

## **Chapter 12**

### **Investing in the Stock Market**

*Most investors, both institutional and individual, will find the best way to own common stocks is through an index fund that charges minimal fees.*

*Warren Buffet<sup>1</sup>*

### **The Indexing Alternative**

The stock market makes people wealthy, not complex strategies designed to beat the market. Why waste time and money trying to find a method that achieves superior returns when the return of the market does the job perfectly well? Investors who accept the return of the stock market are likely to achieve their financial goals sooner and safer than beat the market strategies.

Mutual funds are the most practical way for investors to participate in the stock market. There are two types of funds, *active* and *passive*. An active fund manager attempts to select securities based on their belief that the portfolio they create will deliver superior returns over the market. One example of an active fund is the Fidelity Magellan fund. Its goal is to beat the S&P 500 stock index. A passive fund manager tries to match the performance of a market by purchasing stocks in the same weightings as the market. Overwhelmingly, passive funds perform better than active funds. An example of a passive fund is the Vanguard Index 500 fund. It is designed to match the performance of the S&P 500.

### **The Performance of Active and Passive Funds**

*The market is full of people who think they can [beat it] and full of other people who believe them.*

*Daniel Kahneman*

The evidence is conclusive and overwhelming; passive stock funds achieve higher returns than active funds. There are always exceptions, but this fact cannot be denied for a vast majority of active funds. One reason active managers perform poorly is the inherent cost of picking stocks. Most fund companies hire large analyst staffs, which cost a lot of money. That cost must be passed on to investors in the form of management fees that are five to six times higher than a passive fund, which does not require stock analysts. In addition, active managers buy and sell securities much more often than index fund managers, increasing the trading costs of the funds they manage.

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<sup>1</sup> Warren Buffet, *Berkshire Hathaway 1996 Annual Report*, pg. 16

Why do people pay the extra cost of active funds? Many investors choose higher cost active mutual funds because they are lead to believe the people running the fund have superior stock picking ability and can make up the difference in cost plus extra. Unfortunately, most investors who pay attention to detail are disappointed with the results of their active funds. In the end, the fund managers do not make up the extra fees, and they certainly do not earn an extra return over the index.

Table 1  
**Return of General US Equity Funds  
 Ten Years Ending December 31, 1997**

	<b>Cumulative Rate</b>	<b>Annual Rate</b>
<b>Wilshire 5000 Equity Index*</b>	392.4%	17.3%
<b>Vanguard 500 Index Fund</b>	399.1%	17.8%
<b>Average General Equity Fund</b>	323.1%	15.5%

\*Wilshire 5000 less .30% to reflect an index fund  
 Source: Lipper Analytical Services

The lower return of an active fund could be justified if the risk of ownership was lower or there was a tax advantage, but neither is the case. The risk of owning active funds, as measured by monthly volatility, is about the same as the Wilshire 5000 index. So active funds are not “safer” than index funds. On an after-tax basis, the returns of most active funds are far lower than index funds. The average general equity fund distributes about five times the taxable income as a comparable index fund. From all aspects, costs, taxes, and performance stock index funds are the best way to capture the return of the stock market.

### *Who Uses Index Funds?*

Large public pension plans and insurance companies have been using stock index funds for many years. The first index account was opened in 1974 by the *Samsonite Corporation* and managed by *Wells Fargo Bank*. The account attempted to equally weight all the stocks on the New York Stock Exchange. This means buy all the stocks in the same amount rather than according to their value. The strategy was difficult to manage, and the fund was eventually changed to indexing the S&P 500 according to market weightings. Using a market weighted strategy, the largest companies represented most of the fund and the smaller companies in the index were of far lesser value. Over the next few years, market weighted indexing became a main theme at Wells Fargo, and several large corporations started to convert their actively managed account to the less costly indexing alternative.

Index funds were not available to individual investors until 1976, when John Bogle of the Vanguard Group introduced the first public S&P 500 index fund. It was not an immediate success. The popular press bashed Vanguard for starting an index fund, and active fund companies laughed at the idea.

Fidelity's Chairman Ed Johnson scoffed at the concept. He insisted that the name of the game is to be the best, and the great mass of investors would not be satisfied with "just market returns". How times change. Today, Fidelity offers a wide and growing range of stock and bond index funds.

