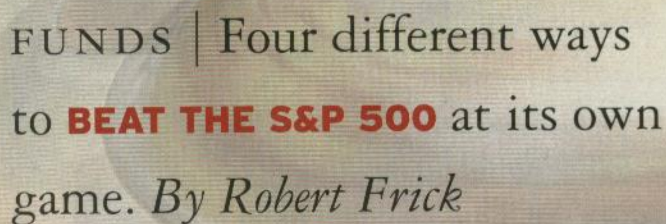
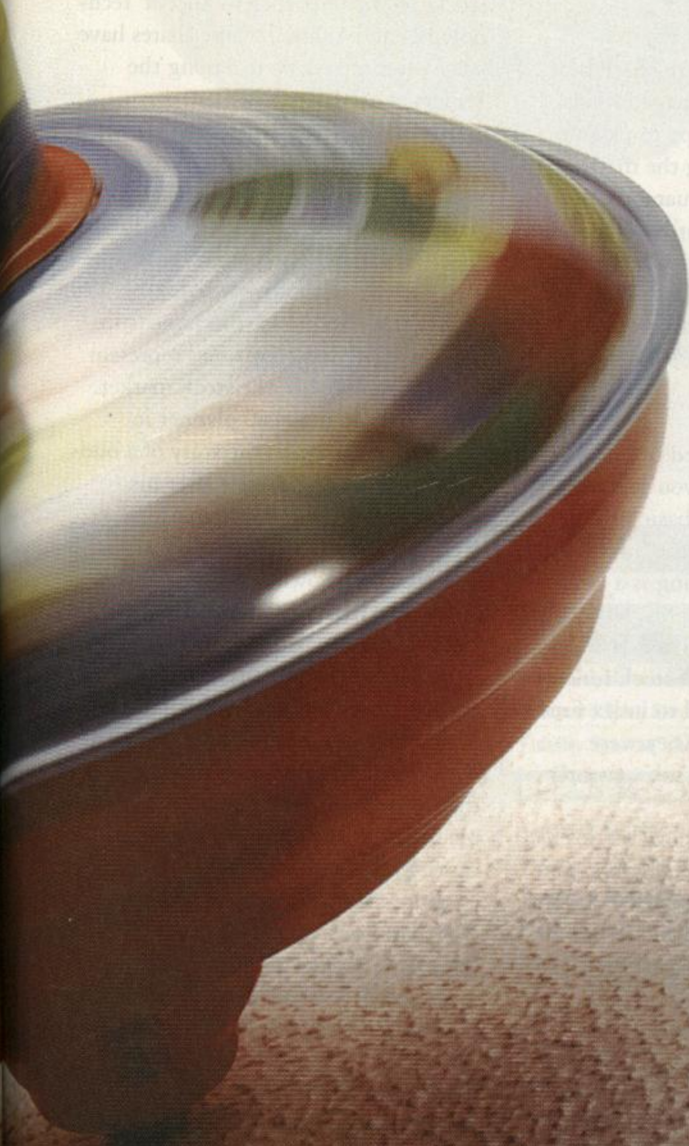


FUNDS | Four different ways to **BEAT THE S&P 500** at its own game. *By Robert Frick*

THE NEW SPIN ON INDEXING



ROXIE and Keith Hubbs thought they were sitting comfortably on a well-balanced portfolio when the stock market began tumbling three long, painful years ago. The cornerstone of their portfolio was Vanguard 500 Index, a mutual fund that mirrors Standard & Poor's 500-stock index, widely regarded as a proxy for the U.S. stock market.

It was particularly important for the Rialto, Cal., couple that their financial house rest on a secure foundation. Keith was retiring after a 40-year career in real estate, and he and Roxie wanted to spend two years on a mission for the Mormon church, free of financial worries.

But it didn't work out that way. When the market began its plunge, so too, by definition, did the S&P 500 and funds that emulate it. Between the market's peak on March 24, 2000, and its bottom, on October 9, 2002, the

S&P 500 sank 47%. If you had invested in an S&P 500 index fund at the beginning of 1998, you would have earned zilch over the next five years. If that doesn't raise doubts, one of the best arguments for funds that track the S&P 500—that they beat most actively managed funds—has shown cracks; over the past three years, they have topped fewer than half of diversified U.S. stock funds.

Should you abandon indexing? Absolutely not. The recent past notwithstanding, a portfolio built with index funds remains a reliable strategy:

They're simple. Index mutual funds seek to mirror a variety of barometers of the stock and bond markets. Rather than attempting to outpace the markets, these funds aim to match the performance of their indexes—saving you the time and effort of trying to pick active fund managers who can consistently outperform the markets.

They're cheap. Because index funds don't require highly paid analysts to research companies, they generally cost little to operate. **Vanguard 500 Index** (symbol VFINX) carries an annual expense ratio of 0.18%, meaning that for every $1,000 you have in the fund, Vanguard will extract just $1.80 per year for operating costs. That compares with an average expense ratio of 1.51% for all diversified U.S. stock funds. Consider the impact of this on a $100,000 portfolio that earns 10% per year before fees. Compared with someone who owns a fund that charges the average expense ratio, an investor in Vanguard 500 Index would earn an additional $29,000 over ten years.

