10 Reasons I Invest in Index Funds

I don't write about it very often, but regular readers know the vast majority of my portfolio is invested in traditional low-cost, broadly-diversified index mutual funds and their exchange traded fund (ETF) equivalents. I'm talking about funds like the Vanguard Total Stock Market Index Fund (25% of my retirement portfolio and 100% of my HSA portfolio) and the Vanguard Total International Stock Market Index Fund (15% of my retirement portfolio and 50% of my 529 portfolio.) Now I have small portions of my portfolio dedicated to things like bonds, small value stocks, and real estate, but you won't see any individual stock picking, market timing, or significant use of active management of publicly traded securities.

Recently I was looking for an old post about index funds to link to and realized I didn't have one. So this is one of those back to basic posts. If you already know index funds rule, feel free to move on to something else on the site. If you haven't, this post is for you.

Top Ten Reasons to Invest in Index Funds

1 Better Performance

This is the main reason I use index funds as the major building blocks in my portfolio and the main thing I look at for those minor portions of the portfolio where I consider doing something different from indexing. The empirical data is quite clear on this. Buying individual stocks (or bonds) introduces uncompensated risk, i.e. a risk that you are not compensated adequately for taking. This is the risk of a company going bankrupt or a borrower defaulting or being downgraded. This is when an individual security goes down in value when the overall market is going up and it happens all the time to people who buy individual securities. It doesn't happen to me though, because I invest in mutual funds. Mutual funds give you broad diversification, pooled costs, daily liquidity, and professional management all for a very low cost.

You can get those particular benefits with an actively managed mutual fund just as well as an index fund. However, the data on active management vs passive management is clear too. Time and time again it has been shown that active management doesn't work well enough to overcome its additional costs, particularly over the long term and even more so in a taxable account. At 10 years, an index fund is outperforming 80%+ of its peers. By the time you get out to your 30-60 year investing horizon and consider all of the asset classes in your portfolio, an index fund portfolio is going to outperform 99% of similar actively managed portfolios.

So when you invest in index funds, over the long run you can expect higher returns than those who pick stocks or mutual funds.

2 Less Time-Consuming

Another important reason I invest in index funds is that it takes dramatically less time to invest in this manner. While I have to spend additional time on my own portfolio to direct significant ongoing contributions, I manage my parents' all-index-fund portfolio in about an hour a year. Seriously. An hour. That's it. What do we do in that hour? We rebalance it and pull out their required minimum distribution. And even the initial set-up didn't take much longer than that.

When you invest in index funds you don't have to spend any time at all researching stocks or following companies. You don't watch CNBC. You don't read Forbes or The Wall Street Journal. You don't have to, because it isn't going to change anything you do. Nor do you want to, because once you realize all that information is completely unactionable, you see just how boring it is to pour through when you could be doing something else with your life. We invest to live, we don't live to invest.

Here's another issue. Most stock pickers or mutual fund pickers don't subtract the value of their time from their portfolio. For a high-earning professional, that cost is hardly insignificant. In fact, it may be your highest investing cost. Even if you manage to beat the market one year, the chances of you having done so after accounting for the value of the time you lost doing it is pretty darn low. You would have been better off doing another procedure, reading a few more slides or CTs, or seeing a few more patients. “But I enjoy it” is hardly an excuse, especially when you’re not only wasting time on it but getting lower performance (see # 1) to boot. I’ll bet there is something else you enjoy more anyway.

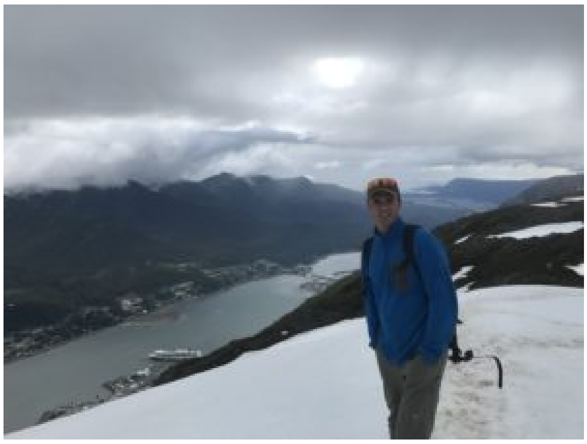
3 Less Risky

Not only do you get to avoid taking uncompensated risk with individual securities, but you also get to avoid manager risk. This is the risk that your manager is stupid, makes a mistake, or retires. “But Warren Buffett is brilliant!” Yes, but he’s also mortal, just like every other money manager out there. (And he recommends you invest in index funds rather than Berkshire-Hathaway.) When you invest in actively managed mutual funds, you’re always left to wonder whether the cause of your recent underperformance is just cyclical or whether the manager is either no longer skilled or no longer lucky. By the time you figure it out, it’s often too late. Not to mention the value of your time managing the managers.

