Index Funds

The Beauty *of* *Average*

Financial firms have been in a race to improve the humble index fund. But are they ruining it in the process?

By Reshma Kapadia

JOHN BOGLE INSISTS HE'S NOT ANGRY. But let us clarify: The 82-year-old financial guru and legendary founder of the Vanguard Group is "not angry" in the same way, perhaps, that a headmaster is not angry when his star pupil is caught cheating on an exam: "I'm not angry," says Bogle. "I'm disappointed." Oh—we get it.

But then you too would be not angry, presumably, if the product you'd invented some three and a half decades ago were now being rampantly copied into shiny knockoffs, fitted with gimmicky buttons and bits of flair, and resold by scores of companies for one heck of a markup.

The product in this case is none other than the humble index fund—an unabashedly simple, proudly inexpensive, trade-minimizing vehicle for owning an entire market's worth of stocks. Since Bogle's firm began offering the first of these marvels in 1976—as a way, he says, for investors "to buy every company in America and hold it forever"—such mutual funds have enabled tens of millions of people to diversify automatically across sectors, earn returns that (by definition) match the market's and outperform the majority of professional money managers in the process. And it is this very notion, say Bogle and many others, that is increasingly under assault.

Don't get us wrong: The $100 billion Vanguard 500 fund is not being forced to close its doors; nor, for that matter, has the SEC recently warned of some devastating industry scam. The threat, rather, comes from a less obvious consumer bogeyman: the upgrade. Yes, the good old-fashioned index fund, it seems, is being new-and-improved to death.

There are now more than 1,400 iterations of the index fund for sale, triple the number available in 2005. All told, the industry, including index funds and ETFs, claims some $2.1 trillion in investor assets. (To put that figure in context: That's roughly the gross domestic product of Italy.) And much of this *abbondanza*, moreover, has rushed in during the past year. According to Lipper, $196 billion flowed into index funds in 2010 alone, even as money was draining out of their actively managed counterparts.

"I see more bad behavior under indexing than under any other umbrella," says Morningstar's Don Phillips.

About a third of index funds, not including ETFs, have turnover rates of 100 percent or more—which means they essentially swap out all of their holdings at least once a year.

Some of the recent entries in the field, it should be noted, follow the same tried-and-true, mimic-the-market principle of the first generation of index funds. Sold under a variety of brand names, they do little but buy and hold steady concentrations of the stocks of a given index—say, the Standard & Poor's 500 or the Dow Jones Industrial Average. For that straightforward service, they typically charge a rock-bottom fee. But increasingly, new funds are going in a different direction. A great many of the newer funds are adding an unfamiliar ingredient to the mix—strategy. The maneuvering ranges from the modest (merely changing the way that equity holdings are weighted in the portfolio) to the downright ambitious (using derivatives or borrowed money to bet against Japanese stocks or the Dow). And it is these funds that are suddenly drawing a significant—and fast-growing—share of investor money: Net assets in so-called leveraged, enhanced and short-selling index funds and ETFs totaled some $415 billion in February, according to Lipper, more than double the $197 billion stake held at the end of 2008. Indeed, such fortified funds now draw a fifth of all dollars flowing into index funds as a whole. This, says Don Phillips, president of fund research at Morningstar, has become the industry's hot spot.

The reason will hardly come as a shock: Fund companies get to charge more for the new offerings. Often, significantly more. Today, more than 20 percent of stock index funds charge annual fees of more than 1.36 percent, the average fee for an *actively* managed fund—and almost one in 10 of the indexers charges more than 2 percent. This new-found pricing power, says Michael Kim, an analyst at Sandler O'Neill who covers asset managers, has helped firms partially offset the pressure from heated competition and an earlier recession-era shift out of stocks into lower-fee bond funds. Given the rush of dollars into the new strategy-enhanced portfolios, analysts expect fund companies to launch even more of them.

ALL OF THIS PROMPTS AN IMPORtant—and surprising—question for investors: If a fund is being actively "strategized" at all, is it still, well, an index fund?

The issue is not merely a semantic one. It matters. Traditionalists in the index world liken it to being a little bit pregnant: Once you start tweaking the indexing process—Bam!—you're an actively managed fund, says Fran Kinniry, a principal for Vanguard's investment strategy group. And the track record for this latter group, to be blunt, has been subpar: Over the past decade, just over half of active equity fund managers underperformed their benchmarks, according to Morningstar. "It's naive to assume that [any of the new adjusting index funds], using freely available data, have stumbled onto some sort of free lunch that the thousands of active managers in the industry have not," says Kinniry.

