EPISODE 54:

The S&P Dow Jones & S&P 500: A Brief History

[INTRODUCTION]

[0:00:05.3] Benjamin Felix: This is the Rational Reminder Podcast, a weekly reality check on sensible investing and financial decision making for Canadians. We are hosted by me, Benjamin Felix and Cameron Passmore.

On today's episode, we had Dr. David Blitzer and he's not exactly a household name, I don't think. I'll be surprised if anybody listening knows who he is. He is the managing director and chairman of the S&P Dow Jones index committee.

[0:00:32.0] Cameron Passmore: Just think about that. He is the managing director and chairman of the S&P Dow Jones index committee. That's S&P like the S&P 500. Dow Jones like the Dow Jones in lab, he is the guy –

[0:00:44.4] BF: The guy. At the center of indexes.

[0:00:47.6] CP: He's been out to send the index revolution for the past –

[0:00:52.0] BF: I think 1982 is when he started at S&P.

[0:00:54.1] CP: 30 plus years.

[0:00:56.1] BF: He's been there from the time when indexes were barely even being traded, the first time S&P Futures began trading, he was there, right? Yeah, he was at S&P at that time and then from there, Indexing's obviously turned into this massive thing and S&P indexes as everybody should recognize this listening to the podcast are at the center of that explosion.

[0:01:21.5] CP: S&P took over Dow Jones. Now they're all one so the Dow index, he talks about this, goes back very long time as the S&P 500. We had a fascinating conversation with him, really a guys, graduate of Cornell University, MA in economics from George Washington

University and a PhD in economics in Columbia. He's retiring this summer, super lucky to have the chance to meet him and get.

And ask all of the questions we wanted, it's so gracious.

[0:01:50.1] BF: It's so gracious, so chilled out, laid back.

[0:01:53.5] CP: Right from the S&P headquarters down at lower Manhattan overlooking like it was pretty surreal experience for us index lovers.

[0:02:00.9] BF: We're in there looking around like, we ask him, "This is it, this is where the indexes are made?" and he's like, "Yeah, this is it."

[0:02:08.4] CP: Yeah, it was pretty impressive, he was very impressive, very nice guy and we're very thankful he was willing to spend time with us.

[0:02:15.5] BF: Talk about insights on indexing and indexes, who else could you ask? I know one of the questions that stood out to me was, I asked him what – where do you draw the line between active and passive when it comes to indexing? We all agreed that we don't like passive as a name for index investing.

[0:02:30.7] CP: He called it intelligent investing.

[0:02:32.9] BF: Yeah, he said that, that name never stuck. Anyway, his answers to every question that we asked were insightful and very thoughtful. Like we said, I'm getting excited talking about it. He's the guy, he was there for all of indexing.

[0:02:49.4] CP: Yeah, we're super lucky to have him for the listeners and yeah, it's a pretty cool interview so episode 54, hope you enjoy it.

[INTERVIEW]

[0:03:01.9] BF: Dr. David Blitzer, welcome to the rational reminder podcast.

[0:03:05.1] David Blitzer: My pleasure to be here.

[0:03:06.0] BF: We're thrilled to have you because you're nearing your retirement. This is a lucky get for us.

[0:03:11.9] DB: Very good, well, it's a good chance to look back and what's happened and maybe even look forward a tiny bit.

[0:03:20.3] BF: That's great. You've been there in terms of being there for indexing from the very beginning.

[0:03:26.1] DB: Well, actually, the very beginning, the S&P 500, I think it was about 1926, I wasn't here then. But if timing is everything, I guess I'm lucky. I joined S&P in the beginning of 1982, that's six weeks after future trading in the S&P 500 started and in terms of the modern era of indexing and index funds and investment with indices, that's really the beginning of the modern era.

[0:03:49.7] BF: Right. What's changed? I mean, from then, from the S&P futures until now, what's changed with indexing in general and index investing specifically.

[0:04:00.2] DB: I think there's been a huge change. Back in 1982 or around then, indexes were really to sell newspapers. The Dow Jones is the most obvious example, when S&P started, it was financial publisher and that's where the S&P 500 came from. The idea that you could invest with an index, you could do it with a Vanguard fund by then but very few people paid any attention to that and the assets were minimal if not.

It's really expanded. I mean, the institutional investors learned about it with the 500 because all of a sudden they could use futures to hedge their portfolios, that was a huge change that they couldn't do before. The rest of us or individual investors began to learn about it, specially in the tech boom in the 1990s, there were a couple months or couple of quarters.

The S&P 500 outperformed something like 95% of all the mutual funds in the United States. Shouldn't happen. It happened because of the technology boom and market cap waiting in the

index. Then we're all forward, you got ETFs which while they were created about 1993 in the US, a little bit earlier in Canada.

They didn't really get going until the early 2000s when a big mark in the effort by what was then called Barkley's Global Investors and now BlackRock. Really decided to sell it to everybody like you and me. That just took off and then you can invest in an index, you didn't have to figure out which index, mutual fund was doing it, where to get a hold of them and how to send something, send checks to them.

