OPINION

How the Index Fund Was Born

By John C. Bogle

Thirty-five years ago, at the completion of its initial public offering on Aug. 31, 1976, the first index mutual fund was born. First Index Investment Trust was sponsored by The Vanguard Group, a new mutual fund complex which itself had begun operations only 16 months earlier.

The idea that passive equity management could outpace active management—then the mutual fund industry's universal strategy—was derogated and ridiculed. The fund, now called the Vanguard 500 Index Fund, was referred to as "Bogle's Folly." Yet today indexing has come to dominate the field. Over the past five years, index funds have accounted for 100% of all equity funds' cash flows, with assets now totaling $2 trillion, one-fourth of all equity fund assets.

Back in 1976, my associates at Vanguard shared my confidence that indexing would ultimately come to reshape the mutual fund industry. After all, an index fund, with its minuscule costs, would guarantee that our investors would earn their fair share of stock market returns. But managed equity funds as a group, because of their high costs—advisory fees, operating expenses, sales loads, portfolio transaction costs, excess taxes—virtually guaranteed the reverse, a substantial shortfall.

> Once derided as 'Bogle's Folly,' the Vanguard 500 Index totals $200 billion.

We were confident that the IPO would be a roaring success. Not only was the math that assured the index fund's superiority unarguable, but the principal underwriters included the four biggest retail brokers on Wall Street. Their target was $150 million. But when the books were closed, the underwriting of First Index Investment Trust produced just $11.3 million, a 93% shortfall from the goal. When the underwriters brought me the news of the abject failure, they suggested we cancel the deal, for the tiny proceeds were insufficient to own all 500 stocks in the S&P 500 Index. I remember saying: "Oh no we won't! Don't you realize that we now have the world's first index fund?"

Nobel laureate economist Paul Samuelson played a major role in precipitating the index fund's creation. While I'd hinted at the idea of an index fund in my senior thesis at Princeton University in 1951 (mutual funds "may make no claim to superiority over the market averages"), Samuelson was much more forceful, strengthening my backbone for the hard task that lay ahead: taking on the industry establishment.

His article "Challenge to Judgment" caught me at the perfect moment. Published in the inaugural edition of the Journal of Portfolio Management in the autumn of 1974, it pleaded "that some large foundation set up an in-house portfolio that tracks the S&P 500 Index—if only for the purpose of setting up a naïve model against which their in-house gunslingers can measure their prowess."

Presented with that challenge, I couldn't resist. While all of our peers had the opportunity to create the first index fund, Vanguard alone had the motivation. The newly formed Vanguard Group (owned not by outsiders but by its own shareholders), I reasoned, ought to be "in the vanguard" of this new concept. Our goal was to offer well-diversified funds at minimal costs, focused on the long term.

The most enthusiastic media comments about the coming underwriting of the index fund came from Samuelson himself. Writing in his Newsweek column in August 1976, he expressed delight that there had finally been a response to his earlier challenge: "Sooner than I dared expect," he wrote, "my explicit prayer has been answered. There is coming to market, I see from a crisp new prospectus, something called the First Index Investment Trust," an index fund available for investors of modest means, "that apes the whole market (S&P 500 Index), requires no load, and keeps commissions, turnover and management fees to the feasible minimum, and . . . best of all, gives the broadest diversification needed to maximize mean return with minimum portfolio variance and volatility."

At the beginning of my sophomore year at Princeton University, I took my first economics course; our textbook was the first edition of Samuelson's "Economics: An Introductory Analysis." Truth told, I found the book tough going and fared poorly in my first stab at this new subject, receiving a grade of 4+ (D+ in today's lexicon) at midterm. Since I was required to maintain an average of at least 3- (C-) to maintain the full scholarship that Princeton had provided me, if my grade did not improve by the end of the semester, my college career would be over. I struggled, but I made it—barely.

From that lowly beginning in 1948, through his support for that first index mutual fund, and thereafter, my association with Samuelson grew ever closer. In 1993, I asked him, by then a Nobel laureate, to endorse my first book—"Bogle on Mutual Funds." To my astonishment, he told me that he would prefer to write the foreword.

Samuelson and I met face-to-face perhaps only a half-dozen times during our (arguably) 61-year relationship that ended with his death in 2009. We also corresponded periodically. One example: In the summer of 2005 he wrote: "Any small influence on you has been more than offset by what Vanguard has done for my 6 children and 15 grandchildren. May Darwin bless you!"

Today, the assets of the Vanguard funds modeled on the S&P 500 Index total $200 billion, together constituting the largest equity fund in the world. (The second largest, at $180 billion, are the Vanguard Total Stock Market Index funds.) Investors have voted for index funds with their wallets, and they continue to do so.

Surely Samuelson's highest accolade for the index fund came in his speech at the Boston Security Analysts Society on Nov. 15, 2005: "I rank this Bogle invention along with the invention of the wheel, the alphabet, Gutenberg printing, and wine and cheese: a mutual fund that never made Bogle rich but elevated the long-term returns of the mutual-fund owners. Something new under the sun."

Those words of an intellectual giant about a mere mortal who has scraped by without a great intellect but with great intellectual curiosity and relentless determination summarize the story of how the professor and the student joined forces to give the world its first index mutual fund.

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