In this issue of Market Perspectives, the Research and Strategy Team discuss index investing, including its risks and limitations.

What you should know before investing in index funds

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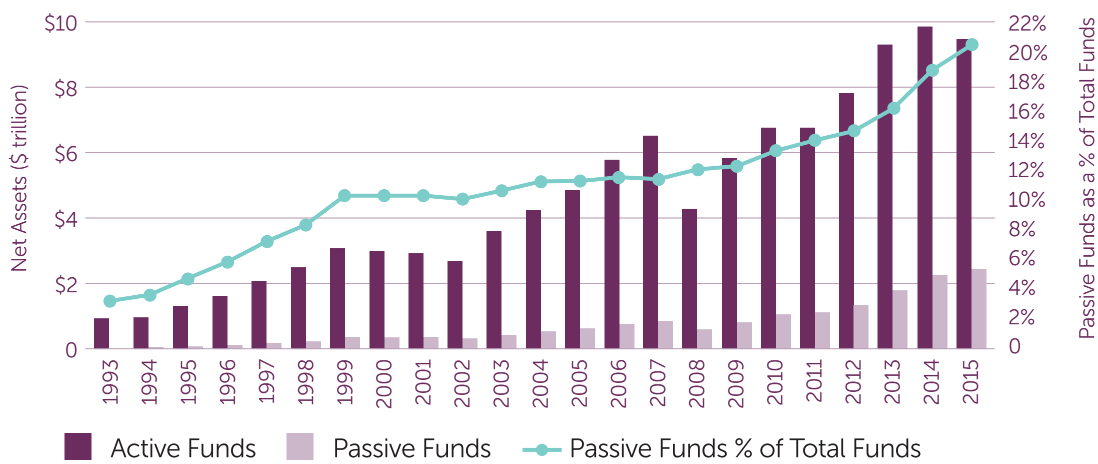
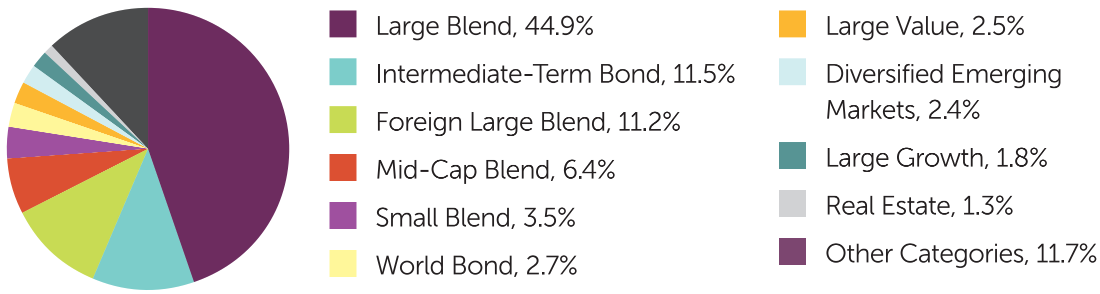
Over the past few years, a large amount of assets have flowed into index funds. The S&P 500 Index funds grew in popularity and received lots of positive press during the most recent bull market. There were almost $2.1 trillion in S&P 500 Index products (including $0.4 trillion of ETF assets) out of a total of $7.5 trillion that were benchmarked against the Index. (Source: S&P DJI's Annual Survey of Indexed Assets as of December 31, 2015).

Active vs. Passive Funds (Net Assets)



Breakdown of Passive Funds

($2.43 trillion in net assets as of 12/31/15)



Source: Morningstar Direct, U.S. Open-end Ex Money Market, Fund of Funds and Obsolete Funds

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Before investing in index funds you should be aware of their risks and limitations.

Index funds tend to do better during bull markets, but active managers tend to do better in bear markets.

Many broad-based domestic equity index funds tend to do better than the average actively managed funds in their respective categories during bull markets. Because of their mandate to track the indexes, however, they do not outperform their markets or superior active managers. This shows the potential value of active management. Due diligence, however, is extremely important when choosing an actively managed fund.

