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Russell Wild, MBA

Author, *Exchange-Traded Funds For Dummies*
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FOR

DUMMIES®

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by Russell Wild, MBA



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About the Author

Russell Wild is a NAPFA-certified financial advisor and the principal of Global Portfolios, an investment advisory firm based in eastern Pennsylvania. He is one of few wealth managers in the nation who is both fee-only (takes no commissions) and welcomes clients of both substantial and modest means. Wild, in addition to the fun he has with his financial calculator, is also an accomplished writer who helps readers understand and make wise choices about their money. His articles have appeared in many national publications, including *AARP The Magazine*, *Consumer Reports*, *Men's Health*, and *Reader's Digest*. He also contributes regularly to professional financial journals, such as *Wealth Manager* and *Financial Planning*.

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The author grew up on Long Island and, after living in various places both in the United States and abroad (including France and Morocco), settled in Allentown, Pennsylvania where he lives with his two children, Adrienne and Clayton, along with Norman, the killer poodle. He spends much of his leisure time gardening, bicycling, rereading old Kurt Vonnegut novels, and whispering sweet little nothings in the ear of his partner, Brenda Lange, also a writer.

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Dedication

To Dennis, who in 1981 sold me 100 shares of the soon-to-go-bankrupt Continental Illinois National Bank and Trust Company. You were my first (and last) stockbroker, Dennis, and you taught me everything I ever needed to know about stock-picking.

Author's Acknowledgments

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New to the team, Ron DeLegge, publisher and editor of www.etfguide.com, was kind enough to do the technical editing, and he did it quite superbly. Check out Ron's syndicated *The Index Investing Show* on radio or podcast: www.indexshow.com. You'll find that I'm a guest on the show from time to time.

I'm very thankful to a number of smart and financially savvy colleagues, especially among my fellow fee-onlys of the National Association of Personal Financial Advisors (NAPFA), who provided helpful input and guidance. Several are quoted throughout the pages of this book.

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And I'd like to give special thanks to John Bogle, father of index investing, for his enormous contributions to the science of finance, the contribution he's made (indirectly only) to my own personal finances and those of my clients, and for so generously lending his time and expertise to this project.

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Contents at a Glance

<i>Introduction</i>	1
<i>Part I: The (Mostly) Nonviolent Indexing Revolution</i>	7
Chapter 1: What Indexing Is . . . and Isn't	9
Chapter 2: A Short History of the Index and Index Investing.....	19
Chapter 3: Why Indexing Works — and Works So Darned Well	33
Chapter 4: Why Everyone Isn't Indexing.....	45
Chapter 5: A New Era Begins: ETFs and Alternative Indexes	59
<i>Part II: Getting to Know Your Index Fund Choices</i>	73
Chapter 6: The Basic Index Investing Components.....	75
Chapter 7: Investing in Stock Indexes: Your Gateway to Growth.....	95
Chapter 8: Investing in Bond Indexes: Protecting Your Principal	133
Chapter 9: Diversifying Your Portfolio with Commodity, REIT, and Other Indexes	151
<i>Part III: Drawing a Blueprint for Your Index Portfolio</i>	171
Chapter 10: Finding a Happy Home for Your Money.....	173
Chapter 11: Developing Your Broad Investment Goals	185
Chapter 12: Fine-Tuning Your Index Selections	197
Chapter 13: Mixing and Matching Passive and Active Investing	209
Chapter 14: Making Your Final Investment Decisions	225
Chapter 15: A Bevy of Sample Index Portfolios.....	233
<i>Part IV: Ensuring Happy Returns</i>	245
Chapter 16: Buying and Holding: Boring, But It Really Works	247
Chapter 17: Seeking Additional Assistance from Professionals . . . Carefully.....	259
<i>Part V: The Part of Tens</i>	269
Chapter 18: Ten Ways to Deal with the Temptation to Beat the Market.....	271
Chapter 19: Ten Ways to Screw Up a Perfectly Good Index Portfolio	277
Chapter 20: Ten Q & As with John Bogle, Father of Index Investing.....	281
<i>Part VI: Appendixes</i>	287
Appendix A: A Select List of Index Mutual Funds	289
Appendix B: A Select List of Exchange-Traded Funds	297
Appendix C: Helpful Web Resources for the Smart Index Investor.....	315
<i>Index</i>	321