Just called up your friendly broker whomever he was, wherever he was. He sold you an ETF and I think that's really put the game on high growth at that point.

[0:05:51.4] CP: I'd like to ask you a very basic question. Can you just explain the relationship between S&P and a product manufacture like a Vanguard, just explain the different roles at a basic level.

[0:06:03.2] DB: S&P Dow Jones Indices is what we call an index provider, we design, develop and then calculate an index, the S&P 500 Dow Jones industrial average and with only a few hundred thousand additional ones. We don't run in investment funds, if you send us a check, we're going to send it back uncashed, we don't do that business and we're not a registered investment advisor, we're not a broker dealer, not any of those.

We're strictly a publisher of indices and so on. Vanguard, BlackRock, State Street, on and on. What they do is they license an index fund, they license an index from us so they license the use of the S&P 500 from S&P and then based on that license, they issue either an exchange rate fund or mutual fund that tracks the index.

[0:06:55.7] BF: That gives them the right to use the brand name and then they have to follow exactly what or their mandate is to track a little, as close as possible to the underlying index.

[0:07:05.2] DB: Well, typically the agreement doesn't put absolute restriction on how close they can track and so on. It depends on how big the fund is going to be, how they're structured, how they're viewing it, that kind of thing.

They license use in a name and they also – we see data from us on, every night of any index somebody like Vanguard or State Street is licensed, they'll get two files. First file will show you exactly what the index will – as it close tonight, putting the closing prices, all the weights, all the security, anything else in it. The second file, if we're making any changes overnight, adding a stock, dropping a stock.

The second file shows you it's going to look like tomorrow morning when the market opens and so on. You can compare the two and figure all – I hope I sold this one and bought that one kind of thing and so on. That's what we do, we obviously promote like tell people about our indices and so on and since the product issue was the State Streets and the Vanguards, you're using index name and the name of their product as you know, we benefit and they benefit and so on.

[0:08:16.5] BF: Naturally. Are there major differences between something like the S&P total US market in the crisp 110? In terms of construction? Is that too technical of a question?

[0:08:25.7] DB: No, I don't think so. There are probably a lot of subtle differences, the way the indices are run and so on, the basic day, I mean the security price, the names, companies. Then there are a whole set of rules on how you choose and select the companies. For example, the S&P 500 and a few other of our indices require that the company be profitable at the time it's added to the index and we're sort of traditional.

We look at generally accepted accounting principles, all these – more novel ways to figure earnings are very nice but not for the index. That's not too common so one big difference between the S&P SmallCap 600 and the Russell 2000 is they don't have a profit screen and we do, we've got years and years of research that suggest that makes a difference in the performance to the benefit of the SmallCap 600.

There will be other kinds of issues, differences of well, the exact security selection, maybe the timing. A lot of indices make changes on a schedule once a quarter, once a month, Russell once a year. For the 500, the Mid Cap 400, the SmallCap 600. We do what we call 'as needed basis'. If stock is going to be very data resistant the middle of next week, sometime this week, we would have made an announcement after the market closed.

Tell you what we're going to do, we'll make the change then when an index, short one stock until the end of the quarter.

[0:10:02.4] CP: You've seen an explosion in the popularity of index investing. Any thoughts on what the main cause was, what the main tipping point was?

[0:10:11.4] DB: Yeah, I don't think there was really a tipping point, it's not like I think back and say, aha, that was the day it all happened.

[0:10:18.0] CP: Creation of ETFs or.

[0:10:20.3] DB: I think ETFs are probably the biggest factor and not just the creation but really, the mass popularization of them and that kind of thing. One factor is that as I think I mentioned, you can call up any broker and buy an ETF, you don't have to go to the particular fund company and that kind of thing.

That meant that instead of having to go to Vanguard for an index fund or go to Fidelity for a Fidelity fund, you just go to your broker, whoever it is and you say, here's what I want to do and you do it. Vanguard instead of having just their sales people or Fidelity, their sales people. Now like that every broker in the country out there and that's made a huge difference. On top of that, if that online investing, you've got certainly the United States, the demise that define benefit pension plans.

Unfortunately, they're vanishing like crazy. The rise of 401(k) plans, all kinds of defined contribution plans, any kind of sort of package investment, the ETF turns out to be ideal and so called robo advisors is probably the current version of this trend.

It seems to be building and ongoing. On top of that, ETFs had created a massive price war across the entire investment community. When Jack Bogle passed away, I saw one comment that more investors owe him more money than anybody else in the history of the world and it's probably true. I'm a beneficiary of that and I have money in Vanguard fund.

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But I think that's definitely helped. We increasingly hear a modest size institutional players who 20 years ago we either ran the money in house or would contract with a State Street or BlackRock to run the money by an ETF.

[0:12:18.9] BF: Really?

