PRIVATE ASSET MANAGEMENT, INC.
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This month, we are going use the Vanguard 500 Index Fund to review the merits of index funds. We are not dismissing the use of actively managed funds, just highlighting the positives of index funds.

Background

Per Vanguard's website: "The fund offers exposure to 500 of the largest U.S. companies, which span many different industries and account for about three-fourths of the U.S. stock market's value."

Low fees are a key characteristic of the Vanguard 500 Index Fund. Individual investors can buy this fund with an expense ratio of 0.04%, which compares to the 0.97% average expense ratio of actively managed mutual funds targeting the same companies.

Don't Think Average

The cost differential is crucial to the index fund's appeal. The math is simple. The average, actively managed fund's performance starts nearly 1% behind the index **every year** due to fees. Therefore, the stock picks of actively managed funds must beat the market by 1% each year just to compensate for fees.

Performance for the ten years ending March 31, 2019 highlights the performance advantage held by the index fund. Using data from Morningstar, a leader in mutual fund research, the Vanguard 500 Index Fund returned 15.9% per year while the average for like funds was 14.5% per year.

This probably overestimates the long-term performance gap. Bull markets usually favor index funds, plus some funds may not be true comparisons. However, even with some adjustments the idea that the index fund outperformed by 1% per year is both valid and supports the idea of not thinking average.

Tax Efficiency in Taxable Accounts

Mutual funds are required by law to pay out income and capital gains on a yearly basis. The Vanguard 500 Index Fund pays out income just like any other fund. Currently, this payout is roughly 2% per year. Tax treatment on this payout is no different than the tax treatment from the income paid out by an actively managed fund.

The tax efficiency aspect of the index fund comes from the capital gains part of the payout equation. By replicating the index, the index fund does minimal trading and doesn't generate capital gains. It appears that the Vanguard 500 Index Fund has not paid a capital gain for nearly 20 years.

An actively managed fund buys and sells its holdings more often. This creates the gains that need to be distributed and, in taxable accounts, need to have taxes paid on them.

Over time, this means that two funds could have the same pre-tax returns, but one fund, the index fund, would have higher after-tax returns. The difference can add up over time.

A final note on this topic. Technically, the index fund could pay a gain in the future. It appears the Vanguard 500 Index Fund paid gains in the late 1990s, plus it currently has unrealized gains in its portfolio. We doubt any gains in the near term would be significant if they occur, but we don't want investors believing the index fund will never pay out a capital gain.

Setting Realistic Expectations

Purchasing any index fund is, effectively, buying the market. By accepting market returns, the investor has a better chance of setting realistic expectations from which to plan their saving and spending habits. For example, assume you believe the S&P 500 will return 7% per year over the next 20 years. By indexing, you are not assuming that your 'special' mutual fund will return 9% per year over 20 years and, therefore, you don't have to save as much.

The same logic applies in retirement. You set realistic spending targets based on this portion of your portfolio returning 7% per year instead of assuming you can spend more because your 'special' fund will return 9% per year.

Reducing Unforced Errors

Vanguard's founder, Jack Bogle, talks about 'knowing what you own'. The Vanguard 500 Index Fund is comprised of the largest U.S. domiciled companies representing a wide variety of industries.

This knowledge of what you own could have been useful in the spring of 2009. The index fund's value decreased 37% in 2008. However, multiple, 'special' funds were down 45% to 55% in 2008.

Investors tended to sell some of these 'special' funds because they weren't sure what they owned, and they weren't sure if the fund would perform well again in the future. Performance for those that sold non-index funds in early 2009 likely suffered. By indexing, investors might have avoided this unforced error by believing that major U.S. companies would weather the storm.

Index funds have their merits. Performance, tax efficiency, setting realistic expectations, and reducing unforced errors are valid reasons for including such funds in your portfolio.

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