Fundies must pass on Worley

Worley's promotion to the big league illustrates the problems of index benchmarking, writes **Tim Findlay**.

Small-cap fund managers will be forced to dump WorleyParsons, one of their favourite stocks, when the company is promoted to the large-cap S&P/ASX 100 Index today.

Since floating in November 2002, the stock has returned more than 1000 per cent. It jumped 49¢ to $19.17 yesterday but this month has fallen 15 per cent to be one of the worst performers in the S&P/ASX 200 Index.

One reason for the decline is that small-cap managers have been forced to sell the shares ahead of the company's removal from the Small Ordinaries Index, where it holds a 3 per cent weighting.

But because of the company's negligible weighting (expected to be 0.3 per cent) in the larger S&P/ASX 100 Index, large-cap funds are not forced to buy the stock.

In theory, stocks due to be included in an index experience rising volumes and prices, as fund managers benchmarked against that index buy into them so as to maintain a marketweight position.

If a stock is excluded from an index, fund managers might choose to ditch their positions, sending the share price lower. But when small-cap stocks make the transition to a larger index, the risk of underperforming is not as great because of the smaller weighting.

Money managers say abandoning a good stock merely on index changes is unnecessary.

"We don't believe in the index system, full-stop," Smallco Investment Manager managing director Rob Hopkins said.

"Just because a stock goes into some artificial number which happens to be the S&P/ASX 100 because the company's now worth over $2 billion, that is a seriously dumb reason to sell a stock."

Smaller fund managers will have some time to sell the shares after today's changes, but Eley Griffiths portfolio manager Brian Eley said those who held WorleyParsons risked its share price heading lower in the short term.

"When WorleyParsons was in the Small Ordinaries, small-cap managers could not afford to ignore it. But when it goes into the S&P/ASX 100, the large-cap managers can completely ignore it because it has gone from having a substantial weighting in the Small Ords to something like 0.2 per cent of the S&P/ASX 100," Mr Eley said.

"That is a seriously dumb reason to sell a stock."

"So they can actually afford not to do any work on it and therefore you might actually end up with a hiatus on the buy side as well."

History supports Mr Eley's thesis. Research by UBS revealed stocks that moved to the top-tier indices underperformed their benchmark immediately after inclusion, but found demand in the longer term.

"The theory is that promotion into the [S&P/ASX 100] does not lead to any passive buying, but instead leads to selling by small-cap managers," UBS said in a research note.

Steve Robinson, senior investment manager at large-cap specialist Alleron Investment Management, said WorleyParsons' inclusion wouldn't guarantee buying demand from larger investors.

"From an active manager's point of view, I don't think WorleyParsons going into the S&P/ASX 100 is going to make any difference," he said.

Today's index readjustment comes as investors raise more questions about Standard & Poor's sharemarket indices, after it was revealed nearly 25 per cent of the stocks in the benchmark S&P/ASX 200 Index, which is tracked by more than $300 billion in active and passive funds including superannuation investments, do not have a five-year performance record.

Mr Eley said that though he wasn't surprised that such a large portion of the benchmark had little long-term history, it challenged the practice of index-based investment.

"It actually begs the broader question as to is an index the best starting point to construct a portfolio, which is the implicit premise that it makes sense to benchmark against an index."

Eric Smith, chief investment officer of Vanguard Investments Australia, said work needed to be done on selection criteria of size, liquidity and volume.

"For us over time, more of the issue is sometimes that there are a number of other stocks that warrant inclusion but don't get included because S&P decide they are a bit too illiquid," he said.

"We think they err on the side of caution rather than inclusion."

CHANGE IS COMING

Today's changes to S&P/ASX indices

Index	IN	OUT
S&P/ASX 100	Worley Parsons	Pacific Brands
S&P/ASX 200	Dyno Nobel ERA Austar	GRD GasNet Australia Fleetwood Corp
S&P/ASX 300	Dyno Nobel ERA	None

Source: Bloomberg