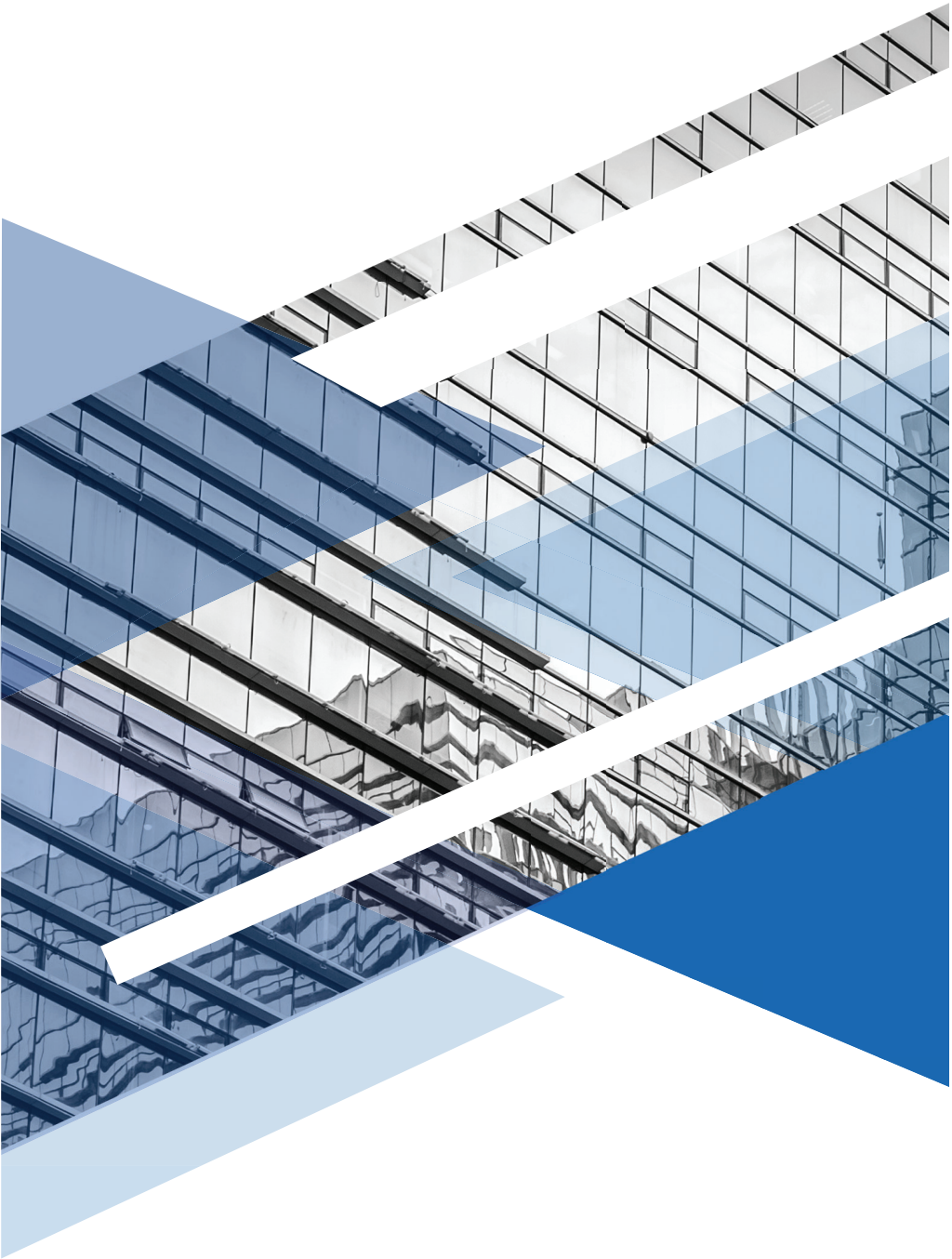
INDEX FUNDS

quick**guide**



EMPIRE SMSF ADVISERS

Superannuation & Investment Specialists

INDEX FUNDS

An index fund is a type of managed fund. Index funds don't try to beat the market, instead they try to match the index. They do this by holding the same shares in the same proportions as they occur in the ASX 200.

The All Ordinaries Index (AOI) is the weighted average of the largest 500 companies traded on the ASX. On the Australian market, these companies account for about 99% of the entire market.

