The Mutual Fund Industry in 2003:
BACK TO THE FUTURE

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It was just over 53 years ago when my career was determined by a fortuitous but life-altering moment in Princeton University's Firestone Library. Ever the contrarian, I was eager to find a topic that had not previously been the subject of a Princeton thesis when, in the December 1949 issue of *Fortune* magazine, I stumbled upon an article describing the mutual fund industry.

The title of the article was "Big Money in Boston." It featured the nation's oldest and largest mutual fund—Massachusetts Investors Trust (M.I.T.)—and its iconoclastic Chairman Merrill Griswold. The story described him as "the leader of a rapidly expanding and somewhat contentious industry of great potential significance to U.S. business." I immediately realized that I had found my topic.

The extensive study of the industry that followed led me to four conclusions: One, that mutual funds should be managed "in the most efficient, honest, and economical way possible," and that fund sales charges and management should be reduced. Two, mutual funds should not lead the public to the "expectation of miracles from management," since funds could "make no claim to superiority over the (unmanaged) market averages." Three, that "the principal function (of funds) is the management of their investment portfolios"—the trusteeship of investor assets—focusing "on the performance of the corporation . . . (not on) the short-term public appraisal of the value of a share (of stock)." And four, that "the prime responsibility" of funds "must be to their shareholders," to *serve* the individual investor and the institutional investor alike.

In retrospect, *the seminal Fortune* article that inspired my thesis described an industry that is barely recognizable today. Not just in size, for, as I predicted, an era of growth lay ahead for this industry. If "Big Money" described a *tiny* industry, I'm not sure what adjective would be adequate to describe today's giant. And while more than one-half of fund assets were managed "in Boston" then, that share is now down to one-sixth. The mutual fund industry today is international in scope.

But the real difference between funds *past* and funds *present*, the principal theme of my remarks today, is not those changes in size and situs, but the change in the very character of the industry. What *Fortune* described a half-century ago was an industry in which the idea was to sell what we made: "*Offering the small investor peace of mind*" through funds that provided a prudently diversified list of investments. It was an industry that focused primarily on stewardship. By contrast, the industry we see today is one focused primarily on salesmanship, an industry in which marketing calls the tune in which we make what will sell, and in which short-term performance is the name of the game.

This change in character is not an illusion. Since that *Fortune* article was published slightly over a half-century ago, there are specific, quantifiable ways in which this industry has changed. Today I'll examine nine of them, and then conclude with an appraisal their impact on the effectiveness with which mutual funds serve their shareholders. I'll be using industry averages to measure these changes. Of course some fund firms—not nearly enough in my view—have strived to retain their original character. But be clear that the mutual fund industry has changed radically. Let me count the ways:

1. Funds are Far Bigger, More Varied, and More Numerous

The mutual fund industry has become a giant. From its 1949 base of $2 *billion*, fund assets soared to $6.5 *trillion* at the outset of 2003, a compound growth rate of 16%. If we'd grown at the 7% nominal growth rate of our economy, assets would be just $72 *billion* today (such is the magic of compounding!). Then, 90% of industry assets were represented by stock funds and stock-oriented balanced funds. Today such funds compose less than half of industry assets (48%) today. Bond funds now represent 17% of assets, and money market funds—dating back only to 1970—constitute the remaining 35%. Once an equity fund industry, we now span the universe of major financial instruments—stocks, bonds, and savings reserves—a change that has been a boon not only to fund investors, but to fund managers as well.

So too has the number of funds exploded. Those 137 mutual funds of yesteryear have soared to today's total of 8,300. More relevantly, the total number of common stock funds has risen from just 75 to 4,800.[1] The investor today has more mutual funds to choose among than common stocks listed on the New York Stock Exchange (2,600). It is not clear, however, that the nature of this increase has created investor benefits, for in retrospect, "choice" has done more harm than good.

