BETTER MARKETS

SPECIAL REPORT

Popularity of Index Funds is Both a Blessing and a Curse

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October 17, 2024

Overview

Index funds now dominate the market. The six largest mutual funds in the world are index funds. The increasing popularity of index funds is a boon for investors because index funds consistently outperform actively managed funds. Yet the fact that three firms dominate the market for index funds means that the popularity of index funds also gives these firms enormous power, which could end up hurting investors and consumers in the long run. So the rise of index funds is simultaneously a blessing and a curse. This report explores the paradox that is the popularity of index funds in our markets.

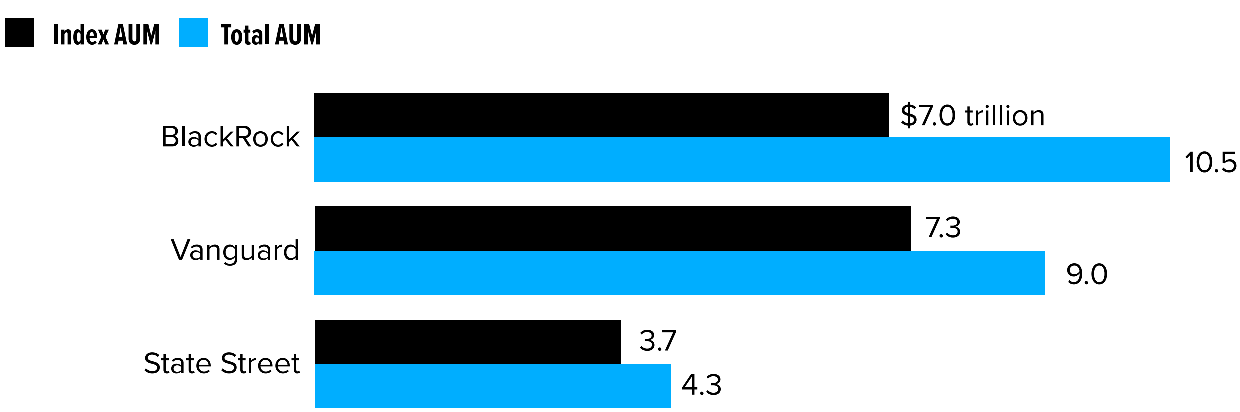
A Primer on Index Funds

Index funds are funds that track a broad market index, such as the S&P 500. The S&P 500 is a U.S. stock index comprising the biggest public companies weighted according to their market capitalization. So an index fund that tracks the S&P 500 aims to replicate the S&P 500's holdings and returns. This means that index funds are passively managed. The fund does not employ a stock-picking strategy but rather tracks an existing stock index.

Conversely, actively managed funds involve a fund manager selecting the fund's stocks and bonds. So funds that are actively managed try to beat the market, whereas index funds are the market. Rather than attempting to identify specific stocks that can outperform the market, they just buy the stocks in an index that tracks a specific market segment. So instead of trying to actively beat a benchmark, an index fund aims to be the benchmark.

The first index fund was founded on December 31, 1975, and started trading on August 31, 1976. It was the first financial product of The Vanguard Group, then a new mutual fund manager, which John Bogle founded in 1975. Today, Vanguard is part of the "Big Three" index fund managers, along with BlackRock and State Street. The Big Three manage over $23 trillion in assets, and 75% of those assets under management are in index funds.

More than 75% of the top investment firms' assets under management are in strategies that are designed to be passive



