"The Chief Cornerstone"

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Before
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This is an Anniversary Speech, for almost exactly thirty years ago, on December 31, 1975; the first index mutual fund was founded. Proudly known as "First Index Investment Trust" when it began, that original fund, now named Vanguard Index 500, is the largest mutual fund in the world.

Since that first index fund was formed all those years ago, indexing has come of age. Now part of the language of investing, "index fund" no longer needs an elaborate explanation; it has gained almost universal acceptance in the world of academe; and it has established the standard—"the hurdle rate," if you will—against which the investment performance of active managers is measured.

What is more, indexing has changed the behavior of investors. Rare is the Wall Street research report that uses those archaic terms "buy," "sell" or "hold" to define its recommendations. Today it is "overweight" or "equal weight," or "underweight" relative to a stock's capitalization in the Standard & Poor's 500 Stock Index, an index-oriented approach to investment advice. Indexing has spawned a half-trillion-dollar "enhanced index" (quantitative fund) industry, largely based on computer-driven strategies aiming to hold market risk constant while marginally outpacing the index with small, often nearly invisible, variations in the weights and composition of the index's individual stock components.

Indexing has also forced managers of mutual funds holding portfolios of large-capitalization stocks to minimize their risk of materially departing from the stock market's return, the better to stabilize cash flows from investors—essentially, therefore, a marketing strategy. Of the 100 largest equity funds, fully three-quarters have market correlations of 0.90 or above, including one-fourth at 0.97 to 0.99. (We call these funds "closet index funds.")

Even more important, though almost never mentioned, is that indexing has been instrumental in awakening the investment world—the buyers and sellers of investment services alike—to the vital importance of *costs*. Intermediation costs, it turns out, are the *only* reliable predictors of the future relative returns of mutual funds. (No, past performance doesn't do the job.) At the same time, indexing has at long last required us to open our eyes to the failure of our financial agents to serve, first and foremost, the interests of the principals who have entrusted their hard-earned money to them. It's fair, I think, to say that indexing has changed the way we think about investing.

The Birth of the Index Fund

It is no secret that the first index fund, while easily conceived, had a difficult birth, and that its neo-natal years were hardly punctuated with success. In fact, without the inspiration of Nobel Laureate economist Paul Samuelson, it might have taken many more years for the creation of "First Index." In an article entitled "Challenge to Judgment," published in the *Journal of Portfolio Management* in the autumn of 1974, Dr. Samuelson demanded that those who did not believe that a passive index would outperform the vast majority of active managers produce "brute evidence to the contrary." He pleaded for someone, somewhere to at least establish an in-house portfolio that tracked the S&P Index.[1]

I quickly accepted the challenge, and examined the brute (or brutal!) evidence. Poring over the records of equity mutual funds from 1945 to 1975, I found that they had consistently failed to beat the market. My study convinced the directors of the newly-formed Vanguard Group to approve the formation of the index fund. When he received the First Index offering prospectus in the mail, Dr. Samuelson was elated. Writing in his *Newsweek* column in August 1976, he happily declared, "sooner than I dared expect, my explicit prayer has been answered."

But the applause for the new idea was, well, less than universal. The offering of that first index fund, planned for $150 million, produced proceeds of barely $11,320,000. The annual returns of the index itself, after outpacing more than 70 percent of equity funds in 1969-1975 fell to the 22nd percentile in 1977-1979, and cash flows into the new fund were minuscule. Small wonder that the fund was widely referred to as, yes, "Bogle's Folly."

Its detractors were voluble, unrelenting, and confident. Fidelity's Edward C. Johnson III couldn't "believe that the great mass of investors are going to be satisfied with receiving average returns." An executive of fund manager National Securities and Research Corporation categorically rejected any thought of settling for the averages, asking, "Who wants to be operated on by an average surgeon?" Another commentator, flaying the indexing concept, urged striving for excellence: "No one ever came up with a handful of dust when he reached for the stars." And a popular poster of the day **(Chart 1)** called index funds "*un*-American" and urged that they be stamped out, the sooner the better.

1.

