Adam Smith, the Invisible Hand, and the Mutual Fund Industry

Remarks by
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I am deeply honored by your selecting me as the 1999 recipient of the Adam Smith Distinguished Leadership Award. Surely Adam Smith, with all of his worldly wisdom about how things work and what makes people's hearts beat, would have understood my feeling. As he expressed it in *The Wealth of Nations*, "honor makes a great part of the reward of all honorable professions."

My entire career has been dedicated to what I believe Adam Smith would consider an honorable profession: to help the citizens of the United States of America put aside part of today's earnings for tomorrow, and invest those savings in the most productive manner possible. The role of mutual funds as a repository for the savings of American families was a prime theme of the senior thesis that I wrote at Princeton University nearly 50 years ago—it was entitled "The Economic Role of the Investment Company"—and I have worked in this industry ever since my graduation. Since I hardly possess Adam Smith's gift for words, I'll use his words to express the fundamental propensity to save that part of our human nature:

> "The principle which prompts to save is the desire of bettering our condition, a desire which comes with us from the womb and never leaves us till we grow into the grave. In the whole interval which separates those two moments, there is scarce a single instant in which any man is . . . completely satisfied with his situation. An augmentation of fortune is the means by which men propose to better their condition. The most likely way is to save and accumulate some part of what they acquire. The principle of frugality not only seems to predominate, but to predominate very greatly."

Later on in his book, he put it even more bluntly: "A man must be perfectly crazy who does not employ the (capital) stock he commands in some way."

My thesis put forth the proposition that the best way for individuals to employ their capital stock was in owning mutual funds. After graduating from Princeton in 1951, I put my career where my words were—"my money where my mouth was" is the conventional formulation—and, given my first break by legendary Wellington Fund founder Walter L. Morgan, joined the mutual fund industry, then described by *Fortune* magazine as "tiny but contentious." For 23 years, I plied my trade at Wellington, before my career took a surprising turn. A mid-career change, when it happens, is not always fun, but I set my new course first to build a better fund *company*, and then to build a better fund *industry*.

To give you some sense of the new direction that I mapped in mid-career, let me give you just a few sentences from a serial white paper that I prepared early in 1974 for our mutual fund Board of

Directors. The paper was entitled "The Future Structure of The Vanguard Group of Investment Companies,"[1] and it took the position that our mutual funds should have:

> ". . . an appropriate amount of corporate and economic independence, the highest quality of services, consistently superior performance, optimum cost-effectiveness, and a structure that is consistent with 'consumerism' and new standards of business ethics."

The whole idea was to make the Vanguard funds independent of an external manager/distributor with its own interests and agenda, high on which was earning a generous return for its own set of stockholders. In this prototypical industry structure, it goes without saying that seeking to serve the interests of *two* sets of stockholders—in this case, the owners of the funds and the owners of the companies that manage them—involves serious conflicts. It also must go without saying that, if the owners of the management companies control the fund-manager relationship, it would be patently absurd to expect them to resolve this conflict in a manner opposed to their own interests. The Apostle Matthew said it well: "No man can serve two masters."

So, it came to pass that Vanguard was organized under a new mutual fund structure, unique then as now. The fund shareholder alone would be served through a Board of Directors unaffiliated with any external investment manager. The funds would employ their own staff, responsible for administration, distribution, and investment management, contracting with outside advisers only when it was advantageous to do so, and then only with contracts negotiated competitively and at arm's length.

Our bet on the future was a gamble that, by moving in a new direction, our enterprise would be able not only to survive but to grown and prosper. We would leave the traditional seller-driven distribution system, in which the marketing/sales organization is king, to a new buyer-driven distribution system, in which the consumer is king. The "Future Structure" white paper was based on a few simple (and, I would argue, patently obvious in 1974, even to one totally bereft of foresight) economic trends: (1) the aging of the American population, a certainty after the post-World War II explosion of births; (2) the growing income and wealth of the population, a simple extrapolation of past trends; (3) a vast and growing reserve of savings generated by these trends, savings which almost certainly would be employed to meet future retirement needs; and (4) with these savings available, a far greater public interest in economic and financial knowledge. After all, with all they would have at stake, these new investors would not only want to, but need to, understand our system of capital formation and how to most effectively and efficiently invest their resources.

The mission of the Pennsylvania Partnership for Economic Education surely both echoes and reinforces these goals. As you salute me today, so I salute you for your accomplishments in increasing and improving the understanding of the American economic system. Of course, this must begin in our primary and secondary schools, for it is never to early to teach our citizens about the management of financial resources, the role of entrepreneurship, and the advantages of being (to quote the words used by Governor Ridge in informing me that I was to be honored with this award) "more productive workforce members, knowledgeable consumers, prudent savers, and competent decision makers."

From our inception nearly 25 years ago to this very day, Vanguard has focused heavily on investor education. We begin with *clarity*, for communication is only impeded by tortuous sentences that sometimes seem almost designed to obfuscate. (We are in the vanguard, as it were, of the "plain English" mandate issued to the securities industry by the Securities and Exchange Commission.) We

[1] Actually, I expected to use the name "The Wellington Group of Investment Companies." But as fate would have it, I would have to choose a new name, and decided that "Vanguard" would do the job.

emphasize *candor*, stressing the risks of investing every bit as heavily as the rewards, a stance that is hardly characteristic of this industry which is engaged not only in preening, pheasant-like, about performance, but in hyping past performance beyond reason. The simple fact, however, is this: *the past performance of a mutual fund has no predictive value*. To the contrary, reversion to the mean, in which top-performing funds come down to earth and bottom-performing funds come up to (or at least toward) earth is the rule of life. In my new book, I call this powerful tendency, "Sir Isaac Newton's Revenge on Wall Street." In all this hyperbole that plays on the notion that the past must be prologue, there is money to be made by fund *managers.* But there is none to be made by fund *investors*.

