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Special Report: Mutual Funds Quarterly Review

Investors Debate the Profitability Of Much-Vaunted Index Portfolios

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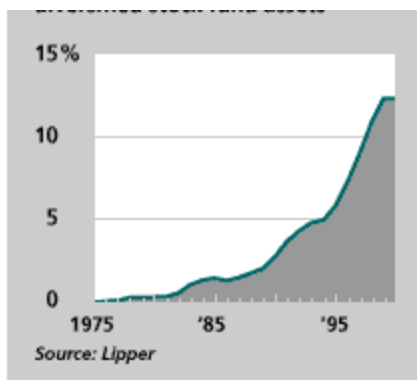
Dare to be average.

That was the message from some investment pioneers three decades ago when they suggested that investors abandon the hunt for great individual stocks and instead simply try to match the stock market's overall trend.

Money manager Rex Sinquefeld remembers the withering reaction he got from a steelmaker chief executive to using this newfangled "index investing" idea for his company's pension fund: "Sonny, I have never been average in my life and I am not going to start now." Other critics derided indexing as un-American and "striving for mediocrity," recalls Mr. Sinquefeld, now co-chairman of Dimensional Fund Advisors Inc. in Santa Monica, Calif.

The reaction was similarly unenthusiastic a few years later, in 1976, when Vanguard Group, then a tiny mutual-fund company in its first year, introduced First Index Investment Trust for small investors. Hoping to launch with \$150 million from investors, that first index mutual fund managed to garner just \$11.4 million in its initial underwriting.

A quarter century later, the picture is very different: That first index mutual fund, now called **Vanguard 500 Index Fund**, reached \$100 billion in assets last year and ranks as the nation's largest mutual fund (when its two share classes are combined). About 12% of the money invested in diversified U.S. stock funds sits in index portfolios, according to fund-tracker Lipper Inc., and among pension funds, indexing accounts for perhaps 25% or 30% of assets, according to estimates.



In all, more than \$1.5 trillion was invested in stock-index mutual funds and other indexed portfolios in the U.S. at year end, according to Pensions & Investments newspaper. Using February asset numbers, Lipper counts 249 index and index-related mutual funds, with a total in assets of \$353 billion; at the same date, there was another \$64 billion in dozens of exchange-traded index funds, according to the Investment Company Institute trade group in Washington.

As the Vanguard 500 fund approaches its 25th birthday in August,



however, there still are significant debates among investors and financial advisers about the effectiveness and role of index investing. For example:

- ⌘ While funds duplicating the composition of the large-stock Standard & Poor's 500-stock index are ubiquitous, with 80 S&P funds in operation, according to Lipper, there is continued discussion about whether indexing works in less-efficient market sectors, such as small stocks and international stocks.
- ⌘ There is also disagreement about whether new exchange-traded index funds -- which are rapidly growing in popularity for tracking U.S. indexes and also are being used increasingly for international investing as well -- are a step forward or a new hazard for investors ([see article](#)³).
- ⌘ Despite a torrent of money flowing into index funds over the past several years, it is also unclear how many investors have truly embraced the principle of index investing. Much of the race into S&P 500 funds occurred in the late 1990s, when the large growth stocks dominating that index were market leaders. In the past year's fall toward bear-market territory, though, those stocks and the S&P 500 have tumbled -- and the rush of cash into S&P 500 index funds has largely dried up.

