The Hidden Costs of Index Replication: What Every Investor Needs to Know About

The explosive growth of index replication strategies—often called "passive investing"—has been fueled by compelling promises: low fees, broad diversification, and simplicity. However, beneath this appealing surface lies a troubling reality that most investors never see.

Recent research suggests that mutual funds and ETFs designed to replicate indices face significant adverse selection costs. These funds must respond to changes in stock market composition as indices rebalance due to IPOs, delistings, additions, deletions, new seasoned issuance, and buybacks. While this approach successfully tracks the index, it creates a systematic pattern of buying high and selling low—adversely affecting fund performance in ways that expense ratios never capture.

The Research: Quantifying the Invisible Costs

In her June 2025 study "On the Hidden Costs of Passive Investing" Iro Tasitsiomi's analyzed the implicit trading costs that funds incur during index reconstitution events. When index providers like S&P or Russell announce changes to their indices—adding new stocks or removing existing ones—passive fund managers must execute these trades to maintain their zero tracking error objective.

Tasitsiomi examined what happens when passive managers, fixated on minimizing tracking variance, wait until market close on reconstitution day to purchase newly added stocks. This approach, while maintaining perfect index tracking, creates predictable trading patterns that sophisticated market participants can exploit. Using a mathematical approach that compared multiple scenarios and reconstitution events, she attempted to quantify the real costs of this "passive" approach versus more strategic trading methods involving gradual share accumulation before reconstitution dates. The following is a summary of her key findings.

1. Significant Hidden Costs

The research revealed that the traditional passive approach of waiting until the market close on reconstitution day results in trading costs that can be in the hundreds of basis points compared to more strategic approaches. This finding is particularly striking because it means that funds with expense ratios of just 0.03-0.10% may actually be costing investors significantly more through these hidden implementation costs. In addition, unlike expense ratios, which are transparent and predictable, these implementation costs are variable and can spike during periods of high market volatility or significant index changes.

2. Market Exploitation of Predictable Trades

Tasitsiomi found that sophisticated traders can consistently earn profits by building small inventory positions after reconstitution announcements and providing liquidity during the actual reconstitution event. This profit comes directly at the expense of passive investors who are forced to trade at disadvantageous prices.

3. The Zero Tracking Error Trap

Tasitiomi's research highlights a fundamental flaw in the passive investing approach: the obsession with zero tracking error increases costs substantially. Fund managers who deviate slightly from perfect tracking by gradually acquiring shares in advance can achieve similar results with dramatically lower trading costs.

4. The ETF Boom Intensifies the Problem

The proliferation of ETFs has intensified demand pressure around rebalancing, especially in crowded trades

The Mechanics of Hidden Costs

Index Reconstitution Events: A Predictable Wealth Transfer

When companies are added to or removed from major indices, passive funds must execute these changes to maintain their tracking mandate. The research shows that several factors contribute to elevated trading costs:

- **Predictable timing**: Reconstitution dates are known in advance, creating opportunities for front-running.
- **Concentrated demand**: Multiple passive funds must execute similar trades simultaneously.
- **Price impact**: Large, concentrated buying pressure drives prices higher (lower) for new additions (subtractions).
- **Liquidity constraints**: Limited market liquidity during reconstitution events exacerbates price impact.

Unfortunately, Tasitiomi's paper mainly math—she didn't show support for the empirical claims made. Fortunately, there is supporting evidence that provides the support.

Supporting Evidence from Additional Research

Tasitsiomi's findings align with other recent studies that expose the costs of mechanical index replication:

Marco Sammon and John Shim, in their January 2025 study "Index Rebalancing and Stock Market Composition," concluded: "Index funds mechanically trade in response to IPOs and net issuance in a way that exactly exposes them to adverse selection by firms who buy back when prices are low and IPO/issue when prices are high. And even though this trading is small relative to the total value of index funds' portfolios (less than 10% of AUM a year), these trades predict significant underperformance." They added: "Index funds' returns could generally be increased if they rebalanced less frequently or reactively." Specifically, they found that a simple adjustment to the way stock indices rebalance—going from quarterly rebalancing to annual rebalancing—would yield an additional 25 basis points (bps) per year to index fund investors. Sammon and Shin also found that: "Index funds mechanically trade in response to IPOs and net issuance in a way that exactly exposes them to adverse selection by firms who buy back when prices are low and IPO/issue when prices are high. And even though this trading is small

