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- Use index funds to secure your retirement
- Understand returns and risk
- Apply winning strategies for long-term investing

Russell Wild, MBA

Author, Exchange-Traded Funds For Dummies *and* Bond Investing For Dummies

Index Investing 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.*

The author or coauthor of two dozen nonfiction books, Wild's last works, prior to the one you're holding in your hand, were *Bond Investing For Dummies* (Wiley, 2007) and *Exchange-Traded Funds For Dummies* (Wiley, 2007). Before those, he wrote *The Unofficial Guide to Getting a Divorce* (Wiley, 2005) along with attorney Susan Ellis Wild, his ex-wife — yeah, you read that right. No stranger to the mass media, Wild has shared his wit and wisdom on such TV shows as *Oprah, The View, CBS Morning News,* and *Good Day New York,* and in hundreds of radio interviews.

Wild holds a Master of Business Administration (MBA) degree in international management and finance from the Thunderbird School of Global Management in Glendale, Arizona (consistently ranked the #1 school for international business by both *U.S. News and World Report* and *The Wall Street Journal*); a Bachelor of Science (BS) degree in business/economics magna cum laude from American University in Washington, D.C.; and a graduate certificate in personal financial planning from Moravian College in Bethlehem, Pennsylvania (America's sixth-oldest college). A member of the National Association of Personal Financial Advisors (NAPFA) since 2002, Wild is also a long-time member and currently serves as president of the American Society of Journalists and Authors (ASJA).

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.

Wild's Web site is `www.globalportfolios.net`. His e-mail is `Russell@Globalportfolios.net`.

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

This is the third book for me in the Dummies series, and I've had the pleasure of working with the same great team each time. The team includes the very talented and pleasant Joan Friedman, project editor, and the gregarious and also pleasant Marilyn Allen, my agent. It also includes Stacy Kennedy, acquisitions editor, and a host of other really good editorial, production, and marketing people at Wiley.

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.

Thanks, too, to the very helpful staff at Morningstar, especially Mark Komissarouk, and at the Vanguard Group, especially Rebecca Cohen, for sharing their excellent research.

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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We're proud of this book; please send us your comments through our Dummies online registration form located at `http://dummies.custhelp.com`. For other comments, please contact our Customer Care Department within the U.S. at 877-762-2974, outside the U.S. at 317-572-3993, or fax 317-572-4002.

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Contents at a Glance

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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 though 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

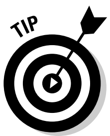
This standard feature in all *For Dummies* books rounds out your index-investing education with a couple of fun but practical lists, plus an interview with the undisputed Father of Indexing, and the man who probably knows more about it than anyone on the planet, John Bogle, founder of Vanguard.

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

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 gadzillions 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