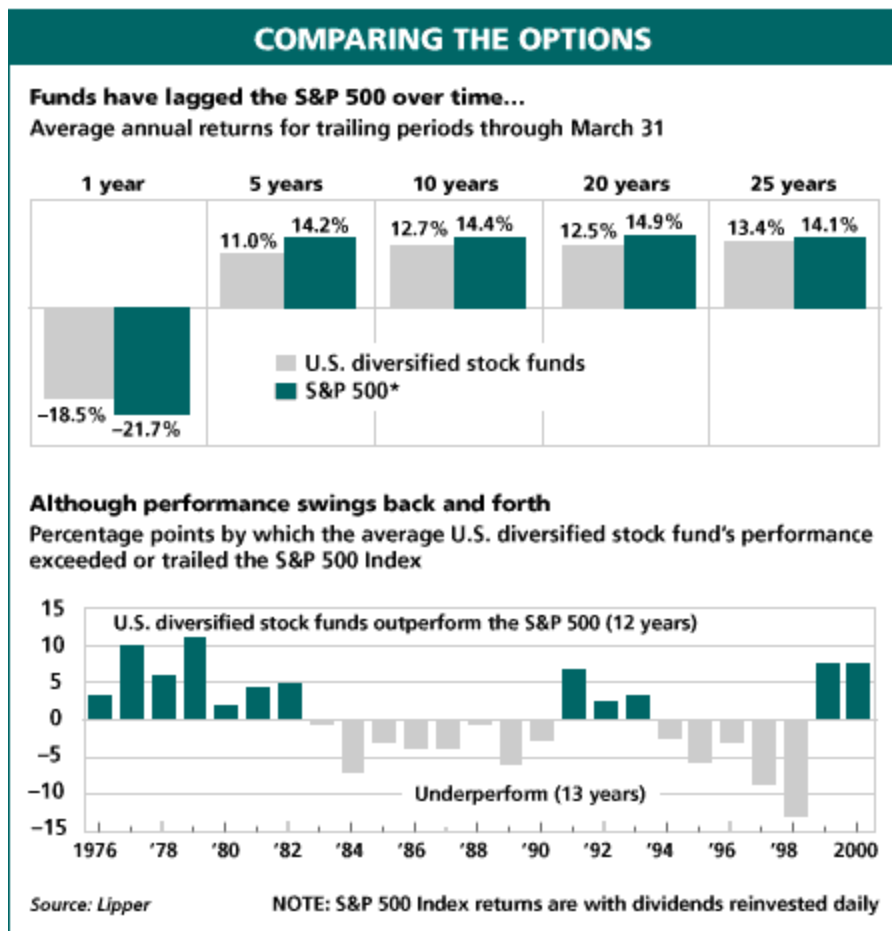
While indexing has attracted "an awful lot of converts" in recent years, says Vanguard stock-indexing chief Gus Sauter, "there certainly were a number of people who were just chasing past performance." Now, with performance down, some are heading for the exits. In January and February, investors pulled more cash out of S&P 500 index funds than they put in, the first back-to-back monthly declines in seven years, according to Lipper.

The earliest index portfolios grew out of the academic world's efficient-market theory, which postulates that stock prices are the product of all relevant information and investor expectations. That view suggests investors can't reliably predict which stocks will outperform in the future. As far back as the 1960s, pioneering studies of the actual performance of pension funds and mutual funds also showed many managers trailing market benchmarks, such as the S&P 500.

From those foundations grew "a very controversial, antiestablishment kind of idea," recalls William Fouse, who helped develop early index portfolios at Wells Fargo Bank in San Francisco. The idea: that investors could beat most "active" stock pickers simply by owning a portfolio that holds the stocks contained in an index like the S&P 500. As the market moves, so does the index fund (see [How Index Funds Work](#)⁴).

It is little surprise that many financial professionals reacted angrily. The indexing concept went "against the best interests of the professional fraternity-securities analysts, Wall Street firms, pension consultants," notes Mr. Fouse, now chairman emeritus of Mellon Capital Management in San Francisco, a unit of Mellon Financial.

In 1971, **Wells Fargo** created what many view as the first indexed portfolio -- an institutional account that aimed to match the performance of a benchmark giving equal weight to all the stocks listed on the New York Stock Exchange. Then, over the next few years, Wells Fargo, American National Bank in Chicago (Mr. Sinquefeld's employer at the time) and Batterymarch Financial Management in Boston all created institutional portfolios that tracked the performance of the S&P 500 by holding all or sometimes just selected stocks in that benchmark.



In the mutual-fund industry, meanwhile, Vanguard Group founder John Bogle emerged as the loudest voice trumpeting indexing. Beginning in the 1970s and continuing today, the former Vanguard chairman makes a simple argument in lectures and books: Since there is no reliable way to identify the fund managers who will outperform the market, investors do best to buy a broad spectrum of stocks at the lowest cost. Index funds fit the bill perfectly, with annual expense charges that can be a fraction of those on stock-picking funds. And because they buy and hold stocks, rather than trade actively, index funds can also produce much lower tax bills for long-time fund investors.