2. Stock Funds: From the Middle-of the-Road to the Four Corners of the Earth

For as the number of stock funds soared, so did the variety of objectives and policies they follow. In 1950, the stock fund sector was dominated by funds that invested largely in highly-diversified portfolios of U.S. corporations with large market capitalizations, with volatility roughly commensurate that of the Standard & Poor's 500 Stock Index. And today such middle-of-the-road funds represent a distinct minority of the total. While 2,450 of the 3,650 equity funds measured by Morningstar are considered diversified U.S. stock funds, only 560 funds would now closely resemble their blue-chip ancestors.[2]

In addition to the diversified U.S. funds, there are 450 specialized funds focused on narrow industry segments, from technology to telecommunications (particular favorites during the late bubble), and 750 international funds, running the gamut from diversified funds owning shares of companies all over the globe to highly specialized funds focusing on particular nations, from China to Russia to Israel. We offer a fund for every purpose under heaven.

Paradoxically, the major new entrant in the stock fund derby since 1950—the stock market index fund—represents a throwback to a simpler age. The first index fund was created in 1975. It holds the 500 stocks in the S&P 500 Index and seeks to match its return (before costs). With its first cousin, the total stock market index fund, introduced in 1987, these consummate middle-of-the-road funds now account for 10% of equity fund assets. On the other hand, there are also market segment index funds (matching, for example, a technology stock index or an index of Austrian stocks), the antithesis of their diversified forebears.

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[1] 66 of these original diversified funds, constituting 90% of equity fund assets, were broadly diversified "blue chip" funds. The remaining nine funds (10% of assets) were largely "single industry" funds that were soon to vanish.

[2] The accepted terminology in equity funds reflects this change. We have come to accept a nine-box matrix of funds arranged by *market capitalization* (large, medium, or small) on one axis, and by *investment style* (growth, value, or a blend of the two) on the other. Yesteryear's middle-of-the-road funds would today find themselves in the "large-cap blend" box, constituting just 23% of the funds in the diversified U.S. fund category, and 15% of the Morningstar all-equity fund total.

In substance, a half-century ago investors could have thrown a dart at a list of stock funds and had nine chances out of ten to pick a fund whose return was apt to closely parallel that of the market averages. Today, they have just one chance out of eight! That old *Fortune* article noted the allegation that M.I.T. did no more than give investors "a piece of the Dow Jones Average." But the author was right when he presciently added, "the average is not a bad thing to own." In any event, selecting mutual funds has, for better or worse, become an art form.

3. From Investment Committee to Broadway Stardom

These vast changes in fund objectives have led to equally vast changes in how mutual funds are managed. In 1950, the major funds were managed almost entirely by *investment committees,* and that original *Fortune* article pictured the M.I.T. trustees and their advisory board as they made their investment decisions. There they are—not quite as dour as the famous Grant Wood portrait of the Iowa couple in "American Gothic," but pretty close—distinguished of mien, serious of visage, doleful of countenance. The picture almost shrieks: *We are conservative*!

But the demonstrated wisdom of the collective was soon overwhelmed by the perceived brilliance of the individual. The "Go-Go" era of the mid-1960s introduced both the concept of far more aggressive "performance funds" and the notion of a "portfolio manager." That era had much in common with the recent bubble, as fund sponsors introduced hot funds with supercharged returns (often based on cooked-up numbers), aggressively marketed through stock brokerages. The new game seemed to call for free-wheeling individual talent, and the portfolio manager gradually became the prevailing standard. Today, the term "investment committee" has vanished, apparently replaced by "management team." But "portfolio manager" is the advisory model for some 3,200 funds of the 3,650 stock funds listed in Morningstar. Indeed, even the 240 index funds that merely buy and hold the stocks in their indexes are described as having portfolio managers.

The coming of the age of portfolio managers who served as long as they produced performance moved fund management from the stodgy old consensus-oriented investment committee to a more entrepreneurial, free-form, and far less risk-averse approach. Before long, moreover, the managers with the hottest short-term records had been transformed by their employers' vigorous public relations efforts, and the enthusiastic cooperation of the media, into "stars," and a full-fledged star-system gradually came to pass. A few portfolio managers actually *were* stars—Fidelity's Peter Lynch, Vanguard's John Neff, Legg Mason's Bill Miller, for example—but most proved to be *comets,* illuminating the fund firmament for a moment in time and then flaming out, their ashes floating gently down to earth. Even after the devastation of the recent bear market, and the stunning fact that the tenure of the average portfolio manager is just five years, the system remains largely intact.