We also believe in *full disclosure* of all of the facts a prudent investor might need to come to an intelligent decision about investment choices. I'll grant that the industry too has traditionally honored this principle. But with one notable exception: cost disclosure. It is not that mutual funds conceal the direct costs of fund investing as such. For the investor who looks long and hard enough, the disclosure of fund management fees, expenses ratios, and sales charges can be found in each fund's prospectus. But there is virtually no disclosure of another *major* cost of fund ownership: the brokerage commissions and market impact costs of the fund's portfolio transactions. The fact that the combination of direct and indirect fund expenses may reduce the gross returns of the average equity mutual fund by as much as 2 ½% per year is nowhere to be found. But one need only look at a compound interest chart with two lines extended over time at 7 ½% and 10% respectively to see that the lower annual return provides only 47%—less than one-half!—of the cumulative value of the initial investment after 30 years. Earning less than half of the stock market's long-term return simply isn't good enough. To state the obvious: *cost matters*.

With costs so high, it is in the industry's interest to ignore that self-evident fact, lest investor knowledge become investor power. Price competition has thus yet to pervade the mutual fund industry. The question may be fairly raised: Where is the invisible hand that Adam Smith relied on? Hear his famous words:

> "Every individual intends only his own security; by directing his industry in such a manner as to produce its greatest value, he intends only his own gain but is led by an invisible hand to promote an end which was no part of his intention . . . promoting the interests of the society more effectively than when he really intends to promote it."

But that invisible hand is, well, invisible in the mutual fund industry. The interests of our society have not been promoted effectively; the interests of investors have been ill-served. Why has Adam Smith's thesis that competition works to produce the greatest value failed to work in the fund industry? Then-future Nobel Laureate Paul Samuelson, writing in the first edition of "Economics: An Introductory Analysis"—the classic text that provided my own introduction to economics at Princeton in 1948, and hence to my senior thesis on mutual funds—had the answer:

> The praise of perfect competition is beside the mark . . . a cynic might say of free competition what George Bernard Shaw once said of Christianity: the only trouble with it is that it has never been tried."

It is clear that price competition has yet to be tried in the mutual fund industry. The expense ratio of the average mutual fund has risen from 1.10% to 1.54% since 1980, a 40% rise in the face of a 7300%(!) increase in equity fund assets. The profits earned by fund managers have grown at a rate so far beyond the profits earned by mutual fund shareholders—even during this great bull market—that they brook no serious comparison. It has been the managers, not the fund investors, who have been the largest beneficiaries of the bull market, as is clearly illustrated by even a superficial comparison of the returns earned by the owners of mutual fund management companies and the returns earned by the owners of the very mutual funds they manage.

When the history of this era is one day written, I believe that Vanguard's principles of clarity, candor, and disclosure—especially cost disclosure—will stand as a major factor in helping to at last bring Adam Smith's invisible hand of price competition into the mutual fund industry. During our early years, I often described the enterprise in which we were engaged as "the Vanguard experiment"—a test of whether a fund organizational structure that honored the interests of fund shareholders over the interest of fund managers could be made to work. Of course, it was easy to foresee it would work well for investors. But would it work in the dog-eat-dog competitive world of mutual funds? Could a business based on these principles sustain itself and grow? Especially in this era of aggressive fund marketing, powerful salesmanship, hot short-term performance, and sleight-of-hand dealing with the facts? Absent the drive of sellers, would buyers respond? Put another way, "if we built it, would they come?"

Now of course, we know the answer. It is with decidedly mixed emotions that I report to you that the Vanguard Experiment is over. For a quarter of a century now, we have grown at a rapid but remarkably steady rate. The assets we manage have grown from $1.4 billion to nearly $500 billion. We have built a pretty good mousetrap, and investors have beaten a path to our door. We have proven, I think, that sound economics and sound investment principles can carry the day.

Adam Smith has today become the icon of the conservative side of the political spectrum, a result of his zealous belief in the free market. As he put it, "it is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from regard to their own interest." But he was not opposed to government intervention when it would be beneficial and not undermine the essentially free characteristics of the system. Students should not forget that part of Adam Smith.

Permit me to close by moving briefly to a higher plane that transcends economics, a message that I particularly send to the young men and women who are gaining so much valuable economic education through the efforts of the Pennsylvania Partnership. Even before venturing into economics in *The Wealth of Nations*, Adam Smith unveiled his credentials as a philosopher. In *The Theory of Moral Sentiments*, he expressed this thought, which I hope every budding entrepreneur-capitalist-businessman will heed, suggesting as it does, that promoting one's own interests must never engage the whole person:

> It is reason, principle, conscience, the inhabitant of the breast, the man within, the great judge and arbitrator of our conduct . . . who shows us the propriety of generosity, of reining in the greatest interests of our own for yet the greater interests of others, the love of what is honorable and noble, of the dignity of our own characters.

With that final wisdom from Adam Smith, I thank you again for the honor you bestow on me today.

Note: The opinions expressed in this speech do not necessarily represent the views of Vanguard's present management.