CONSIDERATIONS ON INVESTING IN INDEX FUNDS

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ABSTRACT: *People around the world are trying to find different solutions to keep their money. Not only will they keep money but also want to invest it to achieve capital growth on this investment. In common knowledge putting money in the bank is the best decision to save money while the interest rate programs in banks are three to four times lower than capital appreciation by placing savings within ETFs (Exchange Traded Funds), index funds or similar devices.The very idea of investing in shares can bring us to a defensive thinking of taking risks, but what happens if we think long-term? Banks currently offers an interest rate of 2-3% per year at a maximum rate of interest that is actually even lower after taxation. Investing in index funds can make a capital increase of up to 10% per year over a period of 5-10 years. Do these investments involve risk? Are these investments guaranteed? What is the liquidity of the money invested? These are some questions that we will try to answer in this article observing the reality that exists in their management and short history.*

KEY WORDS: *index funds, ETF, mutual funds, capital growth, investment.*

JEL CLASSIFICATIONS: *G10, G23.*

1. INTRODUCTION

The brochure entitled "The Triumph of Indexing" was published in 1995. Vanguard included annual reports on six index-type funds which were composed of twenty-one different portfolios from which fourteen portfolios focused on different share classes and bonds and seven portfolios were focused on fiscal targets and strategic administered objectives. Vanguard was able at that time to multiply funds that

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approached the figure of 18 billion dollars by an increase of 8 billion dollars from the time of inception of the first Index 500 portfolio in 1975 (Bogle, The Triumph of Indexing, 1995).

ETF-s are described as a mix between investments on the stock market and investments made in mutual funds. ETF-s were first introduced in the 80s, being an alternative option of investment for the people which don’t want to invest their money in mutual funds.

2. THE DIFFERENCE BETWEEN ETFS, INDEX FUNDS AND MUTUAL FUNDS

A mutual fund is a basket of stocks, bonds or other assets. This profesonist basket is administered by an investment firm on behalf of investors who do not have the time, expertise or resources to buy a diversified collection of individual titles on their own. Instead, the fund charges a fee that can be around 1% of annual assets or more. That's $ 100 for every $ 10,000 invested. In the case of most stock funds, holding companies are selected by a portfolio manager, whose task is to choose the actions that he or she believes will be most efficient. This process is called "active management." but "active management" is not the only way to run a mutual fund.

An index fund adheres to a completely different strategy. Instead of choosing only those actions that the portfolio manager believes will overcome the market, an index fund buying all the shares that make up a particular index such as Standard & Poor's 500 Index which is composed of blue chip stocks or as the Russell 2000 index which is composed of small-stock companies. (Bogle, 1995)

The aim is to replicate the performance of the entire market. But because Index funds are based on buy and hold strategy rather than frequent transactions, they do not require analysts to research companies and they are much cheaper to operate. By definition, when you own all the shares that make up a market, you earn income only "average" of all stocks in this market. This raises the question: Who would want to have just performance "average"? As it turns out, a lot of investors around the world want this. While it is counter-intuitive, academic research has shown that Higher expenses associated with active management and the inherent difficulty of choosing stocks winning consistently over long periods of time means that most funds that aim to beat the market, really get behind it for the long term.

For starters, in a mutual fund, you buy and sell shares often directly with the Fund. The company allows you to trade fund these actions once a day, depending on the day and closing price.

ETFs, on the other hand, are not sold directly by fund companies. Instead, they are listed on a stock exchange, and must have a brokerage account to trade these shares. This convenience comes with a price: As with stocks, investors pay a brokerage commission whenever they buy or sell. That means that for small investors, traditional mutual funds are often more effective.

3. GROWTH OF INDEX FUNDS

We noticed the remarkable success of the investment strategies of the Index in the long term, even if it is shown that the performance of the index Standard & Poor's 500 has exceeded more than 85% of all mutual funds capital actively managed during the previous three years by so that the process is replicable and sustainable. So the growth of the Index funds has attracted increasingly more investors, thus becoming a kind of race that is well to follow effectively and productively investing in securities markets, showing a very broad diversification at a very low cost.