4. Turnover Goes Through the Roof

Together, the coming of more aggressive funds, the burgeoning emphasis on short-term performance, and the move from investment committees to portfolio managers had a profound impact on mutual fund investment strategies—most obviously in soaring portfolio turnover. At M.I.T. and the other funds described in that *Fortune* article, they didn't even *talk* about long-term investing. They just *did* it, simply because that's what trusteeship is all about. But over the next half-century that basic tenet was turned on its head, and short-term speculation became the order of the day.

Not that the long-term focus didn't resist change. Indeed, between 1950 and 1965, it was a rare year when fund portfolio turnover much exceeded 16%, meaning that the average fund held its average stock for an average of about six years. In the Go-Go era, that figure nearly *tripled*, to 48% (a two-year holding period), only to fall back to an average of 37% (a three-year holding period) after the 1973-74 market crash. But that was just the beginning.

With the elimination of fixed commissions on stocks in 1975 and the later burgeoning of electronic trading networks, the unit costs of buying and selling plunged. Turnover rose accordingly, averaging about 80% from the early 1980s through 1999. And it's risen even further since then, with fund managers turning their portfolios over at an astonishing average annual rate of 110%(!). Result: Compared to that earlier six-year standard that prevailed for so long, the average stock is now held for just eleven months.

The contrast is stunning. At 16% turnover, a $1 billion fund sells $160 million of stocks in a given year and then reinvests the $160 million in other stocks, $320 million in all. At 110%, a $1 billion fund sells and then buys a total of $2.2 billion of stocks each year—nearly seven *times* as much. Even with lower *unit* transaction costs, it's hard to imagine that such turnover levels aren't a major drain on shareholder assets.

When I say that this industry has moved from investment to speculation, I do not use the word speculation lightly. Indeed, in my thesis I used Lord Keynes' terminology, contrasting *speculation* ("forecasting the psychology of the market") with *enterprise* ("forecasting the prospective yield of an asset"). I concluded that as funds grew they would move away from speculation and toward enterprise (which I called "investment"), focusing, not on the price of the share but on the value of the corporation. As a result, I concluded, fund managers would supply the stock market "with a demand for securities that is *steady*, *sophisticated*, *enlightened*, and *analytic*." I was dead wrong. Mutual fund managers are no longer stock *owners*. They are stock *traders*, as far away as we can possibly be from investing for investment icon Warren Buffett's favorite holding period: *Forever*.

5. High Stock Turnover Leads to Low Corporate Responsibility

Whatever the consequences of this high portfolio turnover are for the shareholders of the funds, it has had dire consequences for the governance of our nation's corporations. In 1949, *Fortune* wrote, "one of the pet ideas (of M.I.T.'s Griswold) is that the mutual fund is the ideal champion of . . . the small stockholder in conversations with corporate management, needling corporations on dividend policies, blocking mergers, and pitching in on proxy fights." And in my ancient thesis that examined the economic role of mutual funds, I devoted a full chapter to their role "as an influence on corporate management." Mr. Griswold was not alone in his activism, and I noted with approval the SEC's 1940 call on mutual funds to serve as "the useful role of representatives of the great number of inarticulate and ineffective individual investors in corporations in which funds are interested." By appraising corporate management critically and expertly, the SEC added, funds can "not only serve their own interests, but the interests of other public stockholders."

It was not to be. Just as my early hope that funds would continue to invest for the long term went aborning, so did my hope that funds would observe their responsibilities of corporate citizenship. Of course the two are hardly unrelated: A fund that acts as a trader, focusing on the price of a share and holding a stock for but eleven months, may not even own the shares when the time comes to vote them at the corporation's next annual meeting. By contrast, a fund that acts as an owner, focusing on the long-term value of the enterprise, has little choice but to regard the governance of the corporation as of surpassing importance.

A half-century ago, funds owned but two percent of the shares of all U.S. corporations. Today, funds own some 23 percent of all stocks. They could wield a potent "big stick," but, with few exceptions, they have failed to do so. As a result of their long passivity and lassitude on corporate governance issues, fund managers bear no small share of the responsibility for the failures in corporate governance and accounting oversight that were among the major forces creating the recent stock market bubble and the bear market that followed. It is hard to see anything but good arising when this industry at last returns to its roots and assumes its responsibilities of corporate citizenship.