Beyond indexing's appeal as an investing strategy, Mr. Bogle has had business reasons to promote index funds that date back to Vanguard's early days, when he had a tussle with his former partners. He had been president of investment firm Wellington Management Co. until being forced out in 1974 in a dispute over management style.



John Bogle

Mr. Bogle continued as board chairman of the 11 Wellington-managed funds, however, and he convinced the other directors to give his newly formed Vanguard Group the job of handling the funds' administrative tasks. Setting up an index fund gave Mr. Bogle a way to expand his nascent operation while steering clear of Wellington's management and distribution responsibilities for the other funds.

Indeed, he told the fund directors that Vanguard wouldn't actually be managing the index fund, since this new type of fund didn't need to be actively managed. ("They bought that, as surprising as it may sound," Mr. Bogle recalls.) After an initial underwriting by some securities firms, he moved to make the index fund

available to investors without sales commissions, thereby sidestepping Wellington's regular distribution network.

Investors' reaction? The new fund "went nowhere," Mr. Bogle says. "It was not a popular idea." Indeed, it wasn't until 1984 that the second index mutual fund was brought to market by Wells Fargo, also tracking the S&P 500.

Through the 1980s, indexing gained considerable steam in the pension-fund world, but penetration in mutual-fund world was slower. The growth of index mutual funds got a boost with the spread of 401(k) retirement plans, as corporate employers found S&P 500 index funds to be an attractive choice for employees. Other fund companies that initially had scoffed at the index idea followed Vanguard's lead, but often not with great enthusiasm.

Back in the 1970s, for instance, Fidelity Investments chief Edward C. Johnson III had expressed disdain for the indexing idea. "I can't believe that the great mass of investors are going to be satisfied with just receiving average returns," he was quoted as saying. "The name of the game is to be the best."

Fidelity opened an S&P 500 fund for corporate clients to offer their employees in 1988 and a retail fund for individuals in 1990. The Boston fund giant acted to meet investor demand for index funds, says Senior Vice President Sarah Libbey, even though "we as a company definitely stand behind active management as being what over the long term will produce the best results."

The heyday of S&P 500 index funds began in 1995, when 83% of diversified U.S. stock funds trailed the 37.6% return of the S&P 500 index, according to Lipper. The next three years saw more of the same, with the S&P 500 index and S&P 500 index funds posting huge gains that beat the average U.S.-stock fund by a wide margin. Investors flocked to the S&P 500 funds. At the end of 1998, 10.9% of the money invested in diversified stock funds was in index funds, according to Lipper, more than double the 5% figure at the end of 1994.

Some active managers do outperform the broad market indexes over long stretches and many managers do better than the market in some years. In each of the last two years, for example, stockpickers have won bragging rights, breaking a string of outperformance by the S&P 500. Actively managed U.S. diversified stock funds returned an average 28.6% in 1999, compared with the S&P 500's 21% gain, while in 2000, these managers lost an average 1.6%, less than the S&P's 9.1% decline, including dividends.

On average, however, indexing has paid off for fund investors over time. Among U.S. diversified funds in operation for the 20 years through March, for instance, fully 82% lagged behind the performance of the S&P 500 index, according to Lipper. Diversified funds returned an average 12.5% a year over that period, while the S&P 500 index returned 14.9%.

That isn't a perfect comparison because the S&P index is dominated by the largest companies -- which have been stock-market stars in recent years -- while funds have more exposure to midsize and small companies. A pure index also has no operating expenses, as an index fund does, so that also puts actively managed funds at a bit of a disadvantage in the comparison.

But when fund tracker Morningstar Inc. compares the Vanguard 500 with its peer group of "large blend" stock funds, the Vanguard fund similarly has outperformed for the past 20 years, returning an average 14.6% a year vs. 12.4% for the category.

Given such numbers, some indexing advocates are surprised and disappointed that index funds haven't claimed a larger piece of the mutual-fund market. "Indexing has been a failure, in the sense that it should have taken over a good deal more" of the investing market, Mr. Fouse says. He believes "additional headway will be made slowly because people just don't want to believe that they can't win" when pitted against a market benchmark.

