The Motley Fool

Index Funds vs. Mutual Funds

Here's the difference between index funds and mutual funds and why an index fund will almost certainly be a better investment than an actively managed mutual fund.

Jordan Wathen

Aug 27, 2016

Confused by the complex assortment of fund choices? I can help.

Funds are generally broken down into two categories, index funds and mutual funds. These terms are used colloquially to refer to the underlying goals of each fund type.

Index funds can be mutual funds or ETFs that track an index, such as the S&P 500 Index. Mutual funds typically refers to actively managed funds that seek better performance than a market index from professional stock picking. The types of funds can be summarized by the table below.

Fund Type	Annual Expense Ratio	Objective
Index fund	Very low (0.11% on average)	Match an index's return before fees
Actively managed fund	High (0.84% on average)	Beat the index's return after fees

DATA SOURCE: AVERAGE FEES FROM THE INVESTMENT COMPANY INSTITUTE.

What's the difference?

The difference largely comes down to the goals of the fund. By definition, an index fund simply seeks to generate returns that are equal to the returns of an index minus fees. For example, the Vanguard 500 Index Fund ETF (NYSEMKT:VOO) is designed to track the returns of the S&P 500 Index, which is generally made up of 500 stocks that represent the American economy and stock market at large.

Instead of employing analysts to find good stocks, the Vanguard fund simply buys the 500 stocks in the S&P 500 index and holds them in proportion to their importance in the

index. Matching an index is naturally very inexpensive, which allows Vanguard to pass on the lower costs in the form of lower fees. The Vanguard fund's historical performance approximates that of the S&P 500 Index, minus the fund's annual fee of 0.05% of assets.

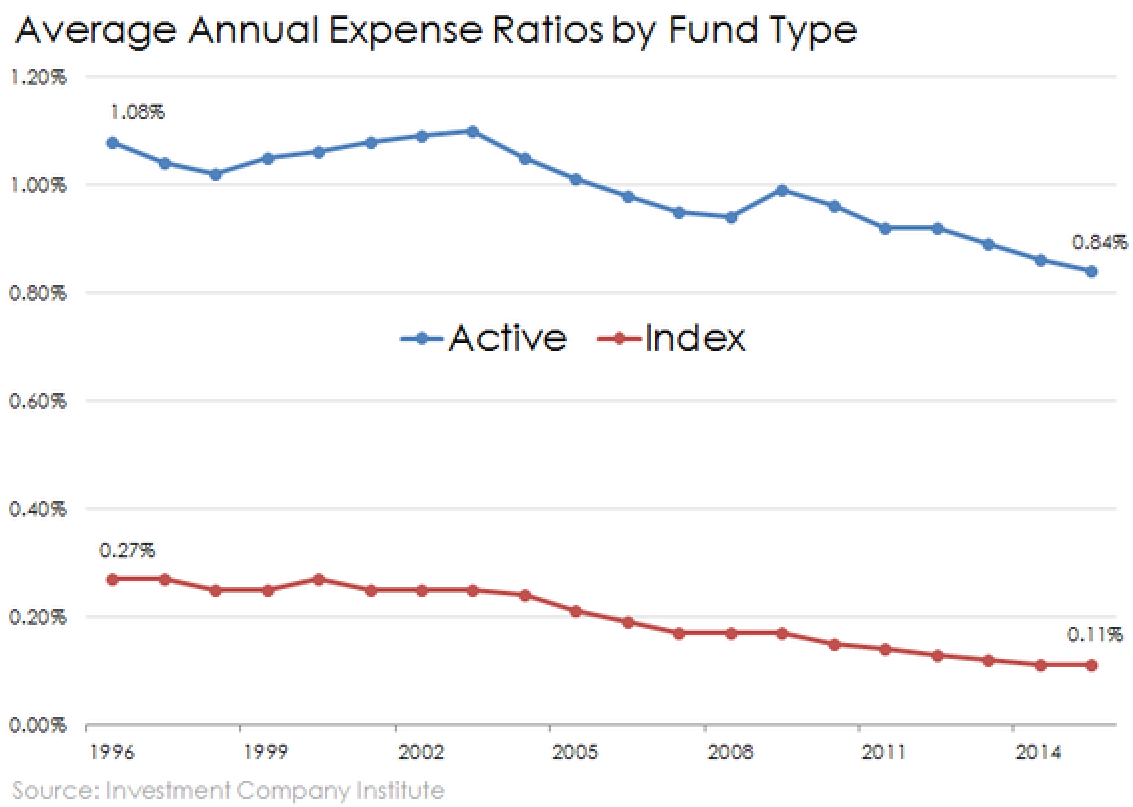
Fund or Index	1-Year Annualized Return	3-Year Annualized Return	5-Year Annualized Return
Vanguard 500 Index Fund ETF	7.32%	12.18%	16.67%
S&P 500 Index	7.37%	12.23%	16.71%
Difference	0.05%	0.05%	0.04%

DATA SOURCE: MORNINGSTAR.

There are, of course, all kinds of index funds. Index funds that track the S&P 500 (large-cap stocks), Russell 2000 (small-cap stocks), and the Total Stock Market Index (all stocks in the United States) are the most popular. But index funds can also track "niche" indexes, like silver mining stocks, dividend-paying stocks, or even something as far out as Nigerian stocks. (Most retirement plans only allow you to invest in simple plain-vanilla index funds, however.)

Actively managed mutual funds employ professional stock pickers and aim to generate market-beating performance. These funds can be categorized as having a higher cost of ownership due to the additional overhead expense associated with paying for professional stock analysts.

The Investment Company Institute found that the average actively managed stock fund carried an expense ratio of 0.84% of assets in 2015, compared to index funds' average expense ratios of just 0.11% of assets annually.



A common argument in favor of actively managed mutual funds is that they can outperform stock market indexes by picking good investments. Indeed, star managers such as Peter Lynch crushed the performance of the stock market average over their lengthy careers. But for every market-beating manager, there are several more managers who underperform.

An analysis by Morningstar in 2015 found that fewer than 22% of large-cap stock funds beat the market over the 10-year period from 2005 to the end of 2014. Fees, of course, play the primary role in underperformance. Fewer than 10% of the highest-cost large cap stock funds beat the market, while nearly 30% of the lowest-cost large cap funds did so.

The primary takeaway is that actively managed funds have a very high bar standing in the way of market-beating performance. Since 1871, the S&P 500 Index has returned about 9% annually. Thus, with an average fee of 0.84%, an actively managed mutual fund would need to generate a 9.84% annual return just to match the returns of an unmanaged stock market index.

Some actively managed mutual funds will earn their pay and generate returns that beat the market average over the next five-, 10-, and 20-year periods. But picking these funds is more difficult than it may seem, and basic laws of mathematics tell us that fewer than half will achieve market-beating returns after fees are taken into consideration. For this reason, the average investor is perhaps better served to simply take the average return minus a very small fee by investing in an index fund over an actively managed mutual fund.