



October 23, 2007

The Ease of Index Funds: No Ins and Outs to Know

By JULIE CONNELLY

IS it worth the risk to try to outperform the market?

“I have yet to meet a retiree that couldn’t have met his or her retirement goals just with market returns — and this is over a 40-year career,” said Paul Merriman, the editor of FundAdvice.com and an investment adviser at Merriman Berkman Next in Seattle.

In his experience, most retired people regard an 8-to-12-percent compounded annual return as satisfactory for their needs. Any investor who simply bought and held a no-load mutual fund that replicated the Standard & Poor’s 500 stock index would have had an 11.2 percent compounded return from 1970 to 2006. So why keep trying to pick stocks and time a volatile market when you can own the market through low-cost index funds?

As of the end of 2006, there were 342 index funds with total net assets of \$748.8 billion, just 7.4 percent of the \$10.4 trillion in all mutual funds. Of course, index funds will go down when the index they replicate does poorly. But indexing works over time, provided you do two things: diversify your investments, and buy and hold.

The argument for indexing is that you cut your risk of being in the wrong stock at the wrong time because you own the market. Transaction costs are negligible because the portfolios don’t trade, and expenses are very low. Vanguard, for example, the largest purveyor of index funds today, charges about one-tenth to one-fifth of what the typical actively managed fund charges for expenses.

You can also index with exchange-traded funds (E.T.F.’s), which you buy like stocks. Index funds are cheaper, however, because there are no brokerage commissions, and they are less volatile.

Index funds are not just for the little guy who can’t take the heat, either. Theodore R. Aronson, an institutional money manager at Aronson Johnson Ortiz in Philadelphia, is paid by his clients to beat various benchmarks like the S.& P. 500 or the Russell 1000 — not to match them. His family’s money, by contrast, goes into 11 Vanguard index funds allocated 80 percent to equities and 20 percent to bonds. “Statistically it is so hard to prove that active managers can outperform, and that any outperformance is due to skill and not luck,” Mr. Aronson said.

His one-year return from indexing as of Oct. 2 was 23.5 percent; his three-year annualized return is 18.8 percent.

The first question to ask when building a portfolio is how to allocate your money between stocks and bonds. Mr. Aronson is 55, and his portfolio is quite aggressive with only 20 percent in bonds. Investors who are at or

near retirement should be thinking more in terms of having 40 percent in bonds. “With this allocation you can protect yourself against a drop in the stock market,” said Holly Hunter of Hunter Advisor, a financial planner in Portsmouth, N.H.

Then, depending on your risk tolerance, you decide how much you want in domestic versus international stocks, large companies versus small and growth versus value.

Using Vanguard index funds, Ms. Hunter recommends the following divided 60 percent in stocks and 40 percent in bonds: 18 percent in Vanguard’s Short-Term Treasury fund, 11 percent in the Total Bond Market fund, 6 percent in the High-Yield Corporate fund and 5 percent in a money market fund. She splits the equities 15 percent in the Growth Index fund, 15 percent in the Equity Income fund, 12 percent in the International Explorer fund, 5 percent in the Selected Value fund, 5 percent in the Small-Cap Value fund, 4 percent in the REIT fund and 4 percent in the Emerging Markets Stock fund. For the 12 months through September, that portfolio returned 15.9 percent, and its three-year annualized return was 14.6 percent.

You don’t need a lot of funds to be diversified. “No more than 10 at most,” says Paul B. Farrell, author of “The Lazy Person’s Guide to Investing.” And you can do it with as few as three, said Ellen Rinaldi, head of counseling and research at Vanguard. Her 60-40 portfolio would consist of 30 percent in her firm’s Total Stock Market fund, with 3,600 United States stocks in it; 30 percent in its FTSE All-World ex-US fund, with 2,000 international stocks; and 40 percent in its Total Bond Market fund. Through September, this portfolio has returned 9.7 percent this year; its three-year compounded return is 13.8 percent.

Once you have set your portfolio up, check in every year or every 18 months and rebalance it if any position has swelled by 5 percent or more. You rebalance by putting more money in the laggards to get your holdings back in line with your original allotments. “If stocks are rising in value and you don’t rebalance, then as you age, your portfolio becomes riskier and riskier,” Mr. Merriman said. You can add new money to the laggards, or reinvest your dividends and interest in them, or take your distributions from the good performers. Rebalancing forces you, in effect, to sell high and buy low — and that’s how [J. P. Morgan](#) says he got rich.

[Copyright 2007 The New York Times Company](#)

[Privacy Policy](#) | [Search](#) | [Corrections](#) | [RSS](#) | [First Look](#) | [Help](#) | [Contact Us](#) | [Work for Us](#) | [Site Map](#)