

Index funds
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changing
the way
Americans
invest

FOR DR. MARK WITTMAN, PICKING STOCKS IS LIKE GOING TO Las Vegas—fun, but not something to which you want to commit a lot of money. The 42-year-old Los Angeles anesthesiologist and entrepreneur prefers to keep about 65% of his investments in index funds, those boring-but-sensible mutual funds that robotically track a market index such as the Standard & Poor's 500. "I'm personally comfortable with matching the market return. I don't have to beat it, but I sure don't want to fall behind it," he says. In fact, the index funds usually do so much better than his own carefully chosen stocks that Wittman sometimes wonders why he doesn't go 100% into indexing. "Old habits die hard," he admits.

Yet die they do, as evidenced by this simple fact: Indexing is changing the way Americans invest. It's cheap, it's easy, and it makes sense to investors who care about long-term gains, not playing the latest hot tip. A citizenry that demands discounts on everything from cars to computers is increasingly dissatisfied with paying stockbrokers and mutual-fund managers to pick stocks and bonds—especially when their choices often don't work out.

This has become increasingly true during the 16½-year bull market, when simply investing in a fund that mimics the S&P 500-stock index,

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THE INVESTOR REVOLUTION

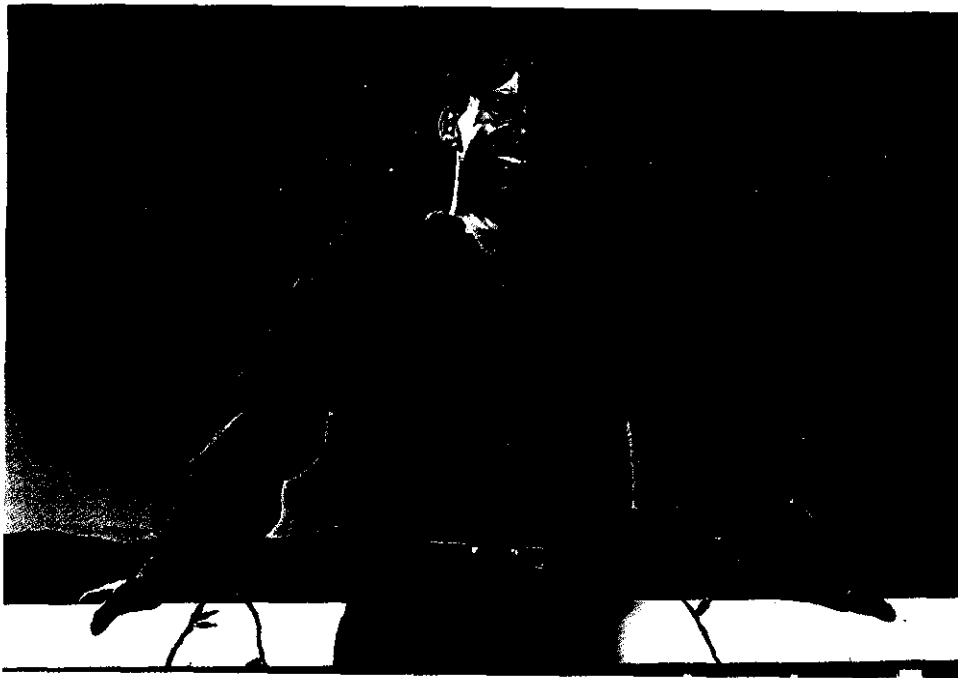
WHO NEEDS A MONEY MANAGER?

composed largely of big, blue-chip companies, has beaten buying managed funds hands down. If you had put \$10,000 into an S&P 500 fund in August, 1982, you'd have had \$193,550 by the end of January, vs. \$114,300 if you'd turned your money over to the average managed equity fund (chart, page 128). Actively managed large-cap funds did better but still fell short of the S&P 500 with a return of \$157,346.

Even as the S&P 500 rose 28.6% in 1998, one-fifth of all U.S. equity funds lost money, and only 17% of fund managers beat the big index. Fewer than 5% did so over the past five years. The major reason is that managers' fees are as much as seven times what most big index funds charge to invest your money. So it's no wonder that investor dollars are increasingly bypassing actively managed funds, even as the fund industry rolls out new ones at the furious pace of one per day.

Last year, index funds attracted some \$42 billion, or 19% of the money committed to mutual funds, according to Financial Research Corp. That number has nearly doubled since 1996—a remarkable feat considering how few dollars are spent advertising the no-frills products. The most obvious sign of indexing's ascendance is the explosive growth of the Vanguard Group's \$79 billion 500 Index fund, which is expected to soon overtake Fidelity Investment's \$83 billion Magellan as the world's largest mutual fund.

