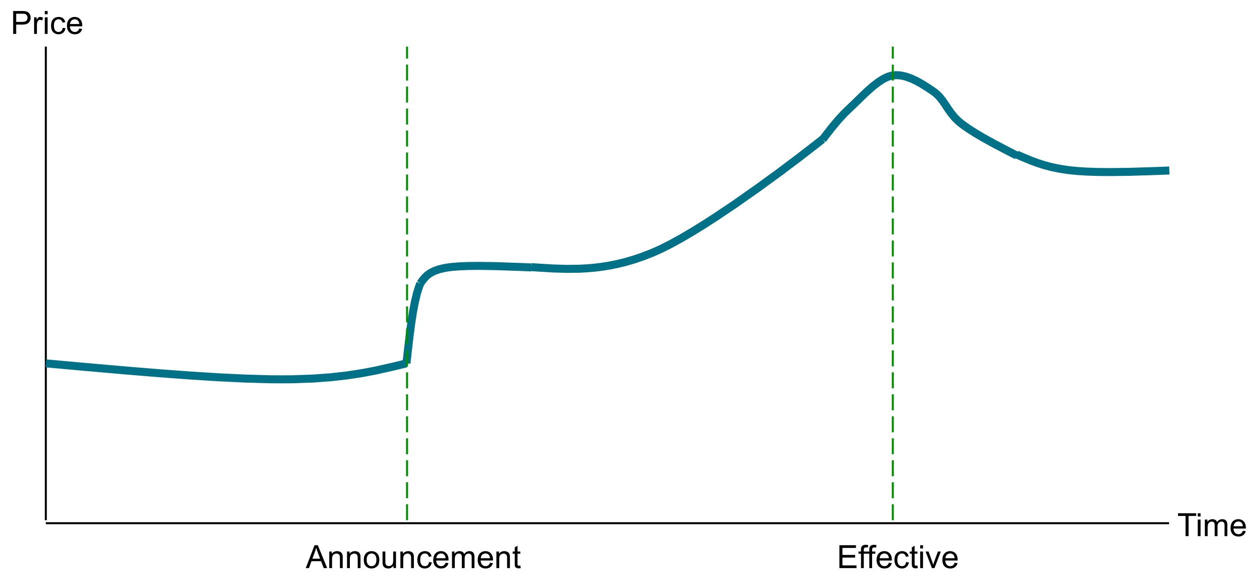
The Effect of Index Reconstitution on Stock Prices

- Stocks rise on announcement of inclusion.
- Index funds are forced to buy high on effective date.
- Buying and selling to track index changes reduces tracking error but generates transaction costs.



	S&P 500 Index	MSCI EAFE Index
One-Day Return after Announcement (%)	3.2	3.4
Run-Up to Effective Date (%)	3.8	4.5
Decay after Effective Date (%)	-2.1	-2.6

In US dollars. S&P 500 data source: Anthony Lynch and Richard Mendenhall, "New Evidence on Stock Price Effects Associated with Changes in the S&P 500 Index," Journal of Business 70, no. 3 (July 1997): 351-83. MSCI EAFE Index data source: Rajesh Chakrabarti, Wei Huang, Narayanan Jayaraman, and Jinsoo Lee, "Price and Volume Effects of Changes in MSCI Indices: Nature and Causes," Journal of Banking and Finance 29, no. 5 (May 2005): 1237-64.
For illustrative purposes only. Past performance is not a guarantee of future results.

Stocks that are added to an index commonly enter a period of abnormal price escalation after the announcement and through the effective date. This results from speculative buying pressure. After the effective date, stocks experience a price decay resulting from lightened demand.

Traditional index managers with rigid tracking policies must acquire the stock when the price is climbing. Buying the stock before the effective date may reduce tracking error, but it also raises both acquisition and transaction costs.

A more flexible trading policy enables portfolio managers to avoid the heaviest trading days and higher prices by deferring the transaction to a more opportune time. This can add value through reduced costs and lower acquisition price.