S&P 500 Index Funds: The New Black?

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S&P 500 index fund investors are sitting very smug. Year to date, including dividends, they've enjoyed a 12.4% return. For the last five years these funds have returned on average nearly 16% annually.

These profits have soundly beaten bonds (up 5.2% this year and 4.2% annually for the last five) and overseas stocks (negative 1.5% year to date and only 5.1% annually for the last five). Moreover, investments in the domestic focused S&P 500 seem to sidestep two of the market's big bogeymen: The threat of higher interest rates and the weak, geopolitically challenged environment overseas.

What's more S&P 500 index investors feel smart that they are paying some of the lowest investment management fees on the planet. Fidelity's **Spartan 500 Index Fund – Advantage Class (FUSVX)** sports an expense ratio of just five basis points, meaning investors pay just 50 cents annually per $1,000 invested, a far cry from the actively managed equity fund average of close to 1.5%, or thirty times more.

S&P 500 investors also like the transparency of knowing exactly what their fund is composed of and the tax friendly low turnover approach.

No wonder that the scuttlebutt from cocktail parties to endowment committee meetings is simply to deploy our entire nest egg into an S&P 500 index fund. S&P 500 index funds are so trendy and popular that they are the equivalent of the "new black" in investment circles.

So, should you join them, and simply toss your nest egg into an S&P 500 index fund?

Bottom Line

As returns have soared investors have embraced S&P index funds, investing billions into them, even suggesting that these investment vehicles are the only ones needed, trumpeting their returns, simplicity, and low cost.

Although we like low costs, an S&P 500 only approach flunks a number of important tenets of investing, including diversification, a search for value, and tax management. Investors are better served by combining the best of the index funds traits, like low cost and infrequent trading, with a more value based approach over a more diversified range of investments.

Index Huggers Should Not Forsake Fixed Income

Even if you're an inveterate S&P 500 indexer, don't omit fixed income from your portfolio. Despite its relative underperformance, this is no time to abandon it.

Bonds may actually outperform going forward. This outcome becomes increasingly likely as stock valuations inflate.

Has that ever happened? Just look back to 2008, when the S&P 500 index fell 37% but the Barclay's Aggregate, the best known bond index, gained 5.24%.

But, that's just one year. How about a longer period? Actually, over the last 15 years the Barclay's Aggregate has trumped stocks, with a 5.56% average annual gain versus the S&P 500's 4.53%. And bonds had a lot less of a roller coaster ride.

Admittedly, given the current low yield environment the prospects for fixed income don't look that appetizing. The problem is, if yields rise, putting pressure on fixed income, equity investors will feel that same downward pressure.

Next time you hear about an investor tossing money into an S&P 500 index fund because "what else is there", think about what all those investors will do when indeed bond yields rise and there is something else there. It may not be pretty for equity index fund investors. Your risk is reduced if you own fixed income along with your index fund.

S&P 500 Index Fans Should Embrace Index Diversification

Using just one index, like the S&P 500, would not be optimal diversification and probably would not be the most profitable. The 500 is just that, 500 stocks out of some 7,000 stocks, and of course the US is just 30% of the world's stocks.

Examples of the groups of stocks to which the S&P 500 provides no exposure are small companies and overseas companies. Smaller companies have historically outperformed the larger companies in the S&P 500, while it's widely recognized that many areas of the world are growing faster than the US, have lower valuations and/or greater dividend yields. So, by incorporating more variety you could potentially enhance returns and reduce risk.

A concrete example is the first decade of this century. An S&P only portfolio would have returned just 1.4% per year. If, instead, you divided your money in fifths, over the S&P, US small stocks, US real estate stocks, international, and emerging markets (EM), you would have ended up with 8.3% annually.

This looks like a particularly opportune time to diversify over both international stocks and EM stocks. For example, the emerging market fund category has recently dramatically

underperformed the S&P, with EM funds down 5.7% this year and up just 3.1% annually over the last five, underperforming even fixed income.

To take advantage using an index approach, consider Fidelity's **Spartan Emerging Markets Index Fund – Advantage Class (FPMAX)**. This index fund sports an expense ratio of just 0.2%.

More importantly, the metrics (per Morningstar) on Fidelity's EM fund compare quite favorably to the S&P 500 index. EM's dividend yield is 3% versus the S&P's 2.3%. Prefer the EM's PE ratio of just 12 versus the 500's 17. EM's projected long term annual earnings growth is 11.8% versus the 500's 9.9%.

Bottom line, even if you stick with the index style of investing don't stick with just the S&P 500 index.

Market Cap Indexes's Big Flaws

In any event, investing by mimicking a market cap weighted index may over the long haul cause you to leave significant profits on the table. That's because in market cap weighting, the more expensive the stock, the greater the allocation of the index funds' dollars, while the cheaper the stock, the lesser the allocation. That's counterintuitive to most investing, which seeks to deemphasize the more expensive and the overpriced, while rotating into the less expensive, the bargains.

Over the last 15 years, S&P 500 index investors have been burned several times as a result of that market cap weighting. For example, in early 2000 the mania for tech/telecom had pushed those sectors to constitute about 37% of the 500 index, and the largest component, at nearly 6% of the index, was **Cisco Systems (CSCO)**, trading without any dividend and at 100 times earnings. Five years later the S&P was down 18%, dragged lower by tech stocks, off 60%, and Cisco, plunging 65%.

In sum, balance out your sectors and exposure despite what might be the popular, over weighted areas in the S&P. That will reduce risk and potentially enhance returns

Costs Matter but Should Never Be the Sole Motivator

It is true that S&P 500 index funds are the lowest cost funds. Just as you wouldn't buy a car that didn't meet your family's needs just because it was the cheapest, creating your investment portfolio simply on the basis of cost makes no sense.

For true cost savings, consider doing an end run around funds entirely by buying individual stocks and bonds. You can then customize your portfolio and pay no fund fees at all.

Moreover, holding your stocks individually as opposed to bundled within a fund gives you more control over the tax implications of your investing. You can make a choice on each stock whether to buy, sell or hold. That allows you to hold onto winners and exit losers to minimize taxes – or not. The point is you are in control, rather than a fund manager, who's in control only to the extent that fund holders stay invested.

Closed End Funds

Even S&P 500 index funds can't compete on a cost basis with discounted closed end funds. Closed end funds are professionally managed portfolios whose shares are traded on the stock exchange. Their shares can often be bought at double digit percentage discounts to the net asset value of their portfolios.

While closed end expense ratios are typically higher than the S&P 500 index funds', you'd have to hold the closed end fund for perhaps over a decade for the expense difference to offset the virtue of buying the shares at a big discount from net asset value.

In sum, the best traits of S&P 500 index approach – low costs, low turnover, and better transparency – can be employed with a more diversified group of index funds and individual stocks to better reduce risk, avoid over valued areas, enjoy greater control over your taxes, and potentially achieve superior returns.