

# “Enhanced” Index Funds: Can They Beat the Market?

By John C. Bogle

Since the inception of the first index mutual fund in 1975, indexing—investing in passively managed, broadly diversified, low-cost, stock and bond index funds—has proved to be both a remarkable artistic success and a remarkable commercial success.

In terms of artistic success, index funds have been able to provide returns to investors that have vastly surpassed the returns achieved by investors in actively managed mutual funds.

Given that artistic success, the commercial success of indexing is hardly surprising. Today, most indexed assets are concentrated in classic index funds representing the broad U.S. stock market (the S&P 500 or the Dow Jones Wilshire 5000), the broad international stock market (the Morgan Stanley EAFE [Europe, Australia, and Far East] Index), and the broad U.S. bond market.

Assets of these traditional classic stock index funds have grown from \$16 million in 1976 to \$445 million in 1986, to \$68 billion in 1996, to \$369 billion in 2006—7% of the assets of all equity mutual funds.

Assets of bond index funds have also soared—from \$132 million in 1986, to \$6 billion in 1996, to \$62 billion in 2006—7% of the assets of all taxable bond funds.

## Success Breeds Competition

Indexing has become a competitive field. The largest



managers of the classic index funds are engaged in a fiercely competitive price war, cutting their expense ratios to draw the assets of investors who are smart

enough to realize the price is the difference.

This trend is great for index fund investors. But it slashes profits to index fund managers and discourages entrepreneurs who start new fund ventures in the hopes of enriching themselves by building fund empires.

So how can promoters take advantage of the proven attributes that underlie the success of the traditional index fund?

Why, create new indexes! Then, claim that they will consistently outpace the broad market indexes that up until now have pretty much defined how we think of indexing. And then charge a higher fee for that higher potential reward, whether or not it is ever actually delivered.

Traditional indexes are cap-weighted. That is, the weight of each stock (or bond) in the index portfolio is determined by its market capitalization. The total U.S. stock market, with a value of \$15 trillion, represents the collective investment of all stockholders of U.S. equities. So it follows that, together, all investors as a group earn precisely the market's return.

If the market rises by 10%, all investors as a group earn 10% (before costs). So the miracle, as it were, of the index fund, is simple arithmetic. By minimizing all those costs of investing, it guarantees that its participants will earn higher net returns than all the other participants in stock ownership as a group. This is the only approach to equity investing that can guarantee such an outcome.

## *The Active Approach*

The only way to beat the market portfolio is to depart from the market portfolio. And this is what active managers strive to do, individually. But collectively, they can't succeed, for their trading merely shifts ownership from one holder to another. All that swapping of stock certificates back and forth, however it may work out for a given buyer or seller, enriches only our financial intermediaries.

The active money manager, in effect, puts forth this argument. "I'm smarter than the others in the market. I can discover undervalued stocks, and when the market discovers them and they rise in price I'll sell them. Then I'll discover other undervalued stocks and repeat the process all over again. I know that the stock market is highly efficient, but through my intelligence, my expert analysts, my computer programs, and my trading strategies, I can spot temporary inefficiencies and capture them, over and over again."

Some fund managers have actually succeeded in this task. But they are precious few in number—over the past 36 years, just three funds out of 355—8/10 of 1%—have consistently distinguished themselves.

Nonetheless, hope springs eternal among money managers, and they strive for excellence. Of course, they believe in themselves (this field has few shrinking violets!), but they also have a vested financial interest in persuading investors that if they have done well in the past they will continue to do so in the future. And if they haven't done well in the past, well, better days are always ahead.

## *Indexing Gets Active*

In recent years, something new has been added to the mix. There are now financial entrepreneurs who believe—I'm sure, sincerely (if with a heavy dollop of self-interest)—that they can create indexes that will beat the market.

Interesting!

They have developed new methods

of weighting portfolio holdings that they vow will outperform the traditional market-cap-weighted portfolio that represents the holdings of investors as a group.

This new breed of indexers—not, in fact, indexers, but active strategists—focus on weighting portfolios by so-called fundamental factors. Rather than weighting the individual stock holdings by market cap, they use a combination of factors—such as corporate revenues, cash flows, profits, or dividends (for example, the portfolio may be weighted by the dollar amount of dividends distributed by each corporation, rather than the dollar amount of its market capitalization). These strategists argue, fairly enough, that in a cap-weighted portfolio, half of the stocks are overvalued to a greater or lesser extent, and half are undervalued.

