EDUCATION | RESOURCES

Index Investing

Why low-cost index funds are the foundation of evidence-based investing.

2026 EDITION

An educational guide from Kimberlite Financial Services

INTRODUCTION

The boring strategy that beats almost everyone.

If you spend much time around investing, you'll meet two confident voices. The first promises to beat the market — with hot stock picks, market timing, and complicated strategies. The second says the opposite: buy a few cheap, broadly diversified index funds, hold them for decades, and let compounding do the work. The first voice is louder. The second has the data.

This guide is the case for the boring voice — written for someone who has never invested before, or who has been investing for years and is wondering why their portfolio of expensive funds is lagging. We'll cover what an index fund actually is, why decades of evidence favor low-cost indexing for the core of a portfolio, why costs matter so much more than they look on paper, the behavioral traps that quietly destroy returns, and where active management still has a defensible role.

> **EDUCATIONAL USE ONLY.** This guide is general information, not investment, tax, or legal advice. Past performance is not a reliable indicator of future results. Index funds, like any investment, can lose money. Diversification does not eliminate risk; it manages it. Talk to a fiduciary financial advisor before making decisions about your specific situation. If a passage in this guide makes you wonder ‘does that apply to me?’, the answer is: ask a pro.

How this guide is organized

Six short parts. Read in order if you're new; skim and skip if you already know the basics. The important argument lives in Parts 2 and 3 (the evidence and the cost math). Part 6 is the part most other guides skip — an honest discussion of where active management *does* earn its keep, and where it doesn't.

PART 1

What is an index fund, exactly?

Step one: an index is just a list.

An **index** is a list of investments. The S&P; 500 is a list of 500 large U.S. companies. The Total Stock Market index is a much longer list — thousands of U.S. companies of every size. The Total International index is a similar list of companies based outside the U.S. The U.S. Aggregate Bond index is a list of bonds. Each list is built and maintained by a research firm (S&P;, MSCI, FTSE, CRSP, Bloomberg) using rules that decide which investments make the cut.

Step two: an index fund just owns the list.

An **index fund** is a mutual fund or ETF that buys all (or a representative sample) of the investments on a given index. If you buy one share of a Total U.S. Stock Market index fund, you own a tiny slice of every U.S. publicly traded company. If you buy a Total International fund, you own a tiny slice of every major company in the rest of the world. That's it. There's no portfolio manager picking winners. The fund holds the list.

Step three: index investing is the strategy.

Index investing is the strategy of using these funds to build a diversified portfolio at very low cost. The simplest version — sometimes called a ‘three-fund portfolio’ — uses three index funds: U.S. stocks, international stocks, and bonds. That's a complete, globally diversified portfolio that takes about ten minutes a year to maintain.

Why it's different from active investing.

An **actively managed fund** hires a manager (and a team of analysts) to pick stocks they believe will outperform a benchmark. They charge for that effort. An index fund doesn't try to beat the index — it tries to *match* it, as cheaply as possible. The result: index funds typically charge a tenth to a twentieth of what active funds charge. As you'll see in Part 3, that small-looking difference compounds into something enormous.

> ***The whole concept in one sentence:*** *instead of trying to find the needle in the haystack, an index fund buys the haystack — cheaply.*

kimberlitefinancial.com | ryan.hammett@kimberlitefinancial.com | (801) 690-8182

PART 2

The evidence: 20+ years, the same answer.

S&P; Dow Jones publishes a research series called **SPIVA** (S&P; Indices Versus Active) that scores how active fund managers perform against their benchmark indexes. The reports go back more than two decades. The pattern is remarkably consistent: the longer the time horizon, the worse active managers look. Below are figures from the most recent SPIVA reporting.

>90%	92.5%	88.3%
U.S. LARGE-CAP	**GLOBAL**	**INTERNATIONAL**
of active U.S. large-cap funds underperformed the S&P 500 over 15 years.	of global active funds underperformed the S&P World Index over 15 years.	of international active funds underperformed their benchmark over 15 years.

Source: S&P Dow Jones Indices SPIVA Scorecards. Underperformance rates are typical of long-term findings; specific figures vary by report period.

Why does active management underperform so consistently?

Three reasons, in roughly the order they matter:

1. Costs.

Active funds charge meaningfully more than index funds. The fund's return has to clear its own fees before it can beat the benchmark. Even talented managers struggle to consistently overcome a one-percentage-point head start in favor of indexing.

2. Math.

The market's return is, by definition, the average return of all investors before costs. So before costs, half of active managers must beat the market and half must lose to it. After costs, the winners shrink and the losers grow. This is sometimes called ‘the arithmetic of active management’ (William Sharpe, 1991), and it is unavoidable.