[0:12:20.7] DB: The liquidities there, you want to move money in and out quickly, you just want the money to be earning something in the stock market instead of sitting to the end in a month when you make payments, you buy an ETF.

[0:12:35.3] BF: The evidence is there too.

[0:12:36.8] DB: Yeah.

[0:12:37.7] BF: What do you think about the role of the data in the shift indexing, obviously there have been numerous academic research papers, efficient market hypothesis which sort of started all of that but then Standard & Poor's publishes the speed report twice a year like how much of a role do you think that's played in people saying well, active's clearly not working that well.

[0:12:54.2] DB: I think it's been a pretty big role and I don't think it's – that big of an impact for individuals as much as it is for small institution. When our people go out and talk to things like state world municipal pension funds and this is not like New York state with literally billions of dollars but this may be the police and fireman of whatever mid-sized city you want to mention.

These groups don't really have the where with all the hire a lot of fancy consultants or to have a huge analytical staff and so on. It's been two firemen on the committee and they do, you know, they're probably better at investments than I am at fighting fires as a matter of fact. You show up with this fever report and the numbers are all there, nicely laid out and we now got I think it's about 15 years history in the United States.

It makes a pretty good argument and so on. You know, people say, do they really work and I say well, you know, if we had a five funds aren't going to beat the index, as a matter of fact, none of those may repeat next year. It's not a great bet in the long term.

[0:14:04.6] BF: A lot of people call index investing passive investing, we personally don't like that term. I'm curious on your perspective on that being a lead and maybe talk about your role as well on the S&P index committee and how that process works.

[0:14:21.0] DB: First thing is, I used to try and call it intelligent investing. I like that better than passive. I'm not sure I go that to stick to anybody else. I think the person to say about the index committee is it really is a committee with a group decision. The numbers varies slightly, it's probably never been lower than six or seven. I don't think it's been much above 10 over the years.

Everybody gets one vote. When I was chairman, I lost some votes too or I was on the minority side if that's the way to put it. One sort of policy or tradition or something was, you didn't want to end discussion or discussion went on and it was clearly disagreement about some topic.

I would just say, we go around the table, meaning, everybody has the chance to say something. He can say well I agree with the last guy but nobody should complain they didn't get their two cents worth to put in. The committee, you know, the committee would review what's going on in the market, review what the index look like, look at pending corporate actions, mergers, acquisition, spinoffs, whatever, that are happening.

We track the news, continuously, which means that at any moment, we probably know of all the mergers that are going to close within in the next six or nine months. That's how long it takes to close a merger between from announcement on out.

The committee constantly is looking at the index and how it's behaving. Probably the most important thing is, well, the committees, the index objective is to track the large cap segment of the US stock market. The committee's job and objective responsibility is make sure the index does that.

The committee is not a stock picker in the sense of like IBM better than Dell or that's not the process of the question at all and the question is, you know, do these 500 stocks, they make the requirements for size and liquidity and so on. The right 500 stocks to meet the objective.

We’re not picking stocks to make it go up, we’re picking stocks to meet the objective that we publish.

[0:16:30.6] BF: Is it hard to keep your opinion out of that so that it does not become an active?

[0:16:36.1] DB: Yeah, I think first of all, none of this permitted to own any stocks, it’s a different, we don’t have any skin in the game in that sense. I mean, clearly, we have skin in the game, there’s a bear market, everybody calls them, blames us. We can’t change that, we can’t prevent a bear market. We would have done it a long time ago obviously, we’d tell you exactly when we would have done it or we could have done it.

I think back of the people we’ve hired and was a period going back I guess prior to the late 90s when we actually had a separate department S&P, not we’re tied index at all, but a separate department that had equity analysts and so on.

Right around the time I became a little work in indexing, I was still running part of that department. People who want to be analysts and pick stocks and different than people that are in indices. It is different mindset and so on. You know, somebody who think he knows the latest hot stock or why Uber is a better IPO than Lyft and that kind of stuff, he’s not the kind of person or she’s not the kind of person that gravitate toward indexing and they got to gravitate to picking stocks or working in a hedge fund or something.

There’s nothing wrong with that. I mean, over the years, we had a couple of people, learn a lot of indexes and put them to side and know how to beat them consistently, they went to a hedge fund, you know? I wish them well I guess is the right way to put it.

[0:18:03.3] BF: Here’s an interesting question. You’re not trying to build the S&P 500 to be an active fund that performs as well, why is it so hard to beat that?

[0:18:13.0] DB: I guess the two or three theories and stories and so on. First is the cost. I happen to call up a bank and ask them about they charge, by yours, treasuries and they quoted me several basis points is the fee and when I sort of got all the shot, that’s not so high and I looked at and saying, I’ll buy a portfolio 500 stocks, cost me about three basis points, anything more than that for you as treasuries, it’s ridiculous.