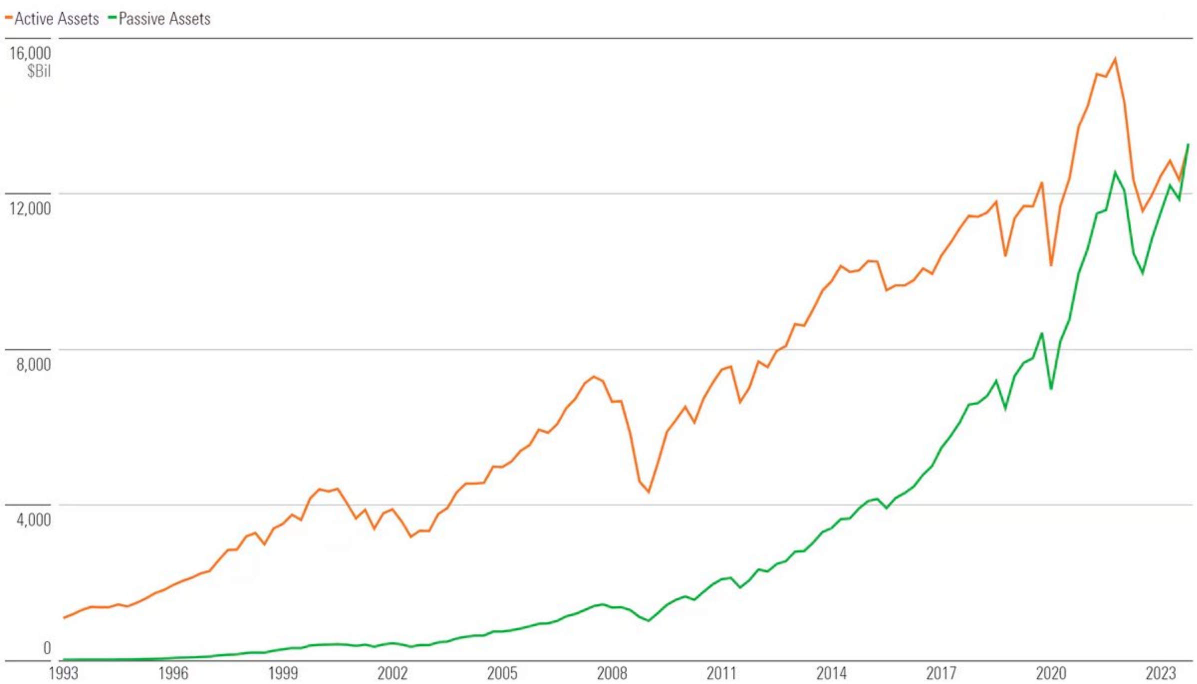
Source: Company reports

Note: Data as of 3/31/24 except for Vanguard, which is as of 2/29/24

The Rise of Index Funds, the Reasons for their Popularity, and Their Benefits

The creation of the index fund is widely regarded as one of the most successful innovations in modern financial history. Although index funds were not popular immediately, the benefits of passive investing have become increasingly clear over time. And investors have taken notice. Over the last five years through March 2024, investors poured $3 trillion into index funds but withdrew $1.4 trillion from active funds. At the end of 2023, assets invested in passive funds overtook assets invested in active funds for the first time.

Historical Fund Assets: Active vs. Passive

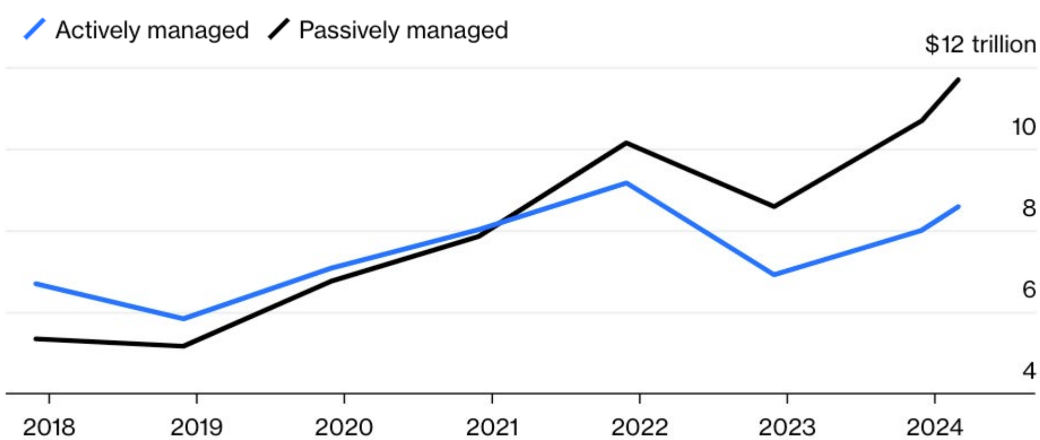


Source: Morningstar Direct Asset Flows. Data as of Dec. 31, 2023.

