Insights

Equity Index Investing

Volume 1
Number 223

From the
T. Rowe Price
Information
Library

The strategy of index investing attempts to approximate the performance of a broad market through stock funds that closely track that market. These funds offer essentially the same potential rewards—and the same risks—as the market in general, and they are an easy, cost-effective way to own stocks. In a world of complex investment products, they are relatively easy to understand and are also appropriate for a variety of portfolio types.

There are index funds covering almost every segment and niche of the market. Today, much of the money invested in index funds tracks the S&P 500 Index, whose value is calculated according to the market value (shares outstanding times stock price) of 500 large companies across several major industry sectors (e.g., industrials, utilities, financials, health care, etc.). In composing the index, Standard & Poor's seeks a representative sample of common stocks that trade on the New York and American Stock Exchanges as well as the Nasdaq National Market System.

While the S&P 500 is the most widely recognized U.S. equity index, there are other benchmarks that measure the performance of different market segments. The Dow Jones Wilshire 5000 Index, for example, represents approximately 5,000 regularly traded stocks of U.S. companies (the actual number varies considerably from year to year)—essentially the entire U.S. stock market. Another broad-based index is the Dow Jones Wilshire 4500 Index, which comprises all of the Dow Jones Wilshire 5000 stocks except those that are members of the S&P 500. This benchmark represents the universe of small- and mid-cap stocks in the U.S. More focused small- and mid-cap indices include the Russell 2000, the S&P 600 SmallCap, and the S&P 400 MidCap.

The basics of index investing

Indexing strategies fall under two broad types. In full replication, a fund manager attempts to invest, in a weighted fashion, in every stock in an index. The alternative is sampling, whereby a manager invests in a smaller group of stocks that he or she believes is representative of the broader index.

The majority of index fund managers attempt a full replication strategy, but some resort to sampling when the size of a targeted index, such as the Dow Jones Wilshire 5000, or the obscurity of some of an index's stocks makes full replication too costly or cumbersome.

It should be noted that even though index funds track the performance of their benchmark indices, they are still likely to underperform slightly, for two reasons. First, index funds have fees and transaction costs that are deducted from net assets, while indices have no expenses. Second, index funds usually have very small cash positions (generally less than 1% of portfolio assets), while indices do not.

Index funds are passively managed, meaning that management of the investment portfolios does not require day-to-day evaluation and selection of individual stocks. Rather, the fund manager's main task is to replicate the index by adjusting individual stock weightings.

Advantages of index investing

Perhaps the primary advantage of index funds is cost. Index funds typically cost less to run than actively managed stock funds because they have lower turnover, which reduces transaction costs, and require no research into individual stocks. Index fund expense ratios are generally lower than those of actively managed equity funds. Assuming all other factors are equal, lower costs will enhance portfolio returns.

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Index funds may also offer an advantage to investors wishing to minimize taxes. The lower turnover rate of equity index portfolios reduces the likelihood of realizing substantial capital gains—gains that are passed on to fund shareholders and are subject to taxation.

There are other potential benefits as well. Compared with equity funds limited to a particular market sector—natural resources or biotechnology, for example—index funds are typically less volatile. Furthermore, because they spread investor assets across a large number of stocks, index funds should be less susceptible than more concentrated funds to the volatility of any individual holding. Of course, diversification cannot assure a profit or protect against loss in a declining market.

Pros and Cons of Equity Index Investing

Advantages
- Low cost, low maintenance
- Low portfolio turnover
- Fully invested portfolio
- Closely tracks stock market performance

Disadvantages
- Fund is limited to companies found in that specific index
- Strategy has no mechanisms to manage market risk
- No opportunity to outperform benchmark

Potential drawbacks to index investing

Index funds are an effective way to gain exposure to the average results of a given market or sector. That can be beneficial in many market environments, but it does create two obvious downsides.

The first is that an index investor is fully exposed to market declines, as well as market gains. When the market that a fund is tracking falls, an index strategy has no option or mechanism to mitigate the losses.

In addition, index funds offer no opportunity to outperform their indices. The index fund manager, unlike an active manager, cannot react to trends within market sectors by shifting assets from one to another. The impact of a particularly strong (or weak) market sector may be more muted in an index fund than in an actively managed one.

Finally, though equity index funds boast extensive diversification within their own universe, they can be limiting on a broader scale. For example, an index fund including only U.S. stocks does not offer the diversity or performance opportunity of a portfolio that includes international stocks, various types of bonds, and money market investments.

Fitting equity index funds into your portfolio

Before making any investment decision, you need to evaluate your overall financial picture and long-term objectives. To build a portfolio that works for you, we suggest you identify your goals and time horizon, and then determine an appropriate asset allocation.

Because of the potential drawbacks to indexing, index funds are often best used within the context of a wider portfolio. Investors can use index approaches within any segment of their overall equity portfolio (see Chart I), though they are perhaps most commonly used as a core holding in the large-cap segment of a diversified portfolio. Investors might also use an index fund to gain instant stock market exposure while complementing their portfolios with actively managed stock funds. (The exact amount of your portfolio that you should have in equities will vary depending on your time horizon; visit troweprice.com for more information.)

Chart I: Suggested Portfolio Diversification—Equity

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