How to Buy an Index Fund

Cut through the clutter to find what's right for you

by Ryan Derousseau, **AARP**, January 18, 2022

It's a classic example of a simple thing gone crazy. In recent years countless financial experts have advised Americans to consider index funds — baskets of stocks or bonds that track the companies or investments that comprise market indexes — as a straightforward, low-cost, lower-risk way to invest without having to depend on a fund manager's luck or skill in picking winners.

So what happened? A massive proliferation of index funds.

Consider that there are 2,400 companies trading on the New York Stock Exchange and 2,500 U.S. index funds at latest count, according to the investment research firm Morningstar (some 60 funds tracking the popular S&P 500 stock index alone!). And although funds once focused on major indexes, such as those meant to represent all U.S. stocks or all non-U.S. stocks, hundreds of funds are now tracking narrow and sometimes obscure sections of the market, like natural gas distributors or water industry companies.

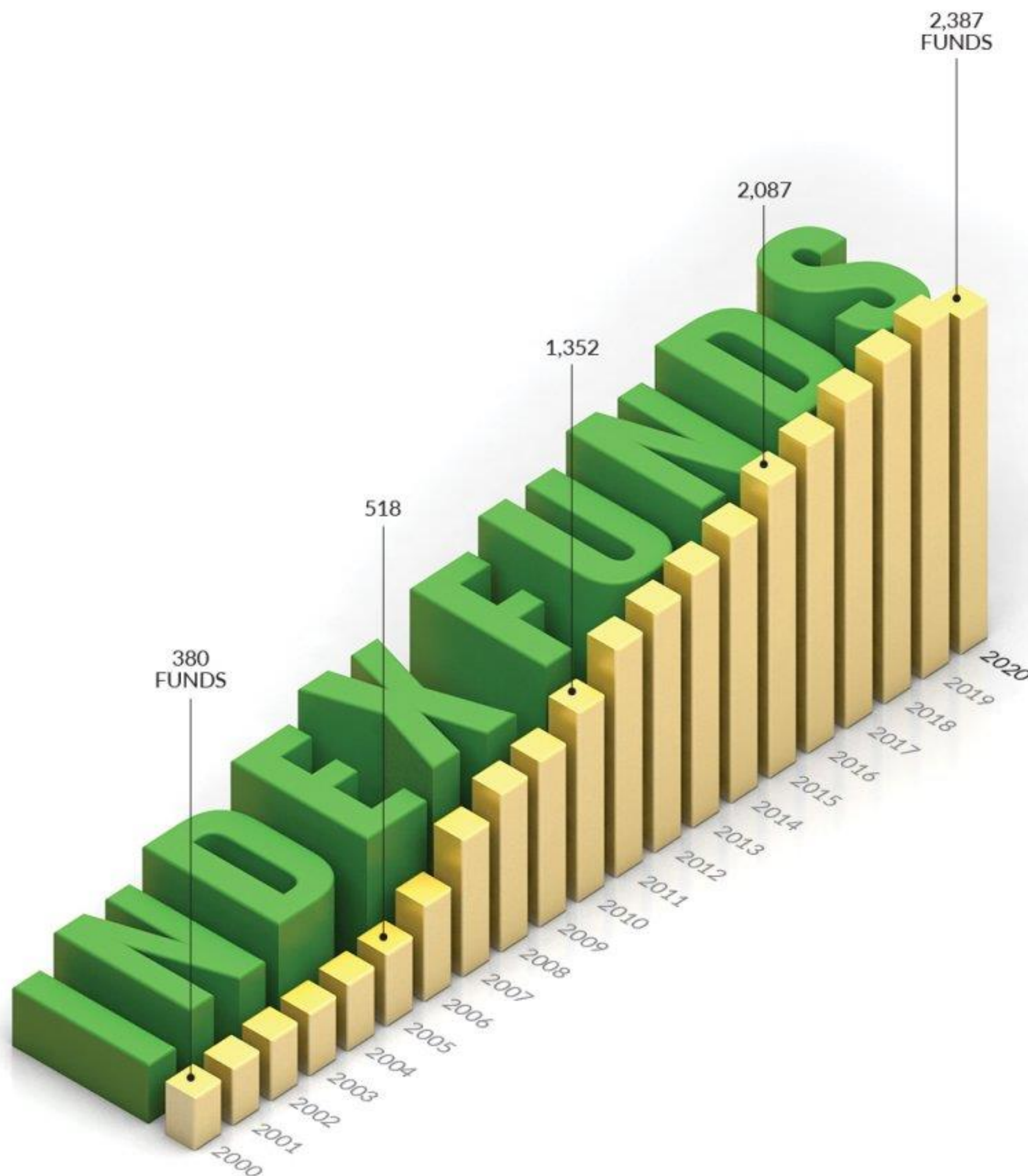
Total U.S. index mutual funds and exchange-traded funds as of end of 2020. Includes all U.S.-domiciled open-end funds and ETFs.

