

Jack Bogle: The Triumph of the Index Fund

By Robert Huebscher
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Jack Bogle has spent his career selling investors on virtues of index funds. In a talk last week, he spoke triumphantly, as if the battle is all but over.

In the first month of this year, he said, the top 50 mutual funds took in \$15 billion of new investor funds, of which \$17 billion came into Vanguard.

“Our top 50 rivals together had outflows of \$2 billion,” he said. “Those trends are not passing fads.”

Bogle is the founder of the Vanguard Group, the largest provider of indexed mutual funds. He now serves as the president of Vanguard's Bogle Financial Markets Research Center. He spoke last week at the Index Universe conference in Philadelphia, where he was interviewed on stage by Ted Aronson, the founder of Aronson Johnson Ortiz, a Philadelphia-based active manager.

About 25% of mutual fund assets are invested in index funds, Bogle said. The number would be higher if closet indexers and quantitative-index strategies were included. In the last five-plus years, he said, index funds have gained \$600 billion in assets, while active managers have lost \$400 billion

“Those are big warning signs,” Bogle said.

Over his career, Bogle said, the investment industry has grown from a cottage industry to a marketing-driven behemoth. It now operates like a casino, and the croupiers – the active managers, whose fees are unjustified in light of the value they fail to add – have opened the door for indexing.

That said, Bogle advised investors to disregard the fact that index funds outperformed active managers by the largest amount ever last year. “It’s not going to happen again,” Bogle said. “It’s simply irrelevant.”

Former Supreme Court Justice Louis Brandeis correctly warned in 1914 that the widespread speculation of that era would lead to a collapse because of the “relentless rule of humble arithmetic.” Investors should recognize that indexing will triumph over the long term because of that same rule, Bogle said.



Bogle took a swipe at fundamental indexing, citing the methodologies of Rob Arnott and Jeremy Siegel. While their ideas are not “terrible,” Bogle said, they do not represent the Copernican revolution that some have contended.

“It probably won’t do anyone irreparable harm,” was the highest praise Bogle could muster for fundamental indexing.

Having examined the track records of numerous money managers, Bogle said it is now easy for him to identify when back-testing ended and the live results began. “The great becomes ordinary,” he said, because managers bring out their methodology when they can best justify it.

Over the last five years, since their introduction, both Arnott’s and Siegel’s funds have performed roughly as well as the overall market, but with markedly higher volatility, according to Bogle. “After five years of reality,” he said, “where did Copernicus go?”

Index managers can add value in one – and only one – way, Bogle said: by slashing costs and keeping turnover down. Vanguard’s index fund charges a fee of six basis points, but Bogle cited a competitor’s fund that charged many times more than that – plus a sales charge. When he asked the executive in charge of that fund how he justified such fees, the manager responded: “It’s our cash cow.”

“That pretty much sums up the problem,” Bogle said. “How is that not a breach of fiduciary duty?”

Bogle said that speculators engage in \$400 trillion of transactions yearly, with the house taking its cut even as value is relentlessly destroyed. By contrast, a mere 5% of that total – \$200 billion – is raised as new capital for companies.

“That doesn’t make any sense at all,” he said.

The remedy, he said, is to be thinking every day about developing a moral culture and values that are devoted to serving the clients. “It’s not a complicated business,” Bogle said. “But I’ve read that there is some big firm in New York that is not doing that.” (His tongue-in-cheek reference was to Greg Smith’s now-infamous resignation letter from Goldman Sachs, which appeared as an [op-ed](#) in *The New York Times*.)

For those who are concerned about turning their backs on active managers and embracing the often-unglamorous world of passive management, Bogle cited the French philosopher Blaise Pascal, who said: “All of humanity’s problems stem from man’s inability to sit quietly in a room alone.”

Investors have to be persuaded by the growing evidence that index funds work, Bogle said. Reversion to the mean, he said, is the unyielding force that operates everywhere in



the markets, on individual stocks and on fund managers alike. It is why Bill Miller, the Magellan Fund, and countless others all eventually suffered sub-par returns.

“Look at Morningstar’s Managers of the Year,” he said. “That is the one place you should not bet – and you shouldn’t bet anyway.”

“Greater activity results in lower returns,” Bogle said. “If each investor looked at his own self interest and invested that way, all these problems would go away.”

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