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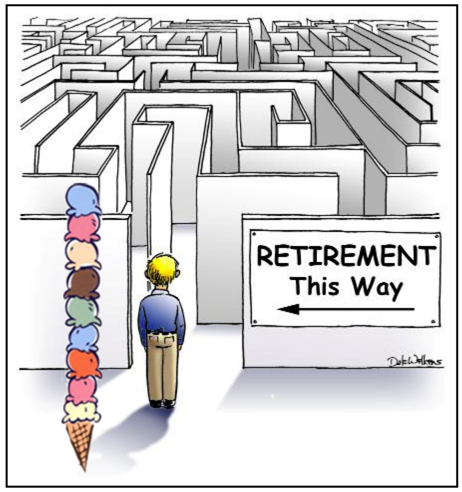
Index Funds: Look Beyond "Vanilla"

Navigating the Retirement Maze



Last month, I covered the importance of portfolio diversification as a way to reduce the risk of large losses and improve your long-term returns. This month, we'll look at how investors don't use index funds to their full advantage, and ways to improve upon this.

As most savvy investors know, indexing is a low cost way to acquire a portfolio of stocks or bonds. Statistics from SPIVA (S&P Indices Versus Active Funds) show that as of mid-year, nearly four out of five U.S. equity mutual funds were unable to beat their benchmarks over the previous three- and five-year periods. So unless you're exceptionally good (or lucky) at consistently picking winning mutual funds, indexing appears to be a better approach. But which index funds should you choose?

S&P 500: No "Blue Light Special"

When people ask me to review their existing portfolios, I mostly see S&P 500 index funds. The S&P 500 has had a great run the past two years, up over 42 percent. While our tendency is to extrapolate recent trends and assume that a rising market will persist, several measures indicate that this index has gotten overpriced.

One of the better long term market forecasting tools is the Shiller CAPE (Cyclically Adjusted P/E). Historically, when the CAPE has been at its current level, annual market returns over the next ten years have averaged only 3.5 percent. Additional evidence comes from Grantham Mayo van Otterloo & Co. (GMO), a Boston-based investment firm that is particularly good at long term forecasting. Their most recent assessment forecasts U.S. large cap stocks losing 2 percent annually (after inflation) for the next 7 years. Not exactly what you'd call a bull market.

What's Your Timeframe?

Investment suitability depends upon timeframe. No need to tap investments for 20-plus years? By then, the S&P 500 should have recovered its mojo and you might have respectable gains to show for your patience. But if you're going to start drawing down your investments within the next ten years, putting all of your equity eggs into one overpriced basket might not be such a good idea.

So which index funds offer you a chance at better gains over the next decade? Going back to GMO's 7-year forecasts, they show the best opportunities to be in emerging markets and high-quality U.S. stocks. Emerging markets tend to be volatile, but if you're investing for at least ten years, then the volatility won't matter as long as you stay the course. As for high quality U.S. stocks, index funds that screen for these types of stocks, as well as other subsets of the stock market that have a good chance of outperforming the overall market.

Many Flavors to Choose From

There is no rule that says you have to choose only one stock index fund for your portfolio. In fact, three or four will give you better diversification and may improve your overall return. Plus, since you can't know which one will perform the best in the long run, spread your bets around. Here are some index funds worth considering.

- **Emerging markets**: Funds from several fund families (VEIEX, FPMAX, SFENX) give you low-cost entry in this segment. Allocate 10 to 15 percent of your equity portfolio here.
- **Increasing dividend stocks**: I put these under the GMO category of "high-quality stocks." Research has shown that these stocks greatly outperform the pack over the long term. (See my June 2012 article for more details.) Vanguard provides two low-cost choices here (VDIGX, VDAIX). For international stocks, exchange traded funds (ETFs) PowerShares International Dividend Achievers (PID) and iShares International Select Dividend (IDV) are good options.
- **Value screens**: 2013 Nobel Prize recipient Eugene Fama pioneered the theory that small cap and value stocks tend to perform better over the long term, so you may want to consider index funds that screen for one or both of these. One that combines both screens is Vanguard Small-Cap Value Index Fund (VISVX). Want to go global? There are a number of funds (e.g., VTRIX, EVAL) that give you this option.

If your custodian offers ETFs, you have a broader range of choices as well as lower fees. Plus ETFs tend to be more tax efficient for funds not held in retirement accounts.

Be an Investing "Couch Potato"

Want to beat the pros? Put together a low-fee, diversified portfolio. Then shut off CNBC, ignore all economic news, glance at your portfolio several times a year and then rebalance it annually. Simple? Yes, but the statistics show that your returns will be the better for it over the long haul, which should be your goal.

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