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Index-Fund Investing

Whenever I write a column about stock-market investing, my mail swells. Although I am not licensed by the SEC to hang out my shingle as a guru of finance, widowers write asking for advice on which stocks to buy.

Not all the letters are admiring. A bad word for gold usually brings in reproof from South Africa and the Rocky Mountains. Revealing the sad truth that front-end loads are hard to justify does not add to one's popularity among stockbrokers. Nor do money managers like to be reminded that their over-all record in security selection has been significantly worse than that of a non-managed "index fund," which merely holds virtually all of the stocks that go to make up the Standard & Poor's 500 Composite Stock Price Index.

When I was writing last April's column on "Investment Secrets," I knew that the wealthy investor or the corporate pension plan could utilize the Wells Fargo Bank of California, or the American National Bank and Trust Co. of Chicago, or the Batterymarch Financial Management Corp. of Boston to engage in prudent across-the-market index investing. But I had then to report, sadly, that:

"As yet there exists no convenient . . . fund that apes the whole market, requires no load, and that keeps commission turnover and management fees to the feasible minimum. I suspect the future will bring such new and convenient instrumentalities."

A BETTER MOUSETRAP?

Where there is a demand, Nature will find a way. Sooner than I dared expect, my implicit prayer has been answered. There is coming to market, I see from a crisp new prospectus, something called the First Index Investment Trust.

It seems to meet four of my five prudent requirements:

- It is available for the person or family of modest means—with $1,500 to $1 million or more.
- It proposes to match most of the S&P 500, eliminating only the smaller firms and those that might raise certain difficulties for any fiduciary. (Example: if a W.T. Grant is about to go into bankruptcy, those who invest other people's money feel they must shun it.)
- Being essentially unmanaged, its management and total expense charges will be only about two-tenths of 1 per cent of net asset value—perhaps only about a quarter that of the usual mutual fund or bank trust department.
- The commissions frittered away in turnover should be extremely low for such an indexed fund.
- Best of all, such an indexed fund gives that broadest diversification needed to maximize mean return with minimum portfolio variance and volatility.

CAVEATS

A professor's prayers are rarely answered in full. This is not a no-load fund. Right off the top of your modest nest egg comes 6.01 per cent in the form of a front-end load to cover selling costs. (If you have more than $1 million to invest, the load drops to 1.06 per cent.)

Good ideas, like bad ones, are not bought. Apparently they have to be sold. And that costs money. In my view a front-end load should be incurred—if at all—only by those who intend to hold some minimal fraction of their wealth in common stocks for enough years to amortize the deadweight initial cost.

If you are under the illusion that you can out-time the market—making a killing on a Carter election victory or defeat, or being able to sell out just before the next recession begins—one of the less diversified no-load funds is your optimum medium.

In buying an index fund, you also give up the illusion that, at some future date, you will be able to boast around the club swimming pool of the tenfold gain you've been able to make in picking stock-market winners. Broad diversification rules out extraordinary losses relative to the whole market; it also, by definition, rules out extraordinary gains.

An index fund is not immune to market risk. If the whole market goes down, your index fund will go down with it.

What each prudent investor must do is to decide what fraction of savings he can afford, in this age of inflation, to keep in equities and in other things. An unmanaged, low-turnover, low-fee index fund is merely an efficient way of holding that part deemed appropriate for equities. As such, it may appeal to the canny.