The First Index Mutual Fund

Introduction

In April, 1995, just two years ago, Vanguard published a booklet which we had the temerity to title, "The Triumph of Indexing." The booklet included the Chairman's letters I had written for the 1994 Annual Reports of Vanguard's six index funds, then composed of 21 separate portfolios—14 portfolios of various classes of U.S. stocks, international stocks, high-grade bonds, and balanced (stock-bond) investments, and seven portfolios focused on tax-managed or life strategy (asset allocation) goals. By then, total assets of the Vanguard index funds had reached $18 *billion*, a remarkable growth from $11 *million* when we formed the first (Index 500) portfolio of Vanguard Index Trust in 1975.

In the introduction, I noted the remarkable success of index investment strategies over the long term, even as I disclaimed the notion that the recent performance of the Standard & Poor's 500 Stock Index—outpacing more than 85% of all actively-managed equity mutual funds during the previous three years—was either sustainable or repeatable. Nonetheless, I looked forward to accelerating growth for indexing as growing numbers of investors came to recognize that "the index fund is the proverbial better mousetrap . . . a very efficient and productive means of investing in the securities markets . . . providing extraordinarily broad diversification at extraordinarily low cost."

And accelerating growth, as it turned out, was just what came to pass. In the subsequent two years, Vanguard Index assets have increased more than fourfold—to $80 billion, including $40 billion in the original Index 500 Portfolio. Indeed, standing alone, without counting the other $200 billion of "conventional" fund assets now managed by Vanguard, the Vanguard Index funds would rank as the tenth largest complex in the entire mutual fund industry. What is more, our original concept, having met with such a fine reception from investors, is finally (and, I suppose, inevitably) being copied by many other fund groups, albeit neither with much enthusiasm nor with particularly attractive operating cost levels (other than through fee waivers that are but temporary) for investors. Be that as it may, however, we have come a long way since "Bogle's folly"—a phrase I heard all too often from the late 1970s through the early 1990s—first saw the light of day in 1975.

In an ideal world, the basis for the growth of index mutual funds would have been the gradual, if grudging, acceptance of the simple theory that underlies index investing: investors as a group cannot *outperform* the market, because they *are* the market. And from that theory flows the reality: investors as a group must *underperform* the market, because the costs of participation—largely operating expenses, advisory fees, and portfolio transaction costs–constitute a direct deduction from the market's return. Unlike actively-managed funds, an index fund pays no advisory fees and limits portfolio turnover, thus holding these costs to minimal levels. And therein lies its advantage. That, essentially, is all you need to know to understand why index funds must provide superior long-term returns.

This self-evident reality, of course, wouldn't matter if experienced professional money managers were able to take advantage of tyros and amateurs. But in highly-efficient markets, that doesn't happen. It doesn't happen because it is the professionals who set the prices that are paid by expert and novice alike. And the record is clear that most major financial markets are indeed highly efficient. The body of evidence—some would say *brute* evidence—(a) that most professional managers fail to outpace appropriate market indexes; and

(b) those who do so rarely repeat in the future their success in the past—is so abundant as to defy substantive rebuttal.

Alas, these compelling propositions account for but a fraction of the recent growth of index funds. Rather, the extraordinarily favorable performance of the Standard & Poor's 500 Index funds—performance we disclaimed in "The Triumph of Indexing early in 1995—has not only continued, it has gotten even better during the remainder of 1995, in 1996, and so far in 1997. Sorry to say, index funds are "a hot product"—*The Wall Street Journal* described Vanguard's Index 500 Portfolio as the "industry darling"—and a significant portion of index fund asset growth appears to be coming from short-term investors who are mutual fund traders, seeking quick returns, rather than long-term investors persuaded by the simple theory and the remarkable opportunity for the optimal long-term returns that indexing offers to investors who "stay the course."

But, as this history of the first index fund—the 500 Portfolio of Vanguard Index Trust 500 (initially operating under the name First Index Investment Trust)--recounts, the first 23 years has had many ups and downs, many challenges and many opportunities. Today, index funds are changing the way investors look at mutual funds—focusing more than ever on the critical issues of cost and diversification. Even if today proves to be, as well it might, a momentary peak in popularity for the remarkably popular and successful index funds based on the Standard & Poor's 500 Stock Index, I believe the fundamentals of low-cost indexing are so strong as to prevail over the long pull. Having survived early defeat, as I note at the end of the chapter, the index fund can also survive victory.

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