Chapter One

A Parable

The Gotrocks Family

Even before you think about "index funds"—in their most basic form, mutual funds that simply buy all the stocks in the U.S. stock market and hold them forever—you must understand how the stock market actually works. Perhaps this homely parable—my version of a story told by Warren Buffett, chairman of Berkshire Hathaway Inc., in the firm's 2005 Annual Report—will clarify the foolishness and counterproductivity of our vast and complex financial market system.

Once upon a Time . . .

A wealthy family named the Gotrocks, grown over the generations to include thousands of brothers, sisters, aunts, uncles, and cousins, owned 100 percent of every stock in the United States. Each year, they reaped the rewards of investing: all the earnings growth that those thousands of corporations generated and all the dividends that they distributed.* Each family member grew wealthier at the same pace, and all was harmonious. Their investment had compounded over the decades, creating enormous wealth, because the Gotrocks family was playing a winner's game.

But after a while, a few fast-talking Helpers arrive on the scene, and they persuade some "smart" Gotrocks cousins that they can earn a larger share than the other relatives. These Helpers convince the cousins to sell some of their shares in the companies to other family members and to buy some shares of others from them in return. The Helpers handle the transactions, and as brokers, they receive commissions for their services. The ownership is thus rearranged among the family members.

To their surprise, however, the family wealth begins to grow at a slower pace. Why? Because some of the return is now consumed by the Helpers, and the family's share of the

* To complicate matters just a bit, the Gotrocks family also purchased the new public offerings of securities that were issued each year.

generous pie that U.S. industry bakes each year—all those dividends paid, all those earnings reinvested in the business—100 percent at the outset, starts to decline, simply because some of the return is now consumed by the Helpers.

To make matters worse, while the family had always paid taxes on their dividends, some of the members are now also paying taxes on the capital gains they realize from their stock-swapping back and forth, further diminishing the family's total wealth.

The smart cousins quickly realize that their plan has actually diminished the rate of growth in the family's wealth. They recognize that their foray into stock-picking has been a failure and conclude that they need professional assistance, the better to pick the right stocks for themselves. So they hire stock-picking experts—more Helpers!—to gain an advantage. These money managers charge a fee for their services. So when the family appraises its wealth a year later, it finds that its share of the pie has diminished even further.

To make matters still worse, the new managers feel compelled to earn their keep by trading the family's stocks at feverish levels of activity, not only increasing the brokerage commissions paid to the first set of Helpers, but running up the tax bill as well. Now the family's earlier 100 percent share of the dividend and earnings pie is further diminished.

"Well, we failed to pick good stocks for ourselves, and when that didn't work, we also failed to pick managers who could do so," the smart cousins say. "What shall we do?" Undeterred by their two previous failures, they decide to hire still more Helpers. They retain the best investment consultants and financial planners they can find to advise them on how to select the right managers, who will then surely pick the right stocks. The consultants, of course, tell them they can do exactly that. "Just pay us a fee for our services," the new Helpers assure the cousins, "and all will be well." Alas, the family's share of the pie tumbles once again.

Get rid of all your Helpers. Then our family will again reap 100 percent of the pie that Corporate America bakes for us.

Alarmed at last, the family sits down together and takes stock of the events that have transpired since some of them began to try to outsmart the others. "How is it," they ask, "that our original 100 percent share of the pie—made up each year of all those dividends and earnings—has dwindled to just 60 percent?" Their wisest member, a sage old uncle, softly responds: "All that money you've paid to those Helpers and all those unnecessary extra taxes you're paying come directly out of our family's total earnings and dividends. *Go back to square one, and do so immediately.* Get rid of all your brokers. Get rid of all your money managers. Get rid of all your consultants. Then our family will again reap 100 percent of however large a pie that corporate America bakes for us, year after year."

They followed the old uncle's wise advice, returning to their original passive but productive strategy, holding all the stocks of corporate America, and standing pat. That is exactly what an index fund does.

. . . and the Gotrocks Family Lived Happily Ever After

Adding a fourth law to Sir Isaac Newton's three laws of motion, the inimitable Warren Buffett puts the moral of the story this way: *For investors as a whole, returns decrease as motion increases.*

Accurate as that cryptic statement is, I would add that the parable reflects the profound conflict of interest between those who work in the investment business and those who invest in stocks and bonds. The way to wealth for those in the business is to persuade their clients, *"Don't just stand there. Do something."* But the way to wealth for their clients in the aggregate is to follow the opposite maxim: "*Don't do something. Just stand there.*" For that is the only way to avoid playing the loser's game of trying to beat the market. When any business is conducted in a way that directly defies the interests of its clients in the aggregate, it is only a matter of time until change comes.

The moral of the story, then, is that successful investing is about owning businesses and reaping the huge rewards provided by the dividends and earnings growth of our nation's—and, for that matter, the world's—corporations. *The higher the level of their investment activity, the greater the cost of financial intermediation and taxes, the less the net return that the business owners as a group receive.* The lower the costs that investors as a group incur, the higher rewards that they reap. So to realize the winning returns generated by businesses over the long term, the intelligent investor will minimize to the bare bones the costs of financial intermediation. That's what common sense tells us. That's what indexing is all about. And that's what this book is all about.

Don't Take My Word for It

Listen to **Jack R. Meyer,** former president of Harvard Management Company, the remarkably successful wizard who tripled the Harvard endowment fund from $8 billion to $27 billion. Here's what he had to say in a 2004 *Business Week* interview: "The investment business is a giant scam. Most people think they can find managers who can outperform, but most people are wrong. I will say that 85 to 90 percent of managers fail to match their benchmarks. Because managers have fees and incur transaction costs, you know that in the aggregate they are deleting value." When asked if private investors can draw any lessons from what Harvard does, Mr. Meyer responded, "Yes. First, get diversified. Come up with a portfolio that covers a lot of asset classes. Second, you want to keep your fees low. That means avoiding the most hyped but expensive funds, in favor of low-cost index funds. And finally, invest for the long term. [Investors] should simply have index funds to keep their fees low and their taxes down. *No doubt about it.*"

In terms that are a bit more academic, Princeton professor **Burton G. Malkiel,** author of *A Random Walk Down Wall Street,* expresses these views: "Index funds have regularly produced rates of return exceeding those of active managers by close to 2 percentage points. Active management as a whole cannot achieve gross returns exceeding the market as a while and therefore they must, on average, underperform the indexes by the amount of these expense and transaction costs disadvantages.

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"Experience conclusively shows that index-fund buyers are likely to obtain results exceeding those of the typical fund manager, whose large advisory fees and substantial portfolio turnover tend to reduce investment yields. Many people will find the guarantee of playing the stock-market game at par every round a very attractive one. The index fund is a sensible, serviceable method for obtaining the market's rate of return with absolutely no effort and minimal expense."