
Sherwood Investment Services
Financial Planning & Investment Management

Eric Linger, RIA
Registered Investment Advisor

425-898-8989
Sherwood-Investments.com
elinger@Sherwood-Investments.com

23705 NE 61st Street
Redmond, WA 98053

The Savvy Investor
The Trouble with Index Funds

Index mutual funds became popular in the late 1990s bull market, when investors' biggest regret was not putting enough cash into stocks.

Indexers happily rode prices higher then, but the ensuing bear market revealed a darker side of indexing: Market return cuts both ways.

Here's why: An index typically is based on a stock's capitalization, or size. Put simply, stocks with the highest market value command a greater percentage of an underlying index. **So, index funds are forced to buy stocks that tend to be overpriced. Not a great investment strategy.**

For example, when large-cap technology, media and telecommunications stocks led the market in the late 1990s, they were disproportionately important to the Standard & Poor's 500.

But any index-fund manager who thought these sectors were overvalued was hamstrung. They were unable to diversify risk by adding undervalued stocks. Moreover, pricey stocks became even more prominent to the index as the market climbed, while neglected stocks got even cheaper. The gap between growth and value opened wide, and when the market cratered, the S&P 500 – along with many actively managed funds – followed suit.

It's possible to avoid such extremes with an index that relies on factors other than market valuation. Trouble is, not many funds operate that way. Another solution is to invest in “managed” those mutual funds that are low cost and perform well in *both* bull and bear markets. The expenses won't be as low as with an index fund, but your fund won't be in an unmanaged free fall when the market goes down.

If you'd like to learn more about selecting quality index funds and mutual funds, please contact us and visit our web site www.Sherwood-Investments.com.