Today, thirty years later, the jury is in. Mr. Johnson's Fidelity joined the index parade in 1988, and now administers nearly $50 billion in index assets. Eager to compete more successfully, the firm recently slashed its index fund expense ratios to a mere 10 basis points (1/10 of one percent). By 1993, National Securities—whose funds had continued to lag the market averages that they didn't wish to settle for—had ceased to exist. As for whether "reaching for the stars" in investing would preclude failure, 114 of the equity funds that were alive and well when First Index was formed—more than one-third of the 333

[1] Other articles that contributed to my thinking included "The Loser's Game," by Charles D. Ellis, *Financial Analyst Journal* (July/August 1975), and Burton Malkiel's classic book, *A Random Walk Down Wall Street* (1973).

funds then in existence—have, well, bitten the dust and gone out of business. And rather than being stamped out, that first index fund has now been joined by 362 others, including such, well, "*all*-American" managers as Merrill Lynch, T. Rowe Price, Dreyfus, Scudder, and Morgan Stanley.

By way of contrast, the steadfast Dr. Samuelson soldiers on. He credits First Index with funding the education of his six children, and remains a vocal advocate. Just three weeks ago, now in his ninety-first year and speaking before an audience of investment professionals in Boston, he declared that the creation of the first index mutual fund all those years ago was the equivalent of the invention of the wheel and the alphabet.

A Slow Start

In the early years, acceptance was painfully slow. First Index didn't cross the $100-million asset milestone until 1982, and then only by virtue of $58 million of assets acquired through an opportunistic merger with an actively-managed Vanguard equity fund that had outlived its usefulness. Our index fund was not copied until 1984, and the second copy didn't arrive until 1986—more than a full decade from our founding, hardly a sign, especially in an industry so prone to quickly mimicking any good idea, that we were on the right track. Those two new index funds, however, were loaded with sales commissions and high expense ratios, and therefore only pallid versions of our original index fund, reminding one of Yogi Berra's wisdom: "If you can't imitate us, don't copy us."

But our commitment to indexing never faltered, and our patience was rewarded. As the assets of First Index Investment Trust (renamed Vanguard Index 500 in 1980), crossed the $500 million-mark in 1987 and headed toward $1 billion, we expanded our index ambit, forming a second 500 Index Fund for institutions, a Total Bond Market Index Fund, and an Extended Market Index Fund (enabling investors to own the remaining 20% of the U.S. stock market, and, combined with Index 500, to own the *total* market). In 1992, we formed the first Total Stock Market Index Fund. With its creation, assets of these funds—all holding assiduously to the classic all-market mandate—reached $25 billion in 1993, $50 billion in 1997, $100 billion in 1998, and now total $218 billion.

As the concept of all-market indexing burgeoned, we created the industry's first "enhanced" quantitative index fund in 1986. (Defying the odds, Vanguard Quantitative Portfolios—later renamed—has actually outpaced the 500 Index itself by an average of some 30 basis points per year since inception.) We also added other funds designed to index major segments of the market—a small cap index fund in 1989; European and Pacific index funds in 1990 (and later two broad international stock index funds); then in 1992, a growth index fund and a value index fund (each segments of the S&P 500), a balanced index fund, and three defined-maturity bond index funds; and in 1994 a series of three index-based tax-managed funds, followed later by four "life strategy" funds with differing allocations to bond and stock indexes. Most recently, we formed a series of four index-based "target maturity" funds, gradually reducing equities as the investor's retirement date approaches.

Vanguard remains by far the largest manager of index mutual funds, now operating some 42 index funds with $385 billion of assets. However, our indexed assets pale by comparison with the institutional index accounts administered by Barclays Global Investors and State Street Global, each of which administer more than $1.2 *trillion* using indexing strategies. Currently, index managers oversee some $2.2 trillion in U.S. stocks, $900 billion in bonds, $1.1 trillion in international stocks and bonds, and, along with $500 billion in enhanced indexed strategies. All told, indexed assets now total some $5.2

trillion, [2] with the $3.2 trillion in U.S. equities representing the ownership of fully 20% of our stock market's capitalization.

