Understanding indexing

Index funds are a way of gaining exposure to an investment market. Most investment markets have an index that measures their value over time.

There is an index that covers almost every industry sector and asset class, including Australian and international shares, property, bonds and cash.

Rather than trying to guess which investments will outperform in the future, index managers replicate a particular market or sector. This means they invest in all or most of the securities in the index.

Indexing is based on the theory that investors as a group cannot beat the market—because they are the market. In fact, when you take costs into account, Vanguard founder John C. Bogle said investors as a group must underperform the market.

This is why, when you look at asset class performance tables at any point in time, there are always winners and losers. Picking consistent outperformers is almost impossible, so indexing provides a way of accessing market performance without the high costs.

The benefits of indexing

Diversification

It can be argued, that if you only hold a single stock in your investment basket, you're leaving your portfolio exposed to the risk that particular company's share price will underperform.

The more stocks you add to your investment basket, the more you're reducing your exposure to that risk.

Index funds invest in all or a representative basket of the securities in an index like the S&P/ASX 300. When you invest in an index fund you are effectively buying the entire market, or a representative sample, and reducing your risk by leaving your portfolio less exposed to the ups and downs of single investments.

Indexing provides a way of accessing market performance without the high costs

By investing in a range of index funds, you can diversify your portfolio across different industries and securities, both in Australia and overseas.

With a broad range of assets in your portfolio, returns from better-performing assets can help compensate those not performing so well.

Low costs

Index funds usually have lower costs than actively managed funds.

- **Lower transaction costs.** Index funds use a buy-and-hold approach, which means their fund managers generally trade securities less frequently than their active counterparts. This reduces brokerage, commission and other trading expenses.

- **Lower management fees.** By tracking the performance of an index, index funds essentially rely on a repeatable investment process allowing for cost efficiencies, as they don't have to employ highly paid research teams to analyse and choose securities.

Potential tax efficiency

When you sell shares, there's the potential for incurring a capital gain. Simply, capital gains is a tax incurred by the investor as a result of selling securities. As a rule, index fund managers have lower turnover of securities, which helps minimise capital gains.

> Investors who have the patience and discipline to stay the course are well rewarded over the long term

In contrast, actively managed funds typically trade more often than index funds so they tend to create more capital gains tax liabilities. The higher your usual marginal tax rate, the more you stand to benefit from indexing's tax efficiency.

Long-term performance

Indexing's buy-and-hold approach is a low-cost way to tap into the long-term returns generated by investment markets.

History tells us that despite bumps along the way, investors who have the patience and discipline to stay the course are well rewarded over the long term. Particularly if you reinvest your returns along the way to take advantage of compound interest.

This is where you earn interest on your interest payments as well as on the principal amount you originally invested.

Using indexing to build your portfolio

Once you've decided on your mix of assets, or asset allocation, you need to decide how to invest in them.

This includes the option for 100% of your portfolio invested in an index fund across asset classes or a core-satellite approach—a combination of both index and active funds.

Indexing's low costs make it one of the most efficient ways to invest your money across a range of assets.

Vanguard's investing approach

It's important that you have full confidence in the fund managers you trust with your investments. With over 40 years of index management experience globally, and more than 20 years in Australia, Vanguard is a leader in the field of indexing.

Vanguard index funds are designed to work as the building blocks of a successful investment portfolio.

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