The rise of index funds is even more pronounced when considering only equity funds:

There's Power in Being Passive

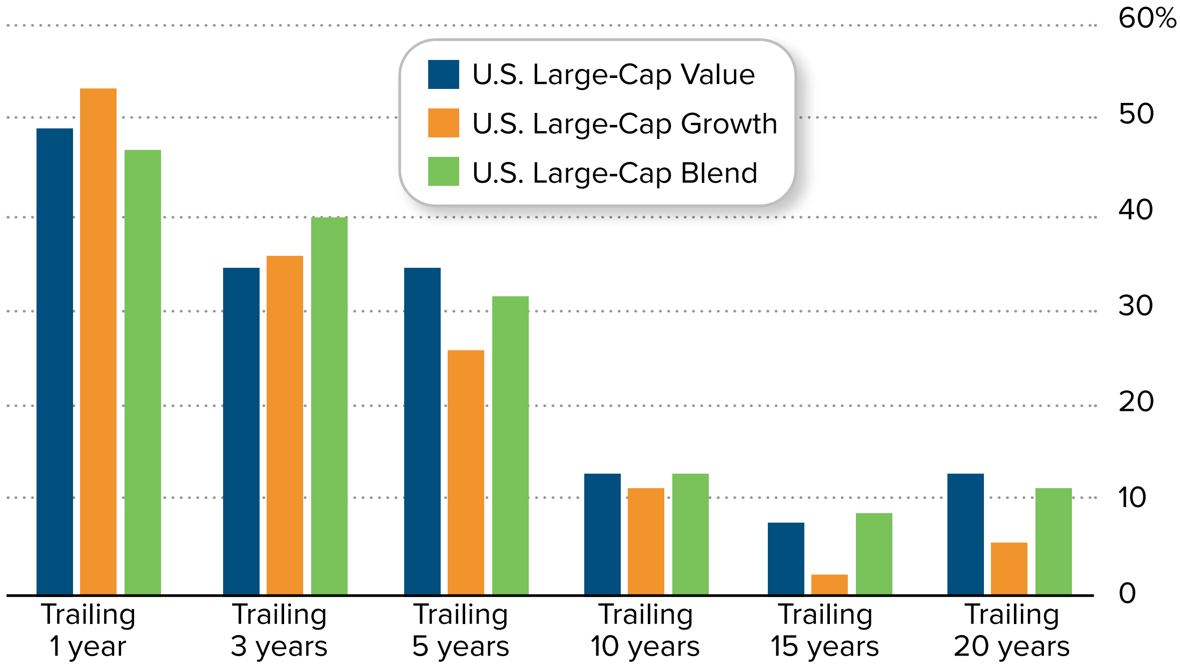
Actively managed equity funds, which tend to charge higher fees, are losing ground to cheaper passive options



Source: Morningstar Direct. Note: Total net assets in open-end and exchange-traded equity funds.

The main reason for the rise of index funds is that they have consistently outperformed actively managed funds. This is unsurprising, since research increasingly shows that actively managed funds are a terrible proposition. Most regularly fail to beat the market.

Percentage of actively-managed mutual funds/ETFs beating their benchmarks through 12/31/2023



Source: Morningstar

On average, in any year, 64% of active large-cap managers fare worse than the S&P 500.

This year appears no different. Only 18.2% of actively managed funds whose primary benchmark is the S&P 500 managed to outperform the index in the first half of the year. That is worse than last year, when only 19.8% of actively managed funds beat the S&P 500.

Because passive funds track the market, this means that active funds underperform index funds. From 2014 to 2023, just one out of every four active funds beat its average indexed peer. Research also shows that, over periods of 10 years or longer, roughly 90% of active managers failed to beat index funds. By some measures, over a 15-year period, only 3% of actively managed global large-cap equity funds beat the equivalent passive fund. The underperformance of actively managed funds relative to their benchmark, and therefore relative to index funds, holds true across all types of funds. And that underperformance becomes more pronounced across all funds the longer the time horizon.

Active Stock Mutual Funds Lag The S&P 500

Every single category underperforms its S&P benchmark over the long term by a wide margin