6. The Fund Shareholder Gets the (Wrong) Idea

The change in this industry's character has radically affected the behavior of the mutual fund shareholder. In the industry described in the *Fortune* article as having "tastes in common stocks that run to the seasoned issues of blue-chip corporations," shareholders bought fund shares and held them. In the 1950s, and for a dozen years thereafter, fund redemptions (liquidations of fund shares) averaged 6% of assets annually, suggesting that the average fund investor held his or her shares for 16 years. Like the managers of the funds they held, fund owners were investing for the long pull.

But as the industry brought out funds that were more and more performance-oriented, often speculative, specialized, and concentrated—funds that behaved increasingly like individual stocks—it attracted more and more investors for whom the long-term didn't seem to be relevant. Indeed, in the 1970s the industry added a not-so-subtle temptation to investors to trade among funds, an "exchange privilege" that facilitated swaps between funds in a given family. Up, up, up went the redemption rate, actually reaching 62% in the year of the 1987 market crash. Last year, the redemption rate (including exchanges *out* of funds) totaled 45%, an average holding period of slightly more than two years. The time horizon for the typical fund investors had tumbled by fully 90%.

This change in behavior has forced a change in the delivery mechanism for fund shares. As "buy and hold" turned to "pick and choose," the average fund owner who once held a single equity fund came to hold four. *Freedom of choice* became the industry watchword, and "fund supermarkets," with their "open architecture," made it easy to quickly move money around in no-load funds. Trading costs are hidden in the form of access fees for the shelf-space offered by these supermarkets, paid for by the funds themselves, so that swapping funds seemed to be "free," tacitly encouraging fund shareholders to trade from one to another. But while picking tomorrow's winners based on yesterday's performance is theoretically attractive, in practice it is a strategy that is doomed to failure.

7. The Modern Mutual Fund . . . Made to be Sold

It is easy to lay the responsibility for this astonishing telescoping of holding periods on gullible, flighty, and emotional fund investors, or on the change in the character of our financial markets. After all, the investment climate was relatively peaceful during the 1950s and early 1960s, while the boom and bust in the stock market bubble of 1997-2002 was clearly a mania driven by the madness of crowds.

But the fund industry was a major contributor to that bubble. Departing from our time-honored tenet, "we sell what we make," we jumped on the "we make what will sell" bandwagon, creating new funds to match the market mania of the moment. First, it was during the Go-Go era when "concept stocks" were the rage, and at least one-half of the new funds we formed were "performance funds," sold not on the soundness of their policies and strategies, but on the glitter of their often illusory and sometimes fraudulent records. Then, during the recent market bubble, when technology and telecom stocks led the way, we formed 494 new technology, telecom, and internet funds, and aggressive growth funds favoring these sectors. It wasn't just the industry opportunists who sought to capitalize on this foolishness. As the prices of "new economy" stocks moved relentlessly upward, many of the most respected firms in the industry—to their later embarrassment—abandoned their investment discipline, formed speculative funds, and offered them to their clients.

But in the recent mania it was considerably easier to bring the investor sheep into the new-fund fold. Why? Because funds were now permitted to advertise their returns, and advertise them they did. Consider just one issue of a single magazine: In the March 2000 issue of *Money*, right at the market peak, 44 mutual funds advertised their performance. *Their average return over the previous twelve exuberant months came to +85.6%*! Small wonder that this industry took in $555 billion of new money—more than a *half-trillion dollars*—during 1998-2000, overwhelmingly invested in the new breed of speculative high-performance funds.

And just as those winners of yesteryear led the market upward and attracted all that money, so they led the market on the way down and saw it vanish. In 1998-99, the hottest ten funds provided a cumulative average return of 332%, only to decline by 75% in 2000-02. While the resultant net gain of 8% for the shareholder of the fund throughout the period, the overwhelming majority came in late, garnering little if any of the upside, and most, if not all, of the downside. The industry's cash flow, of course, traced the same up-then-down pattern. Eternally a trailing indicator in this ever-market-sensitive business, the gushing equity cash flow of the boom actually turned negative in the bust—an $18 billion *outflow* in the year just ended. Today, it is not *irrational exuberance* but *rational disenchantment* that permeates the community of fund owners, many of whom, unaware that the great party was almost over and that a sobering hangover lay ahead, imbibed far too heavily at the punch bowl.