Table of Contents

Introduction 1

About This Book	1
Conventions Used in This Book	2
What You're Not to Read	3
Foolish Assumptions	3
How This Book Is Organized	3
Part I: The (Mostly) Nonviolent Indexing Revolution	4
Part II: Getting to Know Your Index Fund Choices	4
Part III: Drawing a Blueprint for Your Index Portfolio	5
Part IV: Ensuring Happy Returns	5
Part V: The Part of Tens	5
Part VI: Appendixes	6
Icons Used in This Book	6
Where to Go from Here	6

Part I: The (Mostly) Nonviolent Indexing Revolution 7

Chapter 1: What Indexing Is . . . and Isn't 9

Realizing What Makes Indexing So Powerful	10
Turning common investing knowledge on its head	10
Playing tennis — poorly — with your investments	11
Making gains by avoiding mistakes	12
Not All Indexing Is Created Equal	14
Picking your level of market exposure	15
Knowing that indexes have various recipes	15
Selecting what works best for you	16
Becoming an Ultra-Savvy Index Investor	16
Investing with realistic expectations	17
Becoming an enlightened (and just maybe rich!) index investor	17

Chapter 2: A Short History of the Index and Index Investing 19

The Dow Jones Industrial Average: Mother of All Indexes	19
The mechanics of the oldest existing index	20
Long-lasting popularity	20
Mama has a few shortcomings	20
The S&P 500: The Dow's Undisputed Number-One Son	24
New generation, new mechanics	26
The S&P today (still) rules the indexing roost	26

Beyond the Dow and the S&P	27
Indexes of various shapes and sizes	27
Indexing gone amok?	29
Growing Numbers of Fund Companies, More and More Indexing Options.....	29
Indexing goes institutional	29
Eating crow, and creating new funds	30
Chapter 3: Why Indexing Works — and Works So Darned Well . . .	33
Clocking Impressive Returns, Year after Year	34
Intermediate-term index fund performance results: Good!.....	34
Longer-term index fund performance results: Very good!	35
Indexing for Optimal Portfolio Leanness and Meanness	36
Keeping your costs to a minimum	36
Making your financial life more predictable.....	38
Allowing different — and distinct — baskets for your eggs.....	39
Smacking down Uncle Sam’s cut.....	39
Eliminating cash drag.....	40
Assuring greater transparency	40
Theoretical and Real-World Problems with Trying to Beat the Market.....	41
The average investor is very smart and educated	42
Market rigging is rampant.....	43
Chapter 4: Why Everyone Isn’t Indexing	45
Worshipping Wall Street.....	46
Hiding the fees on financial statements	47
Pumping short-term performers.....	48
Tuning In (Tuning Out) the Circus on Television.....	50
Making market calls.....	50
Headlining what’s hot.....	51
Patting themselves on the back.....	52
Delving Deep into the Human Psyche.....	54
Picking darlings, fixating on numbers	55
Keeping track of your own performance	56
Chapter 5: A New Era Begins: ETFs and Alternative Indexes	59
Expanding the Indexing Universe.....	60
Introducing the new kid on the block	60
Tracking indexes that you never knew existed.....	60
Tracking indexes that never existed before	61
Making Sense (or Nonsense) of the Old and New	62
Examining the tried and true.....	62
Grasping weightings and valuations	62
Introducing newer variations (and variations on variations).....	63
Figuring Out Fundamental Indexes and Beyond.....	65
Promoting the uncertain with a positive spin.....	65
Getting even with equal-weighted indexes	66
Creating seemingly sociable screened indexes	67

Turning the world upside down with inverse indexes..... 68
 Keeping hands completely off with unmanaged indexes 68
 Say, can you really call this an index?!..... 69

