43	2.55	2.25	3.76	3.98	-	0.42
LB Global Aggregate	2.29	-4.49	9.27	4.08	7.73	5.67	7.07	-	5.88
Dow Jones Target 2015	2.26	5.31	12.10	11.13	7.05	8.03	9.86	-	5.49
MSCI EAFE	2.03	25.96	10.18	17.41	1.51	4.18	4.46	15.90	9.09
S&P MidCap 400/Citigroup Growth	1.53	14.42	15.78	17.21	7.57	16.04	-	19.90	11.47
Lehman Brothers 1-3 Yr Govt	1.08	1.73	1.07	1.48	3.23	4.85	5.32	-	1.39
Lehman Brothers Aggregate Bond	-0.72	2.43	4.34	2.05	4.97	6.22	6.89	-	4.01
Russell 1000 Growth	-0.93	5.26	6.30	8.35	-0.76	5.42	8.69	20.30	8.74
Morningstar US Growth	-1.01	6.41	4.37	8.49	-3.05	-	-	24.00	10.67
NASDAQ Composite	-1.51	1.37	8.59	10.21	0.11	6.25	10.65	-	13.84
MSCI Japan	-1.88	42.94	9.69	21.78	3.98	-0.46	-0.35	23.50	14.01
Morningstar Healthcare Sector	-2.98	6.75	2.65	3.57	-0.19	8.18	-	21.90	8.76
NYSE Arca Tech 100	-6.25	7.36	11.73	11.72	1.56	14.19	16.94	-	14.87
MSCI Turkey	-26.43	51.60	38.46	40.62	17.18	10.24	5.74	-	40.96

Source: Morningstar. Returns through 6/30/2006. All returns are in dollars. 3-year, 5-year, 10-year and 15-year returns are annualized.
**P/E is price-to-earnings ratio. Std. Dev. is standard deviation calculated over 3 years.*