In another astonishing reversal, this flagrant formation of new funds soon began to unwind. Fund deaths began to match, and will surely soon exceed, fund births. But it is not the old middle-of-the-road funds that are dying; it is largely the new breed of funds—those that sought out the exciting stocks of the new economy and hyped their records. Most of those stodgy funds of 1950 remain survivors. M.I.T. and the other ten largest funds of a half-century ago ($75 million or more in assets!) remain in business today.

Those early funds were, as the saying goes, "built to last." Typically, 99% of the funds in business at the beginning of each year were still around at its end, and nearly 90% still in business after a decade, with some 10% liquidating or merging with another fund. But as "built to last" turned to "born to die" during the Go-Go era, that decade-long failure rate then rose to 60% in the 1970s, only to fall back to 18% in the 1980s. Then, in the 1990s, the failure rate soared to 50%. The acceleration continued in 2000-2002, with nearly 900 funds giving up the ghost—an annual failure rate averaging 7%. If that rate continues (and there is reason to believe it may accelerate), half of today's funds won't be around a decade hence.

8. The Costs of Fund Ownership

When "Big Money in Boston" featured Massachusetts Investors Trust, it was not only the oldest and largest mutual fund, but the least costly. The *Fortune* article reported that its annual management and operating expenses, paid at the rate of just 3.20% of its investment income, amounted to just $827,000. In 1951, its "expense ratio" (expenses as a percentage of fund assets) was just 0.29%, the lowest in the industry, and the average expense ratio for the 25 largest funds, with aggregate assets of but $2.2 billion, was only 0.64%.

What a difference five decades makes! In 2001, M.I.T.'s expense ratio had risen to 1.20%, and its $141 million of expenses consumed 87% (!) of its investment income. The average expense ratio for the equity funds managed by the 25 largest fund complexes has risen 134% to 1.5%, despite the fact that assets have soared 845-fold, to $1.86 *trillion*. The dollar amount of direct fund expenses borne by shareholders of *all* equity funds has risen from an estimated $15 *million* in 1950 to something like $35 *billion* in 2002. There are staggering economies of scale in mutual fund management, but it is obvious that fund investors have not only not shared in these economies, but have been victims of far higher costs.

Of course, the expense ratio is only part of the cost of fund ownership. And in those olden days, the industry's no-load (no sales commission) segment represented less than 3% of industry assets. The predominant form of distribution was the independent broker-dealer, and the fund buyer typically paid a sales charge averaging perhaps 6% on each purchase. Spread over a then-holding period of perhaps 15 years, that additional cost of about 0.4% per year brought the all-in direct costs of fund ownership to, say, 1.00% annually.

The distribution mechanism has changed. Now, no-load funds are a powerful force in the industry, accounting for some 40% of equity fund assets. And for load funds, the traditional front-end sales charge has been largely supplanted by a host of "alphabet" shares, usually with no front-end commission. Rather, the sales charge is paid in annual installments of 1% a year or so, usually aggregating about 6%. Since this "distribution fee" is included in the fund's expense ratio, there are significant conceptual differences in comparing today's fund expense ratios with those of a half-century earlier.

The fund industry reports that the costs of fund ownership have steadily declined, but it is difficult to take that allegation seriously. The decline, if such it be, arises from investors increasingly choosing no-load funds and low cost funds, *not* from substantial management fee reductions. Stripped of statistical legerdemain, recent industry data show that direct all-in equity fund expenses amount to 1.46% of *assets*, not far from the crude unweighted 1.65% expense ratio reported for the average equity *fund*.

But even accepting the industry data at face value, the cost of mutual fund ownership is vastly understated. Why? *Because management fees, operating expenses and sales charges constitute only a fraction of fund costs.* Portfolio transaction costs—an inseparable part of owning most funds—are ignored. Out-of-pocket costs paid by fund investors are ignored. Fees paid to financial advisers to select funds (partly replacing those front-end loads) are ignored. Opportunity cost—the long-term shortfall in the returns engendered by the cash reserves that nearly all equity funds maintain—is ignored. Put them all together and it's fair to estimate that the all-in annual costs of mutual fund ownership now runs in the range of 2½% to 3% of assets.