3. Persistence.

Even when an active manager beats the market in one period, the SPIVA Persistence Scorecard consistently finds that yesterday's top-quartile manager rarely stays in the top quartile. Picking tomorrow's winning fund using yesterday's winning fund is statistically not much better than a coin flip.

PART 3

Why a 0.59% fee can cost you six figures.

The single most underrated number in investing is the **expense ratio** — the annual fee a fund charges, expressed as a percentage of the assets you have invested. Most people see ‘0.64%’ and think ‘that's nothing.’ Over 30 years, that nothing turns into something quite substantial.

Fund type	2025 average expense ratio
Index equity mutual fund	0.05%
Index equity ETF	0.48%
Active equity mutual fund	0.64%
Active equity ETF	0.74%

Source: ICI Research Perspective, 2025; Morningstar Annual Fee Study. Active equity mutual funds are roughly 10× more expensive than index equity mutual funds on a weighted-average basis.

What that gap looks like in dollars.

Consider a $100,000 portfolio earning a 7% annual return before costs over 30 years.

Cost drag	Net annual return	Ending value (30 yrs)	Amount lost to fees
0.05% (index fund)	6.95%	$745,500	—
0.64% (active fund)	6.36%	$631,200	≈ $114,300

Hypothetical example for illustration. Assumes a constant 7% gross return and no contributions, withdrawals, or taxes. Real returns vary; this is a math example, not a forecast.

The hidden costs are real, too.

Expense ratios are only the visible cost. Active funds also tend to generate higher trading costs and higher tax bills (more frequent buying and selling = more capital gains distributions). For investors holding funds in a taxable account, the after-tax gap between active and index can be even wider than the expense ratios suggest.

kimberlitefinancial.com | ryan.hammett@kimberlitefinancial.com | (801) 690-8182

PART 4

Three habits that quietly destroy returns.

Even investors who own great funds often underperform their own funds. The reason is behavior. Morningstar's annual ‘Mind the Gap’ study tracks the difference between fund returns and the dollar-weighted returns investors actually earn — the gap between what the fund did and what owners of the fund did. The gap is consistently negative, in part because of the three habits below.

1. Performance chasing.

The fund that did best last year attracts the most money this year — right before its performance often regresses to average or below. Investors buy high, then sell when returns disappoint, and start the cycle over. Indexing short-circuits this loop because there is nothing to chase. You own the haystack.

2. Market timing.

Trying to step out of the market before a drop and back in before the recovery sounds wise. The data is brutal: missing just the 10 best market days in a 20-year period can cut your final wealth in half. Those best days cluster near the worst days — which is exactly when the temptation to be out of the market is highest.

3. Complexity bias.

There is a deep human tendency to assume a complicated solution must be a better one. In investing, the opposite is usually true. A three-fund index portfolio held for 30 years has, in study after study, beaten elaborate portfolios with specialty sleeves, hedged products, alternative strategies, and frequent tactical changes — especially after fees and taxes. Simple is not the same as unsophisticated.

> ***The discipline cost is real.*** *The biggest single advantage of index investing isn't the low fees, the diversification, or the tax efficiency. It's that the strategy is boring enough that you'll stick with it for 30 years — which is when compounding does its work.*

PART 5

How to actually use index funds.

Three building blocks cover the global investable market. You don't need more than this to be diversified across thousands of companies on six continents and the U.S. bond market.

Building block	What it owns	Typical role
U.S. Total Stock Market index fund	Every U.S. publicly traded company, weighted by size.	The growth engine of the portfolio.
Total International Stock index fund	Companies based outside the U.S., across developed and emerging markets.	Diversification away from any single country's e
U.S. Total Bond Market index fund	U.S. government and high-quality corporate bonds.	Stabilizer. Reduces volatility; provides income.

Asset allocation: how much of each.

The split between stocks and bonds is the single most consequential decision in your portfolio — more important than which specific funds you pick. A general rule of thumb: subtract your age from 110 to get a stock allocation, and put the rest in bonds. So at age 30, that's roughly 80% stocks / 20% bonds. At age 60, roughly 50/50. Of the stock allocation, a common split is 60–70% U.S. and 30–40% international, but reasonable people disagree on this.

Rebalance once a year.

Over time, your allocation drifts as different parts of the market move at different rates. Once a year (or when your allocation has drifted more than ~5 percentage points), sell what's grown above target and buy what's fallen below. This forces you to sell high and buy low — the exact opposite of what most investors do on their own.

Where to hold what (briefly).

A quick note on tax-aware placement: bonds and high-turnover holdings generally belong in tax-deferred accounts (401(k), IRA), and tax-efficient broad stock index funds work well in taxable brokerage accounts. This is called **asset location**, and it can add a real fraction of a percent to after-tax returns over decades. Worth a conversation with your advisor.

kimberlitefinancial.com | ryan.hammett@kimberlitefinancial.com | (801) 690-8182

PART 6

Where active still earns its keep.

