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# FA News

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**Has Bad Debt Killed Market-Cap Weighted Mutual Funds?**
By Maureen Nevin Duffy

Now that all but possibly space aliens have gotten the memo that credit is bad and cash is good, does it still make sense for mutual fund managers to choose the countries and companies with the most debt?

Yet most mutual funds are cap-weighted, populated by debt and equity issuers with the highest debt outstanding. With European countries still wilting under their debt loads, cap-weighted issuers, despite the perceived advantage of market liquidity, can pose the highest credit risk. Could there be a better way?

Investors may find out with a handful of mutual funds that when building portfolios shun cap-weighted indexes in favor of those weighted based on gross domestic product (GDP), the theory being that issuers producing goods should also generate revenues for funding growth and paying down debt. Funds tracking the Barclays Capital Global Aggregate GDP-Weighted Index would give debt strapped Japan only 12 percent of their fund investments. This is much less than Citigroup's G7 Ex-US Cap-Weighted Index, which is more than 50 percent invested in Japan, a country whose debt-to-GDP is 208 percent, according to an August 10, 2012, report posted by The Telegraph, of London. The Japan bond holding in Barclay's GDP index, by comparison, is slightly over 10 percent.

“Just because someone wants to borrow more, why should you invest in them more?” reasons Shane Shepherd, a vice president and senior researcher with Research Affiliates LLC. RA uses a fundamental index strategy that employs GDP along with measures of company size or a country's land area, population, energy reliance and effective use of the economy to get a more rounded impression before selecting and weighting securities, he says. Shepard points out that countries with high debt loads are often subject to government intervention, such as quantitative easing in the U.S., which can lower interest rates on bond holders.

“You can certainly see the logic behind [GDP-based investments], especially where European sovereign debt is a concern for investors,” says Todd Rosenbluth, a mutual fund analyst with S&P Capital IQ. GDP funds can also diversify a portfolio that's invested in cap-weighted funds, he notes. “Whether the strategy works,” he adds, “it is way too soon to say.”

And potential investors won't be able to gather too much from the track records among the six GDP-weighted funds identified by Morningstar, since half were launched within the last 12 months. But RidgeWorth International Equity Index I (SIEIX), J.P. Morgan International Equity Index A (OEIAX), and Pimco Global Advantage Strategy Bond – Institutional (PSAIX) do look encouraging with yields to date (as of 8/20/12) of 6.39 percent, 7.72 percent and 3.94 percent, respectively, all well above their GDP-weighted benchmark's performance for the period.

Toward the end of May, Fidelity Investments introduced two more GDP-weighted funds: Fidelity Global Bond Fund (FGBFX) and Fidelity International Bond Fund (FINUX) under lead manager Jamie Stuttard, Fidelity's head of International Bond Portfolio Management. Both funds invest in sovereign

government debt and corporate and securitized credit securities. Stuttard, describing the benchmark as simply, “growth versus indebtedness,” insists the strategy “reinforces the importance of fundamental analysis” over passive index management. Stuttard notes, in a paper published in Fidelity's May 2012 Investment Insights, that “Japan has more than a 30 percent weighting in many cap-weighted indices because it has the most debt outstanding of any industrialized economy, even though its share of the world GDP peaked more than 20 years ago.”

In the paper, Transformations in Country Dynamics and the Implications for Global Bond Investing, Stuttard acknowledges the liquidity argument for investing in cap-weighted funds: “Liquidity might be a reasonable argument at a snapshot point in time.” But he quickly dismisses it as “not a strategically useful concept over a three-to five-year investment horizon when fundamentals -- and therefore market conditions -- can change.”

With retirement money chasing safer harbors, investors are wise to keep ahead of shifting assets. An important trend Stuttard has noticed is a movement of large streams of institutional deposits into the bonds of safe-haven countries, so much so that cash flows have greatly reduced values to even negative yields.

The flip side of the GDP promise is that there are problems in using the strategy passively, says Stuttard. He questions the sustainability of GDP levels in countries with aging populations, such as Japan and Italy, or where economies have been boosted by a rise in leverage; e.g., Spain, Ireland, perhaps the U.K. and the U.S. And, he says, there generally has been more volatility in GDP-weighted (emerging market concentrated) countries than in market-cap weighted countries. Oversight is needed.

Shepard also has doubts about how well the strategy can work with corporate bonds. “It's not a natural fit,” he says. How would markets compare Ford to GM or GE bonds for fund comparisons, he proposes. The solution, he believes, after working on the question since January of 2010, would be to use corporate sales, the cash flow, to judge the book value of the assets, on the assumption the cash would go toward a company's debt service. “But then it'd be very company specific,” he notes.