What does that mean? While 2½% may look like small potatoes compared to the value of a typical fund investment, such a cost could cut deeply into the so-called "equity-premium" by which investors expect stock returns to exceed bond returns, giving the average equity fund investor a return little more than a bondholder, despite the extra risk. Looked at another way, 2½% would consume 25% of an annual stock market return of 10%. Over the long-term, $1 compounded in a 10% stock market would grow to $17.50 over 30 years; compounded at 7½%—a fund's return *after* such costs return—would reduce that value by exactly one-half, to $8.75. *Costs matter!*

The astonishing rise in equity fund costs since "Big Money in Boston" appeared—despite the truly flabbergasting leap in fund assets, not just on new speculative funds but on old conservative funds—is one more indication that the fund industry has veered from its roots as an investment *profession*, moving ever closer to being just another consumer products *business*.

9. The March of the Entrepreneur

That the line between a business and a profession is an obscure one does not mean that it doesn't exist. We think of a business as an undertaking in which the principal purpose is to earn a profit for the owner, and a profession as an undertaking in which the provider's purpose is to serve clients. Nonetheless, it must be clear that every business must entertain some idea of service to others. (Without that element, the customers would go elsewhere.) And that every profession must also, in some sense, make a profit. (Doctors and lawyers, after all, ought to earn a good living.)

But the industry that *Fortune* described all those years ago clearly placed the emphasis on fund management as a profession—the trusteeship of other people's money. The article is peppered with the words "trust" and "trustee," and frequently refers to the "investment-trust industry." Funds were largely middle-of-the-road in focus, diversified in investments, and built to last. Management fees were used to pay for, of all things, management. Costs were low, and distribution costs were paid not by the funds, but by the investors, as they purchased their shares. (M.I.T., for example, had its own employees (28!), no management company, and no economic or ownership interest in the company that distributed its shares.) And what could better illustrate the triumph of management over marketing than when M.I.T. brought out its first sister fund. It was called, not "Massachusetts Investors Aggressive Equity Fund" or "Capital Building Fund" or "High Return Fund," but "Massachusetts Investors *Second* Fund."

Today, it seems clear that marketing has superseded management as our industry's prime focus. The industry spends, I'd estimate, at least five *times* as much on selling as on supervision, contributing heavily to those soaring expense ratios. Advertising has gone from virtually non-existent to pervasive (or at least it was until the onset of the great bear market). We have put aside our professional judgment and formed new funds when the investing public demanded then, and, when they outlive their usefulness or lose their performance luster, we give them a decent burial, happily consigning their records to the dustbin of history.

What caused the sea change in our industry? Perhaps it's that stewardship was essential for an industry whose birth in 1924 was quickly followed by tough times—the Depression, and then World War II. Perhaps its that salesmanship became the winning strategy in the easy times thereafter, an era of almost unremitting economic prosperity. Perhaps it's because as we became the investment of choice for American families fund shareholders, with no more efficient way to own stocks, bonds and saving reserves, became less discriminating. Perhaps it was the very genetics of the capitalistic system that drives companies to compete and win. But I believe that the most powerful force behind the change was that mutual fund management emerged as one of the most profitable businesses in our nation, with pre-tax profit margins that average 40% to 50% or more. *Entrepreneurs could make big money managing mutual funds.*

The fact is that, only a few years after "Big Money in Boston" appeared, the whole dynamic of entrepreneurship in the fund industry changed. In 1958, it became possible not only to make a tidy profit in managing money, but to *capitalize* that profit by selling shares of a management company to outside investors. Up until then, the SEC had successfully defended its position that the sale of a management company represented the payment for the sale of a fiduciary office, an illegal appropriation of fund assets. Why? Because by allocating future advisory fees to whomever the manager might wish, a sale of the trustee's office would have taken place. If such sales were allowed, the SEC feared, it would lend to "trafficking" in advisory contracts, leading to a gross abuse of the trust of fund shareholders.

