THE WALL STREET JOURNAL EUROPE

N° and issue date : 100616 - 16/06/2010
Circulation : 78230
Frequency : Daily
WSTR_100616_36_36.pdf
Web Site: http://www.wsj.com
Page : 36
Size : 100 %
202 cm2
PRESS INDEX

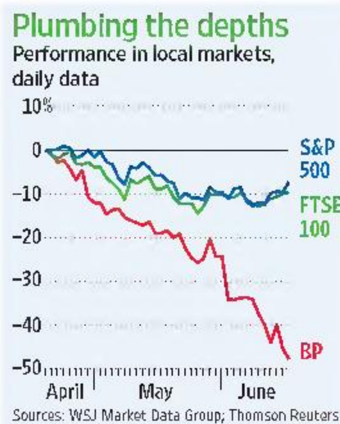
Stock indexes' dead weight

Diversify. Diversify. Diversify. For years it was a trusted mantra: The simple idea that to mitigate the impact of nasty surprises from one company or sector, investors should hold a diversified portfolio of stocks from a cross-section of industries.

The best way, it was thought, was to buy a broad market index, either via an index fund or an index-based exchange-traded fund. Yet the sad tale of **BP** PLC and London's FTSE 100 exposes a key flaw in contemporary diversification strategy. A bias toward market capitalization in many indexes means investors end up with excessive holdings in the biggest stocks. With that comes greater exposure to company-specific risks, diminishing the portfolio's diversification benefits.

Take BP. The day before the Deepwater Horizon rig exploded April 20, the oil giant had a market value of £121 billion ($178 billion), giving it a weighting of 8.22% in the FTSE 100. That ranked it alongside **Royal Dutch Shell** and **HSBC** as the index's biggest components.

Not surprisingly, the subsequent 45% plunge in BP's share price until Monday hit the FTSE hard. BP accounted for more than a third of the index's 10% loss since April 20, FTSE's press office calculates. If not for BP, the FTSE 100 would have outperformed the S&P 500, which is down 9% over the same period.



Sources: WSJ Market Data Group; Thomson Reuters

BP's market cap has since shrunk to £64.4 billion, reducing its weighting to 4.8%. But the damage has been done.

It is a similar story elsewhere. Looking to invest in Argentina? You mightn't want to buy its main index, the Merval. Not only does the country's relatively small energy sector account for almost half the index, but its biggest component, with a whopping 26% weighting, is **Tenaris** SA. It is a Luxembourg-incorporated steel tube maker with entirely overseas operations servicing non-Argentine oil drillers.

At issue isn't diversification, which remains a sound idea. It's that market cap-based indexes have the perverse effect of diminishing diversification.

This problem, thrust into prominence by the bursting of the tech-heavy Nasdaq bubble in 2001 and then emphasized by the 2008 crisis, has spawned a cottage industry. Technicians now are trying to better approximate a risk-neutral benchmark.

One solution lies in equal-weight ETFs, funds which assign each component in an index the same weighting. Yet these suffer from the other extreme, giving too much weight to volatile small companies.

Paris-based asset manager Tobam offers an alternative: "antibenchmark" indexes. Instead of market value, these assign weightings that favor a combination of low historical volatility and low mutual correlations. But the firm doesn't have yet ETFs available.

Until more sophisticated products are developed, investors need to realize that diversity in investing isn't necessarily synonymous with an index fund. —*Michael Casey*

Copyright (Wall Street Journal Europe)
No reproduction without authorisation

Tobam UK