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# Index Funds Will Let You Sleep Better

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Mutual funds can he divided into two groups. those that are actively managed, and so called index funds, which are passively managed. The difference between them is the mandate of the fund manager. An active manager's mandate, for better or worse, is to make continual judgments about which securities to buy and sell. The manager is deemed to have done well if he outperforms the bench-mark for his class of funds. In contrast, index fund managers are told, in effect: “Here is a market, or a whole market sector. Go out and mirror that market at the lowest possible cost." An index fund manager is evaluated on how closely he matches the index, and to perform well, must minimize both trading and operational costs.

Investors who choose to use index funds do so fundamentally be-cause the believe the academic research and historical evidence showing that security selection is a trivial and often negative component determining portfolio performance. By finessing the issue of individual security selection. index funds allow investors to focus on what counts. namely. the asset allocation decision.

Index funds have several other attractive features:

**COST** The operating expense ratio of index funds is typically close to 0.20 percent, while the average expense ratio of actively managed funds is about 1.4 percent.

**TAX DEFERRAL** Everything else equal, index funds provide valuable tax deferral. Index fund managers only make trades to keep the fund in line with an index and so have portfolio turn-over ratios typically below 10 percent and a low level of realized taxable gains. In contrast, active managers engage in significantly more trading, have turnover ratios often exceeding 100 percent, and so create tax-able income for current tax returns that is not controlled by the investor.

**CERTAINTY** To carry out their mandate of mirroring an index, index funds must remain fully invested and so have razor-thin cash levels of about 0.01 percent. In contrast. active managcr5 have cash levels that vary constantly. often in the range of 10 to 35 percent of the portfolio. Besides the uncertainty created by high and varying cash levels, the relatively high degree of trading by active managers introduces the additional uncertainty of being wrong by inadvertently buying high and selling low. Advisors who use active managers are ceding control in a fundamental way. and so are not well positioned to control the risk reward ratio of the portfolio. Thus. they are not positioned to perform one of the key tasks for which they are hired.

**PERFORMANCE** Although it is counter-intuitive . minimizing trading and simply mirroring the market delivers top-notch performance. For example. if you had simply bought the Wilshire 5000 index in 1983 and held through 1993, your performance would have exceeded the performance of three quarters of all equity funds. This performance is quite good. In fact. if it were delivered by an active money manager. it would make headlines.

Because of these advantages. index funds have grown in popularity. Pension plans explicitly index 30 to 40 percent of funds. and probably closet-index another ~0 to 15 percent. The market share of index funds at the retail level is smaller. but growing rapidly. The Vanguard S&P 500 index fund is now the fifth largest fund in the Morningstar database.

It’s not surprising then that financial advisor conferences frequently feature debates about the virtues of active versus passive management. unfortunately. the typical debate often goes something like this:

*Indexer:* The asset allocation decision is the most important factor determining portfolio performance and active managers, being dragged down by high relative costs. do not offer attractive risk/reward ratios.

*Active Manager:* Well, some managers beat the market for many years in a row.

*Indexer:* Of course, the distribution of returns of active managers basically fits a random distribution and just by chance you would expect that a few managers would consistently beat the market.

*Active .Manager-* Well, I'm one of those active managers. and I have consistently beaten the S&P 500 for many years.

*Indexer:* Well. your fund was concentrated in the part of the market, small company growth, or large company value stocks, that was in bloom during the relevant time period. Your fund was positioned where the sun was shining - you better have outperformed the S&P 500 index!

*Active Manager.-* But if you run my returns through a factor model program, and so peel apart my performance to see what was really going on, I ended up with a statistically significant alpha, that is, the measure of what the manager contributes to portfolio return.

*Indexer:* Well, good for you, but alphas, like performance in general, seem to be randomly distributed and factor models are designed to explain past, not future performance. So what if you had a positive alpha? How do I know if you will provide a statistically significant, positive contribution in the future? And how could I have recognized you before you pulled out ahead of the pack? And finally, it costs a lot of money for you to do what you do, and it costs a lot of money for me to look at what you do versus what other active managers are doing, and the cost and the risk of these activities can't be justified to the client.

Such debates fail to bring out the relevant issues, I believe. The central question is not: Could someone or has someone, consistently beaten the market? The question is: What are the obstacles that our clients face, and what can we do to address them?

Clients don't come in asking to beat the market. I've never had a client who said "my 10-year performance is just 50 basis points over the S&P 500. Can you get the relative performance up to 100 basis points?" But clients do, in essence, express the following concern: "Look, I'd like to be financially secure, maybe even wealthy. I'm on this earth only once, so I've got only one chance and I don't want to blow it. I have to pay taxes and transactions costs, which along with inflation, will eat up large parts of my portfolio return. I have to make decisions without full knowledge. I don't really know whether the market will go up or down, and I don't really know which mutual fund will perform well in the future. Given these constraints, what should I do now?"

