

Making Everything Easier!™

Index Investing

FOR

DUMMIES®

Learn to:

- Add index investments to your portfolio
- Use index funds for asset allocation
- Understand returns and risk
- Apply winning strategies for maximum profit

Russell Wild, MBA

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



Index Investing For Dummies®

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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.

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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

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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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