Academics have long talked up the advantages of broad index funds. So have managers of U.S. pension plans, which have \$1.15 trillion—or 25% of their assets—in indexed investments. But it wasn't until the stock market's



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Los Angeles, California

spectacular runup of the past four years that individuals began to catch on. Now, investors are looking beyond the S&P 500 to index funds that track everything from energy stocks to the 100 largest issues in the tech-heavy NASDAQ Index. Last year, about 40¢ of every index-fund dollar went into such S&P 500 alternatives, up from 26¢ in 1990.

You say you want to invest in the entire stock market instead of a single sector? No problem. Increasingly popular are

funds pegged to the Wilshire 5000 index, which captures virtually the entire field of U.S.

equities, including the 20% of the market cap the S&P 500 misses. Even Vanguard’s senior chairman, John C. Bogle (page 132) thinks that an index fund based on the Wilshire 5000 is the purest form of indexing. Wilshire Associates Inc., a money manager based in Santa Monica, Calif., itself launched a Wilshire 5000 fund on Feb. 1.

Brokerage firms and mutual-fund groups insist that in today’s overheated stock market, investors need savvy managers more than ever to find the few remaining bargains. Experienced mutual-fund managers are paid as much as \$5 million a year to comb through financial data, grill chief executives, and develop theories about how markets work. Index funds, by contrast, make no attempt to snap up winners and jettison losers. Computers simply tell traders to buy stocks in

proportions matching their representation in indexes.

So why should you settle for simply matching the market? Because it may be the best you can do long term, say academics and others who believe markets are so sophisticated that stock prices instantly reflect new information. The record strongly supports their view. In this supercompetitive environment, the only investors with a sure advantage are those trading on illegal information. With the odds of being right 50% in every transaction, picking stocks that beat the benchmarks is no different from correctly calling a coin toss.

BIG BANDWAGON. Indeed, whether they like the trend or not, Morgan Stanley Dean Witter, Merrill Lynch, Fidelity, and others have added index funds to their product lines. Online brokerages, which depend on investors who make their own decisions, are also jumping on the bandwagon. In early February, E*Trade launched an S&P 500 fund to be sold on the Web. It plans to add index funds that follow the Wilshire 5000 and the Internet and software industries by summer. “The only funds we will be introducing will be in the index vein,” says Brian Murray, general manager of E*Trade’s mutual-fund group.

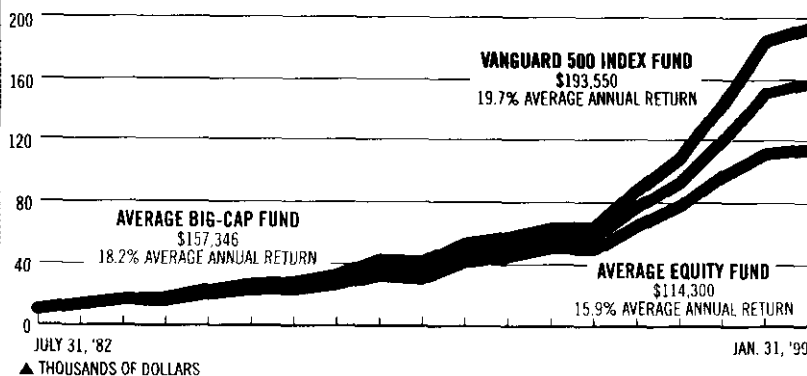
A slew of specialized stock indexes are in development, paving the way for even more index-fund products. S&P is working on a socially responsible version of its 500-stock index. Dow Jones, S&P, and others have been rolling out euro indexes pegged to stocks trading in Continental Europe’s new single currency, and Barclays Global Investors, the world’s largest index-fund manager, is even designing a global index

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INDEXING MAKES A DIFFERENCE

Let’s say you invested \$10,000 in the average U.S. equity mutual fund, the average big-cap fund, and a Standard & Poor’s 500 fund at the beginning of the bull market in 1982. What would those investments be worth today?



WHERE FUND MANAGERS TRAIL THE INDEXES...

that will track the stocks of multinational corporations.

As index offerings have grown more sophisticated, so have their uses. Standard & Poor's Depository Receipts (SPDRs) trade on the American Stock Exchange and invest in the S&P 500 and many of its components. Investors can "short" the market or sectors by selling borrowed SPDRs in the hope of replacing them at lower cost if the indexes fall. In addition, a new crop of "enhanced" index funds tries to outsmart the very indexes they track by tinkering with weightings. Other funds use borrowed money to try to double the returns of indexes including the S&P 500 and the NASDAQ 100.