The Chief Cornerstone

As much as I value Dr. Samuelson's extraordinarily high appraisal of the creation of the first index mutual fund, I'm not so sure he isn't too generous. But I freely concede that indexing has changed the world of investing in all those ways that I enumerated at the outset. My belief is best encapsulated in something I heard while sitting in church some months ago, focused (I *think*) on thoughts far more spiritually uplifting than mere investment strategy. The words were from Psalm 118: *And the stone that the builders rejected has become the chief cornerstone.*

And so it is that "the chief cornerstone" is the title of my keynote speech today, and the foundation of my remarks. I'll first discuss the remarkable achievements of the classic index strategy, and then discuss a strange new direction taken by indexing in the recent investment environment.

Let me begin by carefully defining what I originally meant by the term "*index fund*": *An index mutual fund is a fund designed to return to investors 100 percent of the returns delivered by the stock market, less a nominal charge for expenses, simply by owning the preponderance of stocks in the market, weighted by the value of their capitalizations.* Thirty years ago, that definition was best reflected in the Standard and Poor's 500 Index, which we chose as the tracking standard for First Index Investment Trust, now Vanguard 500 Index Fund. (The 500 represents about 80 percent of the value of the U.S. stock market.) Today, the Dow Jones Wilshire Total Stock Market Index constitutes virtually 100 percent of the market, a broader standard, if only marginally more efficient. One day it will likely surpass the 500 as the prime index fund vehicle.

For me, then, indexing still means today just what it meant to me all those yesterdays ago when it was so roundly rejected by the investment community: a fund created and designed simply to track the returns and risks of the stock market itself, as measured by the Standard & Poor's 500 Composite Stock Price Index. Let's call it the *classic* index fund:

The Classic Index Fund:

1. **The broadest possible diversification,** sustained over
2. **The longest possible time horizon,** operated at
3. **The lowest possible cost,** thereby assuring
4. **The highest possible share of whatever investment returns our financial markets are generous enough to provide.**

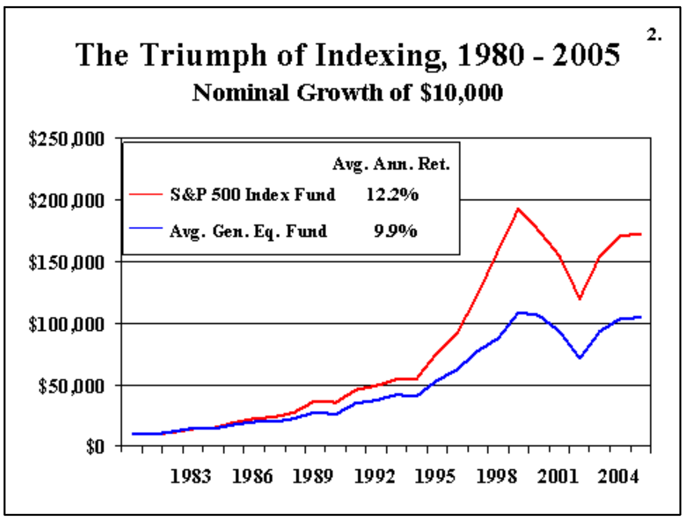
The investment concepts reflected in that simple definition of the classic index fund has lived up to their promise.[3] After those early years of difficulty described earlier, the returns achieved by the passively-managed Vanguard 500 Index fund have done exactly what we expected them to do—outpace the returns of the average actively-managed equity mutual fund by an amount approximating the costs

[2] Including corporate pension and state and local pension funds, which administer perhaps $500 billion in "in house" index strategies.
[3] Pension fund investors get no benefit from the optimal tax-efficiency of classic investing, but it is an enormous benefit for taxable investors.

that the typical fund incurs—advisory fees, operating expenses, sales charges, portfolio turnover costs, and the opportunity cost represented by the failure to be fully invested in stocks.

The Triumph of Indexing

How has classic indexing worked? Beautifully. Consider the record for the 25-year period from December 1980 to December 2005. **(Chart 2)** During that quarter-century, Vanguard Index 500 earned a compound annual rate of return of 12.2 percent per year, compared to a rate of just 9.9 percent for the average equity fund.[4] Assuming a $10,000 initial investment in each, the investment in the index fund grew by $162,500 during that period, compared to growth of just $95,000 by the average equity fund, fully 40 percent less than the index fund accumulation.



