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WEALTH MATTERS

Those Dowdy Index Funds Get a Notable Endorsement

By PAUL SULLIVAN

FOR the wealthy, index funds have an image problem. They are considered the economy cars of the investing world: they'll get you there but not in style and you're always worried they may break down. Anyone at a serious level of wealth, the thinking goes, needs the equivalent of a luxury sedan, with strategic stock choices, hedge funds, private equity, real estate.

Burton G. Malkiel says this is all hogwash.

Best known for his classic investment treatise, "A Random Walk Down Wall Street," Mr. Malkiel has just published "The Elements of Investing" with Charles Ellis, an investment consultant (Wiley, 2009). The book, an unabashed homage to "The Elements of Style" by William Strunk Jr. and E. B. White, is focused on the cleanest, simplest ways for people to invest their savings. He argues that while people of modest means are hurt by not saving regularly, wealthy people lose out by chasing the latest, greatest investment.

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Burton Malkiel, author of investment advice books, practices what he preaches. In his retirement portfolio, "All the serious money is indexed."

Mr. Malkiel, a professor of economics at Princeton University, has long advocated index funds. What's striking now is his belief that the wealthiest [could] have fine returns without the volatility and high fees if they simply used indexes to diversify their money across asset classes.

"This is still a strategy that is good for people of all income levels," he said. "If I took all the mutual funds that existed in the early 1970s and asked the question how many really beat the market through 2009, you can count them on the fingers of one hand."

There are plenty of dissenters to this view. James T. Tierney Jr., a senior vice president at W. P. Stewart & Company, which has $1.6 billion invested in 15 to 20 stocks, equated indexing to judging baseball players against the league average. "It's like saying all hitters hit .275," he said. "That's not the case. Some hit .325 and some hit .200. If you find the ones with the higher average, you're adding real value."

The argument between advocates of the two approaches — indexing versus active managing — is an old one and will not be resolved here. But Mr. Malkiel's assertion that even the wealthiest investors should use indexes is intriguing. What follows are his main arguments in favor of indexing and the rebuttals from advisers who earn their livings doing the opposite.

INACTIVITY STRATEGY Mr. Malkiel has long said that no one can consistently pick winning stocks and bonds. He argues that index funds [could be one of] the best, low-cost ways to invest money you will need. "We say to people in the book, 'Don't try to time the market,' " he said. "It's not that you can't do it; it's that you won't do it. The emotions will get a hold of you."

He pushes everyone to stick instead to a balance of stocks and bonds that are right for their age and to rebalance this annually so the proportions remain the same. Yet in this sense, his advice is not so different from what strategists at wealth management firms do.

"Asset allocation is the most important decision — 90 percent of returns extend from that," said Joseph Jennings, director of investments in Baltimore for PNC Wealth Management.

On the other hand, Mr. Tierney argued that W. P. Stewart's concentrated approach to stock picking serves high-net-worth investors better. "We're selecting high-quality companies with earnings streams and eliminating all the bad stocks in the S.&P. that you have to own because it's an index," he said.

Mr. Tierney pointed out that his strategy has consistently beat the Standard & Poor's 500-stock index. Since the fund's inception in 1974, it has outperformed the S.&P. in its 28 positive years, 23.3 percent to 19.9 percent, and in the in-

dex's seven down years, negative 2.9 percent versus negative 13.7 percent.

FEES Of course, all of W. P. Stewart's returns were reported with its average management fee of 1.2 percent. And this is the area where Mr. Malkiel's feelings are strongest.

While the old adage says you get what you pay for, Mr. Malkiel argues the opposite. "The one thing I'm absolutely sure about is the less I pay to the purveyor of the service, the more that will be left for me," he said. "Whatever bad things happen with buying index funds, things are worse with actively managed funds."

This makes sense for the modest investor with a straightforward portfolio. But the counterargument is that the wealthy need more advice because of the complexity of their assets, and that the advice is worth the fees. (Mr. Malkiel would say the rich just need more tax-planning advice.)

"I understand Malkiel's argument about fees; they should not be overlooked," Mr. Jennings said. "But there are other factors, too. What is the client trying to accomplish? What are they looking to do?"

When it comes to fees, Mr. Malkiel reserves his harshest words for those favorite pre-recession investments: hedge funds. He contends that no one — except university endowment managers — should invest in them, mainly because of their fees — typically a 2 percent management fee and 20 percent of gains. Hedge funds, he said, are "great deals for the hedge fund managers but not super deals for the investors."

NO ALTERNATIVES Even Mr. Malkiel's admirers disagree with his stance against alternative investments. They argue that wealthy, sophisticated investors are shortchanged if they do not have the ability to, say, bet against the stock of a company, as some hedge funds do.

"Being able to short stocks is a very important tool," said Rex Macey, chief investment officer of Wilmington Trust, who calls himself an admirer of Mr. Malkiel. "If you're long only, all you can do is not hold a stock. If you have an opinion and insight into a company that is not good, you have to be able to short it."

But Mr. Macey added, "Burton is absolutely right that you have to be careful of fees."

Still, even if hedge funds' fees were not so high, Mr. Malkiel has another objection to them. "There are very few that are any good," he said. He added that his research had shown the good hedge funds of one era were not the good ones of another. And even if the hedge fund is a good one, he said, it's likely to be selective in its investors or simply be closed to new ones.

This comes back to his argument for indexing broadly and avoiding alternative investments. "You don't need a commodities fund if you're really well diversified and into emerging markets," he said. "You're going to have some investments in Brazil, which is natural resource rich. It's simple."

HIS PORTFOLIO Unlike most advisers, Mr. Malkiel was willing to divulge his own investments. Through his best-selling books and his various board seats Mr. Malkiel, 78, is wealthy enough to have a top adviser. But he said he indexes all the money he needs for his retirement.

"My investments are broken down almost exactly as I indicated," he said. He has put in index funds the money from his individual retirement account, his 403(b) plan — for teachers the equivalent of a 401(k) — and the fees he receives from sitting on various boards.

In addition, he said, he invests in municipal bonds. "I don't buy a fund for that because I think I'm capable of doing that myself, but most people should buy a fund," he said. "Beyond that, I buy a few stocks because it's fun."

"All the serious money," he added, "is indexed."

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