Such high-octane funds are attracting a new, daring breed

erage of 87% of the stocks they own each year.

The bottom line is that while the average large-stock equity fund annually pockets \$2 of every \$100 you invest, most big index funds take only 25¢. With compounding, that cost advantage adds up over time. Indeed, over the past decade, 84% of large-cap fund managers have trailed their main benchmark, the S&P 500, while 76% of all managers have fallen behind the Wilshire 5000. Passive funds have also maintained an edge over stock-pickers in emerging markets, Europe, and Latin America, as well as in mid-cap U.S. stocks and U.S. bonds. Bond index funds are real sleepers (table, page 130). They account for just 3% of overall bond-

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— MARY BALDWIN,
Melbourne, Florida



of investor. Take Herbert Abelow, 75, of Delray Beach, Fla. Last summer, when stocks were crashing, he used two new funds from ProFunds to short the S&P 500 and the NASDAQ 100. The bold move helped him gain 70% for the year.

REAL SLEEPERS. The trouble is, not all of the new products have the low fees that have given index funds their only enduring advantage over active managers. Consider S&P 500 funds. Their expense ratios are around 0.2%, 1.2 percentage points lower than those of actively managed rivals, because they don't have to pay for big-ticket items like research and advertising. Plus, because index funds hang on to stocks until they drop out of the index, they trade less. That saves on brokerage commissions and generates fewer taxable capital-gains distributions than active funds, which replace an av-

fund assets. Yet last year, the Vanguard Total Bond Market Index fund, the biggest with \$7.8 billion in assets, beat 87% of actively managed bond funds, with an 8.6% return. Over the past five years, only 14% of bond managers have beaten the Lehman Brothers Aggregate Bond Index, the closest approximation to the entire investment-grade market.

Don't mistake indexing for a sure thing, however. Although the strategy tends to come out on top over time, it doesn't always beat active managers in a particular year or guarantee positive returns. And by definition, index funds can't escape bear markets. But many stock-pickers haven't been able to sidestep market downturns, either, even though they can flee to cash. True, when the market declined in 1980-82 and crashed in 1987, active managers prevailed. But other times, such as in the

FUND GROUP/ INDEX	AVG. ANNUAL TOTAL RETURN 1989-1998	FUND GROUP/ INDEX	AVG. ANNUAL TOTAL RETURN 1989-1998
GROWTH/INCOME	16.40%	GLOBAL GROWTH/INCOME	10.50%
S&P 500	19.47	MSCI WORLD FREE	12.16
GROWTH	17.00	EUROPE	12.44
S&P/BARRA 500 GROWTH	22.38	MSCI EUROPE	16.54
EQUITY/INCOME	14.89	EMERGING MKTS.	4.60
S&P/BARRA 500 VALUE	17.66	IFCI COMPOSITE	10.05
TECHNOLOGY	21.62	GOLD/PRECIOUS METALS	-2.57
PSE TECHNOLOGY	23.94	GOLD. SACHS PREC. METAL	-1.56
MIDCAP	18.16	ASIA/PACIFIC EXC. JAPAN	6.41
S&P MIDCAP	19.73	MSCI ASIA/PAC. EXC. JAPAN	7.42

...AND WHERE
THEY STILL
OUTPERFORM

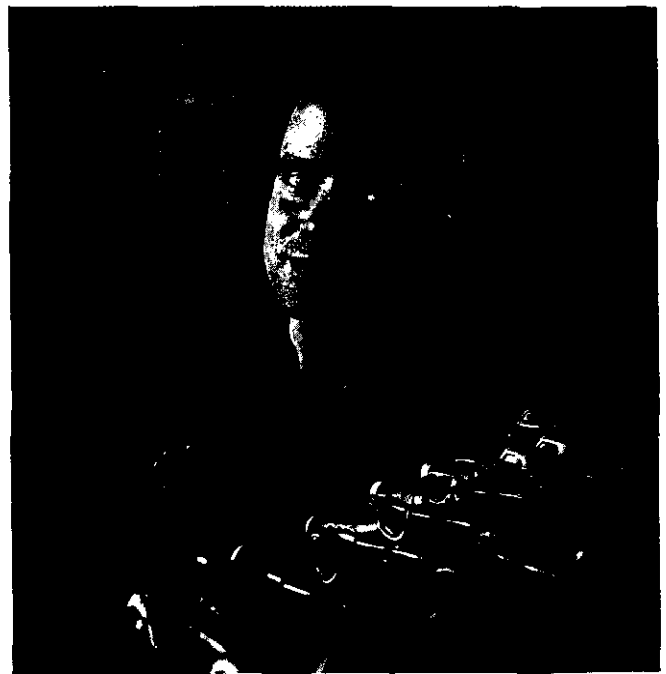
FUND GROUP/ INDEX	AVG. ANNUAL TOTAL RETURN 1989-1998
SMALL CAP	16.03%
RUSSELL 2000	13.88
AGGRESSIVE GROWTH	15.44
RUSSELL 2000 GROWTH	12.49
FINANCIAL	22.34
S&P FINANCIALS	19.18
GLOBAL GROWTH	12.44
MSCI WORLD FREE	11.81
JAPAN	-0.67
MSCI JAPAN	-4.39

