Chapter One

A Parable

The Gotrocks Family

EVEN BEFORE YOU THINK about "index funds"—in their most basic form, mutual funds that simply buy shares of substantially all of the stocks in the U.S. stock market and hold them forever—you must understand how the stock market actually works. Perhaps this folksy parable—my version of a story told by Warren Buffett, chairman of Berkshire Hathaway, Inc., in the firm's 2005 Annual Report—will clarify the foolishness and counterproductivity of our vast and complex financial market system.

Once upon a Time . . .

A wealthy family named the Gotrocks, grown over the generations to include thousands of brothers, sisters, aunts, uncles, and cousins, owned 100 percent of every stock in the United States. Each year, they reaped the rewards of investing: all of the earnings growth that those thousands of corporations generated and all of the dividends that they distributed.[1] Each family member grew wealthier at the same pace, and all was harmonious. Their investment compounded over the decades, creating enormous wealth. The Gotrocks family was playing a winner's game.

But after a while, a few fast-talking Helpers arrive on the scene, and they persuade some "smart" Gotrocks cousins that they can earn a larger share than their relatives. These Helpers convince the cousins to sell their shares in some of the companies to other family members, and to buy shares of other companies from them in return. The Helpers handle the transactions and, as brokers, they receive commissions for their services. The ownership is thus rearranged among the family members. To their surprise, however, the family wealth begins to grow at a slower pace. Why? Because some of the investment return is now consumed by the Helpers, and the family's share of the generous pie

[1] To complicate matters just a bit, the Gotrocks family also purchased the new public offerings of securities that were issued each year.

that U.S. industry bakes each year—all of those dividends paid, all those earnings reinvested in the businesses—100 percent at the outset, starts to decline, simply because some of the return is now consumed by the Helpers.

To make matters worse, in addition to the taxes the family has always paid on their dividends, some of the members are now also paying capital gains taxes. Their stock-swapping back and forth generates capital gains taxes, further diminishing the family's total wealth.

The smart cousins quickly realize that their plan has actually diminished the rate of growth in the family's wealth. They recognize that their foray into stock-picking has been a failure, and conclude that they need professional assistance, the better to pick the right stocks for themselves. So they hire stock-picking experts—more Helpers!—to gain an advantage. These money managers charge fees for their services. So when the family appraises its wealth a year later, it finds that its share of the pie has diminished even further.

To make matters still worse, the new managers feel compelled to earn their keep by trading the family's stocks at feverish levels of activity, not only increasing the brokerage commissions paid to the first set of Helpers, but running up the tax bill as well. Now the family's earlier 100 percent share of the dividends and earnings pie is further diminished.

"Well, we failed to pick good stocks for ourselves, and when that didn't work, we also failed to pick managers who could do so," the smart cousins say. "What shall we do?" Undeterred by their two previous failures, they decide to hire still more Helpers. They retain the best investment consultants and financial planners that they can find to advise them on how to select the right managers, who will then surely pick the right stocks. The consultants, of course, tell them that they can do the job. "Just pay us a fee for our services," the new Helpers assure the cousins, "and all will be well." Alas, with those added costs, the family's share of the pie tumbles once again.

Get rid of all your Helpers. Then your family will again reap 100 percent of the pie that corporate America bakes for you.

Alarmed at last, the family sits down together and takes stock of the events that have transpired since some of them began to try to outsmart the others. "How is it," they ask, "that our original 100 percent share of the pie—made up each year of all those dividends and earnings—has dwindled to just 60 percent?" Their wisest member, a sage old uncle, softly responds: "All that money you've paid to those Helpers and all those unnecessary extra taxes you're paying come directly out of our family's total earnings and dividends. *Go back to square one, and do so immediately. Get rid of all your brokers. Get rid of all your money managers. Get rid of all your consultants.* Then our family will again reap 100 percent of however large a pie corporate America bakes for us, year after year."

They followed the old uncle's wise advice, returning to their original passive but productive strategy, holding all the stocks of corporate America, and standing pat.

That is exactly what an index fund does.

. . . and the Gotrocks Family Lived Happily Ever After

Adding a fourth law to Sir Isaac Newton's three laws of motion, the inimitable Warren Buffett puts the moral of his story this way: For investors as a whole, returns decrease as motion increases.

Accurate as that cryptic statement is, I would add that the parable reflects the profound conflict of interest between those who work in the investment business and those who invest in stocks and bonds. The way to wealth for those in the business is to persuade their clients, *"Don't just stand there. Do something."* But the way to wealth for their clients in the aggregate is to follow the opposite maxim: *"Don't do something. Just stand there."* For that is the only way to avoid playing the loser's game of trying to beat the market.

When a business is conducted in a way that directly defies the interests of its clients in the aggregate, it is only a matter of time until the clients awaken to reality. Then, the change comes—and that change is driving the revolution in our financial system today.

The moral of the Gotrocks story: Successful investing is about owning businesses and reaping the huge rewards provided by the dividends and earnings growth of our nation's—and, for that matter, the world's—corporations. *The higher the level of their investment activity, the greater the cost of financial intermediation and taxes, the less the net return that shareholders—as a group, the owners of our businesses—receive.* The lower the costs that investors as a group incur, the higher the rewards that they reap. So to enjoy the winning returns generated by businesses over the long term, the intelligent investor will reduce to the bare-bones minimum the costs of financial intermediation. That's what common sense tells us. That's what indexing is all about. And that's the central message of this book.

Don't Take My Word for It

Listen to **Jack R. Meyer**, former president of Harvard Management Company, the remarkably successful wizard who tripled the Harvard University endowment fund from $8 billion to $27 billion. Here's what he had to say in a 2004 *BusinessWeek* interview: "*The investment business is a giant scam.* Most people think they can find managers who can outperform, but most people are wrong. I will say that 85 to 90 percent of managers fail to match their benchmarks. Because managers have fees and incur transaction costs, you know that in the aggregate they are deleting value."

When asked if private investors can draw any lessons from what Harvard does, Mr. Meyer responded, "Yes. First, get diversified. Come up with a portfolio that covers a lot of asset classes. Second, you want to keep your fees low. That means avoiding the most hyped but expensive funds, in favor of low-cost index funds. And finally, invest for the long term. [Investors] should simply have index funds to keep their fees low and their taxes down. *No doubt about it.*"

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In terms that are a bit less contentious, Princeton University professor **Burton G. Malkiel**, author of *A Random Walk Down Wall Street*, expresses these views: "Index funds have regularly

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produced [annual] rates of return exceeding those of active managers by close to 2 percentage points. Active management as a whole cannot achieve gross returns exceeding the market as a whole, and therefore they must, on average, underperform the indexes by the amount of these expense and transaction costs.

"Experience conclusively shows that index-fund buyers are likely to obtain results exceeding those of the typical fund manager, whose large advisory fees and substantial portfolio turnover tend to reduce investment yields. . . . The index fund is a sensible, serviceable method for obtaining the market's rate of return with absolutely no effort and minimal expense."