That 2.3 percentage point gap in favor of the passively-managed index fund is suspiciously similar to, albeit slightly lower than, the estimated all-in annual costs incurred by the average actively-managed equity fund: a total expense ratio of 1.5 percent (including some deferred sales charges), estimated front-end sales charges of 0.4 percent, hidden portfolio turnover costs of at least 0.8 percent, and 0.4 percent in opportunity cost.[5]

Not to beat this now ailing actively-managed fund horse to death, but in the *real* world, the index fund advantage gets even *larger*. **(Chart 3)** While the annual return of each investment drops by the same 3 percentage points per year when adjusted for inflation during the period (active fund real return, 6.9 percent; index fund real return, 9.2 percent), when we compound those returns, the gap in favor of indexing reaches staggering proportions. That $10,000 in the index fund grew by $78,000 in real dollars, while that same investment in the active fund grew by just $42,800.

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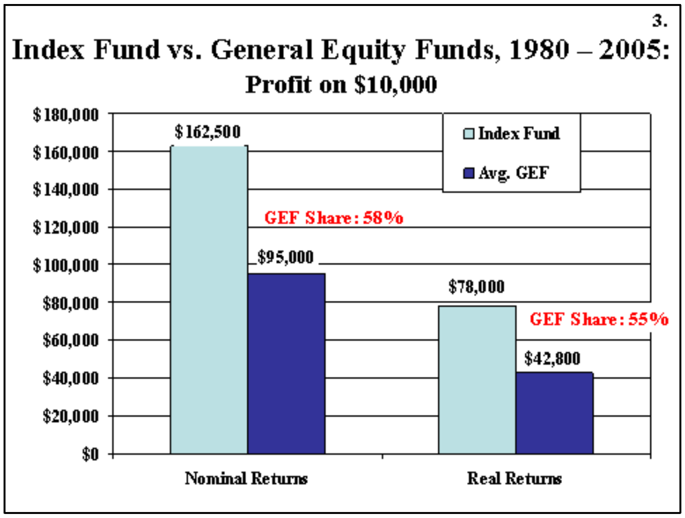
[4] Source: Lipper. Total reported rate of return for the average equity fund was 10.8 percent, which we reduced by an estimated 0.5 percent to account for sales charges and an estimated 0.4 percent to account for survivor bias, for a net return of 9.9 percent.

[5] 5% of assets held in cash earning 5 percent vs. stocks that earned 12-plus percent.



The active fund, then, produced a cumulative real profit that was a mere 55 percent of the profit that lay readily at hand simply by, well, passively owning the stock market itself—with the broadest possible diversification, sustained over the longest possible time horizon, operated at the lowest possible cost, thereby assuring the highest possible share of whatever investment returns our financial markets are generous enough to provide. Buying American business and holding it forever, at minimal cost, is what indexing is all about. And it works!

(I should note that the triumph of indexing is not just an equity fund phenomenon. In the other major segments of the mutual fund industry, the triumph has been equally evident. Vanguard Bond Index Fund, now nearly two decades old, has surpassed its peer group average in 12 of its 19 years. And Vanguard Balanced Index Fund has outpaced its average peer in ten years of its 12-year history. Yes, indexing works.)

We Are *All* Indexers Now

Small wonder, then, that "the stone that the builders rejected"—that original index fund of thirty years ago—"has become the chief cornerstone" of an intelligent investment strategy today. But I have a vested interest in index funds, so don't take my word for it. Listen to Warren Buffett. Listen to endowment fund superstars from Harvard (Jack Meyer) and Yale (David Swensen). Listen again not only to Paul Samuelson, but to (as far as I know) every other U.S. Nobel Laureate in Economics. Ask what the finance professors with whom you studied recommend, and then ask how they invest their own money. Almost without exception, these investors and academics are committed to the validity of indexing as the core investment strategy. The conclusion is clear: *We are all indexers now*.

But, when you think about it, we *all* always have been indexers! That is, all investors together have always held the market portfolio. There's simply no way around that tautology. The problem, simply put, is that, individually, investors are constantly trading its component stocks back and forth with one another, and fall behind the market's return by the amount of their aggregate costs. The net result of all that shuffling of paper: the market portfolio remains unchanged, but the brokers and dealers who facilitate all those trades are enriched. And when investors don't do all that trading *directly*—and in today's financial system, in which financial intermediaries own 68 percent of all stocks, they *don't*—they do it *indirectly*, largely through agents such as pension trustees and mutual fund managers who engage in the same feverish activity, all the while arrogating yet another layer of costs—and an additional share of the market's returns—to themselves.

