

Index fund industry: Behind one of the greatest financial revolutions of the last 50 years

FT financial journalist Robin Wigglesworth has taken what could have been a dry and boring subject and woven a compelling tale with many interesting characters. **By Ronald L Moy**

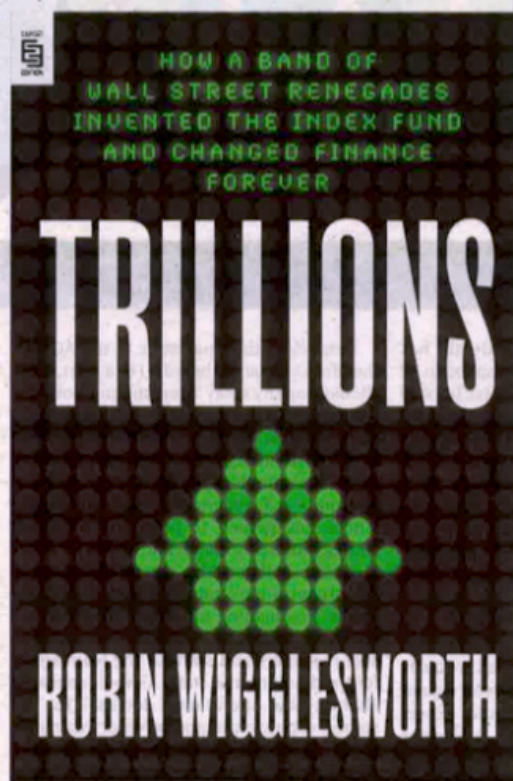
SOME 50 years ago, the index fund revolution began in the financial markets. Like many revolutions, it opened quietly, with little fanfare. As it started to attract attention, many of its ideas were rebuked by the establishment. But the revolution was kept alive by a number of smart, passionate outsiders who were looking for a way to apply the academic research they studied to real-world investing. Today, index funds have moved from being a fringe investment idea to the point of becoming the establishment.

In *Trillions: How a Band of Wall Street Renegades Invented the Index Fund and Changed Finance Forever*, Robin Wigglesworth, the *Financial Times* global finance correspondent, has penned an enlightening history of the index fund industry. With his gifted writing style, Wigglesworth has taken what could be a dry and boring account of the financial markets and woven a compelling tale of the characters who created one of the greatest financial revolutions of the last 50 years.

The book reads much like a good novel, with interesting characters that we meet along the way. Wigglesworth begins by introducing the major players with short blurbs on their backgrounds. Everyone will be familiar with Warren Buffett and John Bogle on the practitioner side, and students of finance will know of Harry Markowitz, William Sharpe, and Eugene Fama. Many of the indexing revolution's founders, however, are less well known, even to those well versed in academic finance. Some may be unaware that indexing's intellectual development did not begin with the aforementioned scholars, but rather with Louis Bachelier, a French mathematician whose early-20th-century work on the random walk laid the groundwork for the likes of Eugene Fama more than half a century later. Sadly, Bachelier was in the wrong field and ahead of his time, so his work languished in obscurity for many decades.

Serendipitous developments

Trillions recounts how a number of academics created the theoretical basis for indexing and how their disciples established an industry based on those principles, but it is also a story of several random events that led to the indexing revolution. Readers are left to wonder what the path of finance might have been without some of these serendipitous developments. If mathematician Jimmie Savage had not discovered the work of Bachelier, would Paul Samuelson and others have studied the random nature of stock prices? If Markowitz had not had a fortuitous conversation with a stockbroker outside of his advisor's office, would modern portfolio theory have begun in the 1950s? Without the foundations provided by Markowitz, would Sharpe have been drawn to finance, or might he have returned to the research he conducted at Rand on a smog tax? If Fama had opted to attend Harvard rather than call the University of Chicago to inquire about his application, would Harvard now be the home of market efficiency? And what about the



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beat any group of hedge fund managers over the decade ending in 2018. Protégé Partners chose five funds of funds, Buffett, the Vanguard 500 Index Trust. Ten years later, the Vanguard 500 Index Trust had trounced the funds of hedge funds, 125.8 per cent to 36.3 per cent. Not a single one of the funds bested the S&P 500.

