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FUND TRACK

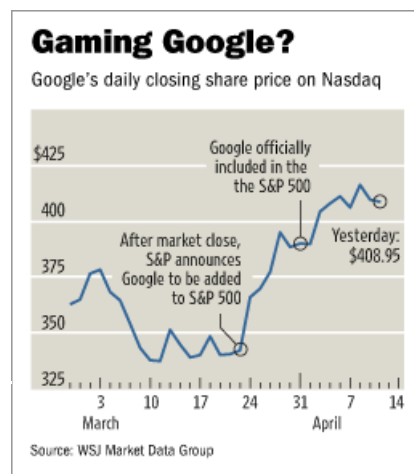
Speculators Take Toll on Index Funds

Trading Ahead of Changes To Benchmarks Like S&P's May Drain Billions in Profits

By SHEFALI ANAND
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A new study says mutual-fund investors lose out on profits of as much as \$2 billion a year when stock indexes such as the Standard & Poor's 500 make changes to their lineups.

The study, one of the first to try to put a dollar amount on the costs to investors, looks at what happens when speculators try to profit from changes like these. When an index announces a lineup change, funds that track the index are forced to buy shares in the new members. So speculators snap up those shares before the change takes effect, hoping to sell them later to funds that need them.



Increasingly, index funds are fighting back. Many now buy stocks a day or two before, or after, the date they join the index, says S&P index strategist Srikant Dash. In addition, funds are also striking deals with their brokers to set a fixed price at which they will buy a stock.

In at least one case, a major fund company switched to tracking lesser-known indexes, partly to avoid speculators, who tend to focus on the better-known: Vanguard Group Inc. three years ago made Morgan Stanley Capital International's indexes the ones for its small-cap offerings, avoiding the more popular Russell 2000 and S&P SmallCap 600. (Both track small companies.)

Still, measures like these haven't been fully successful at cutting down on speculation. In the week after Standard & Poor's Inc.'s March 23 announcement that **Google Inc.** would be added to its S&P 500 index as of March 31, Google's stock went up 6.6%.

Roughly a dozen changes to the S&P 500 have been made or announced this year. Tuesday, S&P said it would add money-management firm **Legg Mason Inc.**, though it

hasn't set a date. In one sign of the risks to speculators who play this game, Legg Mason's share price slipped after the announcement; in 4 p.m. composite trading on the New York Stock Exchange yesterday, the shares were down 78 cents, or 0.6%, to \$122.

The new study, which looks at the S&P 500 and the Russell 2000, is soon to be published in the *Financial Analysts Journal*, a scholarly publication aimed at investment professionals. It concludes that losses range from 0.03% to 0.12% a year of assets under management in S&P 500-linked funds and 1.3% to 1.84% in Russell 2000-linked funds.

It points to two factors: the time lag between the announcement of the change and the date it takes effect, and that investors evaluate index-fund managers based on how closely they track the underlying index. To keep fund and index close, fund managers tend to add or remove stocks on the day the index change takes effect -- not the day it is announced.


It is that time lag that speculators take advantage of. The study's co-author, Vijay Singal, a finance professor at Virginia Tech University, argues that, if fund managers had more flexibility, they wouldn't typically buy on the last day.

Some index providers and fund managers argue that the study's estimate of losses is high. Kelly Houghton, strategic director of Russell Indexes, a unit of Russell Investment Group, says the academic study assumes that all index-fund managers buy the stock on the actual date of change, whereas in reality, managers increasingly trade a few days before or after.

Gus Sauter, chief investment officer at Vanguard, says the effect on a stock's price due to its imminent inclusion in the index has declined over the years. Too many "hedge funds have jumped in" and tried to play the game, so it is hard to profit, he says.

Prof. Singal says that the stock price starts rising immediately on announcement, and sometimes even earlier in anticipation, so buying the stock one or two days before the last day is still expensive. "You have to look at the numbers," he says.

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