Accelerating growth, as it turned out, was exactly what happened. In the next two years, Vanguard Index assets rose four times as much, reaching 80 billion dollars, including 40 billion dollars in the portfolio of the original S & P 500 Index. Vanguard Index Funds would rise as the 10th largest mutual fund complex in this industry (Bogle, John Bogle on Investing: The First 50 Years, 2015).

Moreover, the initial concept, having met with such a warm welcoming from investors was inevitable copied by many other groups of funds, but not with much enthusiasm, nor with very attractive levels of costs of operation for investors. In an ideal world, the basis for the growth of mutual funds would be done gradually, in accepting simple theory underlying the Index investment: investors as a group can not overcome the market because they are the market.

And that theory resorting to the reality that: investors as a group must have lower performance as a market, as costs attendance expenses, consulting fees and transaction costs in the portfolio is a direct deduction from revenue from market.

Table 1. The growth of Index funds

Fund Name	**Net Assets (mil. RON)**	**Total growth in the last 7 years 2010-2017 (%)**	**Growth in the last 7 years Annual median (%)**	**Growth in the last 10 years/from inception (%)**
BT Index România ROTX *	59.72	+79.36	+11.33	*
Certinvest BET FI Index *	2.74	+114.64	+16.37	*
Certincest XT Index *	0.66	+38.39	+5.48	*
Index Europa BRD *	8.64	+59.76	+8.53	*
Certinvest BET Index *	0.887	+55.58	+7.94	*
BT Index Austria ATX *	10.27	+23.75	+3.38	*
Vanguard Growth Index Fund Investor Shares (USA)	342 362.41	+153.24	+21.8	+8.66
Vanguard S&P 500 ETF	356 177.72	+371.60	+53.08	*

**Inception date is near 2010*

Source: Realised by the authors based on data from anual reports of investment funds

To better understand the evolution of index funds in recent years, we have analyzed some of the most important type index funds on Romanian and foreign plan in Table 1.

In terms of the research period we believe that these funds have emerged relatively late in Romania, having a length of about 5-6 years. During the economic crisis all sectors of the economy were affected including index funds which registered a slight downfall in this period.

Certainly there are risks to these investments but are considered to be lower than other types of investments. It is normally accepted that a high level of risk and may bring high earnings potential. To believes that these investments are a gamble can be an opinion but the fact that on average they earn at least double that of bank deposits makes a calculated risk that is acceptable and long-term gains are profitable.

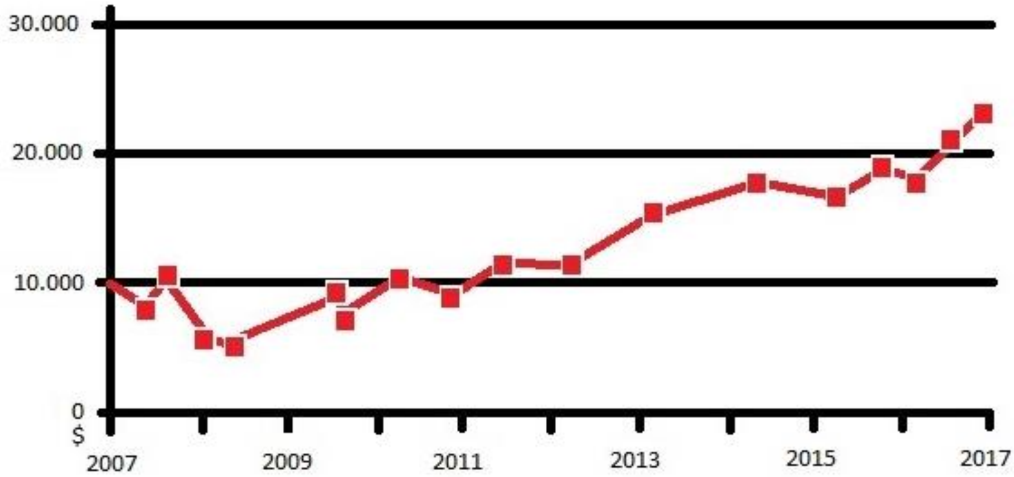
4. HOW AN INDEX FUND WORKS

Unlike actively managed funds, Index funds do not pay any advisory tax and limits portfolio turnover which keeps these costs to minimal levels. Therein lies its advantage. In essence this is all you need to know to understand what type index funds should provide higher returns in the long term. This really goes without saying, of course, that it would not matter if money managers and experienced professionals werent able to take advantage of novices and amateurs, but in highly efficient markets, this does not happen. It does not happen because professionals set prices that are paid by experts and by novices alike. Records show that most major financial markets are indeed extremely efficient.