Part II: Getting to Know Your Index Fund Choices..... 73

Chapter 6: The Basic Index Investing Components 75

Riding the Index Vehicle 76
 Investing collectively through mutual funds..... 77
 Putting your money into the more modern ETF 79
 Facing off: Mutual funds versus ETFs..... 80
 Spotting Rare Birds in the Index Investing Forest..... 82
 Exchange-traded notes (ETNs) 82
 Unit investment trusts (UITs) 82
 Meeting the Major Index Makers 83
 Standard & Poor’s 83
 Dow Jones/Dow Jones Wilshire 86
 Lehman Brothers 87
 MSCI Barra 88
 Russell 90
 Getting to Know Some of the Secondary Teams 91
 FTSE 91
 Morningstar 92
 Dimensional 92
 WisdomTree 93

Chapter 7: Investing in Stock Indexes: Your Gateway to Growth 95

Understanding the Whys and Wherefores of Stock Investing 96
 Distinguishing individual stocks from stocks in the aggregate 96
 Separating the two kinds of risk 97
 Appreciating past performance 98
 Taking a cautionary approach 98
 Investing in Stocks the Right Way 99
 Choosing Wisely among Many Stock Index Funds 101
 Home of the brave: Broad U.S. stock market index funds 101
 Microsoft and McDonald’s: Large cap U.S. stock index funds 106
 Small is beautiful: Small cap and micro cap index funds..... 109
 C’est bon: Developed world index funds 112
 A calculated risk: Emerging-market stock index funds 116
 Value and growth: Slicing the cake with style funds 117
 Energy, technology, health care, and more: Splitting
 the pie by industry sector..... 126
 Exploring the Outer Limits of Indexed Stock Investing 127
 Socially conscious stock index funds: Putting your
 money where your heart is 127
 High dividend funds: Wanting cash in hand..... 129
 Leveraged and inverse “indexing”: Taking a gamble..... 129

Chapter 8: Investing in Bond Indexes: Protecting Your Principal . . . 133

Getting a Handle on What Bonds Are and Why You Want Them.....	134
Traveling into bondland.....	134
Recognizing the many different breeds of bond.....	135
Keeping your expectations realistic.....	137
Buying bonds for the right reasons.....	137
Banking on predictability.....	139
Entering the World of Bond Index Funds	140
Finding a good bond mutual fund.....	142
Buying a fixed-income exchange-traded fund	145
Mixing and Matching Bonds and Stocks with an All-in-One	
Index Fund	148
Choosing the static option	148
Considering the variable options	149

Chapter 9: Diversifying Your Portfolio with Commodity, REIT, and Other Indexes 151

Panning for Gold with Commodity Investments.....	152
Protecting your portfolio from storms	153
Assessing the commodity index options.....	155
Holding Property in Your Portfolio with Real Estate Investment	
Trusts (REITs)	156
Understanding the true nature of REITs	158
Choosing REIT funds that will work best for you	159
Knowing how much to invest in REITs.....	164
Investing — or Not — in Some Truly Unorthodox Indexes.....	165
Cashing in on currency quackery	165
Doing like the rich: Investing in private equity (sort of)	166
Making a preference for preferred stock.....	167
Covering calls with the buy/write index.....	168

Part III: Drawing a Blueprint for Your Index Portfolio 171**Chapter 10: Finding a Happy Home for Your Money 173**

Knowing What's Important and What's Not.....	174
Sorting through apples and oranges	174
Allowing your specific investments to guide you.....	175
Choosing the Financial Supermarket That Best Meets Your Needs	176
The Vanguard Group	176
Fidelity Investments	178
Charles Schwab.....	179
T. Rowe Price.....	180
TD Ameritrade.....	181

Zecco 182
 Dimensional Fund Advisors (DFA) 182
 Other discount brokers..... 183
 What, No Index Funds in Your 401(k)? 183
 Rolling Over Your Retirement Plan 184