bear market of 1973-74, index funds won out. And last August, when the Dow Jones industrial average fell 14%, only two categories of funds, both mid-caps, beat their benchmarks. Like other industry-specific funds, tech funds trailed, falling 20%, vs. 18% for the Pacific Stock Exchange technology index. "The average fund can't keep up with its index when it's sunny or rainy," says Susan Dziubinski, editor of Morningstar's *Fund-Investor* newsletter.

ROUGH EDGES. Two sectors where managers have continued to top the indexes are small caps and diversified international stocks. One theory is that these markets are not as widely followed, so smart pickers have more opportunities to profit. "I definitely believe in index funds for the S&P 500, but small caps are much riskier. I think you need to be more selective," says Mary Baldwin, a financial planner in Melbourne, Fla. Index fans counter that the managers may be taking higher risks or cheating around the edges. Since large stocks have been dominant, many small-cap managers have juiced up returns by buying a few big names. Transamerica Premier Small Company fund has big bets

“The tough thing is hearing about the big hits your buddies have with this fund or that”

— CHRISTOPHER CRAIG,
New York City



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small, at \$9 billion and \$16 billion, respectively.

By drifting away from their advertised investment style, active small-cap funds may be left behind if small stocks take off. Since 1980, small stocks have led the market seven times. And in four of those years, funds pegged to the Russell 2000 have beaten small-cap managers. Unlike managed funds, index funds never drift in style, making them ideal for investors who want to carry out an asset-allocation plan (page 134). "With an index fund, you very much know that what you are buying is what you are going to get," says Randy Oldenburg, a financial planner at Camden Financial in Scottsdale, Ariz.

One thing that could give indexing a black eye would be a tumble in large-cap stocks, since most indexed money remains tied to the S&P 500. After four years of big gains, Van-

guard Chairman John J. Brennan warned in a recent letter to shareholders that the big-cap party "won't last forever." In fact, there is evidence that the money flowing into index funds may be contributing to a speculative bubble in the S&P 500. When Standard & Poor's Corp. (like *BUSINESS WEEK*, a unit of The McGraw-Hill Companies) puts new stocks in the index, the additions see their prices jump an average of 7%.

However, the main reason for the S&P 500's runup is the dramatic increase in the prices of 15 mega-cap companies such as Microsoft Corp., which together accounted for half of the index' rise last year. It is primarily this huge investor appetite for the dominant stocks that pumped up the index, contends Leah Modigliani, a stock strategist at Morgan Stanley. She points out that half the stocks in the S&P 500 rose less than 6.6% last year.

If you're worried about overexposure to the S&P 500 or any other sector, shop for funds that cover the most terrain. "There's a little less risk in a broader index," says Burton G. Malkiel, a Princeton University economist and author of *A Random Walk Down Wall Street* (W. W. Norton, \$15.95). You can cover everything with only three funds: one for U.S. stocks (indexed to the Wilshire 5000), another for bonds (indexed to the Lehman Brothers Aggregate), and a third for overseas stocks (indexed to Morgan Stanley Capital International's EAFE index ("Europe, Australasia, and Far East").

If you choose to focus your money on narrower index funds, including the S&P 500, you're effectively betting you know better than the market as a whole. You may be right, but the bet does run counter to the concept of index investing, which is that you can't beat the market in the long run. That's why Christopher M. Craig, a Manhattan marketing executive, buys only the broadest index funds. "The tough thing is hearing about the big hits your buddies have with this fund or that," he says.

