WEALTH MANAGEMENT

How a Broad Index Fund Can Hurt Retirees

When people sell holdings in an index fund, they are selling a portion of everything held by that fund, regardless of whether a given position has recently been a winner or a loser, says WSJ Wealth Expert Jonathan Guyton. PHOTO: GETTY IMAGES/ISTOCKPHOTO

By

Jonathan Guyton

Mar 5, 2017 10:00 pm ET

Jonathan Guyton is principal at Cornerstone Wealth Advisors Inc., a fee-only advisory firm in Minneapolis.

Broad-based index funds can do a real disservice to retirees. The problem stems when these funds are too broad-based, not from mirroring underlying indexes.

Why?

Unlike when they were accumulating assets, retirees have to sell holdings from time to time to fund their ongoing lifestyle, one-time discretionary expenses or to cover required minimum distributions. When they do so, they are selling a portion of everything held by that index fund, regardless of whether a given position has recently been a winner or a loser.

Of course, you'd rather sell from your winnings and give holdings that haven't done as well some time to recover or catch up. But you can't do that in an index fund or any other fund for that matter.

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This matters more often–and to a greater degree–than you might think.

Take 2016 as an example. The S&P 500 gained nearly 12%, so you'd think that most all its holdings had a pretty good year. Not so. One convenient way to think about this index is that its 500 stocks–all large companies–fit into two categories: Some are value stocks and some are growth stocks. As it happened, large value stocks gained 17% last year while large growth stocks gained just 7%, according to the Russell 1000 Value and Russell 1000 Growth indexes. Note that a 50/50 split of these two yields the 12% gain for the entire broad index.

But what if you needed to take money from your portfolio last year and decided to take some of it from U.S. large-cap stocks? If you owned a broad-based S&P 500 index fund, you'd have been forced to sell from both the value and growth halves. Likely, wanting to sell high, you'd have rather taken the money from the value stock portion.

The way to assure this control is to divide your broad-based index holdings into their component parts–in this case, large value and large growth–so that you have that choice. Most major providers of indexed mutual funds and exchange-traded funds (ETFs) offer the value and growth subsets of the broad-based index. And making this change within your IRA or 401(k) assets isn't taxable, either.

And this isn't just a 2016 phenomenon. Using the Russell value and growth indexes, there have been nine times since 2000 where their annual performance has varied by eight percentage points (800 basis points, to be precise) or more. That's roughly half the years when being able to pick whether to sell value or growth stocks could have made a significant difference.

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Similar results also can be seen across U.S. small-cap stocks, often measured by the Russell 2000 index. And this also holds true for total market indexes. Such U.S. funds give you exposure to value and growth stocks in both the large-cap and small-cap universe. That's four different categories lumped together that can exhibit very different performance results in the same year.

These differences between the style and size factors can matter a lot when using the money you've built up over so many years. Being caught with a one-size-fits-all approach to your index holdings in retirement can cost you.

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