Thirty some years ago, little did I imagine that the creation of the world's first index mutual fund would have such a profound impact on the mutual fund industry. At the time, it was proclaimed a flawed concept and described as "Bogle's Folly" by its detractors. (After all, they asked, why would an investor settle for average returns?) The second index fund didn't see the light of day until 1984, eight years later.

By 1988, total index fund assets had grown to only $5.6 billion, just 1% of the total assets of equity mutual funds. But the trend has been steadily upward ever since. The market share of index funds crossed 5% in 1996 and 9% in 1999, and now constitutes 17% of equity fund assets -- more than $1 trillion of the $6.2 trillion equity fund total.

That first fund was founded on the idea of buying virtually the entire U.S. stock market, eliminating all sales charges and advisory fees, minimizing operating expenses and marketing costs, and virtually obviating portfolio turnover. Such a market portfolio could be held "forever," said to be Warren Buffett's favorite time horizon.

But a funny thing happened on the way to the triumph of indexing -- the model changed. The dominance of the classic index mutual fund came to a virtual halt. That 9% asset share of 1999 has grown to only 10% today. The extra seven percentage points in index fund market share have been accounted for by a mutant of that original investment form, the exchange-traded fund (ETF), as the nearby chart shows.

Currently, ETF assets total $420 billion of the $1 trillion total. But they are growing at a far faster rate, taking in net new capital of $291 billion since 1999, compared to just $173 billion for their traditional cousins.

ETFs, simply put, are index funds that can be traded in the financial markets. In fairness, if they are not traded, they can often be the equal of the classic index funds. If they operate at lower expense ratios and provide potentially higher tax efficiency, they may provide the same diversification at even lower costs (provided that the initial brokerage commissions are amortized over a substantial span of years). In this format, used in that way, ETFs are solid competitors to their classic forebears.

Ironically, that first ETF, created in 1992, was modeled on the classic index fund I designed three decades ago (now known as Vanguard 500 Index Fund), tracking the returns of the Standard & Poor's 500 Index. Holding S&P's depository receipts, the shares
of the original ETF were quickly designated "spiders." But with one big difference. As its advertisements said: "Now, you can trade the S&P 500 all day long, in real time."

But if long-term investing was the paradigm for the classic index fund, trading ETFs can only be described as short-term speculation. And it was only a matter of time until trading overwhelmed diversification as the driving force in the ETF world. Of the 690 ETFs in existence today (including 343 in registration at the SEC), only 12 represent broad market segments, such as the Standard & Poor's 500, the Dow Jones Wilshire Total (U.S.) Stock Market Index, and the Morgan Stanley EAFE (Europe, Australia and Far East) Index of non-U.S. stocks. With each passing day, the market segments available through ETFs seem to get narrower. (Can you believe that we now have a "HealthShares Emerging Cancer" ETF?)

These nouveau index funds starkly contradict each of the principal concepts underlying the original index fund. If the broadest possible diversification was the original paradigm, surely holding small segments of the market offers less diversification and commensurately more risk. If the original paradigm was minimal cost, then holding market-sector index funds that may themselves be low-cost obviates neither the brokerage commissions entailed in trading them nor the tax burdens incurred if one has the good fortune to do so successfully.

In addition to the certain penalty of expenses, there is the less certain -- but omnipresent -- penalty of emotions. Performance-chasing investors in specialized funds are their own worst enemies. The most rapidly growing sectors of the ETF marketplace are those -- no surprise -- that have been the leaders in the recent bull market: indexes of small-cap stocks, energy, emerging markets, international, real estate and, most recently, commodities (especially gold and oil). The annualized share turnover of these sectors averages an astonishing 2500%.

As to the quintessential aspect of the classic index fund -- assuring, indeed guaranteeing, that investors will earn their fair share of the stock market's return -- the fact is that investors who trade ETFs have nothing even resembling such a guarantee. In fact, after all the extra costs, the added taxes, the selection challenges and the timing risks, the typical ETF investor has absolutely no idea what relationship his investment return will bear to the return earned by the stock market.

