# Factor Funds vs. Index Funds

When the first index fund was made available to the general public, it represented a low cost, passively invested, diversified equity portfolio that delivered the general trend of the market. It was low cost because there were no analysts or economists to pay and trading costs were kept to a minimum. Passively invested meant no attempt was made to market time or select securities based on expected future performance. Diversification was achieved by matching a broad index of a major market such as the S&P 500. Thus, several hundred stocks were held in weightings equal to their market capitalization.

Factor funds followed. They were also low cost, passively managed, diversified portfolios. Unlike an index fund however, factor funds are structured or engineered financial products, aimed at a precise financial attribute – such as market capitalization or valuation. They do not need to be capitalization weighted nor do they need to track any popular market index. Factor funds track a specific and well-defined dimension of risk.

Indices were originally invented to be a general guide for investors to see how the market was performing. Thus index funds, which imitate indices, were not designed as portfolio building blocks. Factor funds, however, are so designed. They start with a specifically defined risk factor and build an investment vehicle to match it. Factor funds are tools, which can be used in more intelligent and efficient portfolio construction.

The distinction between index funds and factor funds is well expressed by the following quote from the Morningstar description of the DFA US 9-10 Small Company Fund. "Although the fund's universe is assembled in a passive manner, it should not be confused with a true index fund. It doesn't try to match any index's sector weights, for example….In addition, the fund has more latitude than an index fund regarding which stocks to buy and when. Therefore, the fund has been able to take advantage of discount trades, which results in extremely low transaction costs."

In the late 1990's, the difference between factor investing and index investing became very stark. This occurred because all the popular indices are market capitalization weighted. The explosion in value of a few very large growth stocks, such as Intel, Cisco Systems, or Nortel, combined with the index requirement of capitalization weighting in index construction, resulted in the popular indexes becoming, in effect, large capitalization growth indexes. They were dominated by the performance of a surprisingly small number of stocks, and were, for that reason, very risky.

The Toronto Stock Exchange's 300 Composite Index is made up of 300 stocks, but Nortel – its largest holding – represented 34% of the index in August of 2000! When a small group of stocks become such a large component of an index it destroys one of the founding principles of index funds – providing a diversified portfolio. No longer is the investor following the general trend of the equity market, but rather is tied to the fortunes or failures of one or two companies. Imagine going to a professional investment advisor and being told to hold a third of your assets in only a few securities! This is exactly what owning only a traditional index fund can amount to.

Pinney & Scofield utilizes factor funds, when available, in the portfolios we manage. This allows the investor to be significantly more diversified and should provide more return for a given level of risk.