Most index-investing guides stop at 'active management is bad.' That's not quite right. A more accurate version of the argument: **indexing should be the core of almost every portfolio, but there are specific corners where active judgment still has a defensible role.** The framework professionals use is called **core and satellite**: a large indexed core surrounded by smaller, intentional active positions.

The core: 70–95% of your portfolio.

Broad, low-cost index funds covering U.S. stocks, international stocks, and bonds. This is where the SPIVA evidence applies most cleanly — in liquid, well-researched markets, active management rarely beats the index after costs. Indexing the core means you stop paying for an outcome that the data says you're unlikely to receive.

The satellite: 5–30%, used selectively.

Specific positions where active judgment *can* add value — or where indexing is genuinely harder. Common examples:

Single concentrated stock positions	Long-held employer stock, founder shares, family company stock. Decisions about when and how to diversify these are inherently active.
Less efficient or less liquid markets	Some niche corners — small-cap value, certain emerging markets, high-yield credit — show somewhat more active opportunity in the data, though even there the median active fund still loses.
Digital assets	Crypto and digital assets are a younger, less efficient market with shorter data histories. Indexed crypto products exist but are not yet a clear default; thoughtful active selection (or measured passive exposure) can both be reasonable here. This is where Kimberlite spends much of its active-management thinking.
Alternative investments	Private real estate, private credit, structured products. Often non-indexable by nature.
Tax-loss harvesting and direct indexing	Active management of *which* index components you hold (in a taxable account) to capture tax losses. The underlying strategy is still indexing; the activity is around the edges.

Two rules for satellites.

First: **size them honestly.** A satellite is supposed to be a satellite. If active positions creep up to 50% of the portfolio, you no longer have a core-and-satellite portfolio — you have a complex, high-cost active portfolio with index-fund branding.

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Second: **measure them.** Each satellite should have a benchmark and a documented reason for its existence. If a satellite has lagged its benchmark for years and the original thesis no longer holds, it should be replaced or retired.

REFERENCE

Plain-English glossary.

Active management	Strategy of trying to beat a market benchmark through stock selection or market timing.
Asset allocation	The split of your portfolio between asset classes — typically stocks, bonds, and cash. The single most consequential portfolio decision.
Benchmark	The index a fund or strategy compares itself to. The S&P; 500 is a common benchmark for U.S. large-cap funds.
Diversification	Owning a wide variety of investments so that no single one can ruin you. Index funds deliver this automatically.
ETF (Exchange-Traded Fund)	A type of fund that trades like a stock during market hours. Most index ETFs have very low expense ratios.
Expense ratio	The annual fee a fund charges, expressed as a percentage of assets. Lower is almost always better.
Index	A list of investments built on rules — for example, the 500 largest U.S. companies.
Index fund	A mutual fund or ETF that buys all (or a representative sample) of the investments in an index.
Passive management	Strategy of matching, rather than trying to beat, a market index. Synonymous with index investing.
Rebalancing	Periodically adjusting your portfolio back to your target allocation. Forces you to buy low and sell high.
Three-fund portfolio	A simple, diversified portfolio using three index funds: U.S. stocks, international stocks, and bonds.
Tracking error	The small gap between an index fund's return and the index it tracks. Usually attributable to fees and trading costs.
Turnover	How often a fund buys and sells its holdings. Index funds have very low turnover; many active funds have very high turnover.

CLOSING

The most important investing decision is showing up.

If you take only one thing from this guide, take this: **the most expensive investing decisions are not made in the funds you choose. They're made in the years you don't invest at all, the panic selling you do during a downturn, and the high-fee products that quietly skim percentage points off your returns for decades.**

Index investing is not exciting. It is not clever. It does not produce stories worth telling at dinner parties. What it does produce, more reliably than almost any other strategy available to the ordinary investor, is wealth — over a long enough timeline, and with enough discipline to hold through the parts where the strategy looks ‘wrong.’

That last part is the reason a fiduciary advisor exists. A good plan that you actually follow is worth more than a brilliant plan you abandon during the next correction. Most of what advisors actually do is help clients stay invested, stay diversified, and stay focused on the things that matter — which, in investing, are usually the boring things.

Ready to put a plan around your investing?

Kimberlite Financial Services builds fiduciary financial plans around low-cost indexed cores — with carefully chosen satellites where active management actually has a role, including in digital assets. The first conversation is free, and we'll be honest with you about whether you need an advisor at all.

Schedule a free, no-pressure introductory call:
kimberlitefinancial.com · ryan.hammett@kimberlitefinancial.com · (801) 690-8182

Final disclosure

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