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WEEKEND INVESTOR

Bogle Sounds a Warning on Index Funds

The father of the index fund says it's probably only a matter of time before they own half of all U.S. stocks; 'I do not believe that such concentration would serve the national interest'

Jack Bogle after speaking at the 2018 Bogleheads Conference. The creator of the index fund says their increasing dominance may create some of the 'major issues of the coming era.' **PHOTO:** RYAN COLLERD FOR THE WALL STREET JOURNAL

By John C. Bogle
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There no longer can be any doubt that the creation of the first index mutual fund was the most successful innovation—especially for investors—in modern financial history. The question we need to ask ourselves now is: What happens if it becomes too successful for its own good?

The First Index Investment Trust, which tracks the returns of the S&P 500 and is now known as the Vanguard 500 Index Fund, was founded on December 31, 1975. It was the first "product," as it were, of a new mutual fund manager, The Vanguard Group, the company I had founded only one year earlier.

The fund's August 1976 initial public offering may have been the worst underwriting in Wall Street history. Despite the leadership of the Street's four largest retail brokers, the IPO fell far short of its original $250 million target. The initial assets of 500 Index Fund totaled but $11.3 million—falling a mere 95% short of its goal.

The fund's struggle for the attention (and dollars) of investors was epic. Known as "Bogle's folly," the fund's novel strategy of simply tracking a broad market index was almost totally rejected by Wall Street. The head of Fidelity, then by far the fund industry's largest firm, put the kiss of death on his tiny rival: "I can't believe that the great mass of investors are [sic] going to be satisfied with just receiving average returns. The name of the game is to be the best."

Almost a decade passed before a second S&P 500 index fund was formed, by Wells Fargo in 1984. During that period, Vanguard's index fund attracted cash inflow averaging only $16 million per year.

Now let's advance the clock to 2018. What a difference 42 years makes! Equity index fund assets now total some $4.6 trillion, while total index fund assets have surpassed $6 trillion. Of this total, about 70% is invested in broad market index funds modeled on the original Vanguard fund.

Yes, U.S. index mutual funds have grown to huge size, with their holdings doubling from 4.5% of total U.S. stock-market value in 2002 to 9% in 2009, and then almost doubling again to more than 17% in 2018. Even that penetration understates the role of mutual fund managers, as they also offer actively managed funds, and their combined assets amount to more than 35% of the shares of U.S. corporations.

If historical trends continue, a handful of giant institutional investors will one day hold voting control of virtually every large U.S. corporation. Public policy cannot ignore this growing dominance, and consider its impact on the financial markets, corporate governance, and regulation. These will be major issues in the coming era.

Three index fund managers dominate the field with a collective 81% share of index fund assets: Vanguard has a 51% share; BlackRock, 21%; and State Street Global, 9%. Such domination exists primarily because the indexing field attracts few new major entrants.

Why? Partly because of two high barriers to entry: the huge scale enjoyed by the big indexers would be difficult to replicate by new entrants; and index fund prices (their expense ratios, or fees) have been driven to commodity-like levels, even to zero. If Fidelity's 2018 offering of two zero-cost index funds has established a new "price point" for index funds, the enthusiasm of additional firms to create new index funds will diminish even further. So we can't rely on new competitors to reduce today's concentration.

Most observers expect that the share of corporate ownership by index funds will continue to grow over the next decade. It seems only a matter of time until index mutual funds cross the 50% mark. If that were to happen, the "Big Three" might own 30% or more of the U.S. stock market—effective control. I do not believe that such concentration would serve the national interest.

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My concerns are shared by many academic observers. In a draft paper released in September, Prof. John C. Coates of Harvard Law School wrote that indexing is reshaping corporate governance, and warned that we are tipping toward a point where the voting power will be "controlled by a small number of individuals" who can exercise "practical power over the majority of U.S. public companies." Professor Coates does not like what he sees, and offers tentative policy options—some necessary, often painful to contemplate. His conclusion—"The issue is not likely to go away"—is unarguable.

Solutions to resolve the issues connected with the concentration of corporate ownership are not self-evident, but a number of tentative possibilities have already been advanced:

• More competition from new entrants to the index field. For the reasons noted above, this eventuality seems highly unlikely.

• Force giant index funds to spin off their assets into a number of separate entities, each independently managed. Such a drastic step would—and should—face near-insurmountable obstacles, for it would create havoc for index investors and managers alike.

• Require index funds to hold just one company in any industry. Leaving aside the dubious ability of either academia or federal bureaucrats to define precisely what constitutes a given industry, such a drastic change would lead to the destruction of today's S&P 500 index fund, by common agreement, the most beneficial innovation for investors of the modern age.

• Timely and full public disclosure by index funds of their voting policies and public documentation of each engagement with corporate managers. This would take today's transparent and constructive governance practices several steps further.

• Require index funds to retain an independent supervisory board with full responsibility for all decisions regarding corporate governance. The problem with this idea is that it is not clear how such a board could add to the present scrutiny of the fund's independent directors.

• Limit the voting power of corporate shares held by index managers. But such a step would, in substance, transfer voting rights from corporate stock owners, who care about the long-term, to corporate stock renters, who do not… an absurd outcome.

• Enact federal legislation making it clear that directors of index funds and other large money managers have a fiduciary duty to vote solely in the interest of the funds' shareholders. While I believe that such a fiduciary duty is implicit today, making it explicit, with appropriate penalties for violations, would be a constructive step.

It is time for public officials to consider the pros and cons of these issues with indexers, the financial community, academia, and active managers alike—and develop national policies that support high standards of corporate governance. It will require their working together constructively and cooperatively.

But one thing seems crystal clear. Even if present trends continue (sometimes they don't), the enormous value of index funds should not be ignored. First, index funds provide investors with the most effective stock-market strategy of all time: buy American business and hold it forever, and do so at rock-bottom cost. Second, index funds are among the few truly long-term owners of stocks—for all practical purposes, permanent owners of capital—an enormously valuable asset to society. The long-term focus of index funds is a much needed counterweight to the short-termism favored by so many market participants.

Prof. Coates agrees that nothing should jeopardize the existence of today's index funds.

"Indexing has created real and large social benefits in the form of lower expenses and greater long-term returns for millions of individuals investing directly or indirectly for retirement," he writes. "A ban on indexing would clearly not be a good idea." I can only say, "Amen" to those words.

Mr. Bogle is founder of The Vanguard Group and creator of the first index mutual fund. This article is adapted from his new book, "Stay the Course: The Story of Vanguard and the Index Revolution," to be published by Wiley on Dec. 6.