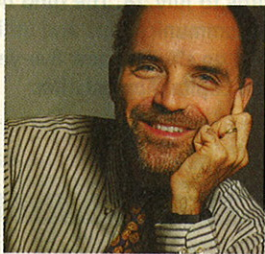


## THE FUNDAMENTALIST



# What you can do to stop index funds from blowing up on you when stocks fall

BY JASON ZWEIG

HERE'S A STARTLING FUND FACT: OF THE \$72 BILLION THAT flowed into U.S. stock funds in the first half of 1997, 22% went into index funds—those “passive” portfolios that mimic a market benchmark. So, after years of singing the joys of indexing, we at MONEY have started wondering: Are index funds *too* popular? Are they full of hidden risks—the financial equivalent of an exploding cigar?

To find out, in late July I visited Gus Sauter, the 43-year-old computer whiz who oversees Vanguard's \$84 billion in indexed stock assets. Here is what I asked him.

► **Are the large stocks that dominate the index dangerously overpriced?** At the end of 1996, the 25 biggest stocks in Standard & Poor's 500 index made up 31.7% of the total value of that benchmark. By the end of July, the top 25 stocks had bulked up to 33.4% of the total. And fully 12% of the index's value is made up of just five giant stocks—Exxon (trading at 20 times its past 12 months' earnings), Intel (24 times), General Electric (30 times), Coca-Cola (42 times) and Microsoft (54 times). The average S&P 500 stock, meanwhile, trades at 24 times earnings.

So with big stocks so bloated, would S&P index funds deflate faster than small-stock funds in a crash? Hard to tell, says Sauter: In the seesaw markets of the late 1970s and early 1980s, smaller stocks did outperform big ones. But in the late 1920s and again in the late 1960s and early 1970s, blue chips generally fared better in rising and falling markets alike.

Here's what we do know: Index funds cannot cushion against market slumps. They carry virtually no cash; they sometimes trade futures contracts (adding at least a thin layer of risk); and, above all, they cannot sell overpriced stocks (like today's blue chips) to buy cheap ones. Of course, the whole point of indexing is to get you out of the business of making market calls. An index fund aims only to match the market's return—when it goes up (which is wonderful) *and* when it goes down (which is dreadful). If the S&P 500 falls 41.92%, as it did in 1973-74, you should expect **Vanguard Index Trust 500** to lose 42.12% of its value (the drop in the market plus the fund's 0.2% in expenses).

► **Are index fund investors facing a tax nightmare?** Say we get a crash, and index fund investors redeem heavily. Would the index funds have to shed big blocks of stock to pay off those shareholders, creating a sizable tax bill for the ones who hang on? Consider this: In 1986, an institutional holder of the Vanguard Index 500 redeemed its 5.5% stake. As a result, the fund had to sell a heap of stock, triggering a painful \$2.02 taxable capital-gains distribution.

But Sauter says a repeat is unlikely, though not impossible: At Vanguard Index 500's recent size, if the market dropped 10% and investors cashed in 20% of their shares, those who were to stay would be left holding a tax bill of about 9¢ for every share (recently, the net asset value stood at \$79.73). As one of these potential victims, I hope this annoying event never occurs.

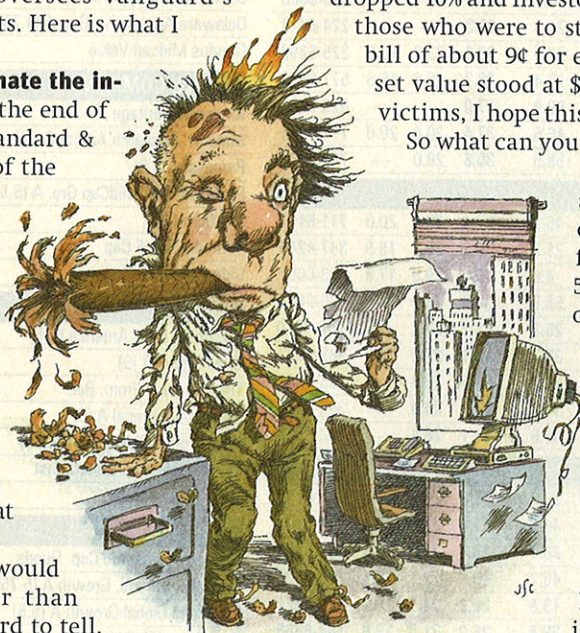
So what can you do to sidestep such pitfalls?

**Diversify.** If you think big stocks are overvalued, then don't buy a blue-chip index fund like Vanguard Index Trust 500, **Fidelity Spartan Market Index** or **USAA S&P Index**; instead, you want one like **Vanguard Index Trust Total Stock Market**, which tracks the Wilshire 5000 index, echoing the returns of nearly all U.S. stocks. That way you get about a 30% stake in medium and small stocks to counterbalance the behemoths. And keep at least one-third of your investment stake in bonds and foreign stocks as well (see “Smart Ways

to Fix Your Mutual Fund Mix” in MONEY's August issue).

**Be tax-wise.** As we've seen, Vanguard Index 500 could hit you with a tax whammy in a crash. A better choice for tax-fearing index fans is one of Vanguard's **Tax-Managed Portfolios: Balanced, Growth & Income** or **Capital Appreciation**, which flatten your tax bill by shunning portfolio turnover and high-yielding stocks. Another alternative: Standard & Poor's depositary receipts (“Spiders”), the tax-efficient unit investment trusts. (These are simply shares in a pool holding all 500 S&P stocks, and they trade on the American Stock Exchange just like stocks.)

**Be realistic.** Over the long run, nothing stands a better chance of getting you to your financial goals than a low-cost stock index fund. But in the short run, if the market crashes, everyone will lose money—including the many investors with index funds. □



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