Chapter 1

What Indexing Is . . . and Isn't

In This Chapter

- Discovering the origin of the index fund
- Appreciating the power of passive investing
- Getting a glimpse at what makes indexing work
- Avoiding the mistakes of the masses
- Becoming a truly savvy index investor

When John Bogle started The Vanguard Group in 1974 and shortly thereafter introduced the first index fund available to the unwashed masses, the brokerage industry and financial press were less than supportive. In fact, the entire venture was slathered in mockery. "Bogle's Folly," it was called. "Un-American" . . . "A sure way to achieve mediocrity."

Ha!

Bogle wound up getting the last hearty laughs. (You'll find an intimate discussion with this undisputed Father of Indexing in Chapter 20.) Vanguard Investments is today the largest fund company in the United States. A majority of its stock and bond funds are still index funds. Those index funds have gadzillions of dollars in them and long-term track records that put most other funds to shame.

Index investors, with Vanguard and other fund companies, have more than prospered over the past 35 years as the science of indexing has emerged as perhaps the surest way to achieve outsized investment results. While other investors (so-called *active* investors) are busy year-in and year-out metaphorically punching and kicking each other silly, index investors (sometimes called *passive* investors) stand calmly on the sidelines, reaping consistently far greater rewards.

You are about to discover why that is so, how we know it is so beyond any shadow of a doubt, and how you can take "Bogle's Folly" and use it to build the leanest, meanest, smartest portfolio possible. You are also about to find out how a number of pinstriped Johnnies-come-lately (part of the mixed blessing of the exchange-traded fund phenomenon) have terribly complicated the index-investing landscape, making it more important than ever to do your investing homework.

Realizing What Makes Indexing So Powerful

If index investing is nothing else, it is counterintuitive. Without any difficulty whatsoever, I can fully understand why just about the entire brokerage industry and financial press in the mid-1970s thought it was bound to be a flop.

Prior to the mid-1970s, people thought that love beads were cool and bell-bottoms were hip. They also thought that the road to investment success was to be had by hiring a professional manager who could beat the markets. Such a manager, with his freshly minted Harvard MBA, would use fancy algorithms, mile-long formulas, and inside information that no one else could harvest in order to pick individual stocks that would outshine all other stocks. Such a financial wizard could move money in and out of the market at just the right time to catch every ascent and avoid every decline. That was the belief.

Many people — most people, in fact — still believe that such "active management" is the way to win at investing. But prior to 1974, *everyone* believed it. That was before John Bogle came around and anyone bothered to study the matter. (A few academic papers on indexing were written prior to Bogle, and there was even some dabbling at the institutional level by Wells Fargo and American National Bank of Chicago, but the populace was kept in the dark, and the funds' popularity didn't go far.)

Turning common investing knowledge on its head

One of the first studies to raise eyebrows and seriously question the status quo came from a guy named Charles D. Ellis, who happens to be a Harvard MBA himself. In 1975, he conducted a study of the markets and mutual fund performance. Based on his findings, he wrote a groundbreaking article entitled "The Loser's Game." It originally appeared in the *Financial Analysts Journal.* It later was turned into a book, *Winning the Loser's Game,* which was published in 1985 by McGraw-Hill and bore some very rough similarity to the book you are now reading.

In the 1975 article, addressed to fellow investing professionals, Ellis made the following statement:

> *The investment management business is built upon a simple and basic belief: Professional managers can beat the market. That premise appears to be false.*

At the time, mind you, this was akin to telling a group of Jewish grandmothers that chicken soup had no medicinal value. Ellis's position was seen as preposterous. And yet Ellis was willing to spoon out the harsh truth. His careful studies revealed that in the prior decade, 85 percent of institutional investors had underperformed the return of the S&P 500 index.

Ellis's explanation: Investing is a "loser's game." Let me explain what he meant by that, and why it has everything to do with indexing.