We don't know precisely how much these agents take. But based on SEC reports, we can estimate the revenues of broker-dealers last year at some $250 billion; mutual fund advisory fees, operating expenses, and sales charges approximated $75 billion; pension fund fees $15 billion; hedge fund fees are now estimated at the $40 billion level; financial advisers are paid perhaps $10 billion; variable annuity commissions maybe $10 billion. Rounding up only the usual suspects—who are by no means the *only* intermediaries in the system—we quickly come up with $400 billion of intermediation costs, more than $1 trillion dollars out of investors' pockets every three years! Playing off the inspired title of a book published a half-century ago—*Where Are The Customers' Yachts?*—we now know why so few of those yachts in the harbor are owned by the customers who play in the stock market casino; they're mostly owned by those who operate the casino. What else is new?

A New Wave in Indexing

And yet, something else *is* new. Even as the share of equity mutual fund assets accounted for by index funds soared from less than 1 percent in 1988 to 5 percent in 1996, to 10 percent in 1999, to 15 percent currently, the character of the index fund is changing. The growth in the assets of classic index funds has come to an abrupt stop, perhaps because they participated fully in the 50 percent market crash of March 2000 to October 2003, as well as in the subsequent modest recovery. No surprise there. The stock market today is slightly below its level at the end of 1999, although when dividends are taken into account its total return is a bare, if positive, one percent, hardly enough to make investors who jumped on the index (i.e., market) bandwagon in the late years of the bull market salivate.

That 5 percentage point increase—in fact, a 50 percent gain—in index fund market share is entirely represented by the rise of a new kind of index fund—the exchange-traded fund. **(Chart 4)** The largest ETF remains the *Spiders* (Standard and Poor's Index Depository Receipts), which make it possible to, in the words of their advertisement, *"trade the Standard and Poor's 500 Index all day long in real time."* The Spiders and similar ETFs, of course, represent substantially the same broad market portfolio as Vanguard Index 500. But these classic index funds have now been joined by a whole panoply of specialized index funds, tracking various market segments—from growth to value and from large cap to small cap—industry sectors—real estate, energy, technology, etc.—and international—diversified, as well as specific country.

But are these *truly* index funds? Well, let's call this new breed index fund *nouveau*[6], and see how they meet the four conditions of that original definition that accounted for the success of the *classic* index fund in the past:

	Classic Index Fund	Index Fund Nouveau: Broad Index	Index Fund Nouveau: Specialized Index
Broadest Possible Diversification	**Yes**	**Yes**	**No**
Longest Time Horizon	**Yes**	**No**	**Rarely**
Lowest Possible Cost	**Yes**	**No***	**No***
Highest Possible Share of Market Return	**Yes**	**Unknown**	**Unknown**

***Including trading costs.**

[6] I understand that I am credited with coining the term *closet* index fund. Whether the coinages *classic* index fund and index fund *nouveau* will take the similar leap into common parlance, only time will tell.

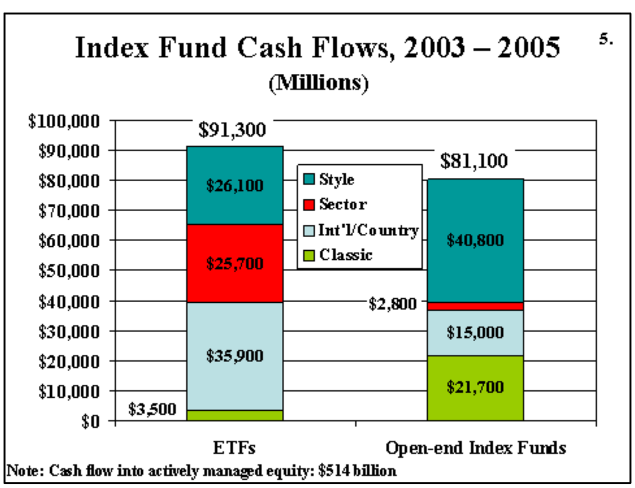
If the original paradigm of indexing was long-term *investing*, surely using index funds as trading vehicles can fairly be described as short-term *speculation*. If the original paradigm was the broadest possible diversification, surely holding discrete—even widely-diversified—sectors of the market offers far less diversification. (In fairness, diversified international funds could fit either as "broad" or "specialized.") If the original paradigm was minimal cost, it's clear that holding market sector index funds that are themselves low-cost still carries the substantial brokerage commissions, bid-ask spreads, and market impact costs entailed in moving money from one sector to another.