The traditional indexer responds: "Of course. But who really knows which half is which?"

The new fundamental indexers unabashedly answer, "We do." They actually claim to know which is which. And—this will not surprise you—the fundamental factors they have identified as the basis for their portfolio selections actually have outpaced the traditional indexes in the past. (This is called data mining, for you can be sure that no one would have the temerity to promote a new strategy that has lagged the traditional index fund in the past.)

The members of this new breed are not shy about their prescience. They claim variously, if a tad grandiosely, that they represent a "new wave" in indexing, a "revolution" that will offer investors better returns and lower volatility, and a "new paradigm." Indeed, they describe themselves as the new Copernicans, after the man who concluded that the center of the solar system was not the earth, but the sun.

They compare the traditional market-cap weighted indexers with ancient astronomers who attempted to perpetuate the Ptolemaic view of an earth-centered universe. And they assure the world that we're at the brink of a "huge paradigm shift" in indexing.

They come armed with vast statistical studies that prove how well their methodologies have worked in the past (or at least since 1962, when their backtested studies began). But think for a moment about one of the most fundamental rules of mutual fund investing: The past is not prologue. These new paradigmists casually ignore that truism.

For example: "Dividend indexes outperform capitalized-weighted indexes." (Not, "have outperformed in the past.") "The fundamental index adds more than twice as much incremental return." (Not, "has added in the past.")

Investors (and managers, too) love to believe that the past is prologue. It would make life so easy. But it is no accident that these new index funds are being introduced only after their strategies have seen their best days. Following the stock market bubble burst in 2000, value stocks outpaced growth stocks (the market-cap index holds both) over the subsequent five years; and for dividend-paying stocks, the pattern is about the same.

Even including this recent advantage, the long-term margins of superiority achieved by these theoretically constructed backtested portfolios are not large—between 1% and 2% per year.

How much of that edge would have been confiscated by their expense ratios? (The lowest is 0.28%; the average is about 0.50%; the highest that I've seen is 1.89%.)

How much would have been confiscated by their extra portfolio turnover costs compared with the classic index funds?

How much would have been confiscated by extra taxes paid by shareholders when that turnover resulted in gains?

Even if the modest margins claimed in the past were to repeat—which, I believe, is highly unlikely—these backtested hypothetical returns would be significantly eroded, if not totally erased, by those costs.

But the central issue remains: How can one claim that the past will be

## Don't Take My Word for It

While I feel strongly on this topic, I am not alone.

First hear these words from Gregory Mankiw, Harvard professor and former chairman of the President's Council of Economic Advisers: "I am placing my bets with Bogle on this one."

Then listen to William Sharpe, professor of finance at Stanford and Nobel Laureate in Economics: "It is quite remarkable that people think that somehow a scheme that weights stocks differently than capitalization can dominate a capitalization-weighted index. ...New paradigms come and go. Betting against the market (and spending a considerable amount of money to do so) is indeed likely to be a hazardous undertaking."

Consider, too, this caution from John R. Minahan, director of research at New England Pension Consultants:

"I am amazed by all the managers that make an assertion of the type: 'In the long run X always wins,' where X could be dividend yield, earnings growth, quality of management, a quantitative factor or mix of factors, etc.—yet are unable cite a reason why X should be systematically underpriced by the market.

"The managers may be able to point to data suggesting that X has been associated with excess returns in the past, but without a plausible explanation of why X should outperform.

"Such data do not convince me that X is likely to outperform in the future."

Finally, consider this affirmation of classic indexing from Wharton School Professor Jeremy J. Siegel, author of "Stocks for the Long Run"—and adviser to WisdomTree Investments, the promoter of the dividend-driven fundamental model:

"It can be shown that maximum diversification is achieved by holding each stock in proportion to its value to the entire market. ...Hindsight plays tricks on our minds...often distorts the past and encourages us to play hunches and outguess other investors, who in turn are playing the same game.

"For most of us, trying to beat the market leads to disastrous results...our actions lead to much lower returns than can be achieved by just staying in the market...matching the market year after year with index funds (such as the Vanguard 500 Portfolio...and Vanguard's Total Stock Market Index Fund."