Chapter 11: Developing Your Broad Investment Goals 185

Understanding Asset Allocation 186
 Setting basic parameters for a sensible portfolio..... 187
 Viewing asset teamwork in action 187
 Zeroing in on your optimal percentages..... 190
 Determining How Much You Need to Have . . . and Save 191
 Employing the 20x rule..... 192
 Using retirement calculators 192
 Understanding Monte Carlo simulations 193
 Knowing the limitations of even the best
 retirement calculators 194

Chapter 12: Fine-Tuning Your Index Selections 197

Expanding Your Geographic Horizons 198
 Considering correlation 199
 Going regional, not national 200
 Choosing Large and Small, Value and Growth Stocks 202
 Sizing up the difference between large and small 202
 Tallying up the difference between value and growth..... 203
 Putting the Stock Side of Your Portfolio Together 205
 Factoring in your personal connection to the markets 205
 Adding up your options 206
 Fixing Your Fixed-Income Side of the Portfolio 206
 Reframing the reason for bonds 207
 Zeroing in on safety first, returns second..... 208

Chapter 13: Mixing and Matching Passive and Active Investing . . . 209

Using Active Strategies That Borrow from the Wisdom of Indexing 210
 Seven rules for investing in actively managed funds 211
 Ten actively managed funds that fit the bill..... 213
 Spotting Irrational Despondency, and Tilting Your
 Portfolio Accordingly 222
 Discovering the secrets of tactical asset allocation 223
 Fine-tuning your portfolio tilting skills..... 223

Chapter 14: Making Your Final Investment Decisions 225

Making the Choice between Mutual Funds and ETFs 226
 Tallying up your costs..... 226
 Adding up your total numbers 227
 Avoiding the itch to rapid trade 227
 Planning to pay less in taxes 228

Deciding between Traditional Indexes and Fundamental Ones	228
Favoring a newer approach	228
Hugging onto the tried and true	229
Who do you believe?	230
Should You Time Your Entry into the Markets?	230
Taking the plunge	231
Living with your decision	231
Counting the Number of Funds You'll Be Buying	231
Trading off diversification for ease and economy	232
Deciding between one index and many	232

Chapter 15: A Bevy of Sample Index Portfolios 233

Investing with Small Change: Choosing an All-in-One ETF	233
Sticking to the Simple and Easy	234
A sleek and sexy ETF portfolio	235
A sleek and sexy (mostly) index mutual fund portfolio	236
Formulating a More Complex Index Strategy	236
Going for glory: Building an aggressive index portfolio	237
Aiming for growth: Creating an aspiring but not too aggressive portfolio	239
Taking few chances: Erecting a (mostly indexed) portfolio with limited volatility	241
Your Personal Nest Egg	243
Looking over your financial situation carefully	243
Positioning your portfolio correctly	244

***Part IV: Ensuring Happy Returns* 245**

Chapter 16: Buying and Holding: Boring, But It Really Works. 247

Keeping Your Eyes Firmly on the Future	248
Disaster-proofing your portfolio	248
Ignoring the hoopla and hype	249
Rebalancing on a Regular Basis	250
Using the calendar to keep your portfolio on an even keel	250
Adjusting your portfolio on an as-needed basis	251
So which method of rebalancing is best?	251
Tweaking Your Allocations as the Years Go By	252
Bucking the common wisdom	252
Entering the golden years	253
Gauging Economic Trends	254
Considering price/earning (P/E) ratios	254
Noticing the interest yield curve	256
Respecting reversion to the mean	256

Noting Positive Changes in the Indexing Industry 257
 Costs, costs, costs 257
 Diversification opportunities 257

