

SECOND OPINION



## Enhanced Index Funds: Interesting But Problematic

**Q:** I've had my 401(k) account with Fidelity for years. I've had my money in its funds most of the time. I have recently compared many of its funds to others, including the index funds that make up many of your balanced, low-cost portfolios. I have found that Fidelity is not the best choice most of the time.

I just received a notice from Fidelity about three new funds it describes this way: "Enhanced index funds build upon the same principles (as index funds) but seek better performance and bring institutional investment strategies to retail investors."

The three funds are FLCEX, FLGEX and FLVEX, all of which carry a 0.45% expense ratio. Not one of these funds has a track record yet. Do you know anything about these funds that would potentially make them worth the extra expense versus a true index fund, and can you comment on their reference regarding "institutional investment strategies"? - S.D., Richardson, Texas

**A:** Enhanced index funds now number 179 distinct portfolios, according to the Morningstar fund database. The Fidelity entrees have a low enough expense ratio - 0.45% - to make them serious contenders for traditional market capitalization-based index funds - provided that their enhancement strategy works. To recover their additional costs over traditional index funds, the new Fidelity funds need only gain 20 to 30 basis points. Everything over that will be "gravy."

I believe many of the ETF index offerings

and enhanced index mutual fund offerings flooding the market will wither and die due to poor trade-offs between performance, expenses and risk. With the enhanced index fund strategies, relative risk is a central issue.

We won't know about the new Fidelity offerings until there is a track record. When there is a track record, however, the first thing to check is whether any increase in return was matched by an increase in risk, as measured by standard deviation.

In the same month, Schwab announced three new funds based on the new "fundamental indexing" concept created by Rob Arnott at Research Affiliates in Pasadena. Arnott back-tested his method and found an improvement in return with a slight reduction in volatility. For 2006, its first full year of operation, the RAFI 1000 ETF returned 18.86%. That's 3.07% more than the S&P 500 index and 3.47% more than the Russell 1000 index - in spite of an expense ratio of 0.60%. That sort of outsized extra gain isn't likely to continue, of course, but it's an interesting start. It's also a good reason for us to watch the development of enhanced index funds very closely.

To learn more, visit my Web site and read the columns on Arnott and Fundamental Indexing (see links below).

**Q:** I invested \$4,000 in a traditional IRA during or before the dot-com bubble. I held stock of a local company that was sold at pennies. My account is now worth about \$120. I don't know whether I can take out that money and declare a loss on the stock. Or should I keep the money as is and painfully watch it grow to \$150 over the next 20 years? - R.P., by e-mail

**A:** You can't take a loss because IRAs hold pre-tax income. This is one of the reasons we should never use qualified plan money for speculative purposes.

If you're going to speculate, do it in a plain vanilla taxable account. Then you can take losses and, if necessary, deduct them (up to \$3,000 a year) against earned income.

If the IRA account is with a firm you want to continue doing business with, I suggest you keep the account. But start funding it with different investments. It will remind you not to do silly things with your money. If you want to do business with another firm, the easiest



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thing to do is sell the stock, liquidate the IRA, and start over.

(Questions about personal finance and investments may be sent by e-mail to [scott@scottburns.com](mailto:scott@scottburns.com) or by fax to 505-424-0938. Check the Web site: [www.scottburns.com](http://www.scottburns.com). Questions of general interest will be answered in future columns.)

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**On The Web**

"Index Funds: The Next Generation" (11/28/04):  
[assetbuilder.com:9669/blogs/scott\\_burns/archive/2004/11/28/Index-Funds\\_3A00\\_-The-Next-Generation-\\_2800\\_2004\\_2900\\_.aspx](http://assetbuilder.com:9669/blogs/scott_burns/archive/2004/11/28/Index-Funds_3A00_-The-Next-Generation-_2800_2004_2900_.aspx)

"Index Funds: The Next Generation" (01/22/06):  
[assetbuilder.com:9669/blogs/scott\\_burns/archive/2006/01/22/Index-Funds\\_3A00\\_-The-Next-Generation.aspx](http://assetbuilder.com:9669/blogs/scott_burns/archive/2006/01/22/Index-Funds_3A00_-The-Next-Generation.aspx)

"Tempest on an Index" (7/11/06):  
[assetbuilder.com:9669/blogs/scott\\_burns/archive/2006/07/11/Tempest-on-an-Index.aspx](http://assetbuilder.com:9669/blogs/scott_burns/archive/2006/07/11/Tempest-on-an-Index.aspx)

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