Advisors who respond to this question saying "hire me, I can pick the high performing investments," do the client a disservice. Predicting the future is not an activity that is likely to be successful, or one that focuses realistically on the client's problems - investment costs (including taxes, fees, and inflation), and risk management through diversification. Advisors who use index funds to construct portfolios, however, can tailor portfolios to the particular risk/return characteristics of the client and can minimize costs. This is the investment activity, along with the substantive advice about estate planing, insurance coverage, budgeting and emergency reserves, that delivers value to the client.

If you go along with these ideas and begin to use index funds for your clients, are you crazy or are you right on the mark? I believe you are right on the mark, for the following reasons:

**The use of index funds is consistent with academic theory.** A review of the history of portfolio theory shows that individual security selection has not been the focus of investment management since before 1952. Before then, investments were matched to clients according to the risk characteristics of the individual security. The less volatile and safe investments were given to widows and children, and the more volatile investments were given to wealthier investors considered better able to handle risk. In 1952, the economist Harry Markowitz introduced a then revolutionary concept - that the risk of a portfolio depends not on the individual risk of each separate investment, but rather on how all of the securities behave together. Markowitz's Nobel prize-winning idea made obsolete the old approach of: "I buy blue chip stocks for conservative clients." The new goal of money management became the construction of portfolios with the highest expected return for a desired level of risk. Diversification, i.e., the idea of owning a variety of assets that perform differently from each other, rather than a bunch of similarly performing investments, became the essence of portfolio construction.

In the early 1960s, William Sharpe helped practitioners bring Markowitz's ideas into the real world by identifying the stock market *in toto* as the most efficient equity portfolio. Sharpe won his Nobel prize for the idea that the optimal way to construct a portfolio is to choose an appropriate level of risk, invest in the market portfolio to the extent of this risk-bearing ability, and then invest remaining funds in low-risk assets such as Treasury bills.

Recently, Professors Kenneth French and Eugene Fama of the University of Chicago offered another advance in portfolio theory. They proposed that two other fundamental factors determine portfolio performance - the exposure of the portfolio to small-company stocks and to value stocks. Their work, which is now receiving increasing acceptance, moves academic theory even further away from individual security selection and closer to building portfolios with generic market slices.

Actively managed funds, in this context, are anchored in the 1950 boutique style of management. Index funds, by bypassing individual security selection and focusing on asset allocation and diversification, fit in with the best that the academics have to offer. It's not bad to be in sync with a trail of Nobel prize winners.

**The use of index funds is consistent with developing trust law.** There have been important changes recently in the standards to which trustees are accountable, as illustrated by the new Prudent Investor Rule that is gradually being incorporated into state law. The new standard for fiduciaries is based on modern portfolio theory and makes a 1950s style of portfolio management obsolete. Here are the a some explicit assumptions on which the Prudent Investor Rule is based, as outlined in the Restatement of the Law Third (May, 1990):

- Diversification is fundamental to the management of risk.
- Asset allocation decisions are a fundamental aspect of an investment strategy.

- Active management must be justified by realistically evaluated return expectations, including investigative and general transactions costs and capital gains considerations.

This is powerful support for the use of index funds. According to this standard, if you continue to pursue a pre-index style of portfolio management, you're not cutting it. In a legal battle, active managers will have to justify their management approach, and there is little academic support behind them.

**The use of index funds is consistent with industry practice.** New mutual funds and 401(k) options, instead of having such names as Magellan or Windsor, more commonly have names such as "Small Cap Value Fund" or "Mid-Cap Growth." This increasingly generic nature of fund names reflects, I believe, the notion that the proper role of funds is to be an ingredient in a portfolio, rather than to be a stand. alone boutique item.

**The use of index funds grounds the client/advisor relationship in reality.** When you don't tell the client that you in effect know the future and can pick the high performing investments, you distance yourself from common false hope that somewhere out there is the answer to portfolio management — if investors could just find it. You differentiate yourself from those in the media who constantly promote the notion that if investors would just try a little harder, they could figure it all out and consistently beat the market. Instead, you focus your and your client's attention on the issues that matter, and for which we have some remedies: expense control and risk reduction through diversification.

In sum, the question is not whether one can beat the market, but what, given the real-world of high costs, inflation, and imperfect information, you can responsibly, honorably, and comfortably offer to clients and still sleep at night. And with index funds, I sleep a lot better.

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