This is a paper that seeks to answer questions, including:

- What are financial indices?
- What is the difference between a financial index and an index fund?
- How and why were indices created – and how have they changed?
- What role do indices play in the universe of investing?

Our great hope is that, in answering these questions, important new questions will be raised – and potential answers discussed by consumers as well as leaders in government and the financial industry. For example:

- How are indices and index funds relevant to everyday investors?
- Do financial indices hold some of the keys to Americans’ retirement savings challenges?
- How should index funds be regulated to protect investors’ rights and promote innovation?

The Basics

Financial indices are designed to provide investors with a way to reduce the complexity and increase the comprehensibility of financial markets – and yet, indices themselves are largely misunderstood. Indices are also commonly confused or conflated with index funds.

Somewhat ironically, indices enable an abbreviated lexicon that is used without an underpinning of deep understanding. Talk about “the market” or “the markets” almost always refers not to the actual financial market (or markets) in question, but rather to one or more major financial indices – for example, the Dow Jones®, the S&P 500®, the Nasdaq 100® – that measures activity in that market.

To simplify and understand, it is helpful to start the beginning:

An index of a market, in any given sub-set of the larger financial markets, is a composite that is created purely for its own informational value. The index is used to measure the performance of a list of bonds and stocks that are selected and weighted according to a specific methodology. An index, once created, cannot usefully be fixed forever. Businesses within the index are bought and sold. As some assets go up and others go down, the weighting must be adjusted. Some indices fold; other new ones are created.

Separately, traded index funds are created based on a specific index. They may or may not be created by the same party that created the index. There may be just one fund based on any given index; there may be several. These funds create the option of lower-volatility investing – rather than picking specific stocks or bonds as if betting on a horse race, an index fund responsibly gathers a collection of instruments in a sub-set of the market. This enables investors to put money into an industry sector (for example) and stay invested for a longer time period, rather than engaging in the exhausting and perilous journey of investing in a specific asset and then reacting to subsequent unpredictable developments.
The Utility of Indices and Index Funds

Financial indices boil down financial markets into digestible pieces that are right-sized – their goal is to simplify market complexity in a way that is not too broad, not too specific, but just right.

Financial indices and index funds are also catalysts for product innovation in the financial services space (analytical power now allows for the creation of indices that cover new markets and empower new strategies) and serve the higher purpose of democratizing investing – making it more economical for non-market-professionals to own efficient, affordable, diversified financial portfolios.

An interesting byproduct of index funds is the increase in competition they create for active money managers. Those who actively manage their clients’ money must work harder and deliver more value to create a return on investment competitive with the returns offered by index funds. (This is not to torture market professionals – just to subject them to the same incentives that apply to people in every other profession who must keep up with the competition to succeed!) We estimate index funds save investors approximately $15 billion in fees per year and when transaction costs are included, those benefits double. The indirect benefits we estimate are $40-50 billion annually.

The Issues

As America faces the realities of both a changing approach to work and saving and its own “graying” – where the proportion of retirees to younger workers will challenge Social Security’s financing – lower-cost, efficient, long-term investing is of increasing importance.

Financial indices and index funds offer help, if they can be made clear to everyday investors.

Just as understanding of, and engagement with, indices and index funds becomes most important, regulators are testing their power to change the shape of these financial tools in the interest of multiple generations of workers and investors. Their actions have real-life implications that must be very carefully considered.

If regulated in a way that maintains their democratic appeal, indices will continue to provide valuable information for investors, and the index funds which are based upon them will continue to offer opportunities for those who want to initiate and manage their own retirement savings without needing to follow financial markets overall, or individual stocks and bonds, in detail – in other words, typical workers and investors can save for the future effectively and efficiently, without themselves becoming investment professionals on the side.

If regulation interferes with the workings of financial markets, however, indices and index funds could become less accessible for those who could benefit most.
The shape and future of indices and index funds are both important and unclear. The pressure on creators of indices and index funds to be transparent is both fair and reasonable – but a lack of basic understanding among lay investors creates challenges for consumers, and opportunities to educate both market professionals and regulators.

The Possibilities

An ideal balance of consumer education and empowerment, along with thoughtful regulation, will leverage the benefits of indices, and index funds, for everyday investors. In a world where investors must take ownership and control of their own financial futures, these financial tools must play a greater role than ever before, for the greater good.

Understanding indices and index funds is the critical first step; this paper is therefore an important doorway to understanding and increasing the democratization of investing.