

New Alternatives to Indexing Not as Attractive as They First Might Seem

Index fund investing is at the core of many wise investors' portfolios. While I do not believe that simple indexing is the best *possible* approach to managing a portfolio, it is better than the vast majority of alternatives. Unless you have significant resources to devote to economic analysis, valuation and manager research, the index fund is the way to go.

There are a host of indexes available for asset classes ranging from stocks, bonds and real estate to hedge funds and managed futures. It is important to remember that you cannot invest directly in an index. An index publisher selects a set of investments, assigns weights to each one, and calculates the index based on how the investments are trading at a given time. An index is nothing more than a mathematical calculation.

Index mutual funds invest the shareholders' money in a basket of securities in an effort to produce returns equal to a published market index. Not all index funds with the same objective will produce the same results. They will be very close but not exactly the same. The single largest reason two similar index funds will produce different results are the fees of the fund manager. For example, the Smith Barney S&P 500 index fund (SBSPX) has fees of 0.59%, while the Vanguard counterpart (VFINX) charges only 0.18%. The total return on the two funds will most likely differ by the amount of those fees over time. Index fund managers also exhibit varying degrees of skill and diligence in controlling trading costs.

An alternative to the conventional mutual fund is an exchange traded fund, or ETF. An ETF is a mutual fund, but is structured and managed differently. Rather than being controlled by a manager that buys and sells stocks as money flows in and out, an ETF is traded out in the open market. If more investors are demanding ETF shares, a large broker dealer will deliver a basket of the component stocks to the ETF sponsor, who will then hand over some ETF shares for the broker to sell to clients. Large broker-dealers perform the task of gathering together the 500 stocks, not a fund manager.

For these and other reasons, the manager fees on ETFs are usually lower than their conventional cousins. The Vanguard 500 fund mentioned above has management fees of 0.18%, while the S&P 500 ETF product from Barclays, called iShares, has a fee of only 0.09%. ETF index investments do not generally result in a sizable payout of capital gains to shareholders. While most index funds pay out very little in the way of capital gains anyway, this is a small advantage in favor of ETFs.

While ETFs are tempting due to the lower annual fees and their marginally more favorable treatment of capital gains distributions, there are a few other things to consider.

First, ETFs are bought and sold like stocks. Even at a discount brokerage firm, it can cost \$20 or more to buy a block of ETF shares. If you add to your holdings in small amounts over time, these trading commissions will eat into your returns. Most index funds can be bought in small amounts directly from the fund companies for no extra charges or commissions.

A talented index fund manager can do a wonderful job with trade execution by buying and selling stocks aggressively and constantly seeking the best deal for the shareholder. Since stocks have to be bought and sold in the fund every day, the best fund managers will relentlessly seek the best deal. If the manager can buy a block of shares at a bargain, the benefits of that bargain price accrue directly to the fund shareholders. Managers can also lend some securities out to short-sellers in exchange for fees. This is where corporate culture matters and is why so many of us favor Vanguard.

On the other hand, the stocks underlying an ETF are bought and sold by brokerage firm arbitrage desks, *not* by someone acting as a *fiduciary* for the ETF shareholders. In the event a block of stock can be acquired at a bargain, the value of that bargain stays at the brokerage firm, and is used to pay bonuses to the arbitrage desk staff. It does not pass through to the ETF shareholder. Once again, we are reminded that the first rule of finance is that there is no free lunch.

My analysis of actual investment returns of a few conventional index funds versus their ETF counterparts shows that the ETFs have trailed their Vanguard twins in each of seven different index sectors I examined. This is despite the lower fees the ETFs charge in each instance.

When buying an index instrument for a long-term hold, I do not buy ETFs for myself or my clients. I believe that the good old-fashioned index mutual fund will produce better results over time.