What accounts for the stampede into these nouveau index funds that march to such a different drummer? Surely the amazing growth of ETFs says something about the focus of money managers on gathering assets, the marketing power of brokerage firms, the activities of financial advisers, the energy of Wall Street's financial entrepreneurs, and the willingness -- nay, eagerness -- of investors to favor complexity over simplicity, continuing to believe, against all odds, that they can beat the market.

To begin, ETFs are a bonanza for fund managers. With $420 billion of assets and an average expense ratio (weighted by assets) of about 0.24% (24 basis points), ETFs are generating some $950 million in annual, well, management fees. But as passive index
funds, they don't even require management in the conventional sense. What's more, since their shares are traded from one investor to another on the stock market, their managers are largely relieved of the onerous costs of shareholder recordkeeping borne by traditional funds.

But those costs don't entirely vanish. They are borne by investors in the form of commissions and bid-asked spreads every time ETF shares trade. And they are traded with a vengeance, with some 400 million ETFs shares changing hands each day. (By way of contrast, the trading volume at the New York Stock Exchange is presently running at a daily rate of about 1.8 billion shares.) If we assume that commissions and spreads run as little as three cents per share on these trades, that's some $3 billion a year. So ETFs are a gold mine to brokers too.

Many financial advisers, even those who have long favored the classic index fund strategy, have also jumped on the ETF bandwagon. ETFs enable their clients to bet on hot market sectors, time purchases during each day's trading, and engage in short selling. But to what avail? Yet if advisers oversee, say, $150 billion in ETFs for their clients, their fees would come to at least $1 billion.

And entrepreneurs have also profited from the stampede into ETFs. One relatively small provider (PowerShares) was recently sold by its owners to a large fund manager for some $730 million, assuming its targets for asset growth are met. And the market capitalization of a brand-new provider, WisdomTree Investments, recently reached nearly $600 million. Yet its ETF asset base is relatively modest ($1.5 billion) and its investment strategy -- betting that dividend-paying stocks will outpace non-dividend-paying stocks -- is unproven in practice. The return on the seed capital of the early investors (so far) is 16,000%.

Adding up these costs, we're talking about ETFs earning billions of dollars for our financial intermediaries. In a sense, that's the American way. Who would dare fault our opportunistic free-market system? And yet there is another side to the argument that we seem to ignore. It is the iron law of the markets, the undefiable rules of arithmetic: Gross return in the market, less the costs of financial intermediation, equals the net return actually delivered to market participants. To the extent that ETFs increase intermediation costs, it follows that they must reduce the returns of investors as a group.

Put another way, ETFs are a dream come true for fund managers, brokers, financial advisers and entrepreneurs. Is it too much to ask whether they are a dream come true for investors? So long as those relentless rules apply -- "forever" -- the idea that ETFs will somehow enhance the returns of investors in the aggregate seems more like a pipedream.

What's more, in a curious turn of events, the ETF format has been chosen by the new "fundamental" indexers, offering portfolios following active strategies focused on portfolios weighted by each corporation's corporate revenues, profits and/or dividends, rather than the classic market-capitalization-based indexes. Such strategies proved enormously successful in the 2000-2002 bear market. So it is little wonder that such
"value" strategies -- described by their creators as the "new paradigm" even though they have been acclaimed in academia for decades -- are brought to market only after their above-market returns have been achieved. By using the ETF format, their promoters seem to suggest that the ability to "trade them all day long, in real time" will further enhance investor returns -- a dubious prospect on the face of it.

So long as the truism that "the more financial intermediaries take, the less their clients make" remains in effect, serious and intelligent investors ought to beware of moving their investments out of classic index funds focused on low costs, broad diversification and long-term, buy-and-hold strategies into index funds nouveau, with their overlay of costs, limited diversification and short-term trading strategies. Industry participants, too, should be concerned. For in the long run, any business that puts the interest of service to self before service to clients will ultimately pay for this contradiction.

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