Paul Merriman: 10 reasons brokers don’t like index funds

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As more investors turn to index funds, brokers and other fund salespeople continue to invent arguments favoring non-index funds, the kind they want you to buy. An index fund attempts to replicate the investment results of a target index by investing in all the securities in that index or in a portfolio that closely approximates it. An actively managed fund tries to beat the market by selecting stocks the manager hopes will outperform the index.

Here are ten bad arguments against index funds:

No. 1: Index funds provide only average returns.

This is true, but it’s a truth designed to fool you. Brokers know people want to buy things that are better than average. Index funds do give average returns. But there’s another average you should know about. In John Bogle’s “The Little Book of Common Sense Investing” he notes that the average U.S. equity fund compounded at 10 percent from 1980 through 2005, while the Vanguard 500 Index Fund made 12.3 percent. Actively managed funds did worse than average, not better as the brokers would have you believe.

No. 2: The Standard & Poor's 500 Index has grown less than 10 percent per year for the last five years. I am recommending funds that made 50 percent more than that.

So am I. The index grew at a rate of 9.1 percent for the five years ended May 28. The other index funds I recommend that focus on carefully selected U.S. and international equity asset classes grew from 13 percent to 29 percent in that same time frame.

No. 3: All the funds I recommend are rated 4 or 5 stars by Morningstar.

This argument plays on a very common misconception, that Morningstar’s ratings – which are based solely on recent comparative performance – are a guide to future performance. Morningstar itself says its rating of any fund “should not be considered a buy or sell recommendation.” Academics agree. They say you are most likely to own a future 4-star or 5-star fund if you buy index funds.

No. 4: Just like Tiger Woods in golf, the fund managers I recommend are the best and the brightest.

This is wrong. There is no evidence that there is a Tiger Woods of investing. There are managers who have achieved extended records of success followed by long periods of mediocrity. There are plenty of reasons for this. The top-performing fund manager of the 1970s, David Baker of 44 Wall Street Fund, was the lowest-performing manager of the 1980s. Even Warren Buffett may be past his best days. Over the past five years his performance has been only about half that of a diversified portfolio of index funds that invest in value stocks.

No. 5: The S&P 500 Index is good for part of your portfolio, but for higher returns you should add some more profitable funds.

Agreed. But the problem is what else you do in the portfolio. Loading up on actively managed funds that a salesperson hopes will beat the market is a high-risk ticket to mediocrity. Careful diversification in index funds is a much-lower-risk ticket to returns higher than most people achieve.

No. 6: There’s no such thing as a free lunch. You only get what you pay for.

The implication of this argument is that it’s in your best interest to pay more than you have to when you’re making an investment. This may be true of a lot of things we buy. But it’s dead wrong in investing. The truth is just the opposite: The more you pay, the less you have for yourself. John Bogle says it this way: “We investors as a group get precisely what we don’t pay for. So if we pay nothing, we get everything.”

No. 7: Managers who run regular mutual funds go to better colleges than index fund managers.

This makes my blood boil because it is so ridiculous. But I have it in writing from a broker who was trying to get a 42-year-old single mother to buy load funds instead of following my recommendation of Vanguard index funds. There is no evidence at all for this claim. And even if it were true, it wouldn’t mean a thing. Maybe active fund managers wash their cars more often, too.

No. 8: The Standard & Poor's 500 Index held onto Enron stock while it fell from $80 to $1 a share.

True enough. But many active managers were not only holding Enron but were also buying more as the price made it an increasingly tempting bargain in their eyes. Brokers like to use Enron as the example when they tell investors that index funds do nothing to protect investors from companies that go bad. But the truth is that owning shares in the dogs as well as the darlings of the market is one reason index funds are so successful.

No. 9: The S&P 500 Index does better than most other U.S. large-cap stock funds, but managers add real value in more inefficient markets like small-cap funds.

The evidence supports exactly the opposite view. Standard & Poor’s publishes an index of small-cap U.S. stocks and another of international stocks. Bogle says that over a recent five-year period each of those indexes outperformed about four out of every five funds in its respective category.

By this point you may be wondering why your broker doesn’t understand all this. I think Bogle nailed the answer: “It’s amazing how difficult it is for a man to understand something if he’s paid a small fortune not to understand it.” And that leads me to my final example in this list.

No. 10: If you invest in index funds, there’s nothing in it for me.

This argument puts the naked truth on the table: The broker is not really working for you. A broker may say something like: “If you want professional guidance you have to buy a fund that compensates me with a commission or other fees.”

I think that’s backwards. If you want objective guidance that isn’t swayed by sales commissions, you should pay an advisor separately for advice on choosing the lowest-cost funds that will be best for you. Depending on your needs, you may pay a one-time fee for one-time recommendations or an ongoing fee for continuing advisory help.

Regardless of whether or not you pay a sales commission, when you buy an actively managed fund instead of an index fund, you will pay higher expenses as long as you own the fund. This is not a good

way to pay a broker for investment advice -- and most of the higher expenses you pay will not go to the broker anyway.