TOP 10 REASONS TO INVEST USING INDEX FUNDS

Ray Gadbois, CFP®
Index Financial Advisors LLC

1. INDEX FUNDS GET HIGHER RETURNS
   Index investors consistently earn above average returns on their money. This sounds counter-intuitive because, of course, index funds track the market averages. But when you take into account all of the costs associated with actively managed investments, it makes complete sense. And the data supports this conclusion. For example, a recent analysis of actively managed US stock funds calculated an average annual return of 7.5% for the 20 years ended in December 2008. During this same period, the S&P 500 index had an average annual return of 8.4%, almost a full 1% better than the active mutual funds. The difference would be even greater if we excluded small cap stocks and adjusted for the impact of capital gains taxes. The bottom line is that index investing is the only sure way to earn above average returns on your portfolio.

2. MOST ACTIVE FUNDS ARE LOSERS (SORRY)
   It may sound harsh, but academic studies have demonstrated again and again that most active funds earn below market returns and lose to index funds over the long run. For example, one study determined that over rolling 10 year periods, 75% of actively managed mutual funds underperformed the market. Other studies which adjust for sales charges, risk, and survivorship bias (i.e. by including funds which fail or merge with other funds) demonstrate even more dramatic results, with 90 – 95% of actively managed mutual funds losing to the market index.

3. THE REST ARE JUST LUCKY (UNFORTUNATELY)
   It is very tempting to look for the few active managers with the knowledge and skill needed to consistently outperform the market. Unfortunately, it is nearly impossible to identify the winning managers in advance because there is no persistence among successful active managers. Studies have found that active managers who outperform the market in one year are just as likely to underperform the market in the following year. As luck would have it, the year to year results are random and unpredictable, like the odds of flipping a coin and getting two or more heads in a row. With active investors, luck seems to be a more important factor than knowledge and skill.

4. INDEX FUNDS HAVE LOWER COSTS
   The cost of active management can be significant. For active mutual funds, they can include sales charges (loads) of up to 5%, or 1% per year for an investment held 5 years. Management fees and operating expenses for active funds add another 1% over the cost of a comparable index fund. Hidden transaction and trading costs which directly reduce the performance of active investments, including brokerage fees, bid-ask spreads, and market impact costs, can add another 1% per year for portfolios with 100% turnover (which is typical). The bottom line is that active management will cost investors an extra 2% or more per year as compared to a simple index strategy. Even the best active managers can't overcome the persistent weight of these higher costs.

5. INDEX FUNDS ARE TAX EFFICIENT
   The tax impact of active management is a major disadvantage for assets held in a taxable account. Active managers tend to have high turnover rates which generate capital gains and the related tax liabilities. Even worse, frequent trading can generate short term capital gains which are taxed at higher rates. Index mutual funds and ETFs (exchange traded funds) are more tax efficient, with turnover of less than 10% per year. The result is less capital gains and lower taxes. Investors can defer the bulk of their capital gain taxes until they decide to sell the original investment. And tax deferral is almost always a good thing, especially when compounded over many years.

6. INDEX FUNDS ARE WELL DIVERSIFIED
   Financial theory and market studies have clearly demonstrated the benefits of diversification in the form of higher returns and/or lower risk. As such, investors should broadly diversify their holdings across companies, industries, countries, and asset classes. Using this approach, investors earn risk-appropriate returns on their invested capital, and participate in the growth of the global economy, while minimizing company, industry, and country specific risk. Index funds provide well diversified portfolios across a wide range of asset classes at low cost to the investor. Unfortunately, most active managers make bets (i.e. speculate) on specific companies, industries, countries, etc. exposing the portfolio to unnecessary risk. Ironically, those who do diversify their investments begin to look and act more like index funds, but with much higher costs.

7. INDEX FUNDS ARE MORE STRATEGIC
   Active managers and investors spend most of their time and energy researching, analyzing and selecting specific investments to buy or sell as part of their portfolio (e.g. individual company stocks). However, research has demonstrated that 80–100% of the long term risk and return of a well diversified portfolio is a function of the allocation across major asset classes (e.g. Treasury bonds, large cap stocks, small cap stocks, international stocks, etc.). As such, investors and managers should focus their investment decisions on the strategic asset allocation, not tactical asset selection. Index funds, which provide low cost, diversified access to a wide range of asset classes, are most appropriate for this strategic approach to managing a portfolio.

8. INDEX FUNDS USE HONEST BENCHMARKS
   Investors should measure and evaluate the performance of their portfolio on a regular basis. The most accurate way to measure performance is to calculate the internal rate of return (IRR) on the portfolio, taking into account the cash contributions and withdrawals during the period. And the best way to evaluate the performance of an investment is to use a risk-adjusted benchmark, taking into account the asset class of the investment. The S&P 500 is a simple benchmark, but not always an apples-to-apples comparison. For example, small cap stocks should be measured against a small cap benchmark and emerging market stocks should be measured against an emerging market benchmark. Some active managers even mix asset classes in one fund, making it more difficult to evaluate their performance. On the other hand, most index funds can be evaluated against a simple, standard and relevant benchmark.

9. INDEX FUNDS ARE LESS COMPLICATED
   Managing an investment portfolio can be a complex and emotional experience for most people. Unfortunately, too many brokerage firms and investment advisors make the experience even more complicated by accumulating a long list of specific and sometimes overlapping stocks, bonds, mutual funds, hybrid securities (e.g. convertible bonds), and alternative investments (e.g. hedge funds), across multiple investment accounts. The resulting portfolio is almost impossible to understand, analyze, measure and evaluate over time. Instead, using a small set of low cost index funds, investors can build, manage, measure and evaluate a relatively simple and straightforward portfolio based on a clearly defined asset allocation strategy. Sometimes less is more…

10. INDEX FUNDS HAVE LOYAL FANS
    Active management has a lot of vocal fans because it represents a multi-billion dollar business for brokerage firms, money managers, mutual funds, hedge funds, etc. But index investors have the strong support of the best minds in academia and beyond. It all began with Burton Malkiel, Professor of Economics at Princeton, who wrote *A Random Walk Down Wall Street*. Paul Samuelson, Nobel laureate in economics, has said "The creation of the first index fund… was the equivalent of the invention of the wheel and the alphabet." Jack Meyer, former president of the Harvard Endowment, was quoted as saying "The investment business is a giant scam. Investors should simply have index funds to keep their fees low and their taxes down." David Swenson, chief investment officer of the Yale Endowment, provides the following advice, "Invest in low-turnover, passively managed index funds…" Even Warren Buffet, renowned value investor, recently bet $1 million that a simple S&P 500 index fund will outperform a collection of hedge funds over the next 10 years.