Two of the most important evidence is that professional managers fail to overcome suitable market indices and that the ones who do so rarely repeat their past success in the future. Unfortunately, these propositions represent only a fraction of the recent increase in index funds. Rather, the extraordinarily favorable performance of the Standard & Poor's 500 Index has continued to grow over the years, becoming an extremely effective product of Wall Street. They describe portfolio Index Vanguard S&P 500 as the best option and a significant growth of fund assets seems to come from short term investors who are traders of mutual funds seeking quick profits rather than long-term investors. They are convinced by the simple theory and of the remarcable optium possibility on long term gains that index funds have to offer to those who remain in the race (Henrik, 2012).

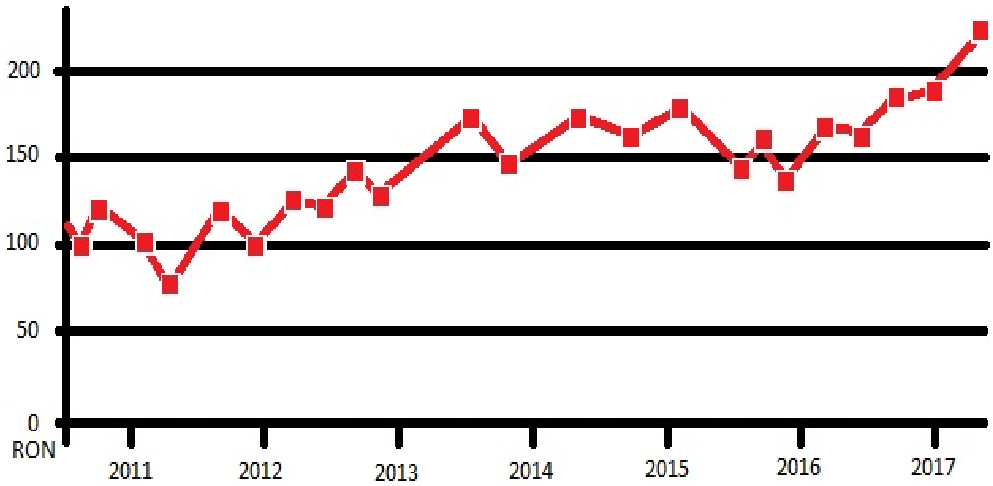
This history of the first Index Fund - The portfolio of the trust Vanguard 500 (originally under the name First Trust Investment) shows that during the first 23 years it has had many ups and downs, many challenges and many opportunities. Today, index funds changes the way investors look at mutual funds, focusing more than ever on critical issues of cost and portfolio diversification. Even if today proves to be a peak moment in popularity for the remarkable and successful popular index funds based on Standard & Poor's 500, low-cost fundamentals of these funds are strong enough to withstand the long term. After surviving defeats at the beginning of its existence, the index fund has shown that it can survive downturns (Graham, 2009).

Analysing the funds over a period of 10 years to 5 years, we can make our overall opinion on the effectiveness of this type of investment. Fig. 1 proves this in the context of the past economic crisis. Investments in these funds are preferable to be held for a minimum period of 5 to 10 years and even if the investor does not use a active method of investing activity, it is appropriate to be inform frequently and to keep in touch with their performance but also about the general state of the market to not be affected by macroeconomic issues or economic crisis. Although they are rare, their impact on investment and the economy in general may be a big impact.