Largest U.S. Index Mutual Funds

Sorted by Total Net Assets in $US Millions

Fund Name	Ticker	$US Millions Net Assets	ER*	Total Return % YTD*	2005	2004	Annualized 3-Year	5-Year	10-Year
Vanguard 500 Index	VFINX	66,855.2	0.18	2.67	4.77	10.74	11.07	2.38	8.25
Vanguard 500 Idx Adm	VFIAX	40,452.4	0.09	2.70	4.87	10.82	11.16	2.45	8.29
Vanguard Inst Idx	VINIX	40,290.2	0.05	2.71	4.91	10.86	11.20	2.50	8.38
Vanguard Tot Stk	VTSMX	33,797.9	0.19	3.27	5.98	12.52	12.77	3.84	8.39
Vanguard Tot Stk Adm	VTSAX	22,727.9	0.09	3.32	6.09	12.61	12.86	3.91	8.43
Vanguard Total Bd Idx	VBMFX	21,086.4	0.20	-0.93	2.40	4.24	1.90	4.40	5.93
Fidelity Spar US Eq Inv	FUSEX	20,420.4	0.10	2.69	4.85	10.73	11.11	2.32	8.15
Vanguard Inst Idx InstPl	VIIIX	17,066.5	0.03	2.73	4.93	10.90	11.23	2.53	8.41
Vanguard Total Intl Stk	VGTSX	15,923.8	0.00	9.53	15.57	20.84	24.93	10.89	6.35
Vanguard Eur Stk Idx	VEURX	14,457.2	0.27	13.54	9.26	20.86	23.28	10.43	10.20
Vanguard Tot Stk Inst	VITSX	10,423.0	0.06	3.33	6.12	12.60	12.90	3.96	8.50
Vanguard Total Bd Idx In	VBTIX	7,560.5	0.07	-0.87	2.53	4.36	2.03	4.53	6.05
Vanguard Em Mkt Idx	VEIEX	7,453.8	0.45	6.14	32.05	26.12	34.08	20.35	7.26
Vanguard Pac Stk Idx	VPACX	7,189.8	0.32	3.53	22.59	18.83	25.30	8.71	1.00
Vanguard Mid Cap Idx	VIMSX	7,111.4	0.22	4.42	13.93	20.35	20.01	10.08	-
Fidelity Spar 500 Inv	FSMKX	6,928.3	0.10	2.68	4.86	10.73	11.10	2.33	8.15
Fidelity Spar 500 Adv	FSMAX	6,629.6	0.07	2.70	4.86	10.73	11.11	2.34	8.15
Vanguard SmCp Idx	NAESX	6,529.0	0.23	6.91	7.36	19.90	19.76	8.97	9.81
Vanguard Gr Idx	VIGRX	6,432.4	0.22	-0.77	5.09	7.20	8.39	1.03	7.27
T. Rowe Price Eq Idx 500	PREIX	6,339.3	0.35	2.54	4.63	10.51	10.88	2.23	8.02
Vanguard ExtMktIdx	VEXMX	6,124.5	0.25	5.48	10.29	18.71	19.08	8.89	9.51
Fidelity U.S. Bond Index	FBIDX	5,785.7	0.32	-0.62	2.26	4.36	2.13	5.11	6.23
DFA Intl Small Cap Value	DISVX	5,568.9	0.75	9.65	23.23	34.80	33.60	23.77	10.28
Vanguard Total Bd Idx Ad	VBTLX	5,355.3	0.11	-0.89	2.49	4.33	1.99	4.47	5.97
DFA US Large Value	DFLVX	5,227.3	0.30	8.10	10.24	18.25	19.45	8.87	11.90
Vanguard REIT Index	VGSIX	4,951.9	0.21	13.21	11.89	30.76	25.60	18.93	14.88
VALIC I Stock Index	F06PNT	4,733.3	0.38	2.54	4.56	10.51	10.84	2.13	7.99
DFA U.S. Micro Cap	DFSCX	4,440.0	0.55	6.26	5.69	18.39	20.45	13.14	12.55
Vanguard Bal Idx	VBINX	4,136.5	0.20	1.67	4.65	9.33	8.45	4.46	7.81
Schwab 1000 In Inv	SNXFX	4,040.8	0.50	2.84	6.05	10.82	11.66	2.95	8.34
DFA Intl Small Company	DFISX	3,944.2	0.64	8.40	21.96	30.92	30.60	20.00	-
Vanguard Inst Tot Stk InP	VITPX	3,917.7	0.03	3.38	6.17	12.69	12.99	4.09	-
Schwab S&P 500 In Sel	SWPPX	3,811.3	0.19	2.70	4.79	10.70	11.09	2.36	8.10
Vanguard SmCp Vl Idx	VISVX	3,762.7	0.23	8.03	6.07	23.55	20.92	11.02	-
Vanguard Inst Tot Bd Idx	SWPIX	3,744.7	0.05	-0.82	2.47	4.36	2.03	-	-

S&P Index vs. Active (SPIVA) Scorecard for Q2, 2006

Percentage of equity funds outperformed by the index

Fund Category	Comparison Index	Last Quarter	Year-To-Date	One Year	Three Year	Five Year
All Domestic Funds	S&P SuperComposite 1500	73.32	48.87	44.71	52.01	61.85
All Large Cap Funds	S&P 500	66.16	58.19	54.67	64.91	67.43
All Mid Cap Funds	S&P Midcap 400	58.22	61.27	60.89	80.45	83.69
All Small Cap Funds	S&P SmallCap 600	56.52	68.14	60.14	80.20	79.15
Large Cap Growth Funds	S&P/Citigroup 500 Growth	64.51	47.45	19.91	40.00	54.30
Large Cap Blend Funds	S&P 500	75.13	53.59	51.06	69.14	69.75
Large Cap Value Funds	S&P/Citigroup 500 Value	79.57	86.91	90.48	90.18	87.15
Mid Cap Growth Funds	S&P/Citigroup 400 Growth	77.17	41.18	44.55	79.27	95.20
Mid Cap Blend Funds	S&P Midcap 400	37.33	58.97	67.19	75.51	82.09
Mid Cap Value Funds	S&P/Citigroup 400 Value	47.32	81.25	73.04	74.77	78.89
Small Cap Growth Funds	S&P/Citigroup 600 Growth	69.55	57.41	38.96	89.12	93.63
Small Cap Blend Funds	S&P SmallCap 600	63.19	70.25	63.41	84.62	81.36
Small Cap Value Funds	S&P/Citigroup 600 Value	41.23	80.10	78.85	70.49	59.87
All Cap Growth Funds	S&P/Citigroup 1500 Growth	55.00	21.65	14.74	27.27	41.38
All Cap Value Funds	S&P/Citigroup 1500 Value	80.30	75.00	79.10	82.93	75.00