Fund category	Comparison index	% of funds that underperformed benchmark (1 year)	3 years	5 years	10 years	15 years
All large-cap funds	S&P 500	59.68%	79.78%	78.68%	87.42%	87.98%
All midcap funds	S&P MidCap 400	49.66	69.97	65.92	80.38	88.2
All small-cap funds	S&P SmallCap 600	48.31	64.24	61.1	88.29	86.91
All multicap funds	S&P Composite 1500	71.98	77.85	82.57	90.7	89.18
All domestic	S&P Composite 1500	75.32	78.97	84.82	91.44	90.84
Large-cap growth	S&P 500 Growth	9.76	72.1	58.55	84.12	87.47
Large-cap core	S&P 500	72.57	79.28	80.65	96.45	94.57
Large-cap value	S&P 500 Value	90.77	93.86	92.92	92.77	93.77
Midcap growth	S&P MidCap 400 Growth	24.41	87.5	44.7	63.31	82.77
Midcap core	S&P MidCap 400	72.07	58.82	78.33	89.31	93.75
Midcap value	S&P MidCap 400 Value	75	70.91	77.42	94.44	91.08
Small-cap growth	S&P SmallCap 600 Growth	54.72	87	53.85	84	84.77
Small-cap core	S&P SmallCap 600	51.71	52.4	60.07	92.55	93.38
Small-cap value	S&P SmallCap 600 Value	36.84	49.32	62.14	88.03	84.87
Multicap growth	S&P Composite 1500 Growth	42.38	76.09	73.22	90.45	88.98
Multicap core	S&P Composite 1500	76.21	82.19	87.65	96.97	94.43
Multicap value	S&P Composite 1500 Value	91.28	88.59	88.06	96.55	92.15
Real estate funds	S&P United States REIT	87.34	94.87	60	76.4	86.54

Source: S&P Dow Jones Indices Spiva as of Dec. 31, 2023.

Index funds have also become tremendously popular due to their low fees. They are able to charge much lower fees than active funds—usually 0.05%—because there is no need for them to research which stocks to include in the fund since the fund simply tracks a benchmark. Conversely, active funds commonly charge 1% or higher for their expertise.

As a result, the consensus is that investors generally and retirees specifically do better when they invest in index funds. It may be that the investment industry rarely promotes index funds because it makes more money selling active funds. But the evidence bears out John Bogle's remark that rather than looking for the needle in the haystack (stocks that will beat the market) investors do better when they simply buy the haystack (the market).

The Costs of Concentration

Bogle nonetheless voiced concerns as index funds became concentrated in the Big Three. In 2018, Bogle worried that index funds could become too popular for their own good:

> If historical trends continue, a handful of giant institutional investors will one day hold voting control of virtually every large U.S. corporation. . . . Most observers expect that the share of corporate ownership by index funds will continue to grow over the next decade. It seems only a matter of time until index mutual funds cross the 50% mark. If that were to happen, the 'Big Three' might own 30% or more of the U.S. stock market—effective control. I do not believe that such concentration would serve the national interest.

These concerns have only grown in the last few years. In 2023, Harvard Law Professor John Coates noted that the Big Three now control over 20% of the votes on the S&P 500. This means that control of most public companies will soon be concentrated in the hands of the dozen or fewer people who manage the top investment firms. So these few people, rather than individual investors, will essentially decide what corporate policies should be. Already, the Big Three represent the key votes on matters such as mergers and shareholder campaigns.

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As a result, these firms have unprecedented power in the market as they act on behalf of their clients' shareholder voting rights. Some question their ability and willingness to use this power to hold company management accountable by voting their proxy shares. Others worry they will be too willing to use their influence to pursue political goals rather than maximize shareholder value and ensure effective governance. Regardless, the fact that these firms are so powerful has a real impact on companies in important policy battles. The Big Three's combined votes and ability to make their views known to directors and CEOs could swing the outcome of important matters such as mergers, major investment decisions, CEO succession, and director elections, making the Big Three potentially the most powerful force over a huge swath of corporate America.

Regulators are beginning to take notice. Currently, regulations require that asset managers certify that they are not seeking to control a bank's management or operations whenever they acquire more than 10% of a bank's shares. The FDIC is now scrutinizing whether the Big Three are sticking to that passive role when it comes to their investments in U.S. banks.

There are also risks to competition. Research suggests that, because index fund investors are likely to own all the major competitors in a given industry since the companies will all be in the index, aggressive competing by one company will reduce the value of the other companies and thus of the index. So companies that are all owned by the same mammoth passive fund may not compete as energetically so as not to damage other holdings in their shareholders' giant portfolios. In other words, companies have less incentive to compete if they are all owned by the same large shareholders. This means that pressure on corporate managers to increase market share fades. For example, if Coke and Pepsi are owned by the same shareholders through an index fund, then there is less incentive for them to compete with one another for a greater share of the profits in the soft drink market. If Vanguard is the largest shareholder in both Ford and General Motors, why would it benefit from competition between the two? Companies that are essentially owned by the same people have fewer incentives to differentiate themselves on prices and products.