The cost is definitely number one, there's the, I remember who the argument is but if you look at the home market, the home market is indexed and so on. There's some winners and some losers, you take only part of it and that kind of thing. I think the other thing is, you know, if you look at the stocks in the S&P 500, across the whole 500 stocks. How they did in a year and obviously some did not very well and a few did very well.

It's cue to the extreme right hand side. If you within as an active manager, if you want six or seven stocks in the extreme right hand tale, the ones that probably a few times, six times with the index overall bit, you'll be in fat city. But the chances of you owning those stocks, even on a random selection basis, not very good, if they're five stocks out, about one of 500 chance, that's in your portfolio.

If you own the index, you own all of them and so on. Over time, these huge stocks at the end and you know, the tail, that account for the lion share of the performance in any given year and so on. I think that's why we're doing it is if you're in the index, through your fund or whatever, you're going to own something of both. That also is part of the reason why the equal weight aversion of the 500 seems to do much better than the cap weighted version over the long term.

If those five stocks out in the edge, the best performers happened to be numbers 96 to 400 by rank in the 500, the accumulative weight's may be 1%. Whereas the equal weighted, you know exactly what it is.

[0:20:31.4] BF: That's really interesting because that does give you a higher weight for potentially in a stock that does really well as supposed to being like a value story or a smaller cap story, it's not really a factor story the equal weight than on the S&P 500.

[0:20:45.5] DB: Yeah, I mean, the equal way to also benefit, I think it benefits from the fact that you're up weighting the smallest stocks and down rating the biggest ones. We had a sort of an – a pretty active debate about in the office about a year ago. Some people see small cap means it's just small stocks and nothing else and I said no, I think it's a continuum.

If I take the bottom hundred stocks out of the 500, I'm getting some small cap benefit even though the smallest stock might be six million dollars of market value or something. The other

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thing he said, value stocks tend to be lower price and growth stocks tend to be higher price and getting the equal weight, overweight's the value as well. I think this queue is a big part of the story in both cases.

[0:21:35.8] BF: Yeah, it's really interesting. What do you think, obviously, we've talked about the explosion of index investing and the data and the speed report and all that kind of stuff, what is the effect that that has had? What do you think the effect of that has had on traditional stock picking and market time and traditional active management?

[0:21:51.6] DB: Glad I'm not in the business I can tell you. I guess it's done a few things and it wouldn't surprise me if it's encouraged a few people who used to be active stock pickers, decide they're going to be hedge funds because they can claim bigger fees and I did many years ago, meet one fellow, I mean, this was probably 15 years back and so on. He said he was sort of rearranging his business, he was no longer money manager, now a hedge fund. I said why?

He said, well, you know, you'll pay me more. It was an honest guy obviously. As I look across the range of yeah, active managers and so on, I think there were some who I guess get cold closet indexers, they're thinking about well, they're close to their benchmark and there's some line about, it's often being better to be conventionally wrong than unconventionally right.

If the way that contracts are written, that makes a point then that's the logical thing for them to do. There are some of the hedge fund.

I think there are a handful of traditional active managers that are out there. I always notice articles of that Bill Miller because he had a record of beating the 500 15 years in a row and my hats off to him. Toward the end of that's been in his letter, his shareholders or his investors, he announced that the best proof of active management was the index committee at S&P running the 500 which is always a nice compliment but I didn't think it was accurate.

But there was a thing in the Wall Street Journal over the last, I think over the weekend. A very short interview with him and he made some of the same points that there are active managers, his target or his style as he described it, is to have a large, active share, he doesn't stick close to the index or the benchmark, whatever it is. He knows he's taking big bets, he's obviously got

the track record to taking big bets. Unfortunately, there's another British portfolio manager in the newspaper lately who took the wrong big bets and –

I think in the long term, there will always be a small group of people some like Bill Miller who really have skill or really demonstrated the skill and I'm sure everybody has their ups and downs, there are all these people who think they can do it whether they can or not. The other thing is, say the S&P 500 was a huge conquer the game, at this point.

Any change that is made to the index is now two to five days in advance. The rules about that index are published, they're on our website, you pull them down, the history of the index going back to 1920 something rather is available on the web and you can't go through the rules and know exactly what stock with the next one shows or something like that.

But you can get very close, you wonder when it's going to happen, just follow all the mergers the same way we do and so on. All that information is out there and if active managing – successful active management depends on – a lot of information. Well, it's there. I presume there will be people out there who harvest it and put it to use.

Indexing is never going to be the whole market and I had no idea where that end point or is, if there is one.

[0:25:11.8] CP: I have a question about our Canadian index market so our team, our firm converted to index philosophy in the mid-90s. We live through – I'm curious your perspective on uniqueness of perhaps the Canadian market where the late 90s, we know what happened to North Talk. It became over 40% of them index I believe, right?

Can you talk about – that's just one example of indexing the smaller market but maybe talk about that experience as well.

[0:25:39.9] DB: Yeah, we do indices in Canada and actually, we have an index committee up in Canada, we have an agreement with Toronto Stock Exchange and as a result, the committee head members on these stock exchange on it as well as S&P members, simply has a majority of the votes but it's not like this, you know, we're very collegial.