And yet, naive or not, that's what many of the new breed of index funds are confident they've discovered. Take, for example, what is now one of the hottest offerings in the realm—funds that do fundamental indexing. Investment firms such as Research Affiliates have developed their own indexes, based on measures of corporate health such as dividends, cash flow and sales. The idea is to buy companies that rank well on these factors, no matter what their size. Research Affiliates, for its part, says that when it back-tested a dozen of its global indexes (which prune out companies with so-called poor fundamentals) against standard benchmarks, the screening strategy offered a better 10-year annualized return in 11 of those 12 cases. (The exception was Japanese equities.) In the 10 years ended in December, the firm's RAFI 1000 index of screened large-cap stocks, for instance, would have beaten the S&P 500 by more than four percentage points a year on average.

Some financial advisers, including Russell Wild of Allentown, Pa., are skeptical that such data reflects any inherent prowess in such funds on the whole; fundamental strategies may have outshined simply because they tend to favor smaller and value-oriented stocks, two groups that performed well during the past decade. "It's historical cherry-picking," says Wild. Jason Hsu, chief investment officer of Research Affiliates, readily acknowledges that his firm's special-sauce indexes won't perform well in every type of market—and volunteers that they took a beating during the financial crisis, as the approach skewed the funds toward financial stocks that were hammered in the downturn. "This is not a be-all and end-all strategy," cautions Hsu. "Investors should diversify."

In just one category—large-cap growth stocks—16 index funds track 10 different benchmarks.

Performance in this group, meanwhile, is far from uniform: One-year returns, according to Morningstar, range from 13 percent to 24 percent.

But such caveats aside, the new fundamentalists are fast drawing believers. Like Jason Gunkel, a financial adviser at Syverson Strege & Co., in West Des Moines, Iowa. Gunkel, whose firm manages $300 million, has been shifting clients' money from traditional index funds to those prescreened for strong cash flows, sales and the like. "When markets get overvalued," he says, "the fundamental indexes are more resilient to market drops, it seems."

The tendency to want to beat the system—to outdo the averages—is innate, says Bogle. It's so strong that even investors and advisers who swear by indexes (and who know full well the low slugging percentages of active mutual fund managers) often can't resist the temptation to seek out some edge. "To do nothing," he says, "seems foolish." What rankles the octogenarian guru, though, is that this fear of feeling foolish—of sitting with one's hands in one's pockets as the markets swirl maddeningly around—has somehow penetrated deep into the once-robotic soul of the index fund.

It started innocently enough about six years ago, with some firms readjusting the individual stock weightings in their benchmark-tracking funds. From the beginning, indexing meant carving up the market by the value of the companies in that universe. The result was that in a portfolio mirroring the S&P 500, for instance, global giants would take on far more weight than smaller companies. In fact, just four companies—Apple, Exxon Mobil, General Electric and Microsoft—make up roughly 10 percent of the typical S&P index fund. Compare that with the four smallest—AK Steel, RadioShack, Supervalu and Titanium Metals—which together make up less than one-twentieth of a percent of the index's market capitalization. Even big gains in each of these smaller stocks would hardly amount to a blip in a standard S&P-tracking index fund. What's more, investors who reinvest dividends and capital gains in the funds will be loading up on stocks that have just registered big gains while giving short shrift to smaller or cheaper stocks.

THAT CONUNDRUM HAS LED SOME fund firms to come up with indexes that give all of their components equal weighting, putting the same percentage of money into Exxon Mobil as into AK Steel, which has roughly one-250th of the market capitalization. Then came an attempt to carve out smaller and smaller categories of the market—and even parts of individual sectors. Why make a big bet on China or on the technology sector as a whole, the thinking went, when you could further narrow your focus to just Chinese tech stocks? Then came index funds that focus on certain strategies—including high-risk endeavors such as using leverage or betting on a declining dollar. And so on, and so on, and so on.

The problems with such funds are potentially many. Morningstar's Phillips fears that some of these more pinprick indexes "encourage investors to do a lot of the things that the basic case for indexing says investors shouldn't do," such as trading aggressively. Matt Hougan, director of analytics at a journal devoted to the industry, agrees: "The narrower index funds are like a siren to trade and make speculative bets."

And individual investors aren't the only ones swapping in and out of bets with abandon; a number of the new funds do so as well. Whereas the original index funds did their level best to stay static, shunning both active trading and the transaction costs that go with it, a striking proportion of funds today seem to be trade-aholics. In fact, about a third of all index funds overall have turnover rates of 100 percent or more—which means their entire portfolios are essentially swapped out over the course of a year. (Count trade-addicted ETFs in the mix and the percentage climbs much higher.)

The Rydex Government Long Bond 1.2 Strategy fund, for instance, is among nearly two dozen index funds with a turnover rate topping 1,000 percent, according to Morningstar. Ryan Harder, senior portfolio manager at Rydex/SGI, says the firm's high-turnover funds are constructed in such a way that the trading does not eat into performance. Harder goes on to add that Rydex also has funds with lower turnover, and that its more trade-heavy offerings are designed for "tactical" investors and not intended for the buy-and-hold investor.