I'm also amused by the idea of the classic ETF as a temporary holding between manager changes. Presumably, the terminated manager has failed to beat the market, so the pension fund will garner the market's return in the interim, before hiring a new manager, who has, of course, beaten the market in the past and is therefore expected to do so in the future. Will it happen? Who knows? But the odds are not good. Surely moving from an index fund, even as a temporary holding, to a new active manager is a classic example of the triumph of hope over experience.

Spiders vs. Sectors

The amount of trading carried on in the shares of ETFs each day is little short of astonishing. Turnover in the Spiders is now running at about 4000 percent per year, compared to a miniscule 15 percent for the shares of that original index fund. Turnover in the Qubes is now at 4,700 percent per year. While it's only guesswork, perhaps 20 percent of the assets of Spiders (about $12 billion), are held by investors with longer-term (if not long-term) horizons, with the remainder held by arbitrageurs and market makers, making heavy use of short-selling and hedging strategies. While the turnover of the more specialized funds is much lower—generally running in the range of 200-400 percent—it is still many times over the (in my opinion, itself excessive) 30 percent shareholder turnover rate for actively-managed equity mutual funds.

Yet recent trends show that the Spider-like ETFs are barely gaining ground, while the specialized ETFs are exploding. **(Chart 5)** Since 2002, broad-based ETFs have drawn but $3 billion of cash flow, while the latter group has drawn $88 billion—$36 billion in international and country funds, $26 billion in style funds, and another $26 billion in sector funds—in each case of course, flows that are hardly unrelated to the buoyant returns in the respective markets (international $14 billion, Japan $8 billion, energy $4 billion, gold $3 ½ billion). "I'm shocked, *shocked* to find that 'performance chasing' is going on here!" (Note, too, the small portion of *non*-ETF index funds now flowing into the classic index model—$21 billion of the $81 billion total. That is *not* a hopeful sign.)



Look, the record is clear that ETFs are used largely for speculation, either through extremely rapid trading of the stock market itself ("in real time") or through moving money from one market sector or style to another, albeit at a slower rate. I have no problem whatsoever in conceding that it is more sensible to speculate in ETFs than in individual stocks. But why speculate at all? Speculation is, finally, a loser's game, in part because our emotions usually lead us in the wrong direction (i.e., looking to the past as prologue to the future performance; it suffers from the fact that it just isn't so).

The Four Es

I also freely concede that, properly used, ETFs have merit. They enable investors to make long-term bets on the total market or given market segments, or to diversify portfolios which are dominated by concentrated holdings of individual stocks. But when "new products" emerge in the marketing-driven mutual fund industry, the reason is far more often that they are introduced to make money for *managers* (i.e., to increase assets under management, thereby increasing advisory fees and commission revenues) rather than to serve *investors*. Even when these new products in fact provide solid returns on a time-weighted basis, however, they are apt to produce *asset*-weighted returns that are pallid, given the tendency of investors to *buy* them (and the tendency of marketers to *sell* them) only *after* high returns have been realized. When a senior executive of one fund firm, eagerly seeking to build an ETF asset base, is quoted as saying, "for most people, sector funds don't make a lot of sense," questioning the *raison d'etre* for the boom in ETFs is hardly unreasonable.

The difference between the classic index mutual fund—that stone of all those years ago that the builders of institutional investing rejected; that stone that has become the chief cornerstone—and today's new breed of ETF index funds *nouveau* that are used far more by traders, speculators, and investors who think they can successfully select winning market sectors in advance can be put simply: it is the difference between a long-term *investment* strategy and a short-term *trading* strategy. I do not believe that is a plus for investors. And if Warren Buffett is right with what I have come to call the four **E**s—"the greatest **E**nemies of the **E**quity investor are **E**xpenses and **E**motions"—there is little doubt about the ultimate victor in this schism, dare I say, of competing religions. It *must* be the classic index fund.