"Indexing has gone from evolution to pollution," says Rick Ferri, an investment adviser at Texas-based Ferri Investment Solutions. "Now everything has become an index."

Compounding the confusion: Traditional index funds are "passive," meaning that they don't require the active daily management by a professional stock picker.

(“Passive” may sound weak, but it isn’t; index funds have typically beaten the investment performance of most professional money managers while generally charging lower prices.) But now pros blur the lines by devising indexes, then launching funds that track the indexes they have helped create. They are dressing active strategies in index-fund clothing.

Given so many options and so little clarity, how do you pick the right fund or funds?



DATA FROM MORNINGSTAR; ILLUSTRATION, NICOLAS RAPP

Look for breadth

Lower your investment risk by buying funds that represent broad slices of the market, not narrow ones. An S&P 500 index fund, for example, contains stock shares of 500 of the largest publicly traded companies in the U.S. Other stock indexes cast even wider nets: You can buy a total U.S. stock market index fund, which gives you exposure to companies both big and small in a variety of industries, or even a total world stock market fund.

The narrower the index, the greater your risk. A fund that tracks only one industry or corner of the world can get walloped by a tiny bit of bad news that leaves the broader market unscathed.

Minimize fees

Two funds tracking the same index can charge you far different amounts, costing you thousands of dollars over time. "Get the one with the lowest cost," says Stephen Craffen, a senior planner at Atlas Fiduciary Financial in Oakland, New Jersey. Specifically, look for no-load funds, which don't charge a percentage of your upfront investment. Then select one that has a low expense ratio, which includes management fees and other costs of running the fund; you can readily find it on a fund's website or on any site with fund quotes.

The fine print matters. Last fall, for example, one S&P 500 index fund had an expense ratio of 0.02 percent, while another fund tracking the same index charged a much higher 1.65 percent. Imagine that you put $10,000 into each fund and the S&P returns 7 percent annually. Twenty years from now, you'd have $38,550 in the inexpensive fund but only $28,360 in the expensive one — a shortfall of more than $10,000.

Be tax-smart

Funds based on a particular index are often sold in two different forms, each with the same lineup of shares: a mutual fund and an exchange-traded fund (ETF). If you're buying inside a tax-sheltered account like a 401(k) or an IRA, either is fine. But if you're using a regular taxable account, buy the ETF, Craffen advises. Why? A mutual fund could expose you to capital gains taxes every year, even if you don't

sell any shares. But because ETFs and mutual funds are constructed differently, ETFs typically avoid capital gains until you sell.

Put it all together

You can build a diversified portfolio, Ferri says, by buying three simple funds: a total U.S. stock market fund, a total U.S. bond fund and a broad-based international fund. You can make this even simpler by buying a single balanced fund or target-date retirement fund that has underlying investments in both stock and bond index funds. Balanced funds typically allocate a fixed portion to stocks and bonds. The exact proportions in target-date funds depend on your age and risk tolerance. But as people near retirement, they tend to increase bond exposure to protect from stock market declines.

Ryan Derousseau has written for Forbes.com, Fortune, Money, Consumer Reports *and* Barron's.