



Press Release

London, Nice, Singapore, June 29, 2010

EDHEC-Risk Study Finds No Theoretical or Empirical Justification for Cap-Weighted Indices

After the financial crisis and the accompanying falls in the stock markets, many commentators have questioned the appropriateness of tracking cap-weighted indices. These indices are particularly inefficient and, through their momentum properties, favour the emergence of speculative bubbles.

New research from the EDHEC-Risk Institute shows that financial theory, despite widely-held views to the contrary, does not support investment in these types of indices. It is therefore urgent for investors to seek alternatives to these indices which are justified by neither fact nor theory.

The three main conclusions of the research are the following:

1. A cap-weighted stock market index is not the market portfolio of financial theory (the Capital Asset Pricing Model (CAPM) theory is often evoked to show that cap-weighted stock market indices are efficient portfolios and attractive investments). That it is not is clear from the choices made in empirical studies that attempt to come up with reasonable proxies for the market portfolio. These studies attach great importance to including many more stocks than indices do, and their proxies of the market portfolio include bonds, real estate, and non-tradable assets such as human capital.
2. Even if it were possible to construct and hold the market portfolio, the theory does not predict that the market portfolio is efficient unless we make highly unrealistic assumptions. In fact, the authors of the seminal academic research in the 1950s and 1960s, Harry Markowitz and William Sharpe, have themselves emphasised (Sharpe (1991) and Markowitz (2005)) that the market portfolio may not be efficient in a more realistic setting.
3. In view of these arguments, financial theory alone does not justify the current practice of cap-weighting. In fact, from a theoretical perspective, cap-weighted stock market indices seem to offer no particular advantage.

The EDHEC-Risk Institute Publication, "Does Finance Theory Make the Case for Capitalisation-Weighted Indexing?" can be downloaded by pressing [Ctrl] and clicking on the following link:

http://docs.edhec-risk.com/mrk/000000/Press/EDHEC-Risk_Publication_Capitalisation-Weighted_Indexing.pdf



Contact:

For further information, please contact **S  verine Anjubault**:

Tel.: +33 (0)4 93 18 78 63 – E-mail: severine.anjubault@edhec-risk.com

EDHEC–Risk Institute

EDHEC Risk Institute—Europe

EDHEC Risk Institute—Asia

393-400 promenade des Anglais
BP 3116 - 06202 Nice Cedex 3
France

New Broad Street House - 35 New Broad Street
London EC2M 1NH
United Kingdom

9 Raffles Place
57#12 Republic Plaza
Singapore 048619

About EDHEC-Risk Institute

EDHEC-Risk Institute is part of EDHEC Business School, one of Europe's leading business schools and a member of the select group of academic institutions worldwide to have earned the triple crown of international accreditations (AACSB, EQUIS, Association of MBAs). Established in 2001, EDHEC-Risk Institute has become the premier European centre for financial research and its applications to the industry. In partnership with large financial institutions, its team of 47 permanent professors, engineers and support staff implements six research programmes and ten research chairs focusing on asset allocation and risk management in the traditional and alternative investment universes. The results of the research programmes and chairs are disseminated through the three EDHEC Risk Institute locations in London, Nice and Singapore.

EDHEC-Risk Institute validates the academic quality of its output through publications in leading scholarly journals, implements a multifaceted communications policy to inform investors and asset managers on state-of-the-art concepts and techniques, and forms business partnerships to launch innovative products. Its executive education arm helps professionals to upgrade their skills with advanced risk and investment management seminars and degree courses, including the EDHEC Risk Institute PhD in Finance and the EDHEC Risk Institute Executive MSc in Risk and Investment Management.

www.edhec-risk.com