Indexed Investing: A Prosaic Way to Beat the Average Investor

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Summary

Indexed investing is a strategy designed to match a market, not beat it. Done properly, it can be cheap and tax-efficient. After costs and taxes, an indexed investor in a market can beat the average active investor. Many investment vehicles, both mutual funds and the more recently introduced exchange-traded funds, make it possible for individuals to invest some or all of their assets in indexed strategies. This talk elaborates on these points, describes some of the more attractive funds and shows how indexed investing can be used to help obtain a globally diversified portfolio.

Indexed Investing

Let me begin with some definitions.

First, according to my ancient dictionary, "prosaic" means "straightforward, lacking in imagination". And that is an apt characterization of what I will describe tonight -- a dull, boring way to be a better investor than many of your friends.

What is this magical method? Indexed investing, which involves procedures designed to replicate a market, not to try to beat it. Let me illustrate with a simple example. Let's say that you want to index the French stock market. Here's how you could do it perfectly. Buy 1% of the outstanding shares of every company listed on the Paris Bourse. You would now have a French Stock Market Index Fund. There are such funds, as well as others that buy a representative sample of securities in order to come close to replicating a target market.

Of course neither approach is feasible for the average investor, but this need not concern you because the financial services industry has created vehicles designed to allow individuals to obtain index funds indirectly. There are two major types.

First, there are open-end index mutual funds. You give your money to the mutual fund company, it buys stocks from the market in question and gives you a share in the overall fund. If at some time in the future you want your money back, the fund can sell stocks as needed to pay you for your share. In many cases someone else will be buying a fund share at the time you are selling yours so the fund company can just transfer the money from them to you at an amount equal to the proportionate value of the underlying portfolio. Index mutual funds have been available since the 1970s in the U.S. and are now widespread elsewhere. Each one attempts to index a particular market or portion of a market.

The second type of vehicle is somewhat newer, having been available only in the last ten years or so. An Exchange Traded Fund (ETF) buys a portfolio of stocks, then issues shares in that portfolio. The shares are sold on a stock exchange where investors can buy them and later sell them directly to other investors. In this sense the fund is closed, but large institutions are able to trade portfolios of the underlying stocks with the fund, which keeps the price of the ETF shares closely in line with the value of the underlying portfolio. Of course to buy or sell shares in an ETF you have to pay brokerage commissions.

For aficionados of indexing there are more exotic vehicles such as index futures, index options and indexed protected products, but I will not try to deal with them here.

Active and Passive Investing

As you can see, the manger of an index fund doesn't have much to do. For this reason we call indexing "passive investing". The alternative is, not surprisingly, "active investing". Active investment managers don't want to buy all the stocks in a market, only the ones that they consider attractive. And since attractiveness changes as information and market prices change, this involves relatively frequent buying and selling -- hence the term "active".

Let's think a bit about the performance of active and passive strategies. Assume that you in this room constitute the entire universe of investors in the French stock market. About a fourth of you will be passive indexed investors, while the rest will be active investors. Collectively you hold all the stock on the French market. Now let's pick a time period -- say a year. And let's say the market as a whole returned 10.0% in that year. Before costs, what did each passive investor get? Exactly 10.0%. Obviously, before costs that average passively managed Euro returned exactly 10.0%.

What about the active investors? One might have made 15.1%, another 3.4%, yet another -23.0%, and so on. But what did the average actively managed Euro invested in the French stock market return before costs? The answer has to be exactly 10.0%. Why? Because the passive part returned 10.0% and the total market returned

10.0%. So the active part had to return the same.

We conclude then that in the French stock market the average actively managed Euro must have the same return before costs as the average passively managed Euro.

But before-cost returns aren't what matters. You don't eat before-cost returns. What you eat depends on returns after costs and, for that matter, after taxes. So let's consider costs and taxes.

The people running index funds are dull but they are cheap. They only need to know the names of securities in a market and the number of shares outstanding. You would not want to be stuck at a cocktail party with one of them. But their costs are minimal. Depending on the market replicated, the cost of managing an index fund should be somewhere between 0.15% and 0.50%, or 15 to 50 "basis points", using financial jargon.

Active managers are very different. They do research on companies, try to untangle the web that corporate officers and accountants sometimes weave, try to predict acceptance of future products, and so on. Their security analysts and portfolio managers are smart, well educated, and fascinating conversationalists at cocktail parties or anywhere else. But they and their activities are expensive. Their costs are likely to be at least 1.0% (100 basis points) higher than those of passive managers in the same markets.

Worse yet, the very activity that these managers undertake adds to costs. Brokers have to eat too, and many active stock funds sell stocks within 6 to 12 months after they buy them.

This is not all. Taxable investors have yet another reason to worry about active management. It generates realized capital gains far more frequently than does passive management. This requires the payment of taxes that could otherwise be either deferred or, in some cases, avoided entirely.

The bottom line is that after costs, the average actively managed Euro (or dollar, or yen) must underperform the average passively managed Euro (or dollar, or yen) in a market. This is simple arithmetic. And this is the basis for the assertion that indexed investing provides a way for you to beat the average investor in a selected market.

How big is the advantage for this approach? It depends on the index fund and the expenses of the active managers. There are many far-too-expensive index funds and there are some relatively frugal actively managed funds. But let's consider the average added costs for active management of 100 basis points per year. This may not sound like much to pay for the chance to be a winner. However, the long-term advantage of stocks over putting your money in the bank is currently estimated by many to be 5 to 6%. If you give up 1% in extra costs you have sacrificed 16 to 20% of your overall gain from investing in the stock market. Over the years this can make a dramatic difference in your wealth, standard of living in retirement, and so on.

