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Financial Connections
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Investing in Index Funds

Ready at last. So you finally made it. You now have $5,000 to invest toward your long-term financial goals. You have already reduced your consumer debt to the point where you can pay each of your credit card balances in full each month. And you have built your cash savings to a level that can take care of most near-term emergencies. Now you are looking toward the more distant future and opportunities to build your wealth.

Choosing can be confusing. You could choose 100 shares of a few different stocks, but do you really have the expertise to evaluate individual stocks, and would the few selections you could afford give you the diversity needed to balance risk with reward? You could also invest in several mutual funds. These would be easier to judge given the amount of data available in popular financial magazines. But here too there are a lot to choose from, and many charge substantial fees for their purchase and management.

Index funds to the rescue. Index funds provide investors with a way to achieve the growth of selected markets without assuming the added costs and risks associated with actively managed funds that try to beat the market rather than meet the market. What this means is that you can invest in a whole market and receive the rewards of that market by investing in a fund composed of representative issues. For instance, you have probably heard of the Standard & Poor 500 as both a selection of 500 major stocks and the index that measures their performance. Through an S&P 500 index fund, you could invest in the performance of these 500 stocks with as little as $500 to $2,500 as your initial investment.

The risks and rewards of indexing. No mutual fund is without risk, but the risk of an index fund is the same as that associated with the whole of the market indexed rather than the success and failure of selected firms. To be sure, not every market makes money every year. For example, an S&P 500 index fund might have lost nearly 27% in 1974, but it would have gained 37% in 1975, and would have averaged about 10.5% per year since 1926.

How much any market and its representative funds return over time appears to be related to the assets involved. From 1960 to 1995, common stocks averaged 10.7% per year, while long-term bonds averaged 7.3%, and cash reserves averaged 6.1%.

Is indexing overrated? A recent issue of *Morningstar FundInvestor* said no, while citing the fact that only 5 percent of actively managed stock funds beat the S&P 500 index over the past five years. Also, the expense ratios associated with actively managed funds are typically 5 to 15 times higher than those of many index funds, due to the added research and transaction costs involved.

Varieties of indexes and index funds. Of the 89 index funds available, there are stock index funds, bond index funds, and some that include stocks and bonds. There are about 12 prominent stock indexes, which differ in terms of the size of the companies that are included and the market segment this represents. These indexes are familiar under such names as Standard and Poor, Morgan Stanley, Wilshire, and Russell. Lehman Brothers is the name associated with all five common bond indexes.

The 1998–99 edition of *The Individual Investor's Guide to Low-Load Mutual Funds* lists 29 index funds that charge either no or very low sales charges. Among these, 14 funds belong to Vanguard (800-635-1511), four to Galaxy (800-628-0414), three to Schwab (800-266-5623), and two to Dreyfus (800-645-6561).

Indexing does not eliminate risk. Index investing offers broad diversity, low expenses, and the opportunity for rewards in keeping with the performance standards all other funds try to meet or exceed. But remember, no mutual funds, indexed or otherwise, are insured, and all involve risk and possible losses. Proceed with the caution all your investments deserve.

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