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**GETTING GOING**  
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## **Building a Winning Portfolio Of Index Funds Isn't Easy**

Index funds are almost guaranteed to win. But that still leaves plenty of room for error.

As many battle-scarred investors can attest, the humble index fund is tough to beat. These know-nothing funds simply buy the stocks that make up a market index, in an effort to replicate the index's performance. That turns out to be a winning strategy because most actively managed funds fare far worse, thanks to the hefty costs they incur.

Still, despite indexing's edge in performance, building a winning portfolio of index funds is no slam dunk. Here are four common mistakes:

### **Feeling Blue**

The most popular index funds are those that track the Standard & Poor's 500 index of large-company stocks. To understand why, just check out the performance of Vanguard Group's giant \$77 billion S&P 500 index fund. In the 1990s, it outpaced 75% of U.S. stock funds.

But that performance is deceptively good. While the Vanguard fund's indexing strategy clearly helped, the fund also got a boost from the heady returns of blue-chip stocks, which easily outran smaller companies and foreign markets in the 1990s.

What if large-company stocks don't shine quite so brightly in the decade ahead? S&P 500 index funds will still stack up well against actively managed blue-chip stock funds. But they may perform poorly compared with funds specializing in smaller stocks and foreign companies.

The implication: You need to buy more than just an S&P 500 fund. I would aim to build a portfolio of index funds that gives you exposure to large stocks, smaller companies, real-estate investment trusts, developed foreign stock markets, emerging stock markets and high-quality U.S. bonds.

## Lacking Commitment

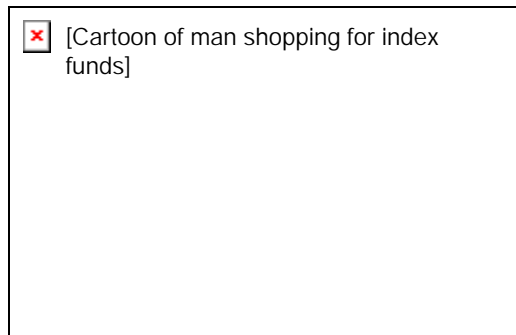
How much should you invest in each of these sectors? Within reason, it doesn't much matter. For instance, you might put as little as 10% of your stock portfolio in foreign stock index funds or as much as 35%. Similarly, you might stash just 5% in real-estate investment trusts or you could go as high as 15% in REITs.

But whatever percentages you adopt, it's critical you stick with them. Over 30 years, all sectors should generate fairly decent returns. But you won't collect those returns if you commit a big chunk of your portfolio to one sector and then panic and sell at the worst possible time. That's one mistake you desperately want to avoid.

What to do? Look to own a little bit of everything, so you get the reduced portfolio volatility that comes with broad diversification. But when settling on target percentages, be careful not to allocate more to a sector than you can stomach.

## Overpaying the Piper

Suppose you decide to invest half your stock-market money in an S&P 500 index fund. Which fund should you buy? One S&P 500 fund might seem pretty much like another. But in fact, there can be huge variations in the costs involved.



For instance, Vanguard 500 Index Fund Investor Shares charges just 0.18% a year, while the broker-sold Morgan Stanley S&P 500 Index Fund B Shares levies an eye-popping 1.5%. Indeed, according to Chicago's Morningstar Inc., there are 60 index-based funds with annual expenses of 1.5% or more.

Buying these high-cost index funds makes no sense. Index funds win by incurring lower costs than their actively managed competitors. If you give up that cost advantage, you are giving up one of the major reasons to index.

While Vanguard's S&P 500 fund has extremely low annual expenses, you might fare even better with iShares S&P 500 Index Fund, which charges just 0.09% a year. But there's a catch. The iShares fund is an exchange-traded index fund, which means you will incur brokerage commissions and other trading costs when you buy and sell.

Which is the best bet? If you plan to invest \$20,000 or more and let it ride for 10 years, iShares S&P 500 will probably leave you with more money. But if you are investing a smaller sum, your time horizon is shorter or you foresee adding regularly to your account, I would lean toward the Vanguard fund, because you

won't incur all the trading costs associated with exchange-traded funds.

#### Too Taxing

If you look at historical performance, index funds handily outpace most actively managed funds. That performance gap widens even further, once you figure in taxes.

Because index funds don't actively trade their portfolios, they tend to realize relatively few capital gains each year. That is good news for taxable shareholders, who have to pay taxes on any capital-gains distributions they receive.

Still, it is a mistake to assume you won't get large taxable distributions from an index fund. Unfortunately, even if you index, some investment styles almost inevitably lead to big taxable distributions, so you'll want to keep these funds in your retirement account.

"The first things you want to put in your retirement account are bonds and your REITs," says Art Canter, a financial planner in Boca Raton, Fla. "Next, you might put in your small-company stocks and after that your value stocks. Meanwhile, in your taxable account, you might buy your large-cap stocks and your large-cap international."

All the interest from your bond-index funds will be immediately taxable as income, so these funds are a clear candidate for your retirement account. Meanwhile, because REITs already get a corporate tax break on the dividends they pay out, most of their dividends won't be eligible for the new, lower dividend-tax rate. As a result, if you don't hold your REITs in a retirement account, you will have to continue to pay income-tax rates on the dividends you receive.

What about value-index funds, which buy stocks that are cheap compared with assets and earnings, and small-stock index funds? With both funds, you can get surprisingly large capital-gains distributions, because so many stocks graduate each year from the underlying indexes. Result? If you can, also try to hold these funds in your retirement account.

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