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Kaitlin Hendrix, Jerry Liu, and Trey Roberts reached similar conclusions in their September 2024 study "Measuring the Costs of Index Reconstitution: A 10-Year Perspective." They found: "With respect to transaction costs, adhering to an index reconstitution schedule can result in relatively poor execution prices—buying higher and selling lower—which are in turn reflected in investors' returns." For example, they found that over the period 2019-2023, price for additions on average went up by 9 bps, relative to nonrebalanced stocks, in the roughly 10 seconds between 4 pm on reconstitution day and market close and then reversed by a relative –13 bps by market open the next morning.

In their study on the costs of rebalancing the Russell 1000 Index over the period 2012-2021, the research team at direct index provider **Index One** found that the hidden cost of rebalancing the Index was 7.5 basis points, or a total loss to investors of $11 billion per year. Rebalancing a week before or two weeks after would have been more efficient.

Key Investor Takeaways

1. Question the "Low-Cost" Narrative

While passive funds advertise low expense ratios, investors should recognize that total cost of ownership includes these hidden implementation costs. For example, a fund with a 0.04% expense ratio might actually cost 0.40% or more when including trading impact.

2. Consider More Sophisticated "Indexing" Strategies

Some fund managers are adopting more sophisticated approaches that accept minimal tracking error in exchange for substantially lower implementation costs. Such strategies are likely to deliver better net returns despite slightly higher expense ratios.

3. Evaluate Fund Implementation Methods

When selecting passive funds, consider how the fund handles index reconstitution events—whether the manager uses predictive trading strategie..

Beyond Reconstitution: Other Hidden Weaknesses

The forced trading costs are just one weakness of index replicating funds. Other issues that result from the desire to minimize tracking error include:

Unintentional Style Drift: Because indexes typically reconstitute annually, they lose exposure to their asset class over time as stocks migrate across categories. According to a 2024 Dimensional study, roughly 25% of the Russell 2000 Index was composed of the largest 1,000 stocks in the Russell 3000 Index on average from 2010 through June 2023. Non-index, but systematic, portfolios (like those of firms such as AQR, Avantis, Bridgeway, and Dimensional) typically reconstitute monthly, allowing them to maintain more consistent exposure to their asset class. That allows them to capture a greater percentage of the risk premiums in the asset classes in which they invest.

Inclusion of Poor Performers: Research shows that very low-priced stocks, stocks in bankruptcy, extreme small growth stocks with high investment and low profitability, and IPOs have poor risk-adjusted returns. Systematic portfolios can exclude such stocks through simple filters.

Limited Tax Efficiency: Index funds have limited ability to pursue tax-saving strategies, including avoiding short-term gains and offsetting capital gains with losses.

Post-IPO Underperformance: Capital markets research shows that mechanical buying of stocks immediately post-IPO by index funds leads to underperformance. Robert D. Arnott and colleagues found in their 2023 study "The Avoidable Costs of Index Rebalancing" that "discretionary deletions beat additions by 22%, on average" in the year after S&P 500 Index changes. Simple rules like trading ahead of index funds or delaying reconstitution trades by 3 to 12 months can add up to 23 basis points annually.

Trade Patiently, Accepting Tracking Variance: Be a provider, instead of a demander, of liquidity by trading patiently.

Summary

While media, academic, and advisor scrutiny on index funds has focused on expense ratios and management fees to investors, the empirical research we have reviewed shows that the hidden costs of passive investing represents a significant, yet underappreciated, drag on investor returns. While passive investing remains a valuable tool for most investors, understanding these costs is crucial for making informed decisions about fund selection and portfolio construction.

Investors should look beyond expense ratios to consider total implementation costs, seek out managers who employ more sophisticated trading strategies, and remain vigilant about the true cost of their "low-cost" investments. As the research demonstrates, what appears to be a simple, low-cost investment strategy may actually be transferring substantial wealth from ordinary investors to sophisticated market participants.

The key is not to abandon “passive investing” but to demand better implementation from systematic strategies and remain aware of the true costs involved in seemingly simple investment strategies.

Larry Swedroe is the author or co-author of 18 books on investing, including his latest *Enrich Your Future*.