*Source: Morningstar and Standard & Poor's. Data as of 6/30/2006. SPIVA index outperformance is based on equal-weighted fund counts. *ER is annual expense ratio. YTD is year-to-date.*

U.S. Market Overview In Style

Trailing Returns %

Morningstar Indexes	3-Month	YTD	1-Yr	3-Yr	5-Yr	10-Yr
US Market	–2.09	3.32	9.88	12.78	3.48	8.38
Large Cap	–1.53	2.58	8.36	10.32	1.45	7.51
Mid Cap	–3.05	4.70	14.13	19.30	8.80	10.32
Small Cap	–4.72	7.31	13.77	19.49	9.48	9.87
US Value	1.38	7.88	12.96	16.69	8.09	NA
US Core	–2.65	2.87	9.54	12.97	4.51	NA
US Growth	–5.20	–1.01	6.94	8.48	–3.05	NA
Large Value	2.23	8.36	13.38	15.04	6.35	NA
Large Core	–2.10	2.06	8.16	10.73	2.22	NA
Large Growth	–5.12	–3.14	3.09	4.86	–5.25	NA
Mid Value	–0.32	6.28	11.70	20.96	12.28	NA
Mid Core	–4.01	3.53	12.46	18.51	10.89	NA
Mid Growth	–4.56	4.42	18.24	18.00	2.64	NA
Small Value	–3.32	6.87	11.53	20.49	14.90	NA
Small Core	–3.22	10.22	16.57	21.69	12.38	NA
Small Growth	–7.62	4.69	13.27	16.11	1.57	NA

Morningstar Market Barometer YTD Return %

		Value	Core	Growth
	US Market 3.32	7.88	2.87	–1.01
Large Cap	2.58	8.36	2.06	–3.14
Mid Cap	4.70	6.28	3.53	4.42
Small Cap	7.31	6.87	10.22	4.69

–8.00 –4.00 0.00 +4.00 +8.00

Sector Index YTD Return %

Energy	15.04
Telecomm	14.01
Industrial Mater	8.54
Business Svcs.	8.27
Utilities	7.97
Financial Svcs.	5.81
Media	5.62
Consumer Goods	2.15
Consumer Svcs.	1.45
Healthcare	–2.32
Hardware	–3.74
Software	–4.08

Industry Leaders & Laggards YTD Return %

Agriculture	56.79
Steel/Iron	53.14
Construction Machinery	29.56
Transport Equipment	29.18
Components	26.86
Rental & Repair Services	26.76
Home Health	–15.08
Managed Care	–15.11
Entertainment/Education Media	–18.60
Radio	–19.59
Online Retail	–25.91
Home Building	–29.99

Biggest Influence on Index Performance

	YTD Return %	Constituent Weight %
Best Performing Index		
Small Core	10.22	
RSA Security Inc.	142.18	0.28
Oceaneering International Inc.	84.21	0.44
Chaparral Steel Co.	138.08	0.24
Aztar Corp.	70.98	0.38
General Cable Corp.	77.67	0.34
Worst Performing Index		
Large Growth	–3.14	
Intel Corp.	–23.08	4.99
UnitedHealth Group Inc.	–27.89	2.78
Amgen Inc.	–17.28	3.20
eBay Inc.	–32.23	1.48
Medtronic Inc.	–18.17	2.29

