Buy Index, Not Actively Managed, Funds

Invest in passively managed index funds, not actively managed mutual funds.

A constant theme of mine for individual investors.

Today, a short video courtesy of The Motley Fool.

Keys to note in the video:

0:20 – note the big discrepancy in expense ratios between the Spider Index Fund (9 basis points) versus the other funds. Every cent you pay in additional fees negatively impacts your performance. And your ability to reinvest your returns for compound growth in the future.

0:20 – note the correlation between expense ratios and performance. Look at the 5 year return. A strong correlation between higher expense ratios and lower relative performance. That gets to my point about how difficult it is for active investment managers to consistently outperform their benchmarks over time. Smart investors stick with low cost index funds.

1:00 – the commentator discusses performance over the last month and three months. When considering investment alternatives, ignore short-term results. Luck or external events can impact short-term performance. Focus on mid to long-term results when researching investment products. Given the number of new offerings out there, three year results may suffice. But if you can assess five and ten year data, much better.

The commentator does not discuss, but when comparing investment options be certain to do apples to apples. In this video, they compare the S&P 500 to a variety of funds. To ensure you are comparing similar risk-return profiles, you want to check to see what benchmark each actively managed fund uses. If it is the S&P 500, then comparisons are probably reasonable. But if the benchmark is something else, then it is not fair to compare the fund to the S&P 500. In this case, the listed funds are primarily large cap U.S. equity funds, so S&P 500 is okay. But if a fund focussed on micro-cap technology stocks or Japanese equities, then using the S&P 500 as a benchmark is useless.