Playing tennis — poorly — with your investments

Charles Ellis's term, "loser's game," comes from an analogy he makes to the game of tennis. Picture yourself in a tennis game with your friend, Joe. We'll assume that neither of you is a professional player. Now pick up the ball and smack it. Joe will attempt to smack it back to you. You pray as you lunge for the ball that your tennis racket will connect with the ball and that you'll be able to smack it back to Joe.

If you and Joe are playing a typical game of amateur tennis, points will be gained by one of you simply returning the ball over the net and waiting for the other to make a goof. The harder Joe tries to win — the more *oomph* he puts into each swing — the better his chances of hitting the net or sending the little green ball out of court, and the better your chances of winning the game.

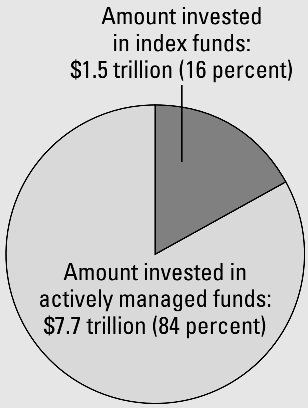
REMEMBER

And so, with this analogy, the world was given its first glimpse at the theoretical underpinning of index investing: Allow the other guys to swing away, trying for those cross-court shots, while you content yourself with simply not making mistakes. In almost every case, you'll eventually win.

Not everyone is as smart as you are: Most investors still fool themselves

Although there has been a veritable explosion in the popularity of index investing, especially since the mid-1990s with the advent of exchange-traded funds, the vast majority of investors are still trying to beat the markets — and consistently failing to do so — with actively managed portfolios. There are currently about 1,000 index funds (index mutual funds and exchange-traded funds) available to U.S. investors. That compares to about 6,500 actively managed mutual funds.

The total amount of dollars invested in index funds is about $1.5 trillion, compared to roughly $7.7 trillion in actively managed funds. That translates to about 84 percent of all fund investments being in actively managed funds. And these figures do not reflect the scores of investors who invest willy-nilly in individual stocks, often recommended by their brothers-in-law, who tend to do the worst of all.



Making gains by avoiding mistakes

What Ellis was talking about was investing success through indexing. That is, by "buying the market" rather than trying to cherry-pick securities, you may not profit from putting a big portion of your portfolio into the next Microsoft, but you won't lose by putting a big portion of your portfolio into the next Bear Stearns, either. Instead, you'll own modest positions in both — along with lots and lots of other stocks — and your portfolio will grow, steadily and surely, along with the market at large.

TIP

By investing in a fund that tracks an entire index (such as the S&P 500 or the Wilshire 5000), you'll be the guy on the tennis court who simply returns the ball. Your friend Joe, by picking individual stocks or hiring expensive fund managers to do it for him, will be trying to smack the ball within an inch of the net. You'll win. Trust me. You'll win.

More specifically, here's what makes index investing work:

- **Lower — much, much lower — management costs:** Those professional money managers who run most mutual funds don't come cheap. According to the latest numbers from Morningstar, the average actively run mutual fund now charges an annual management fee of 1.29 percent, and that figure does not include any of the hideous additional sales charges or loads charged by many of those funds. The typical index mutual fund, in contrast, charges a yearly management of 0.76 percent, and almost never any kind of sales charge. The average exchange-traded fund (almost all of which are index funds) carries an expense ratio of 0.56 percent. But many index funds can be had for expense ratios of less than 0.20 percent — less than 1/6 the management fee of an actively managed fund.
- **Lower everything costs:** It isn't only the management fees that matter. Because they simply mirror indexes, index funds don't have to pay for all kinds of research. They don't have to pay to trade securities. They don't do a lot of advertising. In sum total, Charles Ellis reckoned 30 years ago that the average index fund can be run for about 2 percent less a year than the average actively managed fund. Analysts today say that the 2 percent spread is still a pretty accurate number.