**Chapter 17: Seeking Additional Assistance
 from Professionals . . . Carefully 259**

Sizing Up Your Need for a Helping Hand 260
 Assessing your knowledge and interest 261
 Assessing your wealth..... 261
 Asking Where the Money Comes From..... 262
 Finding out how the advisor expects to be paid 262
 Eliminating biases that could harm you 263
 Using free services from a brokerage house 263
 Sifting Through the Alphabet Soup 264
 Looking up investment advisor John Doe, AAMS, AWMA,
 AFC, ETC 264
 Checking for competency and criminality..... 265
 Shopping for the Best Advisor in Town..... 266
 Finding an index kind of guy or gal..... 266
 Asking the right questions, and getting the right answers..... 267

***Part V: The Part of Tens*..... 269**

**Chapter 18: Ten Ways to Deal with the
 Temptation to Beat the Market 271**

Turn Off the TV 272
 Ask Yourself Who Is Doing the Pushing — and Why 272
 Google the Past 272
 Remember the Rule of Appropriate Benchmarks 273
 Understand the Ratings Claims 273
 Watch Out for Expiration Dates 273
 Recognize Random Success 274
 Pull Out Your Calculator..... 274
 Recognize That Someone, Somewhere Is Betting Against You 274
 Review the Facts 275

**Chapter 19: Ten Ways to Screw Up a
 Perfectly Good Index Portfolio 277**

Chase Hot Sectors 277
 Take Inappropriate Risks..... 278
 Invest in Nonsense 278
 Pay Too Much to the Fund Company..... 278
 Fail to Change with the Times..... 279

Put the Wrong Funds in the Wrong Accounts	279
Allow Yourself to Get Eaten Alive by Little Charges	279
Get Scared and Head for the Hills	280
Pay Too Much for Investment Advice.....	280
Obsess.....	280
Chapter 20: Ten Q & As with John Bogle, Father of Index Investing	281
<i>Part VI: Appendixes</i>	287
Appendix A: A Select List of Index Mutual Funds	289
Appendix B: A Select List of Exchange-Traded Funds	297
Appendix C: Helpful Web Resources for the Smart Index Investor	315
Web Sites with an Index Investing Focus	315
General Investing News, Advice, and Education	316
Financial Supermarkets	317
Index Fund Providers: Exchange-Traded Funds.....	318
Index Fund Providers: Mutual Funds	318
Stock Exchanges	319
The People Who Create the Indexes	319
Best Retirement Calculators	319
Where to Find a Financial Planner.....	320
The Author Himself . . . At Your Service.....	320
<i>Index</i>	321

Introduction

So you want to be an index investor. Or perhaps you want to be a *better* index investor. This book is for you — but not for you and you alone. Even an index-investing agnostic has plenty of reason to read *Index Investing For Dummies*. You see, the lessons of index investing — lessons learned since the first index funds were introduced about 35 years ago — are extremely important to *all* investors.

Index investing — investing in entire markets or segments of markets, rather than trying to cherry-pick securities — is the financial world’s equivalent of Seward’s purchase of Alaska, Henry Ford’s horseless carriage, or milkshake-machine salesman Ray Croc’s little hamburger stand called McDonald’s. It is a stellar example of something that was expected by nearly everyone (including the alleged high wizards of finance) to be a miserable flop, and yet, by almost any measure imaginable, wound up a rave success.

This book explains why index investing has been such a rave success and, more importantly, how you can harness the power of index investing to work for you.

About This Book

By the time you have spent a few hours — pleasurable hours, I certainly hope — thumbing through the following pages, you’ll know a lot about index investing, even more than some professional investors. For right now, I’d like to bring home just a few of the virtues of index investing that will make reading this book more than worth your while:

- ✔ **Versatility:** Index investing gives you the opportunity to build a portfolio that is well-diversified, extremely low-cost, and fine-tuned to your particular needs. Are you an aggressive investor looking for exposure to small cap stocks, real estate investment trusts (REITs), or commodities? Are you a conservative investor more content with blue chip stocks, U.S. Treasury bonds, or high-grade municipal bonds? It doesn’t matter. Indexing allows for all flavors of investment.