The question, however, is whether any investor—particularly any sophisticated one—ought to pay the fees that inevitably go with such fervent trading. This, indeed, is the elephant in the room when it comes to such next-generation indexes: Rydex, for example, has an expense ratio of 2.28 percent—which is to say it charges $228 a year in fees for a $10,000 investment—in one share class of its S&P 500 Pure Growth fund. Compare that with Vanguard ($17 on a $10,000 investment) and Schwab ($9), which both track the broader market. Harder says the higher price is justified because of both the performance and the fact that investors can trade in and out of many of the firm's funds without limitations. Unfortunately, few investors pay enough attention to expense ratios, says Antti Petajisto, a professor of finance at New York University's Stern School of Business, despite the fact that such built-in cost is almost certain to have a far bigger impact on long-term returns than any of the bells and whistles offered by the new funds.

No fewer than 80 index funds are sold with an up-front sales charge of 3 percent or more.

While most of these "load" funds are sold through advisers (with the fees intended to pay for guidance), some analysts think paying a hefty commission for any index fund makes little sense.

The strange upshot is that in many of these new offerings, investors are trading away the very qualities that made the originals such a wonderful idea in the first place: simplicity, low cost and freedom from that irresistible temptation to chase the herd.

Why on earth would fund companies encourage such a thing? Bogle thinks he has the answer. "It's a business," he says, "one in which salesmanship trumps stewardship, and marketing trumps management. That's where the money is." Indeed, from the looks of things, even Vanguard has felt the heat. After falling dramatically, the firm's net cash flows are only now returning to their prerecession levels—a rebound helped, in part, by the launch of a number of ETF offerings, though most are of the garden-variety type. Vanguard, believe it or not, now has 144 funds and ETFs of its own, up from 87 in 2008 and just 30 a decade ago.

Says Bogle of the strange new indexing universe: "It bothers me deeply."

Well, at least he isn't angry.

Old-Fashioned Virtues

Rock-bottom cost. Broad diversification. The ability to offer quick exposure to certain markets in a way that keeps taxes relatively low. Such are the qualities that have drawn millions of investors to rely on index funds for a significant part of their long-term portfolios. While many of the latest offerings in the field seem to run counter to those principles, here are a chosen few—some old, some new—that preach this simple approach.

Dirt Cheap

Minuscule fees have long been one of the biggest selling points for index funds. A Morningstar study found that, in every period tested, funds with low fees outperformed those with high fees. Looking at domestic equity funds, for example, the cheapest quintile outperformed the priciest by more than one percentage point a year over five years.

OUR PICKS	*Expenses*	*One-Year Return (%)*	*Comment*
Schwab S&P 500 Index (SWPPX)	**$9 per $10,000**	**16.7**	Morningstar analysts say it's the best fund for tracking the S&P 500.
Vanguard Total Bond Market ETF (BND)	**$11 per $10,000**	**5.3**	Holds more bonds than its peers but has heavy government exposure.
Vanguard Total Stock Market Index Admiral (VTSAX)	**$6 per $10,000**	**18.1**	Among the cheapest options for people who can invest $10,000 or more.

Low Turnover

Few people expect the holdings of index funds to change dramatically from one year to the next. But in the age of the ETF and tactical allocation, that may be exactly what happens. High turnover—or changing holdings often—triggers trading costs and potentially higher tax bills that can eat into returns. A few funds, though, buck the trend—even in categories where turnover can be relatively high.

OUR PICKS	*Expenses*	*One-Year Return (%)*	*Comment*
iShares Russell 2000 (IWM)	**$28 per $10,000**	**19.9**	Owns some microcap stocks; has only 22 percent turnover.
SPDR Barclays Capital High Yield Bond (JNK)	**$40 per $10,000**	**14.9**	Has turnover of 50 percent—relatively low in a group that sees high turnover.
Vanguard Small Cap Index Admiral (VSMAX)	**$12 per $10,000**	**22.3**	Low tax impact since inception, with taxes eating up just 0.3 percent of returns during the past three years.

Right Exposure

For all their no-fuss, no-muss promise, index funds may not always be best for those trying to tap a niche sector. Take, for example, emerging markets: Funds that carve up a region by the old standby of market cap may miss some sizzle. Such funds often skew toward larger firms, some of which are government-owned and slower growing. For an alternative, Morningstar analyst Mark Rawson suggests funds that divvy up holdings based on cash flow or dividends and tilt toward smaller stocks.

OUR PICKS	*Expenses*	*One-Year Return (%)*	*Comment*
iShares S&P MidCap 400 index (IJH)	**$22 per $10,000**	**24.2**	Has purer midcap exposure than comparable index funds; and a cheaper option than most.
PowerShares DB Commodity Index Tracking (DBC)	**$85 per $10,000**	**22.8**	Minimizes some of the futures markets' quirks.
Wisdom Tree Emerging Markets Equity Income (DEM)	**$63 per $10,000**	**30.6**	Holds more small stocks than its peers; dividend focus can reduce volatility.

SOURCE: MORNINGSTAR