Money and You: Smart investing is remarkably simple

by Lynn_O'Shaughnessy

INVEST IN INDEX FUNDS

If you don't invest in index mutual funds, please answer this question: Why not?

Only 14 percent of investors' money, according to the Financial Research Corp., is tied to indexes. Yet studies, which researchers began cranking out in the dog days of the Vietnam War, have repeatedly shown that over the long haul, index funds perform better than thousands of competing mutual funds.

The consistent mantra of index funds seems wimpy: We strive for market average returns. This isn't the sort of promise that would get the marketers, who create those Bud Light commercials, excited. Average doesn't sell. Index funds, however, are "average" in name only. Index funds, which aim to track their relevant benchmark, such as the Standard & Poor's 500 Index, routinely perform better than their actively managed competitors.

In a commentary about a recent study that again documented the index advantage, Institutional Investor, a well-respected trade publication for the financial community, was rather huffy about the report's conclusions that index funds are superior. "Fair enough," the publication wrote, "but didn't we already know that?"

Surely the folks at Institutional Investor understand the index advantage. So do finance professors at the University of Chicago and the Wharton School at the University of Pennsylvania. But the average guy trying to figure out how to invest his Roth IRA doesn't. And that's the problem.

If you want to invest in index funds, the largest source is the Vanguard Group. An excellent alternative for those who use a fee-only adviser is Dimensional Fund Advisors.

DIVERSIFY YOUR PORTFOLIO

When investing, financial disharmony is great. You ideally should have a portfolio that is bursting with wildly different assets that tend to reduce your risks and improve your odds of financial prosperity. But how exactly do you create a portfolio that resembles a United Nations roll call?

While there are countless investment categories, it's easier to start by focusing on the truly indispensable ones. Just about any long-term investor should include these four broad asset classes in his or her portfolio: Domestic large-cap stocks, domestic small-cap stocks, foreign stocks and U.S. bonds.

During the past 10 and 20 years, if you had held a simple portfolio that was spread equally among index mutual funds invested in these four broad categories, you'd have beaten the performance record of more than 90 percent of the professional managers. And just as importantly, an investor holding this elegantly simple portfolio would have enjoyed greater financial success while incurring less risk.

You can tweak this basic portfolio in many different ways. If you're a young investor or an aggressive one, you may want to skip the bonds. An aggressive investor may wish to tilt more heavily toward small-cap stocks and foreign stocks. A conservative investor would do just the opposite.

An excellent resource that contains a cheat sheet of model portfolios is a book, "The Only Guide to a Winning Investment Strategy You'll Ever Need," by Larry E. Swedroe, a fee-only investment adviser in St. Louis.

AVOID EQUITY INDEX ANNUITIES

This annuity is a godsend for the eager insurance agents, brokers and commissioned planners who receive super-sized commissions for peddling them. When you look closely at equity index annuities - and most people don't bother - the blemishes are clearly visible. Despite its name, this annuity isn't a risk-free stock investment; it's just a dressed-up fixed annuity.

Like a certificate of deposit, a fixed annuity offers a very modest return on an ultraconservative product. If the equity index annuity really was a stock investment, any insurance agent who doesn't possess a securities license would be forbidden from selling them. The equity index annuity is also saddled with surrender charges. In extreme cases, if you want to bail from one of these annuities, the insurance company will confiscate 20 percent of your money before releasing what's left.

Nothing has triggered more mail in the past than when I slam equity index annuities, as well as variable annuities. I possess an equally jaundiced view about variable annuities.

You can limit your risk without getting gouged by the tremendous costs of variable and equity index annuities by maintaining a diversified portfolio of index funds that cover the basic investment categories I just mentioned.

If you absolutely can't afford to lose any money, you can stick your cash in a certificate of deposit, a money market or a savings account. If you're trapped in the office of someone who is trying to peddle these annuities, here's what I'd suggest: Ask where the bathroom is, excuse yourself and then run to the parking lot and get the heck out of there.

KEEP IT SIMPLE

The financial industry doesn't want you to know this, but smart investing is remarkably simple. It really is. Invest in index funds. Invest in those main investment categories. Invest regularly. And then once you've done all that, resist the temptation to mess with your portfolio.

I re-evaluate my portfolio once a year to see if my collection of index funds has grown out of whack. During my annual review this month, I printed out my statements from the family's Roth IRAs, SEP-IRA, rollover IRAs, 401(k) and taxable investment account. I then sat down with a legal pad (I'm low-tech) and figured out what changes might be needed in less than an hour.

Overall, my small-cap value index exposure had grown too large even for my high tolerance for risk so I redirected some of that money into large-cap stock and bond funds. I also adjusted my kids' college accounts. I've been making the kids' accounts increasingly more conservative in recent years for obvious reasons. My daughter, Caitlin, starts college in the fall, and my son, Ben, who just finished his first year at high school, is going to need his college money all too soon.

If you're befuddled by how to divide up the investments in your kids' college accounts, I'd suggest looking at the investment breakdowns inside the age-based portfolios that 529 savings plans routinely offer. You can do the same thing with your retirement money by looking at the investment percentages inside the target retirement mutual funds that the major mutual fund players routinely offer.

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