Index Funds - A Good Way to Invest?

By Bob Adams
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Some investors have no desire or time to learn to evaluate individual companies. They prefer to spend their time on other activities. Index funds to the rescue! They are suitable for young people wanting to begin investing, as well as for those well on their way to retirement

Index funds are inexpensive to buy and own, grow at about the market average (a good return on average), and are as close to a set-and-forget type of investment as you can find. The S&P 500 has an average return of over 12% for the past 90 years. Another low-cost choice is Exchange-Traded Funds (ETFs). However, since a large number of these funds are available, choosing one sometimes becomes a chore.

Be aware that management fees charged by index funds vary, so ask questions before investing in them. Below is a list of S&P 500 index funds that <u>all invest in the exact same companies</u>. The costs vary from inexpensive to very expensive. Note the expensive brokerages charge over 2% in management fees while the inexpensive ones charge less than 0.2%. Over 40 years, that difference of 1.8% represents a very large sum of money you won't get to spend when you start making withdrawals.

Index 500 funds	Expense ratio	w/Load charges
Fidelity Spartan*	0.07%	None
Vanguard Admiral*	0.09%	None
Vanguard Regular	0.18%	None
T. Roe Price	0.35%	None
* Minimum investment and/or specified holding period		
Morgan Stanley	0.64%	1.40%
Wells Fargo	0.64%	1.39%
Evergreen	0.56%	1.31%
J. P. Morgan	0.53%	1.30%

The Little Book of Common Sense Investing—Bogle p128

What if your retirement investment is through a 401(k) or another type of retirement plan? Normally, it's no problem. Talk to the administrator of the plan and ask if index funds are available. If not, ask that they be added. The S&P 500 is one of the most recognized. A Total Market fund is another good choice. Also ask them to choose based on expenses.

Investing in equities, not bonds, is very important while you are growing a retirement account. Depending on your circumstances, the time to invest in bonds is a few years before retirement. Until then, growth is more important.

Five years before retirement, assuming the investment will be used for living expenses, consider moving sufficient money into a "ladder" of five bonds. Plan to have one bond mature in each of the next five years. This will provide a source of income, as well as safety. Invest in a new five-year bond every year as each bond in the ladder matures.

Generally, investors are advised to withdraw no more than 4.5% of the principal each year from a retirement fund. At that rate, you are not likely to run out of money before you run out of time.

A method of determining how much money you will need at retirement, based on a 4.5% withdrawal, is to divide the annual income required by 4.5% (0.45). For example, if you will need $50,000 annually for living expenses, your retirement account will need to equal a little over $1,000,000.

These suggestions make many assumptions that are general in nature and certainly are not for everyone. Individual requirements differ markedly. The purpose of this article is to provide some points to consider when planning your retirement investments.

One more crucial point: stay the course no matter what your investment choice.
A 20-year study ending in 2008 showed the S&P 500 increased in value 8.35%, while the average equity investor's portfolio grew only 1.87%. Why? Investors panicked during a market correction and sold. They repurchased their investments after the market recovered. That's buying high and selling low - not a good thing to do. Stay invested and you'll do well.

Who is *Bob?* I'm a volunteer for Better Investing, a non-profit organization with a goal to help educate investors; a former Director on the BetterInvesting® national Computer Group Advisory Board, and Director Emeritus for the Puget Sound Chapter of BetterInvesting in Seattle, Washington.