

An index fund is not a fiduciary safe harbor

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Fiduciaries hold tens of trillions of dollars of other people's money subject to a sacred trust known in the law as "fiduciary duty." Such fiduciaries have a duty to act loyally, which ordinarily means they must act in the sole interest of the beneficiaries. Such fiduciaries also have a duty to act prudently, which ordinarily means they must diversify the portfolio and appropriately balance risk and return.

Lately, driven by fee litigation and a general shift toward passive investing, fiduciaries have increasingly turned to index funds for fiduciary accounts. In this context, a critical question arises: **Does the selection of a passive index fund provide a fiduciary safe harbor? The answer is no.** Contrary to mistaken conventional wisdom, an index fund is not a fiduciary safe harbor. An index fund may be a prudent choice, but it also may not be, depending on the circumstances. A fiduciary cannot blindly substitute the label "index" for the rigorous, ongoing analysis required by the prudent investor rule.

The term "index fund" captures an astonishingly broad array of mutual or exchange-traded funds that may or may not be prudent for a fiduciary depending on the circumstances. An index fund follows a passive investment strategy designed to track the performance of a specific, predefined benchmark (that is, the "index"). Accordingly, a given index fund may or may not reflect a suitable risk-and-return tradeoff, and it may or may not be broadly diversified. Today, there are numerous index funds constructed by industry, company size, geographic region or other specific criteria. Many index funds are entirely domestic. Others are entirely foreign. Even if an index fund is broadly diversified within its specific target category, it does not follow that the fund is broadly diversified for the purposes of portfolio construction.

To the contrary, even when a fiduciary selects what is labelled a "broadly diversified" index fund, such as one tracking the S&P 500® or a total market index, significant structural biases remain. Such funds are typically market-capitalization weighted and commonly not global. In selecting a market-cap weighted fund, a fiduciary is making an implicit judgment that market capitalization is an appropriate measure of diversification. This presents what we call a problem of **within-index diversification**.

Consider a typical S&P 500® fund, which is usually market-cap weighted. Driven by recent market concentration, the top ten companies in such a fund today account for more than a third of the fund, with the top three alone representing almost 20 percent.¹ Furthermore, seven of the top ten holdings are squarely in the technology sector. Indeed, Information Technology today comprises nearly a third of a market-cap weighted S&P 500® fund, whereas Energy comprises a mere 3.5 percent. A reasonable fiduciary could conclude that this degree of concentration carries too much sector-specific or firm-specific risk. An investment in a market-cap weighted S&P 500® fund is an implicit judgment that these risks are suitable under the prudent investor rule.

Moreover, even a "broadly diversified" index fund may still exclude significant portions of the investable market. This presents what we call a problem of **without-index diversification**. The S&P 500®, for example, is limited to 500 large-capitalization companies. By definition, it excludes small-cap equities, mid-cap equities and the remaining universe of large-cap domestic equities. Additionally, many "broadly diversified" index funds—such as those based on the S&P 500®—are domestic only, excluding global markets. Incorporating global markets, of course, brings its own additional weighting questions and currency risks that a fiduciary should consider. But that's the point. A fiduciary cannot blindly assume that an investment in an index fund that is said to be "broadly diversified" satisfies the prudent investor rule.

All told, a fiduciary cannot rely on an index fund as a guarantee of prudence. The prudent investor rule neither favors nor disfavors indexing as a strategy. To be sure, a reasonable fiduciary could conclude that a market-cap weighted index is appropriate. But a reasonable fiduciary could also conclude that an equal-weighted index or an actively managed fund is appropriate. The prudent investor rule prescribes a facts-and-circumstances test under which no type or kind of investment is *per se* permissible or impermissible. The fact that both active and passive management strategies are widely used by sophisticated investors is strong evidence that either could be prudent for a fiduciary.

What the prudent investor rule requires is a reasoned assessment of a given investment, whether an index fund or otherwise, in the context of the portfolio as a whole. Just as with an active fund, an individual security or other investment, the decision to invest in a specific index fund must be based on a reasonable determination that its distinct risk and return characteristics—including its within-index and without-index diversification—are appropriate for the fiduciary account. Further, as confirmed by the US Supreme Court, the fiduciary must periodically reassess any investment strategy, making adjustments as necessary in light of changing circumstances. Just because a strategy worked well in one period does not guarantee that it will continue working in the next.

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S&P 500[®] is an unmanaged capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

In accordance with Harvard Law School policy on conflicts of interest, Sitkoff discloses certain outside activities, one or more of which may relate to the subject matter of this paper.

¹ These figures are based on the Vanguard 500 Index Fund ETF as of February 28, 2026.