This last quotation is from the first edition of Dr. Siegel's book in 1994. I understand that he has every right to change his mind.

—John Bogle

prologue without a scintilla of apparent doubt?

The new paradigmists have never explained why these fundamental factors have been systematically underpriced by the market in the past. And, if they have been underpriced, why investors, hungry to capitalize on that apparent past inefficiency, won't bid up prices until the undervaluation no longer remains.

Put another way, if these promoters of the purported new paradigms actually have been right in the past, won't they therefore be wrong in the future?

When active managers of equity funds claim to have a way of uncovering extra value in our highly (but not perfectly) efficient U.S. stock market, investors will look at their past records, consider the managers' strategies, and invest or not.

These new index managers are in fact active managers. But they not only claim prescience, but a prescience

that gives them confidence that certain sectors of the market (such as dividend-paying stocks) will remain undervalued as far ahead as the eye can see.

I recommend skepticism.

I have always been impressed by the inexorable tendency for reversion to the mean in security returns. For example, mutual funds with a value mandate have generally outperformed those with a growth mandate since the late 1960s. But since 1977—indeed since 1937—there has been little to choose between the two. In fact, from 1937 through 1967, growth mutual funds rather consistently trumped value mutual funds.

Never think you know more than the market. Nobody does.

We never know when that reversion to the mean will come to the various sectors of the stock market. But we do know that such changes in style leadership have invariably occurred in the past. With so much of the stock market's

volatility based on expectations (emotions) rather than business (economics), what else could we expect?

Before we too easily accept that fundamental indexing—relying on style tilts toward dividends, value, or smallness—is the new paradigm, we need a longer sense of history. We also need to call on our own common sense that warns us that hindsight plays tricks on our minds.

There have been many new paradigms over the years. None has persisted.

- The "concept" stocks of the Go-Go years in the 1960s came and went.
- So did the "Nifty Fifty" era that soon followed.
- The "January effect" of small-cap superiority came and went.
- Option-income funds and "Government plus" funds came and went.

- In the late 1990s, high-tech stocks and “new economy” funds came and went as well.

Today, the asset values of the survivors remain far below their peaks. Intelligent investors should approach with extreme caution a claim that any new paradigm is here to stay.

That’s not the way financial markets work.

Traditional all-market-cap-weighted index funds guarantee that you will

receive your fair share of stock market returns, and virtually assure that you will outperform, over the long term, 90% or more of the other investors in the marketplace. Maybe this new paradigm of fundamental indexing—unlike all the other new paradigms I’ve seen—will work.

But maybe it won’t.

I urge investors not to be tempted by the siren song of paradigms that promise the accumulation of wealth

that will be far beyond the rewards of the classic index fund.

Don’t forget the prophetic warning of Carl von Clausewitz, military theorist and Prussian general of the early nineteenth century: “The greatest enemy of a good plan is the dream of a perfect plan.”

Put your dreaming away, pull out your common sense, and stick to the good plan represented by the classic index fund. ▲

**John C. Bogle was the long-serving chairman and chief executive of the Vanguard Group, which he founded in 1974. Since 1999, he has served as president of the Bogle Financial Markets Research Center.**

**This article is excerpted from John Bogle’s new book “The Little Book of Common Sense Investing: The Only Way to Guarantee Your Fair Share of Stock Market Returns,” (\$19.95) published by John Wiley & Sons, Inc., 2007, and is reprinted with permission.**



For more on investing with index funds, see these past *AAII Journal* articles, linked through the on-line version of this article or accessed using the search tool at [www.aaia.com](http://www.aaia.com):

- “The Actively Passive Trend: Indexes Get a Makeover,” by Maria Crawford Scott, October 2006
- “Capitalizing on the Index Fund Advantage,” by John Markese, November 2005
- “The EZ Approach to ETF Portfolio Building,” by Maria Crawford Scott, October 2005
- “Your Mutual Fund Portfolio: Choosing the Level of Complexity,” by John Markese, November 2002
- “Diversification: How to Get Broad Exposure Overseas,” by Albert J. Fredman, August 2002
- “Keeping Costs Low: Intelligent Indexing With Bonds,” by Albert J. Fredman, January 2001
- “Passively Aggressive: Index Funds and Tech Exposure,” by John Markese, June 2000