1-Year

	Value	Core	Growth
Large Cap	13.38	8.16	3.09
Mid Cap	11.70	12.46	18.24
Small Cap	11.53	16.57	13.27

–8 –4 0 +4 +8

3-Year

	Value	Core	Growth
Large Cap	15.04	10.73	4.86
Mid Cap	20.96	18.51	18.00
Small Cap	20.49	21.69	16.11

–20 –10 0 +10 +20

5-Year

	Value	Core	Growth
Large Cap	6.35	2.22	–5.25
Mid Cap	12.28	10.89	2.64
Small Cap	14.90	12.38	1.57

–20 –10 0 +10 +20

Source: Morningstar. Data as of 6/30/2006.

Dow Jones U.S. Economic Sector Overview

HISTORICAL PERFORMANCE RETURNS

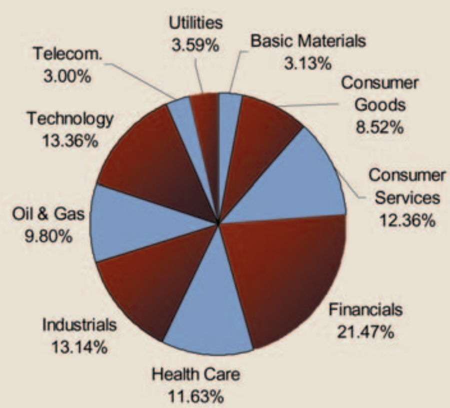
Industry	Total Return (%) 1-Month	3-Month	YTD	2005	Annualized Total Return (%) 1-Year	3-Year	5-Year	10-Year	Since Inception
Basic Materials	-0.31	0.68	9.58	4.96	23.51	19.18	9.91	6.74	8.22
Consumer Goods	0.04	-0.37	1.36	2.04	4.24	10.58	7.12	7.17	9.01
Consumer Services	-0.06	-1.62	2.22	-1.93	3.47	7.59	0.45	8.04	9.43
Financials	-0.14	-0.45	3.92	6.45	12.47	13.75	6.63	13.21	14.79
Health Care	0.29	-4.81	-3.42	8.32	0.10	4.95	1.17	9.60	9.61
Industrials	-0.41	-1.08	7.54	4.82	17.81	17.11	4.56	7.09	9.63
Oil & Gas	2.31	4.32	13.58	34.09	26.32	32.70	15.52	14.64	14.24
Technology	-1.17	-9.02	-4.39	3.31	4.23	8.29	-4.07	6.91	12.13
Telecommunications	4.31	-0.75	14.22	-4.00	13.85	10.39	-3.71	1.85	5.50
Utilities	2.49	5.45	5.05	15.35	5.68	17.63	4.04	8.29	8.16

CORRELATION COEFFICIENTS

Industry	1000	3000	5000	8000	4000	2000	0001	9000	6000	7000
Basic Materials	1.0000									
Consumer Goods	0.5186	1.0000								
Consumer Services	0.5734	0.6513	1.0000							
Financials	0.5727	0.5473	0.5607	1.0000						
Health Care	0.2077	0.5638	0.2641	0.3482	1.0000					
Industrials	0.7633	0.5892	0.7413	0.5699	0.3138	1.0000				
Oil & Gas	0.5928	0.2448	0.1305	0.0046	0.1109	0.3349	1.0000			
Technology	0.5524	0.4782	0.7721	0.6177	0.2394	0.7852	0.2283	1.0000		
Telecommunications	0.3492	0.3768	0.4398	0.4081	0.4050	0.5160	0.2719	0.2905	1.0000	
Utilities	0.0419	0.3318	0.0258	0.1412	0.2265	0.0066	0.3821	0.0295	0.2771	1.0000

