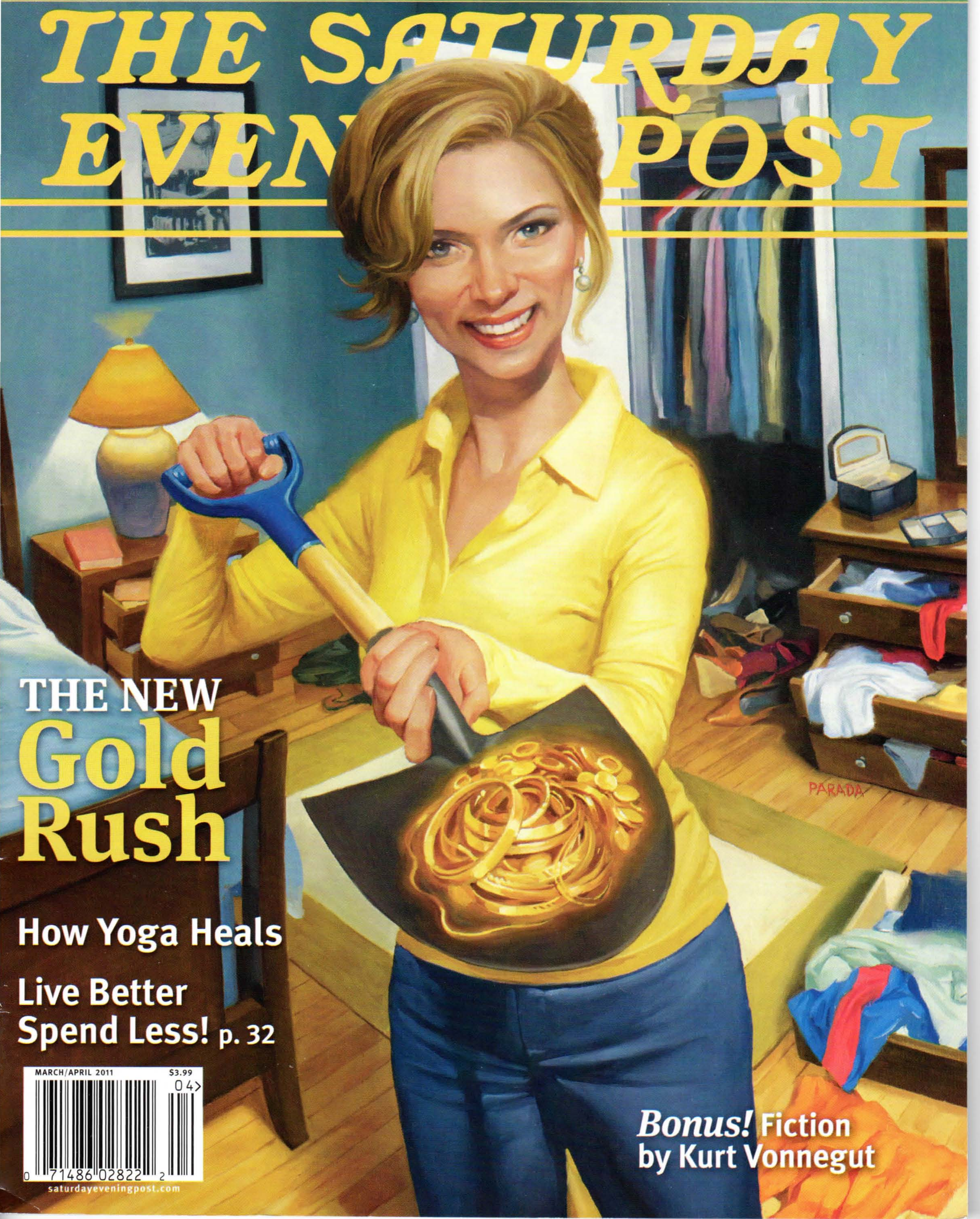
Founded A.D. 1728 by Benjamin Franklin

THE SATURDAY EVENING POST



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Why Index Investing?

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Building a broad portfolio delivers solid returns.

BY RUSSELL WILD, MBA

MIKE TEMPESTA, fresh out of college with a finance degree, figured that he'd invest in stocks and make a mint. It didn't happen. "My investments languished year after year. I did a horrible job of investing," says Tempesta, who six years ago changed his entire strategy. "I've turned my luck around, and I'm just so happy."

Tempesta's winning strategy: Index investing.

You've heard of the S&P 500. And the Dow. And the Wilshire 5000. These are all indexes—collections of stocks used to represent either the entire stock market or a part of the stock market. The S&P 500, for example, tracks 500 of the largest stocks in the United States, from Aetna to Xerox. The Wilshire 5000 includes all of those, as well as stocks of smaller companies. When you become an index investor, like Tempesta, you buy funds that track such indexes and become a partial owner of many companies at one pop.

Index investing—or "passive" investing—contrasts with the "active" investing Tempesta once did. In active investing, you invest in a broad array of stocks (or bonds), trying to pick individual stocks you think will do better than the rest. Alternatively, an active investor might select funds ("actively managed funds"), hoping the fund managers can wheel and deal successfully on your behalf.

Tempesta tried the individual-stock approach first, then tried actively managed funds. "I did poorly on my own," he says. "Then, I learned the hard way that the professional managers often did no better a job than I did."

Indeed. According to the latest research from Morningstar—the company that meticulously tracks investment performance, two-thirds of actively managed funds fail to beat the indexes in a given year and even fewer in the long-run. "Active management doesn't work very well," says Scott Burns, a research director at Morningstar.

Wondering why so few smart people on Wall Street beat the indexes? Largely, it is because of costs. The average actively managed mutual fund, which hires analysts to do the stock-picking, charges 1.33 percent a year in fees; the average index fund charges roughly half as much, with many index funds charging 0.20 percent or less in fees. "Even though some managers can pick winning stocks, the amount you have to pay for that skill often eats up any and all resulting profits," says Burns. And so index investors often wind up ahead of all those investors trying to beat the indexes. Ironic, isn't it?

The reason why index investors do so comparatively well doesn't end with low management fees. The total costs of actively managed funds are not so transparent. Active management involves much more trading of securities, which incurs hidden costs (payments to middlemen and so forth), and typically results in higher taxes, too.

Craig Israelsen, Ph.D., associate professor at Brigham Young University who specializes in personal finance and is the author of *7Twelve: A Diversified Investment Portfolio with A Plan*, calls index investing "a superb idea," but cautions it requires some smarts to do it right.

Three Tips for Optimizing Returns and Minimizing Risk

DIVERSIFY, DIVERSIFY. "Just picking one index fund that has 500 large U.S. stocks isn't enough," says Israelsen. "True diversification requires that your investment portfolio have a wide variety of investments." So aside from an index fund that tracks large U.S. stocks, you may want other index funds that track indexes of small stocks, foreign stocks, and bonds, he adds.

CHOOSE YOUR FUND FAMILIES. Leading providers of index funds (and good places to find those funds that charge 0.20 percent a year or less) include The Vanguard Group (vanguard.com), iShares (ishares.com), and State Street Global Advisors (spdrs.com).

EDUCATE YOURSELF. Each index fund providers' Web site includes helpful information on building an index portfolio. You might want to pick up a book or two on the subject. Consider *Index Investing for Dummies* by Russell Wild—yes, the person who writes this column.

JOHN S. DYKES/STOCK ILLUSTRATION SOURCE