Still, many indexing advocates believe the mechanical investing approach of indexing will claim a larger market share over time. How big? At Barclays Global Investors in San Francisco, which traces its corporate lineage to an early indexing unit of Wells Fargo, global chief executive Patricia Dunn thinks 50% of assets isn't unreasonable. At that point, she says, investors in the aggregate would be "agnostic" about whether "passive" index investing or "active" stockpicking is the winning strategy.

Of course, it isn't necessarily an either-or choice. Even indexing uber-advocate Vanguard, which also runs stock-picking funds, sees virtue in an active-passive mix. "Is it smart to track the market and try to beat it?" asks Vanguard Web ads; yes, they say, recommending active and passive funds "working in tandem."

Ms. Dunn's company is currently at the center of one of the most interesting and debated developments in indexing -- the proliferation of exchange-traded index funds. These funds can be bought and sold, most of them on the American Stock Exchange, throughout the trading day like individual stocks. Barclays last year introduced more than 40 exchange-traded iShares, many focusing on a single industry or country.

The iShares and other ETFs "are a dramatic step forward," says Robert Levitt, a financial adviser in Boca Raton, Fla., who uses index vehicles primarily to invest in large U.S. stocks. Besides the convenience of continuous trading, he says ETFs are even more tax-efficient and sometimes lower in cost than ordinary index mutual funds.



Patricia Dunn

But some long-time indexing purists like Mr. Bogle say ETFs, which first appeared in 1993, primarily encourage short-term trading, a game at which many individual investors lose money.

Ms. Dunn replies that such criticism is "pretty paternalistic" and that ETFs are a more diversified tool than common stocks for investors trying to capitalize on expected market trends. The two largest ETFs track the S&P 500 and the technology-heavy Nasdaq index ([see the latest performance of ETFs](#)⁵).

Another area of debate, one that directly affects the flow of money into index funds this year -- concerns the usefulness of indexing beyond the big stocks in the S&P 500 index. Mr. Levitt, for instance, uses index funds to invest in large U.S. stocks, but believes "active managers can add the most value in less-efficient, less-liquid areas of the markets," including small stocks and international stocks. Some performance statistics suggest that active funds may beat indexing in such areas. Over the 10 years through March, for instance, international-stock funds returned an average 7.2% a year, according to Lipper, topping the 6.2% return on Morgan Stanley Capital International's Europe, Australasia and the Far East index.

Indexing advocates respond that international index funds looked quite strong relative to active managers in the 1980s. And both the 1980s performance and the 1990s record can be traced to Japan. In the 1980s, when the Japanese market was so strong, active managers were hurt by having less exposure to Japan than did the index. More recently, active managers have benefited from choosing to have less

than the index weighting in Japan. Such fluctuations should wash out over extended time periods.

"Indexing by definition works everywhere," declares Mr. Bogle. And since trading small stocks and international stocks is more costly than trading the largest U.S. stocks, he says, "indexing by definition works better in those markets."

Mr. Bogle says investors who bought the Vanguard 500 in recent years only because it was a top performer "are damned fools and are or will be disappointed." Some of those investors may obviously head for the exits.

A 'Humbling' Quarter

Nowhere to run, no place to hide.

So it was for investors in stock mutual funds in the first quarter, as the average U.S. diversified portfolio lost 13.1%, the worst showing since a loss of 14.7% in the 1998 third quarter. Fewer than 8% of stock funds avoided a loss in the quarter, according to Lipper Inc.

The Standard & Poor's 500 Index lost 11.9% in the quarter, including dividends.

"It's been a humbling market," sighs Jane Putnam, manager of the Oppenheimer Capital Appreciation Fund. Ms. Putnam's fund lost 10.4% in the first quarter, yet it was still one of the period's top-performing large-cap growth funds.

Growth funds of all types fell an average of 21.4% in the quarter, while the more-defensive value funds lost a comparatively modest 3.7%. Technology funds took another severe pounding, falling 34.2% on average during the quarter and bringing their total drop for the year ended March 31 to 62.2%.

For bond investors, the picture was brighter. The average taxable bond fund gained 2.24% in the period, the strongest increase for the category since the 1997 third quarter.

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