Have index funds become "Frankenstein's monster?"

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January 25, 2019

That's the issue raised by John C. "Jack" Bogle, who invented the first index mutual fund in 1975. Just weeks before his death on January 16 at 89, he said now that index funds had become the "most successful innovation in modern financial history," we need to ask ourselves the question: "What happens if it becomes too successful for its own good?"

Bogle received much-deserved adulation for "democratizing" investing by giving individuals the ability to own a stake in the entire stock market for a rock-bottom price. His mantra of buying a passive, low-cost index fund and holding it through decades of market ups and downs served individual investors who heeded his advice well.

However, much like Frankenstein's monster, Bogle expressed concerns at the end of 2018 his brilliant invention might have become a danger.

In 1960, Bogle wrote an article under the pen name "John B. Armstrong" actually mocking the notion that a mutual fund should try to replicate the holdings of and settle for the returns of an index. Following dismal fund performance during a brutal bear market, Bogle was fired in 1974 by his partners as president of Wellington Management.

This failure would turn out to be the biggest break in Bogle's career, but not right away.

Bogle founded The Vanguard Group, which launched an initial public offering (IPO) of the predecessor of its Vanguard 500 Index Fund in August 1976, hoping to raise $250 million. The IPO bombed, raising only $11.3 million—95% short of its target. His efforts to convert investors using active, stock-picking strategies to "beat the market" to passive indexing to simply match the market became known as "Bogle's Folly."

Fast forwarding to the present, index fund assets (mutual funds and Exchange-Traded Funds (ETFs)) have surpassed $6 ***trillion***, about 70% of which is invested in broad market index funds similar to the original Vanguard fund. Bogle became an investing legend that legions of "Bogleheads" worshiped.

Bogle warned, *"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 regulations. These will be major issues in the coming era."*

Indeed the indexing field is dominated by three managers with a collective market share of 81%: Vanguard (51%), BlackRock (21%) and State Street Global (9%). Due to miniscule fees (Schwab tried to make a splash with an index fund charging 3 basis points (0.03%), only to be outdone by Fidelity, which offered a fund charging **0** basis points), managers need both ginormous scale and extraordinarily deep pockets to compete.

It is well-known that active managers have underperformed their benchmarks since the Global Financial Crisis (GFC). Passive index funds offer to match benchmark performance, minus fees (which are typically much lower than for active management). We certainly understand the elegant simplicity of the index fund sales pitch, which investors have responded to in droves.

Passive strategies have doubled their market share of assets under management since the end of the GFC to around 40%, at the expense of active, stock-picking strategies. ***It is estimated passive strategies currently account for as much as a whopping 85-90% of daily trading volume.***

Passive index investing "machines" mechanically and mindlessly "invest" this torrent of cash pouring in by buying stocks in the same proportion as in the indices they happen to track, with no regard for company fundamentals or stock valuation. Thus, every index fund tracking the S&P 500 will buy enough Amazon ***every day*** to make it a 3.0% position (AMZN's current weighting in the S&P 500), period.

Our fear is this “virtuous circle” of constant buying leading to higher stock prices leading to more buying will continue—until the music stops at some point for whatever reason. The resulting index fund *outflows* could cause the virtuous circle to turn vicious as indiscriminate buying turns to indiscriminate selling. Index funds haven’t been tested under extreme market stress since they’ve reached gargantuan size.

In fact, trades from passive strategies were likely key contributors to the extreme volatility in December. Lipper reported investors yanked a record $75.5 billion from U.S. mutual funds and exchange-traded funds in December. With index funds simultaneously selling the same positions, the question becomes—sell to whom?

Beware of non-thinking, index-mimicking “monsters” that are distorting the capital markets by setting the prices of stocks and holding immense voting power over publicly-owned companies.
