Tracking an Index Can Be Costly

- Tracking an index may result in significant trading costs.
- Index replication requires executing with pre-specified transactions, stocks, amounts, and trade dates.
- Timing lag between reconstitution announcement and effective date enables non-indexers to buy additions and sell deletions before tracking-sensitive investors, when prices are often more attractive.

When an index sponsor announces the securities to be added or deleted from its composition, managers seeking to closely track the index must buy and sell to adjust their portfolios on the reconstitution date. Prices may be temporarily distorted by the spike in demand from numerous index managers seeking to buy or sell securities on the same day. Other market participants take advantage of this temporary demand.

Market impact is a zero-sum game; to the extent one party is penalized by the reconstitution effect, someone else enjoys a benefit. In any negotiated transaction, the party in a hurry to make the deal is at a disadvantage. Although index managers may successfully track the index, their trading strategy may penalize the return of the index itself. Investors who make low tracking error a priority bear the costs of this activity.