They're rewarding. Even with all the effort they expend, active fund managers have a tough time beating the S&P 500 over time. To a large degree, that's because of the hurdle of higher fees. Over the long run, says John Bogle, founder of the Vanguard Group and one of indexing's staunchest advocates, you can count on the S&P beating 70% of actively managed funds. Many investors are happy to pass up the chance of outpacing the market by a point or two for the guarantee of matching it. "We might have been able to make a little more with actively managed funds," says Keith Hubbs, but "the risk and worry associated with that outweighed the possible benefits."

The bear market notwithstanding, it's hard to beat an indexing strategy over the long term.

Basic principles

If you're tempted to scoff at these advantages, you probably lost sight of some basic principles during the euphoria of the bull market.

For one thing, indexing is a long-term strategy. In the 1990s, when the S&P returned an annualized 16% and beat all but a handful of stock funds, lots of investors flocked to index funds to chase performance. They were shocked when the S&P subsequently dropped so drastically.

Over the long term, however, it's hard to beat indexing. In the ten years from 1992 through 2002, Vanguard 500 Index generated an annualized return of 9%—and it beat more than 73% of diversified U.S. stock funds (a figure that understates indexing's lead because it excludes poorly performing funds that disappeared). This probably explains why some $220 billion is entrusted to funds that track the S&P 500.

But remember that even if you index, you still need to diversify—and, as the Hubbses learned the hard way, a fund mimicking the S&P 500 isn't as diversified as it might appear. The index includes 500 large U.S. companies selected by a committee at Standard & Poor's. But it's a lopsided index. The 50 biggest companies account for half of the index's value, the ten biggest for about 25%.

That's because the index is weighted by the market value of its constituents. For example, Microsoft carries 75 times the weight of discount retailer Dollar General. In the heyday of technology stocks, companies such as Lucent Technologies and Yahoo!, whose shares have since plummeted, were among the leaders of the S&P 500.

To make matters worse, the Hubbses thought they were diversifying by investing in Janus fund. It turned out, however, that Janus was saturated with the same big tech companies that were well represented in the S&P 500.

But funds that invest in large (supposedly) growing companies represent just one segment of the stock market. Todd Black, a financial planner in Cumming, Ga., tells the story of a buddy who sought his advice after his $1.2-million portfolio shrank to $300,000. "He thought he was diversified because he owned five different funds, but they were all in the same kinds of stocks," Black says.

Because different parts of the stock market often move independently of each other, you can build a portfolio with steadier results by holding funds that focus on different areas. For example, in 2000 the S&P 500 lost 9%. But the S&P Midcap 400, which tracks 400 medium-size U.S. companies, jumped 17%. And as their performance over the past few years underscores, the addition of some bonds can smooth out a portfolio's ups and downs.

Back in balance

To get their portfolio back in balance before they headed off to do their mission work, Roxie and Keith Hubbs consulted Christopher Jones, a financial planner in Easton, Pa. Jones invests exclusively in index funds—and spends much of his time educating potential clients about the benefits of spreading money

Portfolios A quartet of index-based fund packages

At right are samples of four portfolios that rely completely, or to some degree, on index funds. The first three are made up entirely of stock funds and are appropriate if you're at least five years away from retirement or ten years away from a longer-term goal. The fourth portfolio, with a 40% allotment to a bond fund, is appropriate for someone who is within five years of retirement or who is saving for another goal that's between five and ten years away.

Vanguard Total Bond Market Index works well in a tax-deferred account. There are no municipal-bond index funds. If you're in a high tax bracket and are investing in a regular account, use **Vanguard Intermediate-Term Tax-Exempt** (VWITX), a low-cost muni-bond fund. The fund has an average maturity of six to 12 years and an annual expense ratio of 0.19%; it returned an annualized 5% over the past five years.

FUND	PERCENTAGE OF PORTFOLIO
SIMPLEST INDEX PORTFOLIO	
Vanguard Total Stock Market	80%
Fidelity Spartan International Index	20
ENHANCED INDEX PORTFOLIO	
Vanguard 500 Index	40%
Vanguard Mid-Cap Index	20
Vanguard Small-Cap Value Index	20
Fidelity Spartan International Index	20
PARTIAL INDEX PORTFOLIO	
Vanguard 500 Index	40%
Vanguard Mid-Cap Index	20
Masters' Select International	20
Royce Opportunity	20
BALANCED INDEX PORTFOLIO	
Vanguard 500 Index	30%
Vanguard Mid-Cap Index	10
Vanguard Small-Cap Value Index	10
Fidelity Spartan International Index	10
Vanguard Total Bond Market Index	40

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among different types of assets. "When U.S. large-company stocks get clobbered, it'll have a marginal effect on a well-diversified portfolio," Jones says.