DOW JONES U.S. INDUSTRY REPRESENTATION

Industry	Market Cap (USD Billions)	Weight in U.S. Total Market Index
Basic Materials	432.54	3.13%
Consumer Goods	1,176.73	8.52%
Consumer Services	1,708.27	12.36%
Financials	2,966.47	21.47%
Health Care	1,607.42	11.63%
Industrials	1,815.67	13.14%
Oil & Gas	1,354.75	9.80%
Technology	1,846.66	13.36%
Telecommunications	414.20	3.00%
Utilities	496.78	3.59%



HISTORICAL DOW JONES U.S. INDUSTRY REPRESENTATIONS (%)

Industry	2006 Q2	2005	2004	2003	2002	2001	2000	1999	1998	1997	1996	1995	1994
Basic Materials	3.13	2.95	2.74	2.67	2.28	1.98	2.47	2.34	3.53	4.31	5.02	6.28	5.82
Consumer Goods	8.52	9.17	9.40	10.22	8.44	8.14	8.34	11.63	13.79	14.72	15.09	15.62	16.28
Consumer Services	12.36	13.99	13.43	12.97	12.84	10.45	14.49	12.57	10.51	9.59	10.09	11.45	11.87
Financials	21.47	21.25	21.01	21.08	19.04	18.02	14.11	16.92	19.31	16.89	15.11	13.51	13.63
Health Care	11.63	12.17	13.33	14.56	14.28	14.23	9.21	12.44	11.35	11.08	11.11	9.90	9.36
Industrials	13.14	12.64	11.87	11.68	12.07	12.54	11.98	11.89	13.47	14.35	14.39	14.50	14.73
Oil & Gas	9.80	7.10	6.05	6.32	5.88	6.00	4.51	5.46	7.17	7.88	7.45	7.91	7.96
Technology	13.36	14.50	16.10	13.53	17.12	19.89	25.59	16.43	11.78	12.25	9.99	8.76	6.81
Telecommunications	3.00	3.00	3.09	3.81	5.03	5.19	6.96	7.20	5.67	5.36	7.29	7.24	7.57
Utilities	3.59	3.24	2.98	3.15	3.02	3.56	2.34	3.12	3.43	3.57	4.45	4.82	5.99

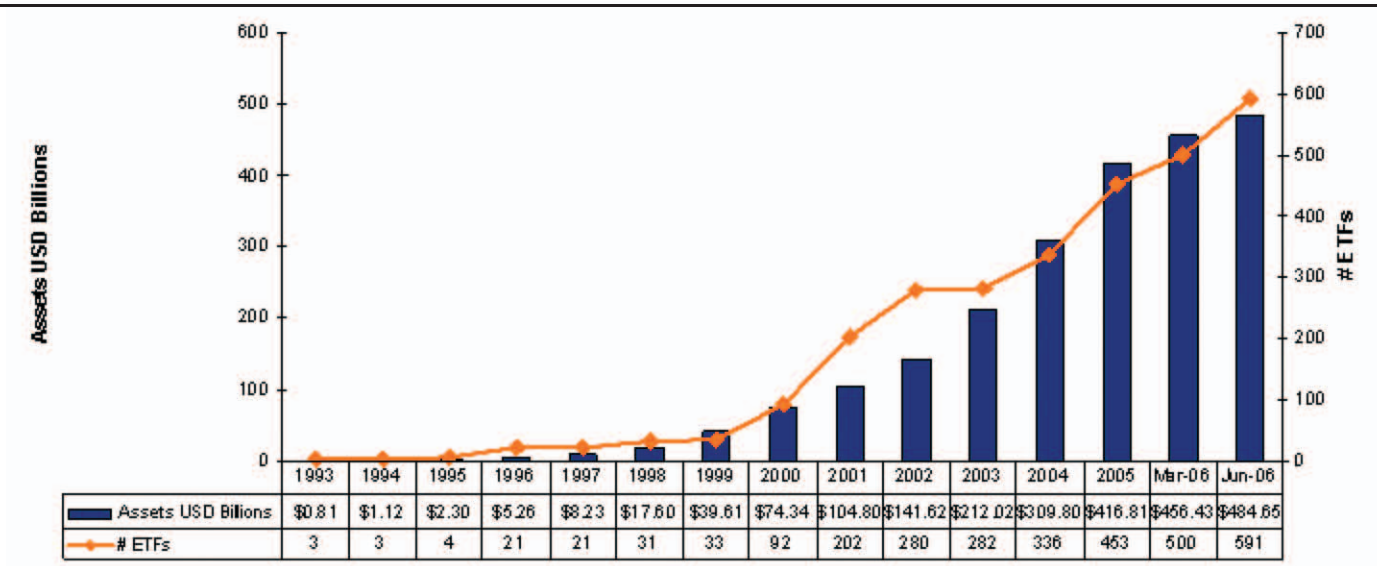
Source: Dow Jones Indexes. Data is based on total return values as of 6/30/2006.