- ✔ **Profitability:** Study after study shows that if you invest in index funds or predominantly index funds, your long-term returns are very likely to far exceed those of most of your neighbors' with their actively managed mutual fund portfolios or individual stock and bond picks. In fact, the odds of an actively managed (cherry-picked) portfolio beating an index portfolio are extremely slim. (I know! I know! You'd think that picking cherries would give you cherry-like returns. Index investing, admittedly, can be as counterintuitive as taking a hot bath to cool off on a steamy August day.)
- ✔ **Taxability:** Without any question, index investors who buy and hold their index funds (the preferred way to invest in indexes) pay far less to Uncle Sam than do those with mutual fund portfolios, or portfolios of rapidly changing stock holdings. That situation is almost certain to continue to be the case regardless of whether the Democrats or Republicans take control of the White House or Congress, or which football team wins this year's Super Bowl.
- ✔ **Simplicity:** You can build a portfolio of index funds that will keep you bobbing merrily along in good times and still stay afloat in bad times — and you won't need anything more than this book to do it. In fact, you'll be better off allowing your subscriptions to *Easy Money* magazine and the *Fast Bucks* financial newsletter to lapse. This book, a simple handheld calculator, and patience are about all you need to be a successful investor.

Ready for more?

Dummies books, such as this one, are written so that you can either plow through from beginning to end or, if you prefer, jump from chapter to chapter. Feel free to look through the index (yes, *Index Investing For Dummies* has an index!) for subjects of special interest.

Conventions Used in This Book

To help you cruise the pages of this book as smoothly as can be, I use the following conventions, probably familiar to all veteran readers of books *For Dummies*:

- ✔ Whenever I introduce a term that is at all jargonish, such as, say, *standard deviation* or *efficient frontier*, the term is set (as you can clearly see) in *italics*. Expect to find a definition or explanation to quickly follow.
- ✔ If I want to share some information that, juicy as it may be, isn't absolutely essential to profitable index investing, I plop it into a *sidebar*, a darkish rectangle or square with its very own heading, set apart from the rest of the text. (See how smoothly this italics/definition thing works?)
- ✔ All Web addresses appear in `monofont`; that makes them easy to find if you need to go back and locate one in a jiffy.

Keep in mind that when this book was laid out, some Web addresses may have been broken across two lines of text. Wherever that's the case, rest assured that we haven't put in any hyphens or other thingamabobs to indicate the break. When using one of those broken Web addresses, just type in exactly what you see in this book. Pretend as if the line break doesn't exist.

What You're Not to Read

Unless you're going to be taking a test on index investing, you probably don't need to know everything in this book. Sometimes, I include some fairly technical information that you don't have to know in order to be a very successful index investor. Or I include some tangential info that you may find interesting but that won't really affect your ability to be a successful index investor. In both cases, I tuck this material neatly into the sidebars. Feel free to stop and peruse them, or jump right past and keep moving with the main topics. It's your choice!

Foolish Assumptions

If you're just beginning your education in the world of investments, perhaps the best place to start would be *Investing For Dummies* by Eric Tyson (published by Wiley). But the book you're holding in your hands is only a grade above that one in terms of assumptions of investment knowledge and background. I assume that you are bright, that you have at least a few bucks to invest, and that you know some math (and maybe a wee bit of economics) — that's it.

In other words, you don't need a degree of any sort or years of portfolio management to be able to follow along. Oh, and for those of you who are already fairly savvy investors, perhaps even skilled at building a portfolio of index funds, I'm assuming that you, too, can learn quite a bit by reading this book. (Oh, you know it all, do you? You may know that international stocks have limited correlation to the U.S. stock market, but do you know which kinds of international stocks have the lowest correlation, and so provide the most powerful diversification? You will after reading Chapter 7!)

How This Book Is Organized

Here's a rough idea of what your eyes will be feasting on in the following pages, laid out juicy part by juicy part.

Part I: The (Mostly) Nonviolent Indexing Revolution

What is an index, and how did index funds — baskets of investments that attempt to track indexes — come to pass? Who were the key players, and what motivated them to swim against the strong stream of convention? In this first stop in our adventure, I guide you through a short history of indexing and walk you through the years to the present. You see how indexing has changed over time — in some ways for the better, and in other ways, maybe not. You get a better sense of what makes indexing such a potentially powerful investment tool and how to best wield that tool.