Not just because it's Canadian but in general. I guess a few things that stand out about the Canadian market. First of all, it's pretty much focused on finance and natural resources and so on and that's the nature of the Canadian economy more than anything else. The financial sector seem to be reasonably stable or quite stable compared to a lot of other financial sectors including the one down here.

The whole idea of diversification is a little bit different and that kind of thing. Some of these talks of course will sit in the US, especially if the large cap index, the S&PTS X60 and so on. I guess the other thing is the index, the principle index for most Canadian investors is the S&PTSS composite which is around 225 stocks at this point.

It's a pretty big chunk of the market, it's compared to say the 500 positioning in the market in the US. Or other markets that we look at and so on. In fact, we built a 60 stock index. The S&PT SX60. The idea of it was sort of an analog to the 500 but you know it is consequently, the composite is a much broader sweep of the market and it's on probably is a little more diversity. It certainly has more diversity than the 60 than the 60 tends to be. You know even with a lot of work by the committee it tends to be very heavily financially oriented and that kind of thing.

The other thing about the composite is the rules for the bottom, which is unusual. Most indices either any stock above X million dollars or you know, a certain number of stock but the composite rule was the smallest stock cap can't be more than I think it is now 1.5%, one and a half basis points to the total weight to the index. It is sort of a you get a tail and how hard down you go depends on the composition of the market.

[0:28:00.2] CP: But it is still market cap weight.

[0:28:01.7] DB: It is still market cap weighted and so on. The other kind of thing that I think one sees when you look at small markets is you probably – investors who run a lot of diversification are more likely to look outside their home market than they are a market like the US, especially since probably half the revenues of the S&P 500 come from outside the US and US invest you can be globally diversified without buying any none US stocks.

I think for Canadian investor to be able to say the same statement it would be very difficult especially because it is going to be very heavily weighted with natural resources in finance but a

lot of other areas waiting is not going to be that diverse or something like that and you know, one consumer goods company instead of three or four consumer goods companies and various other things industry by industry. So there will be those kind of differences and so on.

But yeah, I guess the other thing I should say is working the Canadian market has always been very interesting and there are a lot of other very large substantial well respected institutions that some of the big pension funds I think are much more active in Canada than their equivalent on the United States and that kind of thing and so on, which I think have generally been beneficial to Canadian investors.

[0:29:27.4] BF: There is just a big report in Canada on the Canada pension plan investment board and how their active strategy is actually done quite well over the last little while. We are a bit skeptical of the report but anyway.

[0:29:37.8] DB: I guess over the years I have met with them. Well, we Americans go to the jealousy of Canada's pension plan that actually got real money instead of just book entry items and so on.

[0:29:50.0] CP: There is a big pile of money that is for sure.

[0:29:51.9] DB: You know I mean the other one that I have seen bits of and so in is in Australia where it is all the equivalent is similar to American 401(k) plan except that the amount that you invest is substantially higher. So that this so called super annulation plans they have asset levels that would amaze some Americans.

[0:30:14.9] BF: You mentioned equal waiting and we have talked a lot about different market cap weighted indexes, what are your thoughts on factor weighting? So weighting for value and small cap in excess of market cap weights in index construction.

[0:30:28.0] DB: Factors have probably thought of the current generation of ETF's and designing indexes in many ways. You know we went – we have a lot of arguments going back I guess starting by 2004, 2005 about market cap weighted indices. People started to understand what happened in the tech boom and so on. They realized that waiting for the S&P 500 for

technology stocks got about 33, 34%. Yeah, I could have underweighted compared to the market because the ones that didn't make any money we never put them in the index.

So all the stories about pets.com, if there ever was such a company, never got any index. That doesn't mean we knew what was coming or anything. It just means they never got any index but I think the factor do make sense and so on and there are certain markets or factors that do very well. I don't think there is one factor that works all the time. Value in small cap may work a larger percentage at the time than many others. We have done a lot of work in low volatility stuff at different times.

But it does – if you are going to do factoring and do rotation and shift from factor to factor, you're taken one step away from being a hundred absolutely passive to making some decisions and sometimes you'd do better than the benchmark. Sometimes you'd do a little worse than the benchmark. You know it is not like stock picking where you could be miles away in either direction and so on but there is some of that that goes on but I think it is here to stay. It generates a lot of interest.

[0:32:07.9] BF: Do you think there is an obvious line? And I know we all agree we don't like the term passive investing but I am going to use that, is there a line where we go from being passive to being active? Where is that line?

[0:32:18.8] DB: It is hard to have a particular line. It is sort of a gradual continuum or something like that. Yeah, it may come into the question of should people, how far down that path should you go or should you be a stock picker and obviously not a picker or something and I think part of it is for individuals and this is not for financial professionals and it is not for people sitting in offices with 10 data feeds coming in, in six screens. This is for the regular ordinary people.