  Now, 2 percent may not sound like a lot, but think about it: If the market returns 10 percent a year over the next X years, your active-fund manager is going to have to get consistent annual returns of 12 percent for you, the poor little investor, in order for you to just break even. Your fund manager is going to have to beat the market by a full 20 percent a year, or you lose. How many fund managers can do that? *Very* few.
- **Gentler taxation:** Even if your active-fund manager does manage to beat the indexes by 20 percent a year, doing so will likely involve a lot of buying and selling of securities. That brings up taxes. As any owner of an actively managed fund can attest, those taxes can be burdensome. I discuss how burdensome, and talk more about the tax-cost differences between actively managed and index funds, in Chapter 3.

- **More honesty, more openness.** Want to avoid unpleasant surprises (in addition to unexpected year-end taxes)? When you invest in an index fund, you won't find your fund managers looking for *window dressing* in December — those last-minute purchases made for the sole purpose of helping the fund's annual returns look better than they actually were. And you won't be enticed to buy an index fund, as you may be enticed to buy an actively managed fund, by a salesman posing as a "financial planner" who stands to make a big, fat commission off you. Nor will you buy a fund with a name that implies one kind of investment (such as U.S. stocks) but invests in all kinds of other things (such as, say, Russian stocks). With index funds, you know exactly what you're getting. There's much more information on these kinds of nonmonetary-related benefits of index funds in Chapter 3.
- **Proven results:** Perhaps the greatest reason to buy index funds is that they have such an impressive track record. Maybe you don't want to know why indexing works. Guess what? You really don't have to. Is it important that you understand how the nerves at the ends of your fingers tell your brain to yank your hand away from a hot stove (the neurotransmitters and proteins and all that stuff)? No. The important thing is that the nerve endings and the brain *do* communicate. And with index funds, the important thing is that analysts who have compared and contrasted index fund performance to the performance of actively managed mutual funds generally come to the same conclusion: Index funds are superior.

In Chapter 3, I give you all the cold numbers — return rates from across the investment universe over different time frames — so you can clearly see that investing in index funds is a time-proven, successful strategy.

Not All Indexing Is Created Equal

Although this first chapter — and, in fact, this entire book — may read as something of an ode to index investing, rest assured that I'm not trying to sell you anything. In fact, your having bought this book indicates to me that you were probably sold on index investing long before you and I ever met. More than likely, what you're hoping to get out of *Index Investing For Dummies* are tips to become a better index investor. You won't be disappointed. I promise!

Although it's not rocket science, and it's certainly something you can do on your own, index investing does require some knowledge. Not all indexes are created equal, not all index funds are created equal, and mixing and matching various index funds is crucial to portfolio success. It helps, too, to understand your own financial situation and to pick the optimal index funds for *you.*

Picking your level of market exposure

Some index funds are based on huge indexes, with hundreds or even thousands of stocks or bonds, all across the board. For example, funds that are based on the very popular S&P 500 index give you exposure to 500 large stocks spread out among many industries. A fund such as the iShares Dow Jones U.S. Total Market gives you even a broader exposure to the markets. There are also index funds that in a flash can give you exposure to broad foreign stock markets or the entire U.S. bond market.

Some index funds are narrower, tracking indexes that capture only a sliver of the financial markets. Many of the newer exchange-traded funds fit into this category. Some may track certain industry sectors, such as energy or technology, or industry subsectors such as retail banking or home construction. Others may track certain very specific kinds of stocks, such as those that pay high dividends. An extreme example is the WisdomTree Japan SmallCap Dividend Fund, which tracks an index of small Japanese companies that pay high dividends.

REMEMBER

In general, the larger the index tracked by the index fund (in other words, the more securities represented by the index), the greater the diversification and the less the risk to you — but also the less potential return.

Knowing that indexes have various recipes

Some index funds are based on traditional indexes, such as the S&P 500, which allot stocks to the index based on their relative size. But indexes can be formulated any number of ways, and some make a lot more sense than others. Rather popular these days, for example, are equal-weighted indexes (which may or may not make sense, depending on your objective) and fundamentally weighted indexes (which can make enormous sense or not, depending on the economic fundamentals employed). I discuss these options in-depth in Chapter 5 and then elaborate further throughout Part II.

