Index Funds: Why Choose Anything Else?

This is a guest post from Mike Piper, who blogs at The Oblivious Investor*, where he reminds readers that investing doesn't have to be complicated or stressful. Mike is a long-time GRS reader and the author of* ***Investing Made Simple****.*

Like many other investors, J.D. and I are fans of taking the slow, sure path to wealth. We invest much of our money in index funds. An index fund is a low-maintenance, low-cost mutual fund designed to follow the price fluctuations of a broader index, such as the S&P 500 or the Wilshire 5000. They're boring investments, but they work. (If you're investing for the excitement, you're doing it for the wrong reason.)

Because of their low costs, index funds have been shown over and over to dominate the majority of their competition. Yet many investors shy away from index funds with the reasoning that "the stock market is too risky for me."

People seem to think that index funds are simply mutual funds that track the U.S. stock market. And that's not particularly surprising given that S&P 500 index funds are:

- the largest index funds,
- the index funds mentioned most frequently by the media, and
- the index funds most likely to show up as an choice in your 401(k).

But there are all kinds of index funds aside from those that track the S&P 500. There are bond index funds, real estate index funds, commodities index funds, international stock index funds, and so on.

In other words, **you can create a thoroughly diversified portfolio using nothing but index funds**.

In fact, I'd suggest doing exactly that. By created a diversified, all-index fund portfolio, you'll achieve a list of benefits relative to other types of portfolios.

Lower Risk
Which sounds safer: Having the stock portion of your portfolio invested in 10 different companies, or having the stock portion of your portfolio invested in several thousand companies from more than 10 different countries? I know some people disagree, but to me it's a no-brainer.

By constructing your portfolio from index funds, you'll achieve far greater diversification (and therefore be exposed to less risk) than you would if you constructed your portfolio from individual stocks and bonds.

Lower Costs
Both common sense and historical data tell us that one of the best ways to improve investment returns is to reduce costs. Conveniently, index funds carry significantly lower costs than actively managed mutual funds. For example:

- Vanguard's Total Bond Market Index Fund has an expense ratio of 0.22%. That's less than one-fourth of the average expense ratio among bond funds (1.04%, according to Morningstar's Fund Screener tool).
- Vanguard's REIT Index Fund has an expense ratio of 0.26%, or less than one-fifth that of the average real estate fund (1.45%).

It's quite possible that you could cut your total costs by 1% or more. And while 1% per year may not sound like much, it can really add up over an extended period.

Lower Taxes
Index funds have much lower portfolio turnover than other mutual funds. (That is, they buy and sell investments within their portfolios far less frequently than actively managed funds do.) This makes them more tax efficient than other mutual funds for two reasons:

- The capital gains they distribute are primarily long-term in nature (and thereby taxed at a lower rate than short-term capital gains), and
- Their capital gains distributions are minimized, meaning that you get to defer a significant portion of taxes until you sell the fund.

Added Bonus:
You'll understand what you own. With an actively managed mutual fund, you never know exactly what the fund manager is investing in. With index funds, it's all out in the open.

Do you (like both me and J.D.) have a portfolio made up primarily of index funds? If not, why? Is there a particular concern that's holding you back?

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