Investing for a lot of people is a form of entertainment. There is nothing wrong with that and maybe you think you have bragging rights it gives you something to talk about at the barbecue or whatever it is but it is some of that and so maybe the way to look at it is if you have to strength to look at your brokerage statement once a month then that's it. You don't want to think about this, you want to make sure the money is there buy a nice plain vanilla market cap weighted index fund from a reputable company.

Most of the time you don't have to worry about that every month and the newspaper articles are covered with black ink and blood before that, you got a problem like that's it but the people who gets some interest and benefit from it and so on they now move down and factor is I think a good way to look at things and without planning six nights a week, three hours a night doing research on stock names or something, which I don't recommend and that kind of thing.

But it is sort of a long continuum and I don't know where I draw the line. Most people say factoring, factor base indices, whether it is for some election or waiting or both that is index base investing. I think that is reasonable.

[0:34:06.8] CP: I have the perception that most people are more aware of the brand like Dow Jones Industrial average because that is what shows up in your feed in your smartphone or shows up in the nightly news although the S&P 500 maybe more money invested follow it and the Dow index as I understand it used to be decided upon by the editors of the Wall Street Journal but S&P and Dow Jones have merged, correct? Can you talk about the contrast too?

[0:34:33.1] DB: We are not going through all of the corporate rank arrangements and everything and that kind of thing. In 2012 up until that time was S&P's index business and combined up into that time had been Dow Jones index business came together as one and they are putting it together, the marketing guys decided the name should be S&P Dow Jones Indices. You know I guess standard important Dow Jones Indices would have hung up the phone before it got half way through or something.

So that's how we came about but first I should say it's been very successful. You know a lot of mergers, the good guys and the bad guys, you don't know who they hate each other all the time but that is not the case here. Very rapidly I think we all got along, we all got together and that kind of thing. The only slight disappointment in that category is the gentleman who is my equivalent on the Dow side chose to retire and he and I actually knew each other long before the merger happened.

Just by writing into each other in industry events and that kind of thing. So I was sorry that he retired because it would have been fun working with him and that kind of thing. The perception of the indices I think were different in 2012 and are probably still different now but Dow first of all goes back to 1896. It has an unusual calculation method; it is price weighted.

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[0:35:56.0] CP: Which is very unique.

[0:35:59.1] DB: Well I think the Nikkei 225 in Tokyo does it the same way but I'm not sure I can prove or verify that.

[0:36:05.9] CP: The higher the price of the stock, the higher weighting it has.

[0:36:08.7] DB: That's right. You could do it in the back of an envelope literally. Take the prices of the 30 stocks, add them up and instead of dividing it by 30, divide it by what we call the divisor, which is around 0.1 at this point but that's Dow and yes, the stock, I don't know which is the biggest stock off the top of my head but Boeing used to be very high up. It may have not be so high now. The biggest stock is a couple hundred dollars a share and the smallest stock is $20 a share.

Well it didn't matter what the heck the $20 share stock does at that point because the $200 share is going to carry the day, why? Well back in 1896, that was the way they did it literally. It was 12 stocks then and it was average then that's why it says Dow Industrial average in the name. I used to kid to fail with my counterpart Dow before, we were getting in, "Why the hell would you do it this way anymore? I mean why don't you change, get modern?"

And looked at me and said, "David, we got data going all the way back to 1896. Will you throw it away?" and I said, "Yeah, I guess I wouldn't" and you know, now you got to talk to myself about that I guess but that is really how it came about. If you plot the two of them over long periods of time, in a day or a week, to take 10 years, they're going to track each other very closely.

[0:37:31.2] CP: Which is amazing for such a drastically different index.

[0:37:34.1] DB: Yeah and a different weighting scheme and so in the 500 is 500 stock which was created in 1957 and it was S&P had always had industry groups and sub-industries and so forth. I mean in fact, there was a weekly index in 1923 with the industry groups for about 200 somewhat stocks. The 500 had always been really designed so that you can use it to analyze the market more than anything else. That's why it had companies broken into industries and

there was sub, there were indices calculated for all the different industry groups and that kind of thing.

And all of that was done to make it useful for analyst and S&P when they created it in 1957 from an old 90s stock index was in the business of selling stock market data and it was designed for that purpose. So it grew up as being the more institutional, more analytical, more professional kind of an index. Dow grew up to sell newspapers and you know Wall Street Journal is a great proof of that.

So that is how they came up. The peculiar thing is that it had turned on CNBC, you see the Dow and then once they get past a few other broad indices that aren't ours, they get to the 500 and I always say, "What happened to you guys?" but that is the background in the way they grew up. Today, the committee runs of 500 and a group of other US indices is separate from the committee that runs a Dow and the committee that runs the Dow still has to represent some Wall Street Journal.