For as to the final, quintessential, aspect of the original classic paradigm—assuring, indeed virtually guaranteeing, the achievement of substantially all of the stock market's return—the fact is that an investor who trades ETFs—after all the selection challenges, the timing risks, and the extra costs—has *absolutely no idea* of what relationship his or her investment return will have to the returns earned by the market itself. The ETFs march to a different drummer than the original index fund, yet today they are in the, well, vanguard of index investing. I'm left to wonder, "What have they done to my song, mom?" (Answer, according to the lyrics: "they've tied it up in a plastic bag and turned it upside down.") Yet surely when those awesome apostles of indexing that I cited earlier proffered their powerful endorsements, it was not this old tune that they sang, but the original song that they hummed and then applauded.

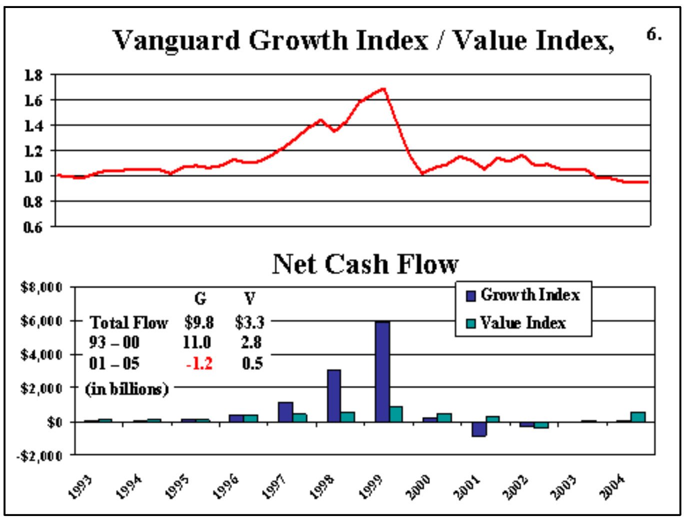
How Do Investors Fare?

There is an important difference between the returns that mutual funds achieve and the returns that their shareholder/owners achieve, for trading among sectors has proven dangerous to the wealth of investors. Whatever returns each sector ETF *itself* may earn, the *investors* in those very ETFs will likely, if not certainly, fall well behind them. For there is abundant evidence that the most popular sector funds of the day are those that have recently enjoyed the most spectacular recent performance, and that such "after-the-fact" popularity is a recipe for unsuccessful investing.

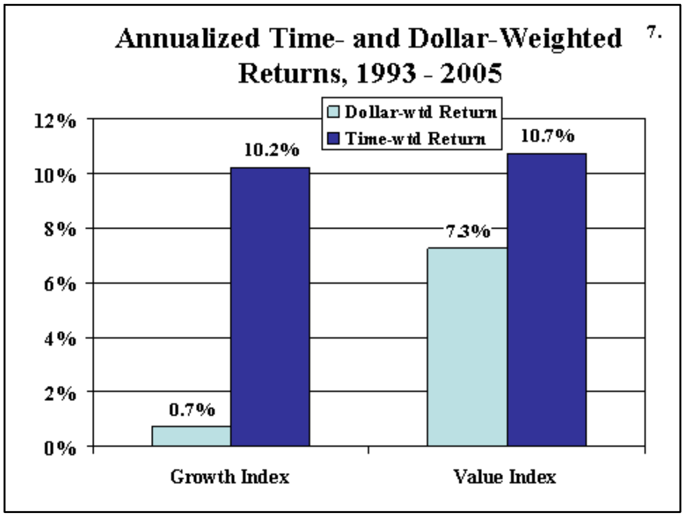
I have observed this evidence in the data, and I have observed it first hand. And I confess to my own share of responsibility for the development of style index funds. When we created the industry's first Growth Index and Value Index funds in 1992, I believed that the former would be held by younger investors seeking tax-efficiency and willing to assume larger risks, and the latter held by older investors seeking higher income and happy to reduce their risks. Alas, while the original idea was strong, the ensuing reality was weak. What followed their introduction was as crystal clear an example of performance-chasing as one could imagine.