Of utmost importance, regardless of how any index is formulated, is cost. Some index funds cost you very little — in the case of certain index offerings from Fidelity and Vanguard, as little as 0.07 percent a year. (It's even less for institutional investors, should you happen to own an insurance company or bank!) Other offerings from other index fund providers defeat a major benefit of indexing and wind up costing you 0.95 percent in management fees a year.

The entire Part II of this book is devoted to helping you pick the best of the best — in price and all other ways — from the 1,000 or so index funds available.

Selecting what works best for you

Ah, but even when I show you which index funds are better than others, you still have homework to do. That's because some index funds may be perfect for you, and others may be better for someone else. As with any other investment, you have to figure out your financial goals and your level of risk tolerance before you spend your money. The personal aspects of index investing are addressed in depth in Part III.

I am often asked, for example, whether I think a certain index fund is "good." Well, it often depends. For example, an index fund such as the Vanguard REIT ETF (VNQ), which gives exposure to the real estate industry, may make great sense for your one neighbor, the dentist, but little sense for another neighbor who is in the real estate business and already has much of his financial fate tied up in this one industry. The iShares Russell Microcap Index fund (IWC) may make great sense for someone who can justify adding volatility to his portfolio. For someone looking to edge toward more conservative investments, the iShares Lehman Aggregate Bond Fund (AGG) may be a much better choice.

The great news is that you have a wealth of choices among the truly good index funds, so chances are you can tailor the portfolio of your dreams without having to step outside the realm of index investing.

Becoming an Ultra-Savvy Index Investor

Picking the best index funds is a crucial part of being the best index investor you can be, for sure. But there's more to it than that. You also want to know how to mix and match your index funds for maximum diversification. If you want to include a few actively managed funds in your portfolio, you also want to know how to best mix and match those with your index funds. These are areas of discussion that I tackle in depth in the latter chapters of Part III.

You also discover there how to place your fund purchases in the right accounts, be they taxable accounts or tax-advantaged accounts, such as IRAs. The goal, despite your level of patriotism, is to keep your taxes as low as possible and, as a direct corollary, to boost your after-tax returns.

In Part IV, you read about the virtues of buying and holding, and how index funds are the perfect vehicles for a buy-and-hold strategy. Mind you, exchange-traded funds (nearly all of which are index funds) make for great tools if you want to day-trade. But I would suggest doing so only if you have nerves of steel, can take great chances, and are reconciled to losing money! A buy-and-hold strategy makes tremendously more sense, and I show you why.

Investing with realistic expectations

Studies show rather conclusively that long-term investors do much better in index funds than actively managed funds (see Chapter 3 for specifics). Even a rather lazy index investor, one who picks his indexes willy-nilly, is still very likely to wind up in the top 40 percent of investors after 10 years, and the top 20 percent after 20 years.

The truly savvy index investor, one who buys the lowest cost index funds and knows how to mix and match index funds for good diversification, can expect to be in the top 20 percent of all investors over the next 10 years, and the top 10 percent over the next 20 years. These are all ballpark estimates, of course.

A caveat: Index investors of any ilk will rarely be in the top 1 percent of investors, either in the short-run or the long-run. The truly remarkable returns are reserved for inside traders (those who don't wind up in jail); extremely lucky gamblers who bet on small positions and win (thereby avoiding living on the street); and (probably the smallest number) the true stock-picking geniuses, such as billionaire investor Warren Buffett (although Buffett himself has numerous times recommended indexing for most investors).

Becoming an enlightened (and just maybe rich!) index investor

So how to become the kind of savvy investor who will leave 90 percent of other investors in the dust? Read the remaining 300 pages of *Index Investing For Dummies*! Don't be afraid to change your thinking, or the way you've always invested before. Understand that market success — like spiritual enlightenment in the Buddhist tradition — can't be forced. It comes with time and patience, and often going with the flow.

In the Buddhist tradition, your patience and wisdom eventually allow you to become one with the entire universe. In index investing, patience and wisdom lead you to become one with the entire market. It's an exciting and potentially very rewarding journey that John Bogle first charted, and I look forward to taking you there!