

ABOVE THE FRAY

Expectations vs. Reality with Index Funds

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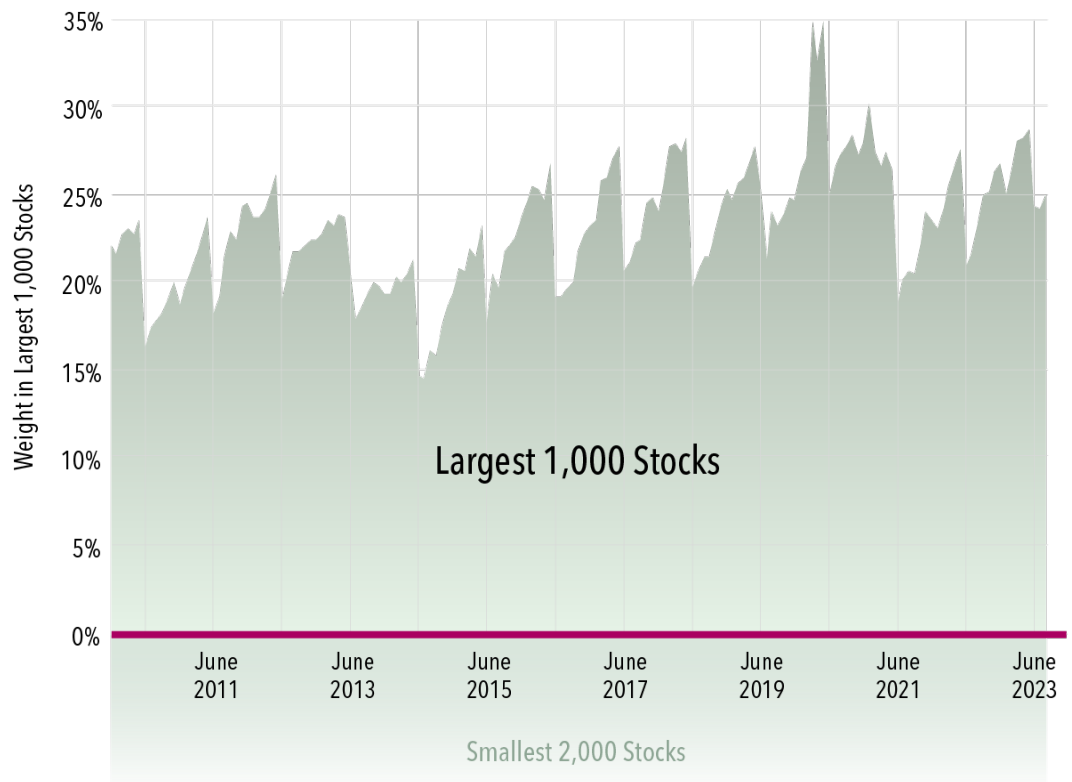
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Based on the name, one might expect the small cap Russell 2000 Index to primarily hold stocks smaller than the 1,000th largest stock in the US market. However, expectations may diverge from reality because of active index construction decisions made by Russell. In an effort to cater to an increasingly large base of tracking funds, the index provider has incorporated a series of methodology adjustments, such as bands minimizing turnover near the market capitalization breakpoint and multiweek lags between the security rank date and reconstitution date. These changes appear to have reduced the Russell 2000's turnover from 29.8%, on average, from 1996 to 2005, to 11.8% since 2006.

While Russell's changes likely help facilitate tracking its indices, they potentially come at the expense of expected returns, due to style drift. The Russell 2000 Index, for example, had on average more than 20% of its constituent weight in the largest 1,000 stocks since 2009. An investment approach whose decisions are guided by risk and return propositions, rather than tracking considerations, can better align expectations with reality.

Exhibit 1**Bending the Rules**

Market cap weight of
Russell 2000 Index
constituents among the
largest 1,000 stocks,
December 2009–August
2023



Past performance is no guarantee of future results.

Indices are not available for direct investment.

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