The Index Fund Approach: Tracking the Market

The goal of many individual investors is to beat the market. A large number, however, don't—particularly when the costs of trying to do so are considered. One alternative is to apply the old adage, "If you can't beat 'em, join 'em."

The index fund concept allows investors to do just that. A portfolio of stocks is constructed to mirror a market index, such as the S&P 500 index. Because stocks are not bought and sold on a continuous basis, transaction costs are reduced substantially. And there is no advisory fee, since there are no active management decisions that must be made. Because the costs are so low, index funds have the ability to closely track the index they are mirroring. The only risk that an index fund investor undertakes is market risk—the risk that the stock market itself will lose value. All other risk, such as following a strategy or picking a fund that underperforms the market, does not exist.

John C. Bogle, founder of The Vanguard Group, has been one of the prime movers in making the index fund concept available to individual investors. The Vanguard Index Trust was started in 1976 and it mirrors the S&P 500.

Bogle agreed to discuss the index fund concept with the Journal. *The interview took place in early December 1986.*

What is the Index Trust?

Vanguard Index Trust is a no-load index mutual fund, which is designed to replicate the performance of the S&P 500 stock index on a consistent basis. [The fund is now called the Vanguard 500 Index fund (VFINX).] It has no investment adviser and therefore pays no advisory fee. It owns all 500 stocks in the S&P 500 index, weighted according to their weightings in the index.

Why did you set up the Index Trust, and why would an individual investor want to use an index fund approach to investing?

We set up the Index Trust because we wanted to prove that indexing could work as a practical business matter. It's all right to talk about the market index as a theoretical portfolio that has no transaction costs, no need to price the securities every day, no need to handle shareholder accounts and no need to raise cash. The only way you can really see what an index fund can do is to put one in business. And so we did that.

The idea was that it would track the index closely enough to do what the index itself has done over the last 15 or 20 years—and that is to outperform on average over 65% of the professionally managed equity portfolios on a long-term basis. The idea was to get a low-cost vehicle—hence a no-load fund—and a low expense ratio vehicle—hence no advisory fee—that would come as close to tracking the index as would be possible.

The index fund concept is popular among the institutions, such as the major pension funds and endowments. However, one of the arguments they use to justify the use of an index fund is that their portfolios are so large they can't possibly beat the market, because they are the market. Individual investors' portfolios, however, are smaller. Can they compete successfully against the market? Your index fund concept would argue "no."

Individuals can compete successfully in the market—just as successfully as the institutions. But when you cut through it all, if there is a return of X in the market, investors collectively will divide up X minus Y, with Y being the cost of being in the market, such as commissions, advisory fees, spreads—the whole works. The fact of the matter is, if the market itself provides a 10% return, investors will divide up closer to a 9% return. If an index fund can come in and give investors a good fraction of 10%—let's say 9¾% because it has operating costs—it will outpace most of the managed accounts. And that is exactly what has happened.

In other words, some individuals will outperform the market, but others will underperform it. And the sum total is the market return minus costs.

That's correct.

What are the Index Trust's costs due to?

Our operating costs run about 0.25%—the cost of getting the price in the paper, handling shareholder accounts and the allocated share of Vanguard's costs. It is the lowest cost mutual fund that I have ever seen.

The other cost in an index fund is the cost of having a cash position, because people are going to be putting money into the fund and taking money out of the fund. When money comes and goes, and when securities in the index change, we have to buy and sell securities. This produces transaction costs, which in our experience has come to about 15 to 20 basis points. [A basis point is 0.01%. Commissions do not show up in expense ratio figures, but reduce net asset value.] So, if you put that figure on top of the 0.25% operating costs, you are looking at a shortfall in terms of performance versus the S&P 500 of about 0.40%. And that is in fact about what we have been able to achieve.

Your own Windsor Fund is one of the better arguments against an index fund approach.

That fund has outperformed the market over a long period of time. The Windsor Fund itself is closed to new investors [as of early 1986], but why shouldn't investors put their money in the other Windsor-type funds of the mutual fund industry?

A lot depends on the investor's objective. If he can pick the very best-performing fund, then the index fund is going to pale by comparison. But the odds are probably equally great that he will pick the worst-performing fund, in which case the unmanaged index fund will look like it is managed by a genius.

I would argue that an individual investor would want to do both. He can put part of his equity money in a completely predictable fund—stocks go up, he goes up; stocks go down, he goes down. There is no one interposed between him and the stock market. An active manager can make the performance better, to be sure, but that manager can also make performance worse. Probably some combination of an index fund and a more actively managed fund is something that is worth thinking about.

You are suggesting an approach similar to the core portfolio concept, which is to invest the bulk of the equity portfolio in an index fund, and then use specialty managers to add extra value. For an individual investor, the specialty managers would be actively managed mutual funds.

Sure. There are a lot of ways to do it. There are no simple answers. For example, you may want an 80% indexed core portfolio, and 20% in a more actively managed fund, such as the Vanguard Explorer, which is a very aggressive fund. On the other hand, if you invested in a fund such as Windsor, which is fairly conservative, you might want 80% in Windsor and 20% in the Index Trust—the opposite ratio. Windsor is going to parallel the market to a much more predictable extent than Explorer.

You mentioned earlier that the Index Trust is a market-weighted fund. I have read that Vanguard was considering an equal-weighted fund. What would be the advantage of this type of fund?

Actually, that's not true. We have never seriously considered an equal-weighted fund [Editor's note: As of January 2018, Vanguard still doesn't have an equal-weight mutual fund or exchange-traded fund]. What we are doing is something a little bit different. We are starting the Vanguard Quantitative Portfolio, a computer-managed fund that is oriented toward the index. In other words, the computer will grind out, on the basis of 28 different models, which stocks seem to be the most attractive and which stocks seem to be the least attractive. The fund will not just go out and buy those stocks. Rather, it will increase its S&P weighting in the attractive ones and reduce the S&P weighting in those that are not attractive. Our objective is to outperform the market by 2% a year net of all expenses. Whether this can be done … we believe it can be done, but we're not certain.

The Index Trust is perfect for market timers, but you emphatically discourage that. Why?

They would be the goose that killed the golden egg. We have a fund that has been performing very well. It has been attracting the right kind of investors—people who are in there for the longer run. If market timers were to come in and put in a lot of money on Monday and take it out on Tuesday, the fund would be buying a lot of stocks on Monday and selling a lot of stocks on Tuesday. That pyramids your transaction costs, and you can't set out to do what you wanted to do in the first place.

You also recommend against that for an individual investor's strategy in your prospectus.

Yes. Because it can't be done, in my opinion. No matter what anyone says, the security markets in the U.S. are highly efficient [stocks are correctly priced based on all publicly known information]. What you are doing when you go in and out of the markets is neither more nor less than simply guessing. You would think that an investor would be right half of the time and wrong half of the time, which would probably not be too bad, except for two things. One, it is going to cost money to move in and out; and two, the market timing investor, like all the rest of us, tends to get a little bit carried away with the emotions of the moment. We all feel better when the market is up and worse when the market is down. Well, if you are taking action on that, it follows that you are buying stocks when the market is high and selling stocks when the market is low—which is one reason the market swings high and low.

I think investors' emotions get in the way of an intelligent investment program.

This is an edited version of an interview with John C. "Jack" Bogle, founder and former chairman and CEO of The Vanguard Group, that ran in the January 1987 issue of the *AAII Journal*. Bogle was the 2015 recipient of The Cloonan Award for Excellence in Investment Education, which is presented by AAII to individuals who have made significant advances and contributions in the area of individual investor education.