Proper diversification also means holding stocks of smaller companies and foreign stocks. While you can do this with index funds, actively managed funds on average beat index funds that concentrate on small or foreign companies. A recent study by professors Rich Fortin of New Mexico State University and Stuart Michelson of Stetson University found that between 1976 and 2000, actively managed funds that invested in small companies outpaced the Russell 2000 index by 4.5 percentage points per year, on average. The advantage for actively managed overseas funds isn't quite as pronounced. Over the past ten years, they have edged Morgan Stanley's

Europe, Australasia, Far East (EAFE) index by 0.6 percentage point per year.

Analysts don't follow small companies and foreign outfits as closely as they do big U.S. companies, so managers stand a better chance of identifying underpriced stocks. That said, even Michelson admits that indexing makes sense for the bulk of a portfolio. "I've done enough research to realize that it's hard to beat the market," he says.

Different strokes

WHILE MANY pros agree on the advantages of index funds, they don't all use them the same way. Some try to mirror the U.S. stock market, with a heavy dose of S&P 500 funds. Jones, on the other hand, boosts his holdings of index funds that invest in foreign stocks, among other things, while cutting back on S&P 500 companies. And financial planner Black builds portfolios using a combination of index funds and actively managed funds.

Below, we identify a variety of indexing strategies. Although a number of companies offer index funds, we recommend Vanguard's in every case but one. As the industry leader in indexing, Vanguard (800-635-1511) offers a wide variety of funds that are uniformly cheap. In each case, we use Vanguard's "investor" class of funds, which require a $3,000 minimum for a regular account and $1,000 for a retirement account. Another alternative is to invest in exchange-traded funds. You buy and sell ETFs, which track specific indexes, just as you would a stock. For example, you could use **iShares S&P 500** (IVV) instead of Vanguard 500 Index (see "Who's Afraid of Spiders?" June 2002).

Kiplinger.com

Lowest-cost indexing. Explore the advantages of exchange-traded funds at **kiplinger.com/magazine/links.html.**

Some pros build portfolios with both index funds and funds that are actively managed.

Simplest indexing. To match the performance of all U.S. stocks, buy the **Vanguard Total Stock Market Index** (VTSMX). It tracks the Wilshire 5000, which has more than 6,000 U.S.–based companies. S&P 500 stocks represent 70% of the Wilshire's market value, and medium-size and small companies account for the rest. Over the past ten years, Total Stock Market returned an annualized 8.6%, versus 9.3% for the Vanguard 500 Index. Over longer periods, the funds should deliver similar returns, although Total Stock Market should be a bit less volatile.

To cover the rest of the world, place 20% of your stock portfolio in **Fidelity Spartan International Index** (FSIIX; 800-544-6666), which tracks the widely followed EAFE index. The minimum investment is $15,000, but you can use iShares MSCI EAFE (EFA), an ETF, as an alternative. The EAFE index returned an annualized 4% over the past ten years.

For the bond portion of your portfolio, use **Vanguard Total Bond Market Index** (VBMFX), which seeks to replicate the Lehman Aggregate Bond Index. With an average maturity of five to ten years, it has returned an annualized 7% over the past decade.

Enhanced indexing. You can also use index funds to make bets on different types of stocks. Using the S&P 500 as a base, you could juice up your portfolio with the addition of a fund that mirrors the S&P Midcap 400 index. The index, which tracks 400 medium-size companies, has returned an annualized 12% over the past ten years, and 15% over 20 years. **Vanguard Mid-Cap Index** (VIMSX) tracks this gauge.

Over time, small, cheap stocks perform better than other small stocks. So, you could add a fund from the small-company-stock sector. **Vanguard Small-Cap Value Index** (VISVX) seeks to replicate the performance of the cheaper stocks in the S&P Small Cap 600 index. The index has returned an annualized 13% over the past decade.

Consider the enhanced index portfolio—with 40% in the Vanguard 500 fund, 20% in Vanguard Mid-Cap, 20% in Vanguard Small-Cap Value and 20% in Fidelity Spartan International—described in the box that appears on page 37. Over the past ten years, it would have returned an annualized 10% versus 9% for Vanguard 500 Index alone, which would have been 35% more volatile—with higher peaks and lower troughs.

Partial indexing. Because the case for indexing isn't as compelling in some areas, you could use index funds to invest in larger U.S. companies, and select actively managed funds for smaller and foreign companies. You'd be trading the simplicity of an all-index portfolio for the chance to earn a higher return (and, of course, the possibility that the managers you select will trail their benchmarks).

A good alternative to an overseas index fund is **Masters' Select International** (MSILX; 800-656-8864; expense ratio, 1.19%). The brainchild of Ken Gregory (one of this magazine's columnists), the fund asks four top-flight managers for their best picks. The fund gained an annualized 5% over the past five years, eight percentage points per year ahead of the EAFE index.

A worthy small-cap value fund is **Royce Opportunity** (RVPNX; 800-348-1414; 1.19%). In four and a half years under manager Boniface "Buzz" Zaino, Opportunity has returned an annualized 10%, compared with 3% for the Vanguard small-cap fund. **K**

—*Reporter:* **JOAN GOLDWASSER**