Three from S&P and two from the general, very much the same the Canadian stock, the S&P of that committee has got people from the Toronto Stock Exchange and so on. So that that's – and it continues and –

[0:39:30.4] CP: I can only imagine the debate when you decided to remove GE from the Dow.

[0:39:37.0] DB: You know I think the best way to say is that any index that have been around for a long time and both of these have been around. The 500 goes back to 1926 or maybe it is a junior member but it is not that junior. You know there is a sense of the way it is going to be perceived in the history and that kind of thing and yeah, there was a lot of discussion. GE had not continuously have been a member of the Dow since 1896. If you go back to the very early days, they were really active stock pickers. You can look at the history, stuff came in and out a lot.

But up until probably the first world war and for the first I'd say 20 years of that index there seemed to be a lot of activity and I don't know why I have never found them. I never found the right history book or something to tell me that but I have seen that the ins and outs, which is I

think up on our website too. If you go back to the idea that's supposed to be representative of the US market, clearly the Dow has changed. It is no longer 100% industrials.

It's still rules which are also published, still say no utilities, no transports because there are other indices, Dow indices for those but it changes and keeps up with the time too.

[0:40:53.2] BF: You mentioned earlier that you don't think the whole market will ever be indexed. Do you think there is a point where indexing can get too big?

[0:41:00.9] DB: I'm not sure what will make it too big or something like that. From the point of view of the average investor, I don't worry about it. First of all and we talked before, I don't think it's going to squeeze out active managers. In fact, if anything more and more of the market is predictable because it is indexed and indices are transparent then probably the active guys have a small leg up from that. I think what they have done for the average investor certainly in the United States.

Because I understand more about the US than other countries but without defined benefit plans and with social security funding that aside from this morning's newspaper that again says they are going to run out of money in 15 years but very few Americans can live on their social security. That is the honest, the unfortunate but honest truth. So being able to say that investing is really important and index investing I think has been a huge plus for that for a lot of people that way.

And so in that sense, I don't think it gets too big and I think there is cycles in everything. So that either some other investment idea will come along that will pick up on a lot of what index investing and ETFs do now or there would be some other shifts happening like that but the way to growth is might be to slow down just because you can't keep growing these kind of great neck paces forever and the FT that had an article within the last couple of days that pointed out that on a global basis money would come out of ETFs in the month of May for the first time in I think three years had been a down month. It didn't make a very big dent but it did make a headline.

[0:42:41.7] BF: You have mentioned the average retail investor a couple of times now, how great indexing is for them, for that type of investor. They are trying to achieve their retirement

goal or whatever it is. Do you think other than entertainment, which you mentioned, do you think there is any logical reason for them to do active management?

[0:42:59.6] DB: I don't want to say no because somebody may come after me for this one but the way I am picturing this individual is it is not that they are not intelligent or anything like that but it is investing in finance and economics and not their business and in a sense, maybe the best odd analogy is, I am not a medical doctor and the last time I took biology I think I was in 10th grade or something like that. So when I don't feel well I go to the doctor.

And I go to the doctor once a year to get a checkup and so on and so forth because I am not a medical professional. In the same sense, the doctor is not a financial professional and that kind of thing and he or she read a book when they need the expertise to look for that way. So you want to be a good stock with who, imagine you have the next Warren Buffett. Well you'd better go to Columbia Business School like he did and the next, what is seventy years working at it or something like that.

That is why I think for somebody who doesn't really have the financial background and skills and doesn't have the motivation to do it, they probably are better doing something else and I agree that there are people who like to do it for entertainment and some of them may do it by asking the guy by Subway whether you buy it this week or something like that, which is probably not the best way to pick stocks but you know, if they want to do that that's fine too.

[0:44:33.0] CP: So my last question for you, I mean you have a very impressive career and been at the heart of some very interesting work in a big fast changing industry. I am really curious how going forward are you in the verge of the next phase of your life starting this summer I believe, right? How do you define success for yourself going forward from here?

[0:44:55.0] DB: You know I am not sure I have an absolute answer and so on. You know, on the long list of things that I like to do, travel, go see this place, go to see that place, spend time with my wife, my kids, my grandchild, you know all that kind of stuff but I don't think I have this sort of specific answer to do this, this and this but usually the question I get sometimes I have college groups come in or something like that is how do you count getting where you did or what was the test points and so on.

And my story for better or for worse is dumb luck to be in the right place at the right time and it sounds silly but when I came to S&P, I worked with Beverly Hill, which was then the parent company. It's long since ancient history, I came down to S&P and one of my goals is to survive as the chief economist for the first year or two and hope that the forecast weren't so bad, they were stupid and roll forward about 15 years somebody gave me an nice award for it.

So I figured I managed to get that far. On the other hand, I figured that we are going to get that much better. So when I started the index business they're knocking at the door, I opened the door in a big hurry. I mean I guess at that point my goal was that I'd figure out after 10 to 20 years in business that if you want to make more money you'd better be in the piece of the firm that is growing quickly and the piece of the firm that is not growing that's, you know, no matter what they say you're not going to get as big of a raise as you're in the fast growing spot.