Realised by the authors based on data from the source: https://personal.vanguard.com

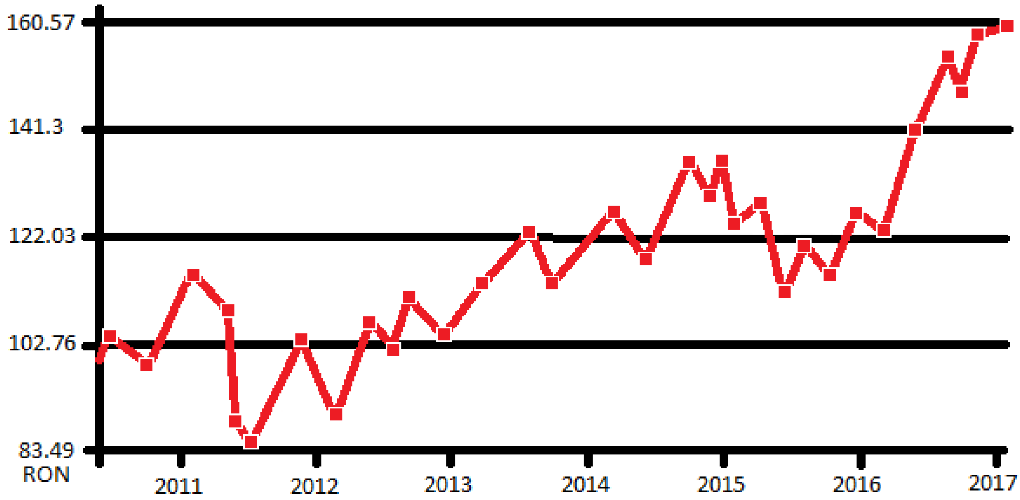
Figure 1. Vanguard Growth Index Fund Investor Shares (USA)



Realised by the authors based on data from the source: http://investitii.certinvest.ro

Figure 2. Certinvest BET FI Index

We believe that the investor commits to a undefined period of variability of which the capital is subject to over a long period of investing. If the variation supported by the investor is longer, the efficiency will be higher. Figure 2 and figure 3 describe the long period of variability.



Realised by the authors based on data from the source http://www.brdam.ro

Figure 3. Index Europe BRD

5. WHY SHOULD WE INVEST IN INDEX FUNDS?

To invest in an index fund it only takes a few minutes through a broker on the Internet and follow the steps. With the growth of the overall market, placed in the fund and savings grow. The fund management costs are low so that by choosing a fund with low management fees will bring greater benefits. No need for hard work in the investment in these funds as a passive strategy requires no more than monitoring the state and the market index fund. There is a great versatility if it invests in an ETF because it can do daily transactions, thus meaning that it can make profit when the market is growing rapidly by the action of selling before the market falls again (Zvi Bodie, 2014).

According to the hypothesis of efficient market view (not to be afraid of hard times) It is better to keep money in the market than actively trying to correlate it with the market. Not only will it be hard to beat it in the battle, but the fees will eat revenues before the investor can enjoy them. Certainly no investor wants that. The most actively managed funds do not even get average market yields. So to have optimal growth, indec funds should be considered as an alternative to management large fees, lost time and worries. It is not known what will be tomorrow's market trend and it would be a shame to be left out of a trend that could bring profitable gains.

6. CONCLUSIONS

We must make shift to new forms of investment because relying on banks can make our deposits stagnate in the long term. Also we consider that it takes time to understand the potential and also the functioning of index funds. By investing in these funds, the investor can accommodate and better understand the market without exposing a high risk investment activity since the beginning.

As regards the capital increase, we believe it should continue to be a concern regardless of the possible downfall of the market situation that could lead to a profitable gain.

In our view, long-term investments are best if it is desired to save capital, which would be specific to the sustainable development.

We consider that investing in Index funds it is an advantage for those who do not have the time and knowledge required to invest in shares, because in index funds they do not have to choose stocks individually because they are predetermined by analysts.

Investing in these devices requires passive investing and in this way the investor has time to deal with other things besides investment.

Another advantage is instant and complex diversification. Investing in S & P 500 index for example automatically diversify company shares components to mirror as well as possible the S&P 500 Index.

Over time there have been sought various forms of capital investment requiring little effort from the investor, to bring important benefits to capital growth. Passive income in popular terms means an investment that started to have benefits in the future without putting aut an amount of work. So we consider investing in Index funds a form of passive income alongside investments in stocks, income from rent or other ways to raise capital in this form.

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