Of course, many active managers will beat the market and their passive brethren before costs in any given period. And a substantial minority will beat the market and the index funds after costs. The trick is to identify the winners in advance. While it would be tempting to say that this only requires looking for those that have won in the past, the evidence is not very supportive of this assertion. To some extent this is due to the fact that many past winners were simply lucky. In other cases, competition among professional investors results in prices adjusting so previously winning methods no longer work.

This is not to say that one shouldn't have actively managed funds as part of an overall portfolio. But it makes good sense to consider using index funds for at least a set of core holdings, to minimize both costs and the risk of ending up with big losers.

Choosing Markets

Well and good, but in which markets should one invest? French stocks? U.S. Stocks? U.S. Bonds? Large Capitalization U.S. Stocks? Stocks issued by firms in Emerging Countries? Indexed and actively managed funds exist for all of these markets and for many more.

The best answer is that no simple formula can answer this question for everyone. Investors differ in location, profession, age, risk tolerance, consumption preferences and many other aspects. A good investment advisor, advisory service or preferably an advisor using a good service is the best source for guidance on this crucial question -- as long as the costs are reasonable. But we can say something.

Financial Economic theory suggests that the average investor should hold everything available, in market proportions, and arithmetic shows that this must be true. Of course, no investor is likely to be completely average. But it is still useful to know the composition of the so-called "global market portfolio", which provides a baseline. To be sure, the values of its parts change from time to time as market prices change and securities are issued and expire. Moreover, we can only obtain market prices for the parts represented by publicly traded securities. We these caveats in mind, here are some ballpark figures, all in terms of market values:

- Stocks represent about 60% of the global portfolio of bonds and stocks
- Issuers in the United States account for about 50% of both global bonds and global stocks
- Of the stocks issued outside the United States, 85 to 90% come from issuers in developed countries
- Of the stocks issued in developing countries, about 70% are from Europe

The global market portfolio might be a good choice for a truly international investor, who lives in hotels and on airlines, pays taxes everywhere, consumes goods from all over the world, is of average age and risk tolerance, and so on. Of course this is not likely to describe anyone in this room. But the global market portfolio is a good place for you to start, tilting each of your investment positions in a direction that makes sense, based on the differences between your characteristics and those of this fictional global investor. Good investment advice will help you do this effectively.

Interesting Index Funds

Thus far my remarks have been very general, if not abstract. To leave you with something more concrete, let me describe a few interesting index funds. Each covers a quite broad market and provides extensive diversification, which is the cornerstone of an efficient investment strategy according to Financial Economic Theory. Each has very low costs. And each has low turnover, which provides tax efficiency.

For large capitalization U.S. stocks (more simply, stocks of big US-based companies) here are two attractive candidates, each of which is designed to replicate the performance of Standard & Poor's 500 stock index, which covers about 75% of the value of the US stock market

- The Vanguard Index 500 mutual fund has an expense ratio between 15 and 18 basis points per year, depending on the amount you invest.
- The exchange-traded Standard and Poor's Depository Receipts (known as SPDRs) have an expense ratio of 11 basis points

For the overall US stock market, here are two ways to replicate the performance of the Wilshire 5000 index (which actually includes more than 5,000 stocks)

- The Vanguard Total Stock Market index fund has an expense ratio of 20 basis points
- The exchange-traded VIPERs, also managed by Vanguard, have an expense ratio of 15 basis points.

For the US Bond market, Vanguard has a Total Bond Market mutual fund, replicating the performance of the Lehman Aggregate Bond Index, with an expense ratio of 22 basis points.

Vanguard also offers mutual funds for other areas than the U.S.. The Europe fund has an expense ratio of 29 basis points, the Pacific an expense ratio of 37 basis points and the Emerging Market fund an expense ratio of 59 basis points. The exchange-traded IShares MSCI EAFE, which tracks stocks in Europe, Australia and the Far East, has an expense ratio of 35 basis points.

There are many other index funds, both mutual funds and ETFs. With them you can invest in large capitalization stocks, small capitalization stocks, growth stocks (selling at high prices relative to earnings, book value and the like), value stocks (selling at low prices relative to earnings, etc.), large growth stocks, financial stocks, and so on. These narrower funds are typically more expensive. They also tend to incur more turnover and hence are less tax efficient than broader, more diversified funds. While a few may fit well in an overall portfolio it is not sensible to try to achieve diversification by holding a great many of them, since a broader index fund can provide the same coverage, lower expenses, less turnover and hence more tax efficiency.

Summary

If I have whetted your appetite for index funds, I suggest that you go to the web site www.indexfunds.com for more information.

Let me conclude with the obvious question: Should everyone index everything? The answer is resoundingly no. In fact, if everyone indexed, capital markets would cease to provide the relatively efficient security prices that make indexing an attractive strategy for some investors. All the research undertaken by active managers keeps prices closer to values, enabling indexed investors to catch a free ride without paying the costs. Thus there is a fragile equilibrium in which some investors choose to index some or all of their money, while the rest continue to search for mispriced securities.

Should you index at least some of your portfolio? This is up to you. I only suggest that you consider the option. In the long run this boring approach can give you more time for more interesting activities such as music, art, literature, sports, and so on. And it very well may leave you with more money as well.