Next, you meet and greet *exchange-traded funds* (or portfolios): the latest (and in some fashions, greatest) way to build an index portfolio. An exchange-traded fund is something of a cross between a mutual fund and a stock, and as of this writing there are more than 700 of them to choose from.

If you have a great sense of curiosity, or a technical bent, this part ends with a discussion of the nuts and bolts of how indexes are actually constructed, and how that construction may make some indexes better foundations for investments than others.

Part II: Getting to Know Your Index Fund Choices

In the second part, this black-and-yellow book starts to get intensely practical. You get a full primer on the differences between the two major choices for index investing: the time-honored mutual fund and the newer and flashier exchange-traded fund. I introduce you to the major indexes on which so many of these funds are based, as well as some of the more obscure indexes. And we look at the people behind the indexes — the builders: who they are, and how much you can trust them.

I give you lots of examples of the different kinds of investments that are commonly indexed: stocks, bonds, and commodities. In each category of investment, you find popular index funds (both the best and the worst) compared, contrasted, and thoroughly evaluated. There's a veritable smorgasbord of index funds out there, but do you know which are the healthiest pickings?

Part III: Drawing a Blueprint for Your Index Portfolio

Continuing along in the practical vein of Part II, this part is where I introduce the recipes for mixing and matching index funds to form the ultimate portfolio. (No, a single index fund probably won't do it.) I talk about brokerage firms, where you'll be housing your index funds. I talk about how many funds you'll need and in roughly what quantity. I talk about what to do if you like the idea of index investing but don't want to limit yourself entirely to index investing. (That's okay, really! There's not a law against it.) I show you how to build a "mixed-marriage" portfolio.

For dessert, I serve up some sample portfolio pies, examples of real portfolios using index funds, or primarily index funds, that you can use as models for your own well-tailored investing strategy.

Part IV: Ensuring Happy Returns

An index portfolio that's just right for you today may no longer be appropriate a decade from now. Things change: your age (alas), health, income, expenditures, and number of kids in college, for example. A portfolio must change along with them. In this part, I outline what kinds of maintenance ensure a smooth-running, age-appropriate, profitable portfolio for years to come.

If you are a do-it-yourselfer, the information you garner in Chapter 16 is essential. If you prefer someone to hold your hand, Chapter 17 reviews the various kinds of financial professionals that you might engage — and those you are probably best off not engaging.

Part V: The Part of Tens

This standard feature in all *For Dummies* books rounds out your index-investing education with a couple of fun but practical lists, plus an interview with the undisputed Father of Indexing, and the man who probably knows more about it than anyone on the planet, John Bogle, founder of Vanguard.

Part VI: Appendixes

In this part, I provide handy-dandy lists of the major indexers and index fund providers, as well as very helpful resources for further information about index investing.

Icons Used in This Book

Throughout the margins of this book, you find cute little drawings in circles. In the *For Dummies* world, like in the cyberworld, these are known as *icons*, and they signal certain notable things going on in the accompanying text.



Although this is a practical book, you also find some chit and some chat. Any paragraph accompanied by this icon, however, tends to be chitless and chatless — just pure, unadulterated practicality.



The world of index investing — although generally not as risky as some other kinds of investing — still provides plenty of opportunity to get whumped. Wherever you see the bomb, know that money can be lost by ignoring the adjoining advice.



Read carefully! This icon indicates that something really important is being said and is well worth reading twice to allow your noggin to soak it up.



Wall Street is full of people who make money at other people's expense. Where you see the pig face, know that I'm about to point out an instance where someone (perhaps even someone calling himself a proponent of index investing!) may be digging his plump fingers into your pockets.

