PERSONAL FINANCE

The Index Fund Turns 40—and (

“They said, ‘You want to buy all the dogs?’ They thought we were crazy.” (

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The idea of an index fund seemed a bit of a joke at first. Indiscriminately buying l

Aside from being impractical to build in the infancy of computers, an index fund was an insult to investors who prided themselves on picking the best stocks out of thousands. It sounded pretty cool to economics professors and a few of their financial geek students. Almost everyone else “thought we were crazy,” Oldrich Vasicek, a mathematician who worked on one of the first index products, once recalled in an interview[1].

“They said, ‘You want to buy all the dogs … You just want to buy whatever garbage happens to be traded?’ ”

Exactly.

In 1960, two University of Chicago graduate students published an article in *Financial Analysts Journal* calling for an “unmanaged investment company.” “Investment companies as a whole have not outperformed representative stock averages,” Edward Renshaw and Paul Feldstein wrote, so why not offer a portfolio that automatically buys every stock in the Dow Jones Industrial Average or some other index?

Easier said than done. It wasn’t until the early 1970s when Vasicek and others at Wells Fargo tried using computers to build index portfolios for pensions. And it wasn’t until Aug. 31, 1976—40 years ago today—that a new firm started offering an index mutual fund, one that anyone could invest in.

Today, that firm, Vanguard Group, is the largest fund company in the world, with $3.6 trillion in assets. Buying an index fund is now the conventional wisdom, even if it means giving up your hopes of outperforming the market with a smart manager. In the 12 months that ended in June, Morningstar estimates, investors pulled $317 billion from actively managed funds while putting $373 billion into passive index funds.

But back in 1976, an investment firm executive **wrote** that all but “a very small minority” believe “index funds are a ‘cop-out’ and a fad that will soon disappear.” Indexing’s biggest fans in the 1970s were mostly on campus.

Nobel Prize-winning economist Paul Samuelson touted indexing in his column in *Newsweek*, attacking investors’ “Napoleonic delusions of being able to pick winners that will quadruple their money.” Princeton economist Burton Malkiel’s 1973 book, *A Random Walk Down Wall Street*, spread the idea that it was almost impossible for an active mutual fund manager to beat the market in the long term.

The problem was that no mutual fund existed that offered the general public that “random walk.” And Wall Street firms had no incentive to create a product that would bleed away their profits.

Luckily for the future of indexing, at the beginning of 1974, Wellington Management Co. fired its chairman and CEO, John Bogle. Bogle went on to found Vanguard Group and, a year later, convinced Vanguard’s board to launch the First Index Investment Trust, a mutual fund designed to match the performance of the Standard & Poor’s 500-stock index. *Fortune* called index funds “an idea whose time is coming,” bolstering Bogle’s optimism that Vanguard could raise as much as $150 million in an offering for the new fund.

“It was a complete flop,” Bogle recalled in 2014. The world’s first index mutual fund launched with just $11.3 million.

The critics pounced. “Moving from a fully managed fund to an index fund is merely trading one set of risks for another,” Stanford Calderwood, a consultant, wrote in *Financial Analysts Journal* in 1977. He warned that index funds could be “self-defeating,” moving stock prices with their automatic buying and attracting “some MIT computer genius” who could “rip off the index funds” by trading against them. To this day, Vanguard takes great pains in trading its trillions of dollars in assets to avoid moving prices or giving other traders an advantage. (**Here's how they do it.**)

Vanguard initially decided its new fund couldn’t own all 500 stocks in the S&P index. Instead, First Index Investment Trust—later renamed Vanguard 500 Index Fund—owned only the 200 largest stocks in the S&P 500 and 80 smaller stocks chosen as representative of the others.

Samuelson praised the new fund but complained that it came with a load of as much as 6 percent of assets invested, a fee encouraging brokers to sell the fund to their clients. In 1977, Vanguard eliminated its loads. That only made it harder for it to attract assets to the fund.

Without brokers working hard to sell the fund, investors would come only if there was “some ‘proof of the pudding’ in the fund’s performance,” Bogle said.

The early years were underwhelming. From 1977 to 1979, the fund beat only a quarter of other stock mutual funds, according to Bogle, and from 1980 to 1982 it outperformed only half.

Then it started living up to the theory, beating three-quarters of competing mutual funds in the rest of the 1980s. Other firms started experimenting with index funds in the mid-1980s, though they charged higher fees, which dampened their appeal. Vanguard kept lowering its fees and putting out new index funds to capture the returns for small stocks, the total U.S. stock market, international stocks, and the bond market.

By 1995, Vanguard could declare “the triumph of indexing,” though the product's stellar performance since then shows that boast was premature. Investors piled into exchange-traded funds, now with about $3 trillion in assets, most of them index-based. PricewaterhouseCoopers predicts that number could hit $7 trillion in five years. Vanguard’s assets have more than tripled since 2008. The recession and financial crisis only caused the popularity of indexing to soar, as the S&P 500's recovery produced gains of more than 200 percent and investors became more and more reluctant to pay fees for active management.

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Four decades ago, a financial research firm, Leuthold Group, distributed a poster to clients on Wall Street. "Help Stamp Out Index Funds," it declared, over an image of Uncle Sam. "INDEX FUNDS ARE UNAMERICAN!" Employees of the firm later said it was a joke. Last week, Sanford C. Bernstein & Co. **argued** that index funds interfere with the most productive allocation of capital. The firm warned that passive investing is "worse than Marxism."

It's still easy to criticize index funds. It's just harder to laugh at them.

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1 In a 2006 book by sociologist Donald MacKenzie, *An Engine, Not a Camera: How Financial Models Shape Markets.*

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