An index fund is a type of managed fund. In fact, the name 'managed' fund might be a misnomer. Index funds could be more accurately described as 'administered,' rather than managed. This is because the index fund manager tells investors exactly what it will do with money that they invest.

Index funds don't try to beat the market, as measured by an index such as the ASX 200, instead they try to match the index. They do this by holding the same shares in the same proportions as they occur in the ASX 200. The sample matches the population. This means the sample should experience the same results as the population. So if the ASX 200 goes up by 1%, the index fund will go up by 1% too.

Sounds great, but remember if the ASX 200 falls by 10% the index fund will fall by 10% too.

Are index funds big?

Index funds are huge! They have hundreds of billions of dollars invested in them, right around the world, in thousands of different funds.

Who uses Index funds?

Warren Buffet says you should use index funds. And he has been saying this for decades:

In 1993, he had the following to say:

> *"By periodically investing in an index fund, the know-nothing investor can actually out-perform most investment professionals. Paradoxically, when "dumb" money acknowledges its limitations, it ceases to be dumb."*

What is an index?

An index is a number. This number represents the change in the value of a number of securities that have been grouped for the purpose of 'measuring the market.' A commonly quoted index is the 'All Ordinaries Index' (AOI).

The AOI is the weighted average of the largest 500 companies traded on the ASX. On the Australian market, these companies account for about 99% of the entire market. Therefore, the AOI is basically the average performance of the entire market.

For this reason, investing in an index fund that tracks such a broad index is sometimes said to be basically investing in the share market as a whole.

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Indexing involves the fund purchasing a representative sample of shares, in accordance with the proportions of the index that the company represents.

Index funds – An example of passive investment

Indexing involves the fund purchasing a representative sample of shares, in accordance with the proportions of the index that the company represents. For example, if a company's shares make up 2% of the total value of the index, then the index fund will allocate 2% of its investment funds to shares in that company.

This strategy is often described as 'passive' because the fund manager does not try to predict the future performance of individual shares. Instead, the fund manager merely follows the market's estimation of this future performance.

The opposite of passive management is known as 'active management.' Active management is where the fund manager deliberately tries to pick those assets that will do well and/or avoid those that will perform poorly.

Why passive investment?

In a nutshell, the reason some people prefer passive investment is the belief that active investment managers sometimes struggle to justify their fees.

Consider this: In an article dated 8 July 2004, Fairfax and ABC journalist Alan Kohler detailed how only one fund manager in a comprehensive survey beat the All Ordinaries Index. No managed superannuation fund managed to do this.

Why Would Passive Investment Be Expected to Outperform Active Management?

The basic reason is fees. The fees attached to managed funds are obvious. Consider a basic example. An investor has $100,000 to invest in the share market, and chooses an actively managed fund. The fund manager pays a commission of 3% - or $3,000 – to the adviser. The fund manager also employs an analyst (who charges his own fee) to sit down and think through how the money should be invested. By the time the money is actually invested into the market, there is $96,000 left.

This means that in the first year of the investment, the fund has to earn 4.16% just to bring the balance back up to $100,000.

Compare this situation to an index fund investment where the overall cost of fees can be as low as .5% ($500). So in this case, $99,500 has made it into the market. This means that the index fund only has to achieve a return of 0.526% to get the balance back up to $100,000.

Remember, over time most active managers will revert to the average performance. The passive manager will have been there all along. But as the name suggests, the active manager does a lot more work in getting this result – and this work costs money. Index funds happily accept the market average; and the fact that this acceptance allows them to avoid most of the fees and taxes that the active manager incurs.

The reason some people prefer passive investment is the belief that active investment managers sometimes struggle to justify their fees. And, in truth, they do not find it difficult to justify this conclusion.

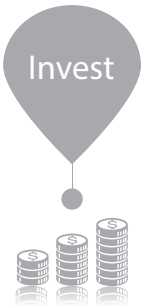

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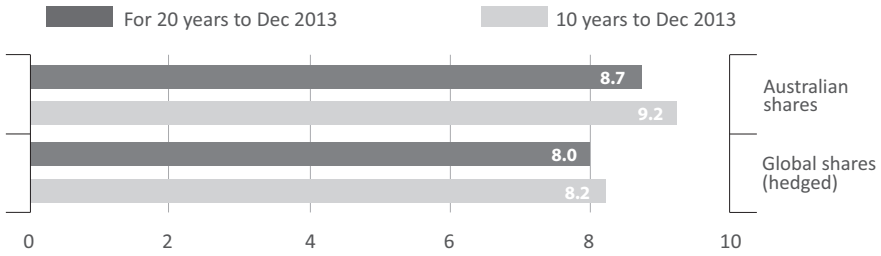
Figure 1.

