Edison
Wealth
Management

# All hands to the index

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It is exactly 50 years since a self-described anarchist became the pioneer of an industry today worth over $11 trillion. Together with a team of academics at US bank Wells Fargo, John McQuown created the first ever equity index fund.

Prior to 1971, the investing landscape was flooded with actively managed mutual (or 'collective') funds. Many failed to beat their benchmarks whilst charging high fees for the pleasure. In McQuown's eyes, the gradual homogenisation of the industry had resulted in very little diversification.

Index funds are designed to solve these shortcomings. They are investment vehicles comprised of equities (shares) or bonds that aim to generate the same return as a particular index. But before continuing, what exactly is an index, and why would investors want to track its performance?

The 'Dow Jones' index was created in the 1890s and is still in use today

In statistics, an index is simply a way of measuring changes in the value of data. One of the earliest uses in finance was by Charles Dow and Edward Jones in the late nineteenth century. In a time when data was hard to come by, the pair wanted a simple way to gauge the performance of various US sectors. So, they bundled together baskets of companies into distinct indices. The most popular remaining example is the Dow Jones Industrial Average (DJIA).

The DJIA, commonly referred to as simply the 'Dow Jones', is unusual and rather antiquated in its approach. It includes 30 of the largest and most prominent US companies, each of which make up a fraction of the index proportional to its price. It is thus referred to as a price-weighted index.



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# Insight: All hands to the index

Many still use the Dow Jones as a bellwether for the strength of the US stock market. But critics of price-weighted indices rightly point out that they ignore percentage changes in share prices. Additionally, for the Dow Jones, its small range of 30 companies could be seen as too narrow, considering there are nearly ten thousand listed shares in the US.

Today, many indices use a weighting based not on price but on the market value of each underlying company. Driven by a desire to find suitable benchmarks and comparators, there are now over 3.3 million stock market indices globally. They include measures for fishing, obesity, millennial trends, artificial intelligence, and of course the familiar FTSE 100, which tracks the largest UK companies.

With this information, it is possible to better understand John McQuown's innovation. He realised the power of being able to invest in an instrument that tracks the index. After all, active fund managers were measuring themselves against a target index. When failing to consistently beat the index, why not replicate it and do away with the active manager's stock selection altogether.

Index funds are vehicles that attempt to closely mirror the performance of a benchmark. A FTSE 100 fund might simply buy the same 100 companies in formulaic proportions. Where the underlying market is larger, the index fund may use a sample of companies that demonstrate similar movements to the market as whole.

These approaches are broadly referred to as passive investing. The fund manager's role changes to replication which is a lower cost endeavour than active stock selection. Passive funds generally benefit from lower fees.

We have written previously about the trade-offs between active and passive investing. Index-tracking funds are by no means a one-way bet. Lower fees are accompanied by the knowledge that investments will experience all the ebbs and flows of the market. We tend to use passive investments in highly efficient markets where it is hard to outperform the index with consistency.

Passive investing also presents challenges when attempting to incorporate non-economic factors into the selection process. Despite growing awareness of sustainable investing, index trackers tend to take a light-touch approach even where they are marketed as 'sustainable' funds. Investors could end up indirectly owning one or more companies with poor records on climate or societal issues.

> Sustainability means taking active choices about how you invest

Sustainability means taking active choices, which in many ways is incompatible with a hands-off approach. We have spent the last few months researching and improving the way we select and manage our sustainable strategies. We'll provide an overview of the sustainable investment landscape, as well as the enhancements to our own strategy, in next quarter's Investment Update.

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If you have any questions on the above or to find out more about our investment service, please call 020 7287 2225 or email hello@edisonwm.com.

You can read more about us by visiting our website www.edisonwm.com.

# Important Information

**Important information**

This document does not constitute advice.

The value of investments and the income arising from them can go down as well as up and is not guaranteed, which means that you may not get back what you invested. Past performance is not necessarily a guide to the future.

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22a St James's Square, London, SW1Y 4JH, United Kingdom
+44 (0)20 7287 2225 hello@edisonwm.com edisonwm.com

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