4 Lower Cost

Costs matter, and over the long run, they matter a lot. The main reason index funds outperform actively managed mutual funds is that they have dramatically lower costs. You avoid mutual funds loads and 12b-1 fees. Your expense ratio is likely to be only 1/10th that of an actively managed fund (0.02-0.2% versus 0.5-2%.) There are hidden costs as well- commissions and bid-ask spreads that come from the higher turnover most actively managed funds have. And of course, your highest cost- the value of your time selecting and monitoring a portfolio of managers.

5 More Tax-efficient



Mt. Roberts above Juneau on an Alaskan Cruise—Index investing allows me the time and money to go on cruises and climb mountains

An index fund portfolio is generally much more tax-efficient than an actively managed portfolio. The turnover is lower, so there are fewer capital gains distributions, particularly with a broadly diversified index fund, such as the total market funds. The only time these funds have turnover is when there is an Initial Public Offering (no capital gain distribution) or when a company gets delisted from the exchange (again, no capital gain distribution.) Theoretically, the turnover ought to be 0%. In actuality, it’s about 4% for various technical reasons. That means the average stock is held for 25 years. Considering the average mutual fund turnover is 85%, holding their average stock for just a little over a year, 4% is basically 0%.

Capital gains are also minimized by the fact that you don’t have to change funds every few years when a fund manager retires or loses his touch.

6 Easy Portfolio Building Blocks

One of the best parts of index fund is that they simplify the portfolio construction process. If your investing policy statement calls for 5% of the portfolio in REITs, you can simply invest 5% of the money into the Vanguard REIT Index Fund. Done. Need international stocks? Add an international fund. Corporate bonds? There's a corporate bond index fund. No style drift. No worries about overlap with other holdings. You know what's in the fund just by reading the fund name. Sometimes I think it's amazing that anyone would pay thousands of dollars a year to someone else to build their portfolio for them when it can be so easy.

7 Wide Availability

I can buy my favorite index mutual fund, the Vanguard Total Stock Market Index Fund in my partnership 401(k), our individual 401(k)s, our Health Savings Account, our Roth IRAs, our children's 529s, our children's UGMAs, our children's Roth IRAs, and our taxable account. It is a component of the portfolio in our partnership defined benefit plan too. Even my old 401(k), the TSP, has a similar fund. It's as universal as it comes. So no need to find a different mutual fund for every account you invest in. And even if I didn't have access to Vanguard funds or a Total Stock Market fund, the chances of me not having access to an equivalent fund from Fidelity, Schwab, or iShares (or at least a 500 index fund) are low and getting lower all the time.

8 Capture Market Returns

l love that index funds guarantee me the market return. If the market goes up 8% one year, I got 8%. The S&P 500 index is up 1% today? So's my fund. No worries about tracking error. Beating the market is very tough, and most who try fail (and fail big). Of those who succeed, they usually only do so minimally. But matching the market? Nah, that's easy.

9 No Factor Risks

The Total Market versus Factor Investing debate will go on for years. Most of the time you can use low-cost index funds for either approach. But one nice thing about a total market approach is that you can be agnostic about sectors and factors. If small stocks do well, you own those. If value stocks do well, you own those. Low volatility? Check. Momentum? Check. Any other factor or sector you can come up with? You own that too. You don't have to worry about a factor being discovered, bid-up, and then underperforming.

10 Minimize Regret

I owned Apple before it skyrocketed. I got in on the ground floor. Same with every other high-flying stock out there. Sure, I own lots of losers too, but I never have to worry about missing out on the meteoric rise of a stock. That helps me control the most important thing in my portfolio- my own behavior.

There are many roads to Dublin. If you build a reasonable portfolio, fund it adequately, and control your behavior, you are highly likely to reach your financial goals. But for whatever portion of your portfolio you invest in stocks and bonds, do yourself a favor and use an index fund.

What do you think? Do you invest in low-cost index funds? Why or why not? What do you like about them? What do you dislike? Comment below!