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The Hidden Differences Between Index Funds

by Shauna Carther (Contact Author | Biography)

Think of your trips to the candy store as a child. You'd pick out your favorite candy… let's say it was jelly beans. Orange tasted like oranges and yellow tasted like lemons - but sometime later, the yellow jelly beans you purchased might taste like pineapples, or popcorn! What was up with that? The lesson here, that appearances can't be trusted, can be applied to index funds too. Although an S&P 500 or Dow Jones Industrial Average index fund should each replicate its respective index, the fund's performance is not guaranteed to be the same as others like it or as the index it mimics. Read on to learn about the sometimes hidden differences between index funds.

The Cover: Index Fund

An index fund is a passive investment. As such, the fund manager selects a combination of assets for a portfolio that is intended to mimic an index, such as the S&P 500. Because the fund's underlying assets are held and not actively traded, operating expenses are usually lower. (If you need to brush up on index funds, see the *Index Investing Tutorial*.)

A Closer Look

To some investors, it is reasonable to assume that all index funds perform the same; however, a deeper look will uncover all sorts of discrepancies between funds.

The most important difference that will eat into your return is a fund's operating expenses, which are expressed as a ratio - the percentage of expenses compared to the amount of annual average assets under management:

Example - Expense Ratios

Investors who choose to place their money in index funds generally expect lower operating expenses. After all, the fund management doesn't have to select or manage any securities whatsoever! In general, expenses are very important to consider when investing, and index funds are no exception to the rule because expenses reduce an investor's return. Consider the following comparison of 10 S&P 500 funds and their expense ratios as of April 2003:

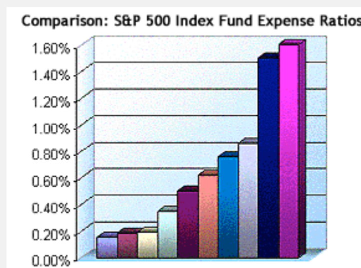

Figure 1

The different bars in the chart above represent different funds. Notice that expense ratios range from 0.15% to almost 1.60%. Bear in mind that the yearly return of the S&P 500 as of the end of April 2003 was approximately 5%. If we assume that the fund tracks the index closely, a 1.60% expense ratio will reduce an investor's return by about 30%!

Fee Factor

It is outlandish that index funds with almost identical portfolio mixes and investing strategies can get away with charging higher fees. The sad truth is that some index funds actually charge front-end loads, back-end loads and 12b-1 fees - all of which will eat into your return. For example, one fund in the above chart (which will remain unnamed), does not have the highest expense ratio but charges a back-end load of 3% and a 12b-1 fee of 1%!

Larger funds and more established funds, such as the Vanguard 500 Index fund, tend to charge lower fees. This may be because management has more experience in tracking indexes or because of the ability to use the economies of scale that a large asset base produce; furthermore, more established funds do not need additional advertising to attract investors. Whatever the reason, there is simply no justification for higher fees or, for that matter, operating expenses for the exact same product.

The Tracking Error

Another way to compare index funds is by looking at their tracking errors, which measure how much the fund deviates from the index it is mimicking. The tracking error is usually expressed as a standard deviation, and a large deviation indicates that there are large inconsistencies between the return of an index fund and its benchmark. This large divergence could be an indication of poor fund construction and/or large fund fees and high operating expenses.

High costs can cause the return on an index fund to be significantly lower than the index's return, resulting in a large tracking error. Deviation creates smaller gains and larger losses for the fund. Consider Figure 2, below, which compares the S&P 500's return (red), the Vanguard 500 (green), the Dreyfus S&P 500 (blue) and the Advantus Index 500 B (purple). Notice that the index fund's divergence from the benchmark increases as expenses increase.