I guess I managed to pick indexing in the fast growing spot at the right moment and so on. So I don't have any absolute goals but the last 38 years had been one hell of a run. We get the next 38 or even, I'll call it success right there so.

[0:46:47.6] BF: That is usually our last question but I've got one more to follow on what you just said.

[0:46:51.9] DB: Yeah, you may want to edit some of that out because I was rambling.

[0:46:54.7] BF: No that was great, I don't think we need to edit it. You talked about you got into the indexing business at the right time. Can you just talk a little bit about the effect of the growth of indexing on S&P?

[0:47:07.3] DB: I haven't worked in a lot of other companies. Out of graduate school I worked at economic consulting for about three and a half years. There was a time where I knew about litigation environmental rules but there were different rules back in the late 1970s but the scale is hugely different. When I came to S&P there were few people in the whole company than on the index business today, you know there were probably 400 –

[0:47:32.3] BF: There were fewer in the whole company –

[0:47:33.8] DB: The whole company than in the index business today. Now back in 1982, the US was emerging from a horrendous recession a decade when the market did nothing. Everybody says, “So why the hell would anybody even go down to Wall Street?” or something like that. Fed Ponzo was probably about 14% in the first half of 1982. You know why would anybody buy stocks? By the way, the inflation we were talking about 13.5% and so on.

You know we were still in the second of two back to back recessions. One ran about six months and the second one run about a year, maybe a big more. Jimmy Carter had lost the election by a point and Paul Walker to the Fed who then jacked rates to the roof and shot to everybody and then it all took off. So I think we walk up with a big shock in 1982. The first didn’t happen to the index business was he started to make serious money because of the S&P 500.

If you choose at the CMA, not overnight but certainly within a couple of years, it was making serious money and that made a big difference by the way. It had to expand a certain extent here because there is more work to be done because it is easier to use and so on. The first index that was added was what’s usually called the OEX, the S&P 100 with the basis of the real index futures on Cboe. That was actually created by Cboe and they couldn’t figure out how to run the index.

So they gave it to us in fact and it wasn’t we didn’t really add a second index of any substance until the early 90s with the mid cap index and so on. So from 1982 let’s say roughly about 1997 there was gradual growth. The size of the group expanded. It gradually became a little more formal and structured but you know probably went from five people to 12 people to 25 people or something like that over that period of time. When I became head of the index committee, which was in 1995 I think there were about 15 people who were officially part of the index group.

I wasn’t. I was still – we were being paid by another group and I had three people who worked in indices who are also being paid by some other group in the firm in Dow. So maybe we had 20 people all together at that point. You know we went through a series in management shifts through most of the 1990s and so on and I know you guys ’97, we had new senior management come in who looked around and said we should look at further fields than United States.

And Canada was really the first thing we did but between then and in rapid order S&P Indices opened operations in Canada and the Canadian Stock Exchange and Australia with the

Australian Stock Exchange, acquired emerging market indices from the IFC division of the World Bank, acquired a global set of indices from City Group, which originally have been called and originally have been built by Solomon Brothers and they went through various name changes.

That took us up at about 2005, then we acquired commodity indices from called GSCI, GS took from Goldman Sachs. They are really a Goldman Sachs commodity index now just GSCI. So in about 10-year period we went from few foreign indices in the United States to people based in – now trying this to all of the countries, Toronto, Sydney, Australia. We had a group in London even before we are doing indices in Europe. We had the merging market indices and it just sort of blossomed.

When the commodities game figured that out and so on and so we expanded very rapidly and the timing was right because it was the same period when the investment world discovered the idea of investing with industries as ETFs started to grow and everything and it came together. So by the time you rolled up to 2012 when we joined with Dow, we've gone from simple taste standard who to S&P. You mentioned the – or I mentioned the blog piece and the history.

What it reminded me of when I came to S&P, the equity research group used to publish these middle one page reports on each and every stock and they had three huge sets of volumes, New York, AMEX and OTC. AMEX that means the American Stock Exchange. They were called tear sheets but they were called S&P and I think right after I joined S&P I went out to theater one night there was a play called "Other People's Money" and the villain in the thing who is trying to buy out six companies yells, "Give me the S&P" he wanted the tear sheet.

Nowadays, the S&P means the 500 so that is sort of the evolution that's what happened to all the stock pickers too I think.

[0:52:42.9] BF: Right that was a fascinating little history. Well Dr. Blitzer, this has been phenomenal. I can't believe how much time has passed.

[0:52:52.1] CP: Yeah, this has been an amazing voyage and we learned so much and for you to be so gracious to welcome us into your boardroom overlooking lower Manhattan is I must admit it's –

[0:53:02.8] DB: You should have come at a clearer day. You can't see much view.

[0:53:06.1] CP: It's quite an experience I must say and yeah, thank you very much.

[0:53:10.6] BF: I agree, thank you.

[END]

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