Exchange-Traded Funds Corner

Overview of ETFs around the World

Country/Region	# Primary Listings	New ETFs In Q2 2006	New ETFs In 2006 YTD	Total Listings	AUM $US Bln	# Managers	# Exchanges	Planned New ETFs	Planned Cross Listings
US	275	59	71	275	$344.39	13	4	79	-
Europe	216	20	51	433	$71.34	24	14	69	11
Japan	13	-	-	13	$39.53	4	2	-	-
Canada	17	-	1	18	$11.45	2	1	-	-
Hong Kong	8	-	-	10	$7.67	4	1	-	-
Israel	18	-	-	18	$3.31	2	1	3	-
Taiwan	1	-	-	1	$1.43	1	1	2	-
South Africa	9	2	2	9	$1.63	4	1	-	-
Australia	4	-	-	4	$0.60	2	1	-	-
China	1	-	-	1	$1.00	1	1	5	-
South Korea	13	8	8	13	$0.83	3	2	-	-
New Zealand	6	-	-	6	$0.49	3	1	-	-
Singapore	3	1	2	8	$0.70	2	1	1	-
India	6	-	-	6	$0.12	3	2	10	-
Malaysia	1	-	-	1	$0.15	1	1		-
ETF Total	**591**	**90**	**135**	**816**	**$484.65**	**61**	**34**	**169**	**11**
HOLDRS	17			17	$10.25	1	1	-	-
ETFs & HOLDRS Total	**608**	**90**	**135**	**833**	**$494.89**	**62**	**34**	**169**	**11**

Worldwide ETF Growth



U.S. ETFs Sorted By Total Net Assets

Fund Name	Ticker	Net Assets $MM	*ER	YTD*	2005	2004	2003	Std. Dev.*	P/E*
SPDR Trust Series 1	SPY	54,525.3	0.10	2.67	4.79	10.75	28.39	7.72	16.6
iShares MSCI EAFE	EFA	28,584.5	0.36	10.08	13.39	19.75	38.45	10.28	14.7
Nasdaq 100 Trust	QQQQ	19,276.4	0.20	-4.33	1.64	10.51	49.18	14.88	27.3
iShares S&P 500	IVV	16,677.5	0.09	2.67	4.83	10.77	28.53	7.74	16.6
iShares Japan Index	EWJ	13,572.0	0.57	1.48	24.65	14.78	35.54	16.51	18.0
iShares MSCI Emerg Mkts	EEM	11,552.0	0.77	5.72	33.78	25.53	-	18.77	14.1
iShares R2000 Index	IWM	9,283.5	0.20	8.13	4.46	18.15	46.94	14.58	19.3
MidCap SPDR Trust	MDY	9,068.2	0.25	4.14	12.17	15.84	35.20	10.89	19.3
streetTRACKS Gold Shares	GLD	7,333.4	-	19.37	16.65	-	-	-	-
iShares R1000 Value	IWD	6,788.4	0.20	6.47	6.92	16.28	29.70	7.80	14.3
iShares DJ Sel Dividend	DVY	6,108.6	0.40	4.61	2.98	17.90	-	-	14.3
DIAMONDS Trust	DIA	5,732.7	0.18	5.12	2.40	5.12	28.00	8.48	16.9
Vanguard TSM VIPERs	VTI	5,654.4	0.07	3.34	6.10	12.55	31.43	8.44	18.0
iShares R1000 Growth	IWF	5,565.4	0.20	-1.02	5.08	6.10	29.46	8.73	20.3
iShares Lehman 1-3 T	SHY	4,935.3	0.15	0.96	1.48	0.80	1.78	1.35	-

