Michael Edesess' "Last Word" to Rob Arnott on Fundamental Indexing

Michael Edesess
Partner and Chief Investment Officer
Fair Advisors
February 24, 2009

The following letter is in response to last week's letter by Rob Arnott, Rob Arnott's Rebuttal to Michael Edesess.

I'm impressed that Rob Arnott has generously offered me the final rebuttal on fundamental indexing.

Arnott's chief rebuttal is that I can't break free of the classical finance world-view of efficient markets—as if I were a struggling addict. It's funny because I don't recall saying anything about efficient markets.

He then says that he noticed six instances in which I changed his core assumptions or otherwise materially altered his arguments—and offers a choice Bordeaux to each reader who can identify them. (To the cost-conscious client, this might suggest that his firm's fees are too high.) For my side, I will interview anyone for a role in my firm if they can find **anywhere** that I materially changed his assumptions. My email address is above.

What Arnott does not do is to rebut my simple arguments. I said:

> "My criticism is of the excessive claims made by promoters of the fundamental indexing methodology. The promoters are not content to rest their case on the empirical evidence that an index weighted more heavily in value stocks would have significantly outperformed a market-weighted index historically. They go much further by intimating that it is mathematically provable that a fundamentally-weighted index must outperform a capitalization-weighted index."

When Arnott suggests that he can prove his theory mathematically, he stands on the roof of his house of cards shaking his fists. Since he is unable to respond to my proofs with math, he gives names of his co-authors. The nice thing about math is that if it's wrong, it's wrong. If it's bad math then, even if Einstein said it, it's still wrong. And Arnott's statements to the effect that a market-cap-weighted index portfolio is inferior to *any* non-market-weighted index portfolio are 100 percent wrong.

Let me remind Mr. Arnott that I have a Ph.D. in mathematics in the field of diffusion processes—the field in which, on occasion, Arnott and his some-time co-authors have dallied in abortive attempts at proofs of their claims.

So here we are, Sisyphus-like, attached to our alleged respective addictions. If, in a year, Arnott continues to parrot seductive locutions to the effect that "capitalization-weighted indexes overweight overpriced stocks and underweight underpriced stocks," and, "if we have a cap-weighted portfolio, we know most of our money is in companies that are above fair value"—well then, Rob, see you in rehab!