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Alex Frino, David R. Gallagher

The Journal of Portfolio Management Fall 2001, 28 (1) 44 - 55
DOI: 10.3905/jpm.2001.319822

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Abstract

Although index funds have grown significantly in the 1990s, empirical research concerning these passive investment offerings is surprisingly scarce. While the theory and objectives of an index strategy are both simple and well known, potential difficulties arise for index managers attempting to replicate the returns of the target benchmark. The source of the problem is that the underlying index is measured as a paper portfolio, and there is an implication that simple duplication is achievable without cost. In reality, tracking error in index fund performance is unavoidable because of market frictions. The authors highlight the difficulties faced by index funds. They examine both the extent and the variation of tracking error over time for S&P 500 index mutual funds, and provide a direct performance comparison between index funds and active mutual funds. The findings indicate that S&P 500 index funds, on average, outperformed active funds after expenses over the sample period.

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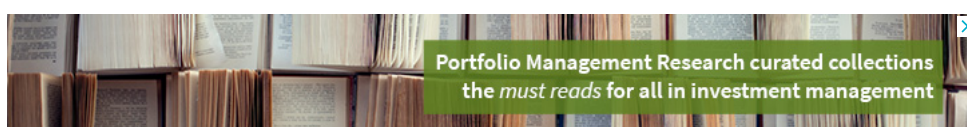
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