A comparison: global shares and Australian shares

Gross returns (%pa)



Note: All returns are net of costs
Source: ASX Russell Investments | Research: Misa Han

Figure 2.

All ordinaries index - 16 years 2000 to 2016

The All Ordinaries Index is considered the barometer for the Australian stock exchange. The chart on the left measures activity over a sixteen year period.

Index funds and Accepting the Average

Over a 100 year period from 1901 to 2001, the average annual performance of every share traded on every exchange in Australia was 7.5% plus inflation. This figure was obtained by the Australian Securities and Investments Commission. Note that the return is in addition to the inflation rate. What this basically means is that the purchasing power of a dollar invested in such a way as to achieve the market average would have doubled every ten years or so. By the end of the 100 year period, $1 invested such that it obtained the market average would have been worth just over $1,000 – in real terms.

Investing is not a winner takes all activity and being average is usually quite good.

The average annual performance of every shared traded by the ASX over a 100 year period.

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In terms of time and money, the index fund offers the most efficient means of owning a diversified portfolio.

Diversity

Index funds represent optimum diversity. While it is a given that the shares that are held will include some poor performers, taking the cue from history, most of the shares will perform well over time.

Russell Investments

BLACKROCK

Vanguard®

Some other Benefits of Index Funds

There are some other benefits of index funds that are often commented upon. As described below, these benefits come down to efficient risk management

Automatic Diversity

The predominant retail index fund in Australia is the Vanguard Index Australian Shares Fund ('VIASF'). The VIASF tracks the ASX 300. To do so, it buys shares in approximately 265 companies traded on the exchange. (It does not hold shares in the smallest 35 shares in the ASX 300, as these shares make up such a small component of the index that holding them would not affect the return).

This represents optimum diversity. While it is a given that the 265 shares that are held will include some poor performers, taking the cue from history, most of the shares will perform well over time - remember the long term average of 7.5% plus inflation was for the average Australian share. The more shares that are owned, the more likely the return will be average.

It would be virtually impossible for any individual to own shares directly in these 265 companies. The administrative and brokerage burden would be too great. Therefore, the index fund offers the most efficient means of owning a diversified portfolio.

Ease of Management

In addition to automatic diversity, index funds also facilitate easy management. One of the main arenas in which this advantage manifests is where the investor is an SMSF. At the end of the financial year, the index fund manager will provide the investor with a short summary of all the transactions during the year. The summary will also show how the information should be accounted for. The information provided by the index fund manager makes the annual accounting and auditing task a lot less time-consuming.

Index funds also lend themselves to internet banking, whereby you can automate your buying of units in the fund.

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Share market investments of any sort, are typically not appropriate for investors with a short term horizon. This includes Index funds.

Some sharemarket investors choose not to invest in shares in companies that are involved in certain activities. Gambling, alcohol, mining, timber etc are commonly avoided by what are known as 'qualitative investors.

When should index funds not be used

Index funds do have some drawbacks. These include:

Short Term Volatility

Index funds that invest in the share market will perform with considerable volatility in the short term. This is because the share market is volatile.

If the investor only has a short term horizon (eg if the investment will only last a year or two), then the index fund may not be appropriate. More precisely, a share market investment of any sort is typically not appropriate for investors with a short term horizon.

Unsuitability for 'Ethical Investing'

Some sharemarket investors choose not to invest in shares in companies that are involved in certain activities. Gambling, alcohol, mining, timber etc are commonly avoided by what are known as 'qualitative investors.'

Index funds, almost by definition, cannot avoid these types of companies. So, an investment in an index fund that seeks to track a substantial index such as the ASX 300 will include shares in companies that the investor might like to avoid.

A quick summary of the benefits of using index funds

- They have great corporate governance.
- They are very low cost.
- They do not pay commissions and similar inducements.
- They consistently out-perform active fund managers: most fund managers cannot beat the market.
- They do not cause as much stress or take up much time.
- They are very long term: ten years or more.

GENERAL ADVICE WARNING

The advice may not be suitable to you because it contains general advice which does not take into consideration any of your personal circumstance. All strategies and information provided on this website are general advice only.

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