

## The Cutting Edge

By Gary Gastineau, Tina Lazarian - Monday, 01 January 2007



Warning: This column discusses issues of etymology and lexicography. Consequently, it is not suitable reading for young children.

The title and topic of this column was inspired by a Clifford Asness (2006) article that appeared in the October issue of Institutional Investor. The same question was echoed in the headline of an even more recent article by Ian Salisbury (2006) in The Wall Street Journal. Both articles examine the recent development of "fundamental indexes" and other non-market-cap-weighted approaches to indexing.

Asness raises some interesting questions on the "value" of fundamental indexing, as advocated by Research Affiliates and WisdomTree, along with their respective gurus, Rob Arnott and Jeremy Siegel. Asness's paper deserves the attention of any serious student of indexes and indexing.

We take issue, however, with Asness's case for restricting the definition of "Index."

The notion that "Index" should be narrowly defined encouraged us to retrieve and update some research we did a few years ago for another purpose. As the following tree diagram shows, we examined the origins and the breadth of English definitions for "Index" dating to its emergence in antiquity (probably between 1350 and 1400) from Latin antecedents. The tree provides a rough timeline of citations from Samuel Johnson's Dictionary of the English Language, The Oxford English Dictionary and a variety of other English and American dictionaries of more recent vintage. (Lest there be any confusion, we do not offer this diagram as a wisdom tree.)

Anyone who proposes to restrict the definition of "Index" must deal with the fact that the word has been part of our language for more than six centuries, and has been used for many purposes over that period. Some of the boxes in the tree have a heavy border indicating that the definition inside is an antecedent of how the financial community uses the word "Indexes" today. Common equity market indexes probably originated with the S&P 500 approximately 1957. The S&P 500 was described as an "Index" in an attempt to distinguish it from the Dow Jones Industrial "Average."

We cite below a number of financial "Index" definitions from dictionaries and glossaries of recent vintage. Unlike the original print editions of Johnson's Dictionary and The Oxford English Dictionary, many online dictionaries are updated without the document trail that etymologists and lexicographers have used to track changes in usage over time. In some cases, the definition of "Index" in these dictionaries has changed since our original research.

Surprisingly, the controversial Wikipedia Web site does not provide provocative "Index" definitions. We hope no one takes that statement as indicating a fault in Wikipedia's efforts. We have quite enough "Index" definitions. We are not asking for more.

### Selected Definitions Of "Index"

**"Index":** A number calculated by weighting a number of prices or rates according to a set of predetermined rules. A financial market index is a statistical construct that measures relative or absolute price changes and/or returns in stock, fixed-income, currencies, or futures markets. The purpose of the index calculation is usually to provide a single number whose behavior is representative of the movements of a variety of prices or rates and indicative of behavior in a market. "Indexes" serve as underlyings for a number of products, particularly in equity and fixed-income markets.

- *Dictionary of Financial Risk Management (1999)*1

**"Index":** Often applies to derivative products. Statistical composite that measures changes in the economy or in financial markets, often expressed in percentage changes from a base year or from the previous month. Most relevantly, indexes measure the ups and downs of stock, bond, and some commodities markets, reflecting market prices and weighting of the companies in the index.

- *Forbes Online Financial Glossary*

**"Index":** A specialized average. Stock indexes may be calculated by establishing a base against which the current value of the stocks, commodities, bonds, etc., will change; for example, the S&P 500 index uses the 1941-1943 market value of the 500 stocks as a base of 10.