So less competition means less innovation, which hurts customers and investors in the long run. There is already evidence that companies' concentrated ownership is associated with lower wages and employment and leads to price increases in some industries. A 2018 study found that, when the same firms are the largest shareholders in branded drug companies and generic drugmakers, the generic companies are less likely to offer cheaper generic drugs, potentially resulting in higher drug prices. Similarly, a 2014 paper found that airline prices were 3% to 7% higher because large funds owned stakes in so many airlines. As a result, Einer Elhauge, another Harvard Law School professor, has written that concentrated ownership presents the greatest anticompetitive threat of our time.

> *Research suggests that passive investing leads to less aggressive trading, less accurate prices, and a more volatile market.*

Passive investors also may not be incentivized to take an active role in the companies in their index funds since their portfolio will include several hundred companies. Indeed, they may not even know what companies are in the index fund they own. And index fund managers may not want to invest the time to actively supervise the companies in the index because any effort to increase the value of a company will also increase the value of the index, which would benefit every other index fund that tracks that particular index. This may lead to insufficient checks on corporate governance. But active managers who pick shares in a handful of companies will push for them to be well-run.

Active funds, even mediocre ones, also help direct capital to well-run companies and away from poorly-run ones. Index funds, as passive instruments, make no attempt to ensure capital is being directed to the right places. So the rise of index funds, along with the concomitant fall in the number of active traders engaged in identifying overpriced or underpriced companies, could lead to a greater misallocation of investors' capital.

Another potential issue is whether prices will become less efficient if everyone buys and holds the same stocks through index funds. Active trading helps to set efficient prices because traders sell stocks that are overvalued and buy stocks that are undervalued. This moves the price of the stock. But index funds just hold the stocks in the index. Prices may be less efficient because passive investors do not pay as much attention to information in the market. Stocks may be overvalued as a result. Indeed, research suggests that passive investing leads to less aggressive trading, less accurate prices, and a more volatile market.

Conclusion

Index funds have come a long way since 1975. The first index fund, Vanguard's First Index Investment Trust, collected only $11 million during its initial underwriting. The fund, which is now known as the Vanguard 500 Index Fund, now has over $1 trillion in assets. Indeed, the S&P 500 is now tracked by over $4 trillion of passive index funds. But this popularity is becoming a problem. Policymakers will have to manage the dangers of index fund concentration without limiting the benefits to investors of these firms' low-cost funds:

> BlackRock, Vanguard, and State Street have been extraordinarily good for investors—their passive-investing index funds have lowered costs and improved returns for millions of people. But their rise has come at the cost of intense concentration in corporate ownership, potentially supercharging the oligopolistic effects of already oligopolistic industries.

This is the paradox of index funds—a financial innovation regarded as unambiguously beneficial for investors also poses tremendous risks. Bogle himself recognized this dynamic. At the end of his life, he touted the benefits of index funds while urging policymakers not to ignore the growing dominance of the Big Three.

So, what can be done to preserve index funds' benefits while mitigating the risks of concentrating so much power in the Big Three? It is possible that competition from other fund managers could diminish the Big Three's dominance. But because asset management is a business of scale, meaning the more money a firm manages the more it can lower fees, it is difficult for new companies to enter the business.

Increasing the transparency with which index fund managers exercise their power could have more potential. Bogle recommended the timely and full public disclosure by index funds of their voting policies and public documentation of each engagement with corporate management. Coates thought that, in addition to greater disclosures, fund advisers should be required to consult with investors in order to gather feedback that might inform their decisions.

Professor Anat Admati of Stanford has the simplest suggestion. She says that fund companies should use their leverage to make sure corporations are managed in the true interests of a fund's clients. If funds ensure that companies have better controls to prevent fraud, deception, and reckless practices, then in her view competition may improve and costly scandals may be avoided.

Whatever the prescription for the problems the rise of index funds presents, the potential flaws of index funds must be set against the very real savings they offer investors. Despite his concerns about the concentration of power in the hands of the Big Three index fund providers, Coates agrees that index funds have created real and large social benefits in the form of lower expenses and greater long-term returns for millions of individuals investing directly or indirectly for retirement. Thus the paradox. Index funds have so benefited investors that their very popularity poses risks. Policymakers must find a way to guard against these risks while preserving investors' ability to benefit from these funds.

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