Because indexing's main advantage is its low cost, stay away from funds with

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BOND FUNDS CAN'T BEAT THE INDEXES

DATA: STANDARD & POOR'S DRI

FUND GROUP/ INDEX	AVG. ANNUAL TOTAL RETURN 1989-1998
TREASURY	9.14%
LEHMAN GOVT.	10.09
INT. TREASURY	8.86
LEHMAN INT. GOVT.	9.25
GOVT. MORTGAGE	8.72
LEHMAN GOVT./MORTG.	10.06
SHORT TREASURY	7.56
LEHMAN 1-3-YR. GOVT.	8.26
CORPORATE	9.23
LEHMAN GOVT./CORP.	10.26

FUND GROUP/ INDEX	AVG. ANNUAL TOTAL RETURN 1989-1998
HIGH QUALITY CORP.	9.35
LEHMAN AAA CORP.	10.67
HIGH YIELD CORP.	10.06
LEHMAN HIGH YIELD	11.48
GOVT. AGENCY	6.41
LEHMAN CORP./MORTG.	10.32
CONVERTIBLE	12.56
GOLDMAN SACHS CONVERT.	12.60
STRATEGIC INCOME	9.06
SALOMON WORLD GOVT.	9.88

high expense ratios and 12(b)-1 fees, which pay for marketing. It was easy to dismiss the Domini Social Equity fund's 0.98% expense ratio when the fund delivered a 33% gain last year. But if the market falls, those expenses—nearly twice the average for index funds—will take almost as big a bite out of returns as those of some managed funds.

While index funds may seem to be interchangeable commodities, good managers can save shareholders a few basis points here and there. Last year, Vanguard's S&P 500 fund beat the S&P index itself—28.62% to 28.58%. How? By buying S&P 500 futures when they were trading at a discount to the actual stocks. To prevent cash

from sitting around in a rising market, traders invest new contributions immediately. "They always say a monkey could run an index fund, but it's not true," says Vanguard managing director Gus Sauter.

Index funds like Sauter's are a thorn in the side of active money managers, many of whom are humiliated after years of trailing funds that use not a whit of research or judgment. Some stock-pickers say it's unfair to be measured against capitalization-weighted indexes, which allow rising stocks like Microsoft to account for an ever-growing portion of their performance. Like it or not, though, index funds are here to stay. With their unbeatable cost advantage, they represent a powerful and lasting challenge to the comfortable old ways of managing money.

By Anne Tergesen and Peter Coy in New York

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THE DEBATE GOES ON: USE BRAINS OR INDEXES?

Byrone R. Wien, U.S. equity strategist at Morgan Stanley Dean Witter, and John C. Bogle, senior chairman and founder of Vanguard Group, are good friends. But the Wall Street veteran and the index-fund pioneer differ on the merits of investing in funds that replicate broad measures of market performance. The two have debated the issue since Wien wrote an essay, "I Hear the Death Rattle of Indexing," in 1993. With indexing anything but dead, they turned to *Personal Finance* Editor Anne Tergesen to chronicle the latest installment of their argument.

Will active managers have their day?

BOGLE: If we get a big recovery in small stocks, it is possible, and I would even say likely, that the average mutual fund will begin to outperform [the Standard & Poor's 500-stock index]....

People are investing very heavily in the S&P 500 because they are always looking for the hot fund. But where index funds find their finest fruition is in the total stock market [the Wilshire 5000 index]. That is the theory of indexing: Own the market and by the time we take out our tiny costs, you will beat most participants.



BOGLE: "Own the market and... you will beat most participants"



WIEN: "Investment management is a rare skill, refined over time"

WIEN: Like any other strategy that works, indexing has a susceptibility to get overdone. When that happens, it will underperform for a period. This market tends to recognize what's working well and investors flood into it, ignoring the wallflowers. Right now, the top 50 stocks in the S&P 500 have an average price-earnings multiple of 47 on forward earnings and the other 450 have a P/E of 20.... If the 50 most dominant stocks that are driving the index slow down and the bottom 450 start to outperform, chances are the active managers will start to outperform. That's because they own a disproportionately smaller share of the dominant stocks and a disproportionately larger share of rest.

Does indexing work for smaller stocks?

BOGLE: Small-cap indexing works better than large-cap indexing, in

part because [managed] small-cap funds are a lot more expensive to run. Also, small-cap stock funds take on about 35% more risk than the [Russell 2000] index. Therefore, on a risk-adjusted basis, small-cap index funds do 4.4% better than active managers.

WIEN: It's hard to find a good small-cap index that's representative of the asset class. In-

ternational indexes very often have more serious problems. In some countries, you can have a single stock that represents 30% of the market. Very few people would be willing to put that much of their assets in one company.

Are index funds the wave of the future?

BOGLE: Five years ago, I said the Vanguard 500 Index Fund would be the largest fund in America by the end of the millennium. I don't have any trouble thinking that will come true.

WIEN: Investment management is a rare skill, refined over time. Some money managers, over longer periods, have beaten the market by quite a lot. There's no guarantee they will do it in the future, but that's the way to bet.