Where to Go from Here

Where would you like to go from here? If you would like, start at the beginning. If you're mostly interested in, say, stock index funds, you are free to jump right to Chapter 7. Bond index funds? Go ahead and jump to Chapter 8. Commodities? Chapter 9. It's entirely your call. Maybe start by skimming the index at the back of the book.

Part I

The (Mostly) Nonviolent Indexing Revolution

The 5th Wave

By Rich Tennant



"I asked my investment advisor for something that was low cost, easy to manage, and also functions on its own. He suggested an index fund or a robo vac."

In this part . . .

These first five chapters guide you through the history of indexing from its advent through the modern era. You discover the reasons that index investing makes so much more sense than trying to pick cherries or time the markets. You come to understand why index investing was so controversial from the start — and probably always will be! You find out why the great, unwashed masses don't index — and probably never will. (In short, they aren't as smart as you are, and they are more susceptible to Wall Street's propaganda and the silly ramblings of the financial press.) And you are brought up to speed on some recent changes in indexes and index funds that have really changed the nature of index investing forever — in some ways for the better, in some ways, for worse.

Chapter 1

What Indexing Is . . . and Isn't

In This Chapter

- ▶ Discovering the origin of the index fund
 - ▶ Appreciating the power of passive investing
 - ▶ Getting a glimpse at what makes indexing work
 - ▶ Avoiding the mistakes of the masses
 - ▶ Becoming a truly savvy index investor
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When John Bogle started The Vanguard Group in 1974 and shortly thereafter introduced the first index fund available to the unwashed masses, the brokerage industry and financial press were less than supportive. In fact, the entire venture was slathered in mockery. “Bogle’s Folly,” it was called. “Un-American” . . . “A sure way to achieve mediocrity.”

Ha!

Bogle wound up getting the last hearty laughs. (You’ll find an intimate discussion with this undisputed Father of Indexing in Chapter 20.) Vanguard Investments is today the largest fund company in the United States. A majority of its stock and bond funds are still index funds. Those index funds have gazillions of dollars in them and long-term track records that put most other funds to shame.

Index investors, with Vanguard and other fund companies, have more than prospered over the past 35 years as the science of indexing has emerged as perhaps the surest way to achieve outsized investment results. While other investors (so-called *active* investors) are busy year-in and year-out metaphorically punching and kicking each other silly, index investors (sometimes called *passive* investors) stand calmly on the sidelines, reaping consistently far greater rewards.

You are about to discover why that is so, how we know it is so beyond any shadow of a doubt, and how you can take “Bogle’s Folly” and use it to build the leanest, meanest, smartest portfolio possible. You are also about to find out how a number of pinstriped Johnnies-come-lately (part of the mixed blessing of the exchange-traded fund phenomenon) have terribly complicated the index-investing landscape, making it more important than ever to do your investing homework.

Realizing What Makes Indexing So Powerful

If index investing is nothing else, it is counterintuitive. Without any difficulty whatsoever, I can fully understand why just about the entire brokerage industry and financial press in the mid-1970s thought it was bound to be a flop.

Prior to the mid-1970s, people thought that love beads were cool and bell-bottoms were hip. They also thought that the road to investment success was to be had by hiring a professional manager who could beat the markets. Such a manager, with his freshly minted Harvard MBA, would use fancy algorithms, mile-long formulas, and inside information that no one else could harvest in order to pick individual stocks that would outshine all other stocks. Such a financial wizard could move money in and out of the market at just the right time to catch every ascent and avoid every decline. That was the belief.

Many people — most people, in fact — still believe that such “active management” is the way to win at investing. But prior to 1974, *everyone* believed it. That was before John Bogle came around and anyone bothered to study the matter. (A few academic papers on indexing were written prior to Bogle, and there was even some dabbling at the institutional level by Wells Fargo and American National Bank of Chicago, but the populace was kept in the dark, and the funds’ popularity didn’t go far.)

Turning common investing knowledge on its head

One of the first studies to raise eyebrows and seriously question the status quo came from a guy named Charles D. Ellis, who happens to be a Harvard MBA himself. In 1975, he conducted a study of the markets and mutual