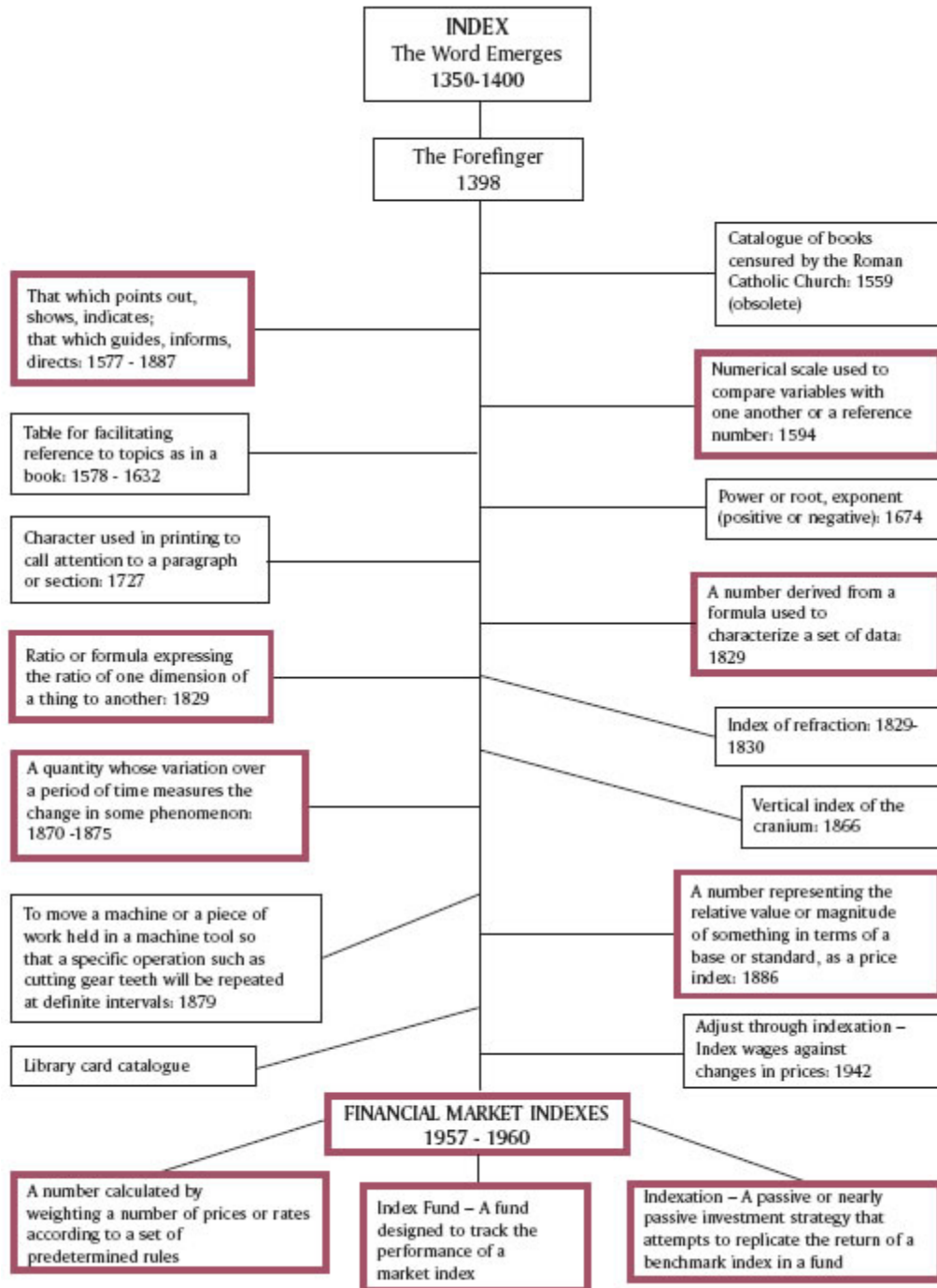
- *Guide to Futures and Options Terminology*

**"Index":** A statistical yardstick expressed in terms of percentages of a base year or years. For instance, the Federal Reserve Board's index of industrial production is based on 1947-49 as 100. In January 1957, the index stood at 146, which meant that industrial production that month was 46 percent higher than in the base period. An index is not an average.