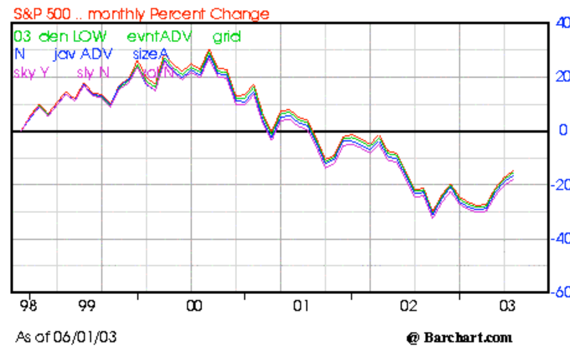

Figure 2

Source: Barchart.com

What's in a Name?
When screening for an index fund that fits your investing needs, do not be misled to believe that all index funds labeled as S&P 500 or Wilshire 5000 only follow those indexes. Some funds actually have divergent management behavior. Within the S&P 500 fund group, there is a socially responsible index fund and an enhanced fund. Both of these funds can be found within the S&P 500 Index Tracker funds category - but are they really index funds?

When a portfolio manager for an index fund performs additional management services, the fund is no longer passive. Consequently, funds with these added selling features have fees that are well above average.

Take, for example, the Devcap Shared Return fund, which is a socially responsible S&P 500 index fund. As of June 4, 2003, it had an expense ratio of 1.75% and charge a 12b-1 fee of 0.25%. Another fund, the ASAF Bernstein Managed Index 500 B, was categorized as an S&P 500 index fund, but it actually sought to outperform the S&P 500!

Fund Name	Ticker	Expense Ratio	Fees		
			Front-end	Back-end	12b-1
Devcap Shared Return	DESRX	1.75%	0	0	0.25
ASAF Bernstein Managed Index 500 B	MBIFX	2.04%	0	1.00	1.00

Figure 3

It's not a problem to want to buy a fund that tries to beat the S&P or is socially responsible. The point here is not to get confused between true index funds and funds that just have index-like names.

Final Considerations
Within the index fund category, not all funds listed are as diversified as those tracking an index such as the S&P 500. Many index funds actually have the same properties as focused, value and/or sector funds. Remember that focused funds tend to hold fewer than 30 stocks or assets within the same sector. The lack of diversification in sector funds - like the American Gas Index fund - and value index funds that invest in fewer than 30 stocks - like the Strong Dow 30 Value fund - expose investors to higher risk than a fund tracking the S&P 500, which is comprised of 500 companies within various sectors of the economy. (For more information, read *Do Focused Funds Provide a Better Outlook?*)

Due to the increased risk, it becomes even more important to consider fees, because they reduce the amount of return received for the risks taken. Consider the following comparison of Dow 30 index funds:

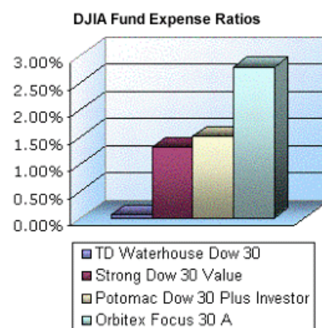

Figure 4

In this example, the Orbitex Focus 30 A has an expense ratio of almost 3%! A closer look shows a front-end load of 5.78% and 12b-1 fees of 0.40%. Because the Dow lost around 12% over the year ending at the end of April 2003, investors in this fund would have lost around 15%!

Take-Home Notes

If you are an investor who would like to invest in an index fund, be sure to look beyond just the cover:

1. *Costs and tracking errors* - Try to choose investments that have minimal operating expenses and, preferably, no fees or tracking errors. An excellent resource that we've found useful for screening index funds, especially those tracking the S&P 500 index, is Indexfunds.com. This website's screening feature allows you to sort funds according to their expense ratios, returns and other elements.
2. *Compare your chosen index fund with other similar funds* - This will allow you to determine the reasonable range of expenses and tracking errors for that particular fund group.

Conclusion

Not all index funds perform the same. Expense ratios, fees and tracking error can drastically affect an index fund's performance. Investors should carefully investigate an index fund before buying in to make sure that its fees are low and that they have a firm understanding of what the fund invests in, as well as the strategies and goals that management uses to meet its objectives. Index funds can be very dependable investments, but investors are more likely to find one they can count on if they weed out any element of surprise.

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