Active managers tend to do better than passive managers in down markets. Index fund managers match the index, which gives them no control, while active managers can take defensive measures in times of market distress. For example, active managers can increase their cash positions, adjust sector allocation by moving to more conservative sectors, adjust duration of their fixed income holdings, and reduce exposure to overvalued securities or sectors.

Index funds tend to inherit indexes' flaws.

Passive managers typically follow market capitalization weighted indexes, which are heavily influenced by a few holdings with the largest weight. Apple, for example, has grown from 0.54 percent of the S&P 500 Index to 3.28 percent in the last 10 years and has become a major driver of the Index's performance. The sector weighting of the indexes have changed over time. For example, the S&P 500's Energy sector exposure declined from 25 percent to less than 7 percent between 1979 and 2015. Healthcare received the highest gain over the same time period, going from about 6 percent to over 15 percent of the Index. During this time frame, your portfolio would have changed significantly if you were using an index fund and often you would be exposed to possible market bubbles and increased risk (measured by standard deviation).

Other concerns with some broad market indexes might include industry concentration and market narrowness. The Russell MidCap Value Index, which has high exposure to the Banking sector, Real Estate Investment Trusts (REITs) and Utilities, is an example of industry concentration. The DJ U.S. Select REIT Index, which currently has an almost 10 percent allocation to one REIT, is an example of market narrowness.

Index funds have a mandate to match their indexes and therefore need to be rebalanced when there is a change in the index. Rebalancing occurs when a company is added or removed from their respective index. New companies to the index may enter at an inflated price as increased demand from indexed funds will push the price up, while companies that leave the index typically suffer a price decline.

Passive implementation of some asset classes is not always feasible and available.

While the concept of index funds can work reasonably well for broad-based U.S. equity indexes, such as the S&P 500 Index, it does not work well for all markets and indexes. Active funds can make more sense in more inefficient or less liquid markets (i.e., small-cap and micro-cap markets, emerging markets, and high yield bonds) where managers can add value.

It is often practically impossible and too expensive to own all securities in some of the bond or emerging market indexes.

There are a limited number of index funds available to gain exposure in certain asset classes and categories. Our research (using the Morningstar Database of open end funds) shows there are no index funds available in some categories where we have funds, such as bank loans, conservative allocation, high yield bonds, multi-sector bonds and most of the municipal bond categories.

Even if there is an index product available in less liquid asset classes, it often has a relatively high tracking error and high expense. For example, passive high yield exposure can be accessed only via ETFs, which fail to have broad high-yield market exposure and have relatively high-tracking error.

Furthermore, many of the index funds in certain categories have a limited track record. For example, the only available municipal bond index fund was launched in August of 2015.

Some index funds that follow very narrow or more complex indexes often have high turnover and are expensive, eliminating the biggest advantages of index fund investing. For example, the only index fund in the Morningstar's Foreign Large Growth category has a net expense ratio of 1.55 percent. Some available index funds might not be suitable for all investors.

The Conclusion/Bottom Line

Before investing in an index fund, you should be aware of the risks and limitations. These include:

- Index funds don't try to beat the market; active managers do, which is even more important during down markets.
- Active management can add value in illiquid and data-inefficient markets, where mispricing of securities is more frequent and therefore the added value can be more substantial.
- Actively managed funds also often do better than index funds in a more volatile and less friendly market environment, like the markets we are experiencing today.

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At Foresters Investment Management Company, Inc., registered investment adviser for the First Investors Funds, we have a dedicated team of experienced portfolio managers and investment analysts who employ a top-down, bottom-up approach to investing through rigorous analysis in the disciplined selection of securities for our portfolios.

While no investment is guaranteed, our goal is to produce solid, long-term performance for our clients, while effectively managing risk.

The exceptional combination of broad investment capabilities, asset allocation expertise, conservative risk management and a personal approach to clients, is what gives Foresters Financial its competitive edge.

Foresters Investment Management Company, Inc. also works with outside subadvisers who specialize in specific market sectors. Their expertise, knowledge and experience collectively broadens the scope of the products that are offered by the First Investors family of funds.

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