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# Index fund investing questioned

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The stock market is down sharply for the last few weeks, and so are the much-loved index mutual funds that promise — and mostly deliver — the same returns as the indices they mimic.

Many bright people believe the stock market is going down even more, and some fear it will go down a lot more. If it does, people who sell index funds all but promise their funds will go down by about the same percentage.

So it's time to dump index funds and invest elsewhere, right?

Maybe not. Take a look at the chart with this story. It compares total returns of the granddaddy of index funds, the Vanguard Index 500, with the returns of hundreds of mutual funds that have a similar investment style.

In 12 of the last 15 years, the Vanguard fund — second-largest mutual fund in existence — did better than the large-cap, blend funds with which it can be compared. It's true the \$60.8 billion Vanguard fund fell further in the one year the underlying Standard & Poor's 500-stock index lost ground. But the difference was only 0.2 percentage points. When Vanguard was ahead, it led by as much as 5.4 percentage points, in 1995.

Another study, published this month in *The Wall Street Journal*, found S&P 500 funds performed better than actively managed general stock funds in five of the last seven market downturns. That's not a bad record.

"The real question is not whether to buy an index fund," said John C. Bogle Sr., senior chairman of the Vanguard Group and leading cheerleader for index investing. "An index fund goes down with the market, point by point and no question about it. The real issue is, should you be in equities at all? And that's a question of long-term vs. short-term investing. If you've been building capital all these years, should you stay the course?"

There are several reasons for the index funds' relatively strong performance. Over the last few years, the

major reason is large-cap stocks have appreciated very quickly, carrying the S&P 500 index with it.

Over the longer term, performance was boosted by the fact index funds are very cheap to operate. An index fund attempts to match the performance of a particular stock market index. It buys all or a representative sample of the stocks in the S&P 500, for example. Then it holds those stocks.

Both operating costs and trading costs are typically much lower than those incurred by actively managed funds. That means more of the profit goes to the shareholder — you and me — and less goes to the fund managers.

That buy-and-hold orientation also means the funds typically have low turnover in their portfolios, which reduces taxes investors must pay when they profit from stock sales.

"They give you a broad exposure to the market at extraordinarily efficient cost," observed Don Phillips, chief executive officer of Morningstar, a widely respected mutual fund research firm.

Momentum may be a performance booster, too. Lots of people are buying index funds these days, partly because of their excellent returns in recent years and partly because many 401(k) retirement plans include an S&P 500 index fund among the choices they give to employees. That buying creates demand for the underlying stocks, which is a support for their prices.

There's also the time-tested rule that when things go bad, bigger stocks hold up better than smaller ones.

But is an index fund the single answer to all your investment worries? No.

For one thing, an index fund limits you to only one type of asset. If you buy an S&P 500 fund, for example, you are investing mainly in large U.S. companies. Even if you move to a fund that tracks the Wilshire 5000-stock index, you're still investing only in U.S. stocks. Most people would like more diversification than that.

A potential problem grows from the fact index funds are weighted toward the largest companies in them. Among the S&P 500 stocks, a handful of huge com-

panies account for most of the growth in the overall index.

"By definition, you own the most of whatever has gone up the most in the recent past," Phillips said.

Another frequent objection to index funds is their goal itself — being average. "I want the opportunity to pick a winner," said William J. Kring, a certified financial planner in Atlanta. The trick, of course, is to find active managers who have been market beaters with some consistency over a period of years. A majority of mutual funds don't gain as much as the indices in any given year.

So what is an investor to do?

One possibility is to put a portion of your portfolio into an index fund, and consider it a core holding. If you plan to hold that investment for, say, 10 years or more, you have time to live through some market downturns. Over a long period, the savings from low operating costs also will boost your total return significantly.

Another possibility is to stick with indexing but slide away from funds that follow the S&P 500 index. There are very specialized index funds, including single-country funds, various bond funds and even socially responsible funds. If you want to confine yourself to U.S. stocks, there are funds that track the Wilshire 4500 and Wilshire 5000 stock indices.

Another tactic is to make all your moves gradual ones, whether into or out of index funds. Bogle, who made a very successful career by building index funds, said if he inherited a chunk of cash, he would not shove all of it into stocks right now.

He might invest two-thirds in stocks, he said, putting the remainder in fixed-income investments. He would shift the remaining third into stocks gradually, over several years.

"That's very sane and sensible, and it could easily be wrong," Bogle said. "The investor is in the tough position of trying to deal with his future when the future is very, very cloudy. The weather is never very clear in the stock market.

"The main thing is to take the first step, but not to be so precipitate that if you're wrong, you come to regret it forever."