The stock market was relatively placid during the 1993-1997 period, and value stocks and growth stocks delivered similar returns. Then growth stocks took off in the "new economy" bubble, leaving value stocks in their dust, peaking at a 70 percent premium in early 2000. *Après moi le deluge!* **(Chart 6)** As reversion to the mean took hold, growth stocks plummeted through 2002. Today the cumulative returns of both growth and value index funds for the full period are about the same.

Investor interest in the two fund styles was well-balanced during the relatively placid stock markets of the mid-1990s. But during the bubble that followed, investors poured $11 billion dollars into the soaring Growth Index Fund, four *times* the $2.8 billion invested in the sedate Value Index Fund. Then, in the aftermath, investors switched their loyalty, with net *redemptions* of $1 billion in the growth fund and net *purchases* approaching $1 billion in the value fund.



Since 1993, the two *funds* have achieved returns that were virtually identical on a standard *time-weighted* basis—10.2 percent per year for Growth, 10.7 percent for Value. The *investors* in each index fund, however, by their counterproductive timing and selection, have not come even close. **(Chart 7)** The average *dollar-weighted* return of the investors in the Growth Index Fund was a pathetic 0.7 percent per year. Investors in the Value Index fund did better, but their return of 7.1 percent still lagged the Value Index by 3.4 percentage points per year. Compounded since 1993, with both index funds gaining about 220 percent in value on a time-weighted basis, the Growth Index investor earned but 9 percent, and the Value Index investor earned about 130 percent. Despite my best intentions at the outset, our Growth and Value index funds proved to be a paradigm for the ways that investors fool themselves, relinquishing perfectly acceptable long-term returns in the search to find the Holy Grail of extra returns in the short run. *Mea culpa*.



Summing Up

Warren Buffett's timeless warning about the toll taken by expenses and emotions is gradually getting out to the world. Given my role in creating the first index mutual fund and my dedication to classic indexing, of course I welcome his strong support. But I *know* I'm on the right track when even the conservative editorial opinion page of *The Wall Street Journal* joins the chorus:

> "Will fund customers keep supporting the enormous overhead required to sustain ineffectual, unproductive stock picking across an array of thousands of individual funds devoted to every 'investing' style and economic sector or regional subgroup that some marketing idiot can dream up? Not likely. A brutal shakeout is coming and one of its revelations will be that stock picking [and sector picking] is a grossly overrated piece of the puzzle, that cost control is what distinguishes a competitive firm from an uncompetitive one."

For those active investors—and active managers—who are using index funds *nouveau* that are different—not just in degree, but in kind—from that original *classic* index fund of nearly 30 years ago, I do not foresee a favorable long-term outcome. Sooner or later, the job of investment strategy is to deliver to investors their fair share of market returns. Some investment programs designed primarily to meet the marketing objectives of fund managers will, of course, succeed for a time. But if they fail to build client wealth—and I believe that is exactly what will happen—they will ultimately fade away.

Lead into Gold?

So mark me down as an index fundamentalist, a passionate believer that the original index fund design, even all these years later, continues to represent the chief cornerstone for investors. If that is true, then by definition every *other* strategy—whether actively managed, passively indexed in sectors or styles, rapid trading, or anything else—represents, at least theoretically, a dilution of that standard. Put another way, that original design is the Gold Standard. Yet even as the alchemists of ancient days vainly sought to change lead into gold, so too, do many of today's financial intermediaries seek to provide a similar alchemy in the financial markets. But I struggle to develop any methodology (other than relative costs!) for identifying winning managers or winning sectors in advance, and for successfully predicting how long the winning streaks of those sectors will persist. But since the returns of investors in the aggregate fall short of financial market returns by the amount of intermediation and trading costs, the more we pay the intermediaries and the more we trade, the more we lose.

So there's a simple, undeniable fact here: The winning strategy is *long-term investing*; the losing strategy is *short-term trading*. There is too much at stake in providing optimal wealth to the investors who have entrusted their hard-earned dollars to us for investment professionals to allow a Gresham's law to prevail in which bad indexing drives out good indexing. "Good indexing," clearly reflected in the concept of that very first classic index fund, remains the chief cornerstone of investing today. It cannot, finally, be shaken or compromised.