Marketing was difficult for the fledging Vanguard 500 Index Fund in 1976. It had low management fees and a very small advertising budget. At first, the fund was offered through stockbrokers. But the sales commission offered to brokers by Vanguard was not up to the level of other mutual fund companies. So, the brokers ignored the fledging index fund. After that miserable experience, Vanguard cut the brokerage firms off and established a direct no-sales charge distribution system. That meant spending more on advertising and distribution, which put the fund further behind schedule.

Word of the new Vanguard 500 fund spread slowly at first, mostly by word-of-mouth. Vanguard took enough in to survive, and by the mid-90s, the fund was thriving. In 1999, the Vanguard 500 fund was vying for the top spot as the largest mutual fund in the country, second only to the Fidelity Magellan fund. Still, less than 10% of the money in the stock index funds belongs to individual investors, and large institutions like banks and insurance companies control over 90%.

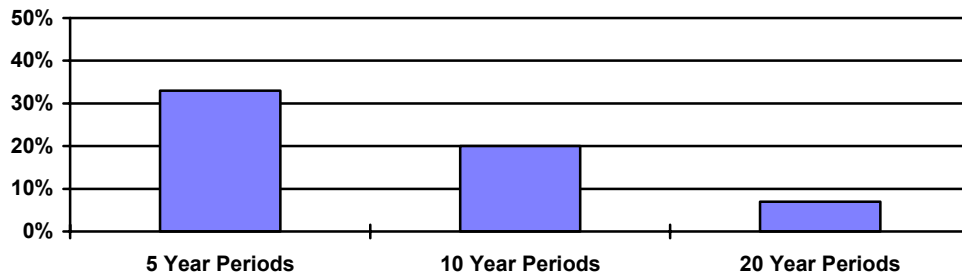
### *Structuring a Portfolio of Index Funds*

A few years ago only a handful of index funds existed, and it was impossible for individual investors to develop a complete index fund portfolio. Times have changed. The number of index funds has grown by popular demand. As of this writing, there are over 265 index funds covering a wide variety of markets, including small-cap stocks and International markets. The wide availability of index funds has made most active management obsolete. Investors can now build portfolios of index funds that cater to their individual need without the hassle of trying to pick the next superstar fund. A portfolio of index funds is low cost and it eliminates the need to chase the hot dot. Thus, an indexing strategy helps shrink the performance gap between market returns and investor returns.

### **The US Stock Portion**

The structure of the US stock market can be broken down by market capitalization. The largest and most successful companies in each industry make up the S&P 500 index, i.e. General Electric, Coca Cola, Microsoft. These companies have market values ranging from roughly seven billion dollars to several hundred billion. The S&P 500 companies made up over 70% of the entire stock market in 1998.

**Chart#1**  
**Percent of Active Large-cap Funds that Beat the Vanguard 500**  
**1976 - 1998**



Source: Morningstar Principia

The remaining 30% of the US stock market is made up of mid-cap and small-cap stocks. Companies with values between one billion and five billion are considered mid-cap stocks and account for roughly 20% of the market. The remaining 7000 or so small-cap stocks make up the final 10% of the market. Investors can purchase each segment of the market through a specific index fund, or they can purchase the entire market in the correct proportion through a total stock market index fund.

Indexing the US stock market has another inherent advantage called *style diversification*. Typically, stocks are divided into two broad styles, growth and value. Growth stocks include Microsoft and American Online and value stocks include companies like John Deere and Exxon. Index funds capture all styles of stock, so there is no need to chase a hot investment style. This helps reduce the performance gap.

### *One Fund Does it All for US Stocks*

One mutual fund can cover all your US stock investments. A *total stock market index fund* mirrors the performance of the Wilshire 5000 index, which is a complete composite of all actively traded US stocks. About 70% of the Wilshire 5000 is made up of large stocks and the remainder is in small to mid-size stocks.

There are several advantages to purchasing a total stock market fund. The management fee is minimal and turnover of stocks in the fund is exceptionally low. This fund reduces the desire for investors to chase the hot dot, since they already own all the dots. The low turnover of stocks in the fund is also good for taxable accounts because it delays capital gains. If I were to choose one US stock fund for a lifetime, it would be a US total stock market fund.

There are several total stock market funds on the market. The oldest is the Vanguard Total Stock Index Market fund. Competitors include the T. Rowe Price Total Stock Market fund and the Fidelity Total Stock Market fund. Other mutual fund companies are introducing total stock market funds in the near future.