*Source: Morgan Stanley Investment Strategies and Morningstar. Data as iof 6/30/2006. *ER is expense ratio. YTD is year-to-date. Std. Dev. is standard deviation. P/E is price-to-earnings ratio*

OPINION

Good Luck, Domini: You'll Need It

By Matt Hougan

A leap of faith off the cliff of active management.

Ann Domini, the co-creator of the world's first socially responsible investing index, the Domini 400, has gone over to the dark side.

No, she hasn't started investing all her money in Phillip Morris and ExxonMobil. And no, she hasn't switched her assets to the International Securities Exchange's SINDEX, with its toxic combination of alcohol and tobacco-related names, either.

It is worse than all that … far worse: She's abandoning indexing in favor of active management.

Domini launched the Domini 400 Index and a related index fund in 1990 to prove that it was possible to have a conscience AND make money in the stock market at the same time. Remarkably, it worked: Since inception, the Domini 400 has beaten the S&P 500, delivering annualized returns of 12.03 percent vs. 11.31 percent for the erstwhile 500. In other words, you can have your organic, homemade, GMO-free cake … and eat it too.

Thanks largely to the success of the index, money has flooded into the formerly tiny field of socially responsible investing (SRI). According to the Social Investment Forum, there are $2.29 trillion invested in a socially responsible manner in the U.S. The Domini 400 Index Fund has a healthy $1.2 billion of that.

Recently, however, Domini asked her shareholders to take a leap of faith … off the cliff of active investing. Seduced by the siren song of active management, Domini filed a proxy looking to drop the fund's boring old index philosophy and ride the sweet gravy train of momentum-based trading to better returns. The social screens will stay in place, but Wellington Asset Management will use a fancy, computer-driven analysis to choose hot stocks.

Oh yeah, I almost forgot: The expense ratio is going up, too. Domini will boost the expense ratio on the fund from an already high 95 basis points to a downright startling 1.15 percent. The 20 basis point jump works out to an additional $2.4 million per year in cold, hard cash. To keep the green coming in, the group is introducing loaded shares as well. Could a hedge fund be next? Two and 20 sounds mighty attractive. (I can see the hybrid convertibles and luxury eco-villas twinkling in the eyes of the worker bees at Domini headquarters.)

As a student of indexing, Ann Domini must know that this approach is doomed. In fact, I *know* that she knows that it is doomed. Just look at the Domini Funds Web site: "While some actively managed funds have excellent long-term records, index funds, on average, tend to have better long-term returns than actively managed funds with similar objectives."

Good advice, I'd say.

> "I can see the hybrid convertibles and luxury eco-villas twinkling in the eyes of the worker bees at Domini headquarters."

The funny thing is, it's not just Domini that's mucking up their SRI investment policy. Another socially responsible fund company, Pax World Funds, recently announced plans to loosen its "zero tolerance" policy for alcohol and gambling stocks. I know that Vegas is the hot new family vacation destination, but seriously: What does this all mean?

The truth is that these old-line socially responsible investing firms are falling victim to their own success. Having proved that social investing can work, they've attracted the behemoths to the field—companies like Vanguard and Barclays Global Investors have recently launched socially screened funds, using their heft to drive down expense ratios and grow assets. At the same time, a rebound in smokestack industries has made it hard for social funds to put up impressive performance numbers. And it's all about performance. These indexes rode the tech boom; now they're trying have it both ways and actively dance their way around underperformance.

But going active—or embracing gambling—well, that just seems desperate. Instead, take a page from the true index investor's playbook. If you're looking for better returns, don't embrace the dark side of active management. Try lowering your fees instead.