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Birth of the Index Mutual Fund: 'Bogle's Folly' Turns 40

John Bogle *PHOTO: ASSOCIATED PRESS*

By **JASON ZWEIG**
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Forty years ago today, the index mutual fund was born when Vanguard Group's First Index Investment Trust (now Vanguard 500 Index Fund) opened for business with $11.3 million in assets.

That was far short of the $150 million target that Vanguard's founder and the fund's creator, John C. Bogle, had set. The investment banks underwriting the fund were so disappointed by the measly amount they had raised that they wanted to give investors their money back. "I said, 'Hell no,'" recalls Mr. Bogle, 87 years old.

Today Vanguard 500 Index Fund holds more than $252 billion, and index mutual funds and exchange-traded funds invest nearly $5 trillion in combined assets.

Index funds, which own essentially all the stocks or bonds in a benchmark like the S&P 500 or the Barclays U.S. Aggregate Bond average, seek only to match the market rather than beat it. They cost almost nothing to run and outperform most of the highly paid active managers who try to do better.

The idea wasn't quite crazy in 1976, but it was close. Swashbuckling fund managers, often called "gunslingers," roamed the markets in the late 1960s and early 1970s; in 1968, several "go-go" funds had earned returns in excess of 100%.

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Critics called the index fund "un-American" and a sure path to mediocrity. The directors of Vanguard, then a brand-new investment firm that Mr. Bogle had carved out of Wellington Management Co., approved the idea only because "they were sick and tired of all the trouble I was giving them over it," he recalls. One Vanguard director was so convinced the fund was doomed to fail that he voted in favor of it but refused to join its board, Mr. Bogle recalls.

The index fund meshed perfectly with Mr. Bogle's ambition to make Vanguard into the fund industry's low-cost provider, he says, since indexing is so cheap to implement.

One inspiration was the late Massachusetts Institute of Technology economist Paul Samuelson, who had written an article in 1974 called "Challenge to Judgment," arguing that selecting superior stock pickers was a futile endeavor.

"A respect for evidence," wrote Prof. Samuelson, "compels me to incline toward the hypothesis that most portfolio managers should go out of business – take up plumbing, teach Greek, or help produce the annual GNP by serving as corporate executives."

As he was refining the idea for the index mutual fund, Mr. Bogle recalls, Prof. Samuelson often called him to offer free advice. "He became in many respects my mentor," says Mr. Bogle. "I would put the phone on speaker so I could write down his ideas as he rattled them off."

There were other precedents, although they weren't available as mutual funds the general public could buy.

At least as early as 1963, the great financial analyst Benjamin Graham had advocated the creation of what we know today as the index fund.

In 1971, a division of Wells Fargo launched a $6 million indexed portfolio of major New York Stock Exchange companies for the pension fund of Samsonite, the luggage manufacturer.

But the fund owned equal amounts of each company, rather than holding them proportionate to their market value within the index. That required frequent trading and made the fund cumbersome to run, recalls Mac McQuown, the former Wells Fargo executive who was in charge of the project. "This was fresh earth we were breaking," he says. Soon the managers learned to hold stocks in proportion to their size rather than in equal amounts, although several years went by before the fund attracted more than a handful of other clients.

By June 1975, a rival firm, American National Bank in Chicago, was running about $300 million in several index funds after two years of slowly attracting institutional clients, recalls Rex Sinquefield, who worked there as an investment officer.

All the index funds grew fairly slowly during the sluggish markets of the 1970s. But an epic bull market ran from August 1982 to March 2000, with stocks returning an average of roughly 18% annually. "First we got better markets," says Mr. Bogle, "and then the index fund gave you your fair share of great markets."

As Hemingway wrote, bankruptcy happens "gradually and then suddenly." The popularity of indexing occurred the same way. From their start at $11 million in 1976, index funds grew only to $511 million by 1985. But they expanded more than 100-fold over the next decade, to $55 billion in 1995. Their assets hit $868 billion by 2005, and no end to their growth is in sight.

Happy birthday, index funds. Although critics still abound, we should all celebrate an innovation that has cut the cost of investing by more than 90% and radically democratized the financial markets.

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