- *The Language of Investing, A Glossary (1957)*

**"Index":** A statistical composite that measures changes in the economy or in financial markets, often expressed in percentage changes from a base period or from the previous month. For instance, the CONSUMER PRICE INDEX uses 1982-84 as the base period. That index, made up of the prices for key consumer goods and services, moves up and down as the rate of inflation changes. By the late-1990s, the index climbed from 100 in 1982-84 to 160 and higher, meaning that the basket of goods the index was based on rose in price by more than 60 percent. "Indexes" also measure the ups and downs of stock, bond, and commodities markets, reflecting market prices and the number of shares outstanding for the companies in the index.

- *Barron's Dictionary of Finance and Investment Terms (1998)*



### Definition: Stock Indices2 And Averages

Indicators used to measure and report value changes in representative stock groupings. Strictly speaking, an AVERAGE is simply the ARITHMETIC MEAN of a group of prices, whereas an INDEX is an average expressed in relation to an earlier established BASE MARKET VALUE. (In practice, the distinction between indexes and averages is not always clear; the AMEX Major Market "index" is an average, for example.) "Indexes" and averages may be broad-based- comprised of many stocks representative of the overall market- or narrowly based, meaning they are

composed of a smaller number of stocks reflecting a particular industry or market SECTOR. Selected indexes and averages are also used as the underlying value of stock index futures, index options, or options on index futures; these derivative instruments enable investors to hedge a position against general market movement at relatively low cost. An extensive number and variety of indices and averages exist.

- *Barron's Dictionary of Finance and Investment Terms (1998)*

### **Back to Asness**

Returning to Asness's article, his answer to the question of "What Is An 'Index'?" is, "the loosest definition is any rulebased method of constructing a portfolio. The method can be completely mechanical-this is how we usually think of it-but it can also be the result of a committee decision such as that undertaken to construct the Standard & Poor's 500 "index." What is important is that it is defined "ex ante," so we know the components before we see the results." This quotation clearly indicates that Asness is thinking about the use of an index for construction of a portfolio, not necessarily an index to be used as a portfolio benchmark. He also explicitly indicates that the use of the index is to prescribe the contents of a portfolio. Asness continues with the popular refrain, "a definition of an Index that is stricter and, for some purposes, more useful ... describes a combination of assets we can all invest in without distorting prices." In short, he is talking about a capitalization or, perhaps, a float-weighted "Index". As any diligent reader of this journal is aware, and as any viewer of the etymological "index" tree will readily agree, today's definition of "Index" is far broader. Any word that has antecedents that were centuries old when it was first used as a financial market indicator is hard to control.

Whatever the merits or demerits of fundamental indexing, Intellidexes, active indexes and other recent additions to the workload of future generations of lexicographers, there is no scope for narrowing the definition of a financial market index. The cat is out of the bag, the horse has been stolen from the barn and, of course, Elvis has left the building.

### **Endnotes**

1. We especially recommend the Dictionary of Financial Risk Management, Gastineau and Kritzman, 1992, 1996, 1999 and an annually updated version at [www.amex.com](http://www.amex.com) (scroll to the bottom of the home page and click on Dictionary).
2. The Latin root of "index" suggests that the preferred plural should be "indices" rather than "indexes". To prove that index purity is a dead issue, any writer on index topics will find that copy editors will change the plural from indices to indexes without a second thought. Thus, this etymological observation is not a call for a change in the title of the Journal of Indexes.

### **Bibliography**

Asness, Clifford, "The Value of Fundamental Indexing," *Institutional Investor*, October 2006, pp. 94-99. Gastineau, Gary and Mark Kritzman, *Dictionary of Financial Risk Management (DOFRM)*, John Wiley & Sons, 1992, 1996, 1999 and <http://www.amex.com>. Salisbury, Ian, "ETFs Redefine What Is An 'Index'," *Wall Street Journal*, October 31, 2006, p. C-13.