The author continues the story of indexing through the development of Standard & Poor's Depository Receipts (SPDRs) and exchange-traded funds. Although exchange-traded funds (ETFs) have acquired a high profile in the financial markets, their origins and creators are not as well known as indexing's. The idea of ETFs came from Nate Most, the head of product development at the American Stock Exchange. Well acquainted with the concept of traders buying and selling warehouse receipts for commodities rather than the physical products, Most applied it to a basket of securities. Like mutual index funds before them, ETFs encountered outspoken critics, including Vanguard founder Bogle.

Wigglesworth points out several distinctions between ETFs and traditional indexing. Unlike index mutual funds, the rapidly proliferating ETFs now straddle and, in some cases, cross the line between

students whom Fama inspired at Chicago, such as David Booth and Rex Sinquefeld?

It is widely thought that indexing began with Bogle's introduction of Vanguard's flagship 500 Index Fund in 1976. In reality, passive investing originated several years earlier with Wells Fargo Investment Advisors' management of a portion of luggage maker Samsonite's pension fund.

Passive investing's early days met considerable resistance and extremely limited acceptance. By the end of 1976, Vanguard had succeeded in gathering only US\$14 million for its first fund offering, an S&P 500 tracker. Today, Vanguard manages more than US\$5 trillion.

That spectacular growth reflects the way time has proven the concept's validity. Wigglesworth tells the now legendary tale of Buffett's wager with the investment management firm Protégé Partners. Buffett bet that a fund that tracked the US stock market would

passive and active investing by tweaking the indexes in various directions. For example, Robert Netzly's Christian Wealth Management has designed ETFs to align with Christian values. Among the many other ETFs that depart from the notion of passive is HACK, which buys stocks in computer security companies.

No book on indexing would be complete without a discussion of the indexes that the funds track. Wigglesworth reminds us that an index's composition is not magically handed down from heaven. Rather, it is the construct of a committee that decides which companies are included in the index and even determines how companies are classified for the purposes of assignment to the various indexes. For example, the tech industry has come under political fire from both the left and the right for several reasons, yet some of the most frequently criticised companies are not classified as tech. The index constructors assign Amazon to the retail category, while Google and Facebook are deemed to be communications firms. On the other hand, financial payments companies, such as Mastercard and Visa, are classified as technology stocks. Index committees wield additional market power due to the price impact that is felt when a stock is added to or removed from an index.

Entire ecosystem

The indexing revolution has likely saved investors billions of dollars in fees and has shaken up the investment industry. These changes have not been costless, however. They have put pressure on the revenues of a financial industry that does not exist merely to line the pockets of analysts and portfolio managers, but instead supports an entire ecosystem. This includes such functions as furnishing active managers with research reports and executing trades, all of which are necessary for the indexing industry to survive.

Wigglesworth also raises provocative points about the pitfalls of indexing, most notably the inability of index funds to adapt to new economic or social conditions. The Feb 14, 2018 shootings at Marjory Stoneman Douglas High School serve as an example. In the wake of that deadly incident, index fund providers, such as Vanguard and BlackRock, were unable to divest stocks of gun manufacturers, prompting calls to boycott them. Similarly, index funds that are not expressly designed for the purpose cannot divest stocks that fail to meet the environmental, social, and governance (ESG) movement's standards.

Additional challenges confronting index funds arise from their own success. The industry's explosive growth has endowed the largest index fund providers with substantial percentages of shareholder votes. They may consequently end up exerting an outsized influence over governance policy, facing critics on both sides of every issue.

With *Trillions: How a Band of Wall Street Renegades Invented the Index Fund and Changed Finance Forever*, Wigglesworth has produced a book that is historical, entertaining, and thought-provoking. It is one that both finance professionals and interested laypersons will enjoy.

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