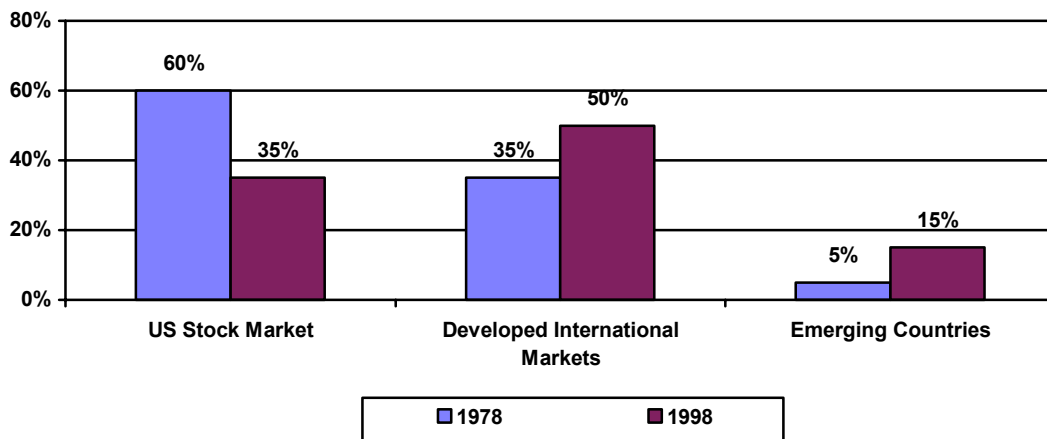
### **Indexing Global Equity Markets**

Since we live in the US and pay our bills in US dollars, it only makes sense to have a significant portion of our stock money in US stocks. In fact US stocks should make up about 70% of a portfolio. The other 30% should be invested in International stock market index funds.

The US market is one part of a growing global stock market. In fact, the US market is becoming a smaller portion of the global market every year. In the early 1970's the US stock market accounted for 60% of the value of all stocks traded around the world. By 1998, the US portion of the global market dropped to 35%. The growth in value of International stock markets occurred even though the US stock market went up ten-fold since the 1970's. The US share of the global market will continue to shrink as major countries like China, Russia, and India privatize large government controlled companies.

Chart 2

### **Market Capitalization As a Percentage of the World Equity Market 1978 - 1998**



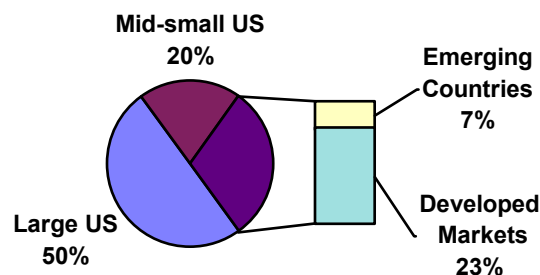
Investing in International stocks has several benefits. Over the long-term, global diversification proves to be an effective tool in reducing portfolio risk, which leads to slightly higher returns. It also gives you a hedge against a decline in the US dollar. About a 30% position in International equities rounds out a well diversified US stock portfolio. Some investors may prefer more or less in International stocks. Most research on this subject recommends between a 25% to 35% commitment. In either case, individuals

should participate in this growth by investing a portion of their retirement money in International index funds.

Generally, the international stock market is divided into developed markets, which cover countries such as Japan and Germany, and emerging markets, which cover growing economies such as Mexico and Korea. International Index funds are now available in a wide variety of those markets. You can invest in index fund specific to each market, or invest in the Vanguard International Stock Index Fund, which covers the entire spectrum.

Chart 3

### Suggested Global Index Fund Portfolio



### The Two Fund Portfolio

Every veteran of the military is familiar with the acronym KISS – *keep it simple stupid*. Indexing that portion of your portfolio devoted to stocks is a KISS strategy. By keeping it simple, you will achieve all the benefits the markets have to offer.

A portfolio of approximately 70% US index funds and 30% International index funds is an excellent lifetime portfolio for most investors, and there would be little need to change this mix over time. An investment in only two mutual funds can accomplish this goal. By placing 70% of your stock allocation in a Total Stock Market Index Fund and remainder in a Total International Stock Index Fund, no other stock investments are needed...ever.

Von Baron once said, “The way to win is by not losing”. Stock index funds are such a concept. By reducing the cost of investing and eliminating the desire to chase the hot dot, investors will greatly reduce the performance gap and greatly increase their retirement savings. It’s that simple.