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On Personal Finance | Indexing brings peace of mind to mutual funds

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If you had money to put into a mutual fund at the start of 1976, there wasn't the choice you have today. There were only a few hundred funds, and all were the "actively managed" type that pays big bucks for analysts and stock pickers to hunt hot investments.

Your profits could easily have been eaten up by hefty charges - broker's commissions when you bought and sold, and high annual fund fees to pay all those pros.

Then came John C. Bogle with a revolutionary idea, for which small investors will forever be in his debt. On Aug. 31, 1976 - 30 years ago last Thursday - Bogle's Vanguard Group launched the first cost-saving index-style fund for small investors, First Index Investment Trust.

Instead of constantly changing its holdings in pursuit of the next super-stock, this indexer - and those that followed - simply bought the stocks in a standard market benchmark and held them. This dramatically reduced fund fees.

Although the start was slow, index investing took off.

Now called the Vanguard 500 Index Fund, Bogle's baby is the world's third-largest fund, with nearly \$67 billion in assets, according to Lipper Inc. the fund-data company. (Disclosure: A smidgen is mine, through my 401(k) and a regular account.)

Though it and 176 other funds track the Standard & Poor's 500 index, there now are indexed investments linked to all sorts of market gauges - small stocks, foreign stocks, value stocks, growth stocks, stocks in specific industries....

Today, index funds hold more than \$1 trillion, representing about 12 percent of the money invested in mutual funds, Lipper says.

Indeed, a new study by two finance professors at Yale, Martijn Cremers and Antti Petajisto, finds that most actively managed funds actually use index strategies for large portions of their holdings. Thus, only about a quarter of all funds can truly be described as actively managed today, the study found.

Indexing theory is simple: Over time, the average active manager can do no better than to match the market's return. Once stock-hunting costs are deducted from a fund's assets, the average fund's return will, therefore, trail the market.

Indexers try to match the market and reduce costs. Investors in the Vanguard 500 indexer, for instance, pay as little as 0.09 percent, versus 1.4 percent for the typical managed stock fund.

Also, annual taxes tend to be lower with indexers, since they hold stocks for the long term and avoid the capital gains tax triggered by sales.

Study upon study has shown that indexing works - with indexers often beating a large majority of the managed funds in their categories.

The Vanguard 500 Index Fund has beaten the average comparable managed fund over periods of one, five, 10 and 20 years, according to Lipper.

So what's the bad part of the story?

First, that of the more than 11,000 stock funds available today, the vast majority are actively managed. Though many are "closet indexers," as the Yale professors put it, they charge managed-fund-type fees.

Clearly, many investors still don't understand the long-term damage done by higher-than-necessary fees. Or they're being misled by investment advisers who prefer high-fee funds that are more profitable for the broker than the investor.

Second, fund investors still tend to overemphasize returns and underemphasize risk.

A managed fund that's been hot for 12 months may well have used a go-for-broke strategy that could hurt it over the next 12 months. Sure, a few active managers may be smarter than the others, but I'm not smart enough to know which hot managers are smart and which were just lucky.

With an indexer, you don't have to worry about that.

In fact, with an indexer, you need not care who the manager is - or whether he'll lose his touch, quit or retire, leading you to dump the fund and perhaps pay a big tax on profits.

An indexer has a steady hand on the tiller.

For me, that's the chief benefit: By using indexers, I can sleep at night.

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