But in 1954 a California management company, in effect challenging the SEC's position, sold its shares to an outside investor. The SEC went to court, and lost. As 1958 ended, the gates that had prevented public ownership for 34 years came tumbling down. *Apres moi, le deluge!* The rush of public offerings began. Within two years, the shares of a dozen management companies, including some of the industry pioneers, were brought to market via initial public offerings. Over subsequent years, many others followed. Investors bought management company shares for the same reasons that they bought Microsoft and I.B.M. and, for that matter, Enron: Because they thought their earnings would grow and their stock prices would rise accordingly.

But the IPOs were just the beginning. Most of the companies that went public were ultimately acquired by other financial companies. Giant banks and insurance companies also acquired *privately-held* management companies, taking the newly-found opportunity to buy into the burgeoning fund business at a healthy premium—averaging 10 times book value or more. "Trafficking" wasn't far off the mark; there have been at least 40 such acquisitions during the past decade, and the ownership of some firms has been transferred several times. Today, among the 50 largest fund managers, only six (!) are privately-held, largely by their executives. 23 are owned by giant financial conglomerates, six are major brokerage firms, and giant foreign financial firms own another seven. (In 1982, even the executives of M.I.T. and its associated funds sold the management company to Sun Life of Canada.) The seven remaining firms are publicly-held.[3]

It must be clear that when a corporation buys a business—whether a fund manager or not—it expects to earn a hurdle rate of, say, 12% on its capital. So if the acquisition cost were $1 billion, the acquirer would likely defy hell and high water in order to earn at least $120 million per year. In a bull market, that may be an easy goal. But when the bear comes, we can expect some combination of (1) slashing management costs; (2) adding new types of fees (distribution fees, for example); (3) maintaining, or even increasing, management fee rates; or even (4) getting its capital back by selling the management company to another owner. (The SEC's "trafficking" in advisory contracts writ large!)

It's not possible to assess with precision the impact of this shift in control of the mutual fund industry from private to public hands, largely those of giant financial conglomerates, and the change in the industry from profession to business. But such a staggering aggregation of managed assets—often hundreds of billions of dollars—under a single roof, much as it may serve to enhance the development, to whatever avail, of fund complex's "brand name" in the consumer goods market, seems unlikely to make the money management process more effective, nor to drive investor costs down, nor to enhance this industry's original notion of stewardship and service.

Summing Up: A Half-Century Perspective: For Better or Worse?

While my characterization of the changes that have taken place in the mutual industry that was described in 1949 in "Big Money in Boston" may be subjective, the factual situation I've described is beyond challenge. This *is* an infinitely larger industry. The variety of funds *has* raised the industry's risk profile. The management mode *was* largely by committee and *is* now overwhelmingly by portfolio manager. Fund turnover *has* taken a great upward leap. Fund investors *do* hold their shares for far shorter periods. Marketing *is* a much more important portion of fund activities. Fund costs, by any measure, *have* increased, and sharply. And those closely-held private companies that *were* once the industry's sole modus operandi *are* an endangered species.

All this change has clearly been great for fund managers. The aggregate market capitalization of all fund managers 50 years ago could be fairly estimated at $40 *million*. Today, $240 *billion* would be more like it. Way back in 1967, Nobel Laureate Paul Samuelson was smarter than he ever could have imagined when he said, "there was only one place to make money in the mutual fund business—as there is only one place for a temperate man to be in a saloon, behind the bar and not in front of it . . . so I invested in a management company."

But our charge is to answer the question posed at the start of this speech. Have these changes served the interest of the mutual fund investor? The answer is a resounding no. Using Dr. Samuelson's formulation, it's a simple statistical matter to determine how well those on the other side of the bar in that saloon have been served, from the old industry, and the new.

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[3] Vanguard is omitted from the list, since it is owned by the mutual funds it manages.

- During the first two decades of the period I've covered today (1950-1970), the annual rate of return of the average equity fund was 10.5%, compared to 12.1% for Standard & Poor's 500 Stock Corporate Index, a shortfall of 1.6 percentage points, doubtless largely accounted for by the then-moderate costs of fund ownership. The average fund delivered 87% of the market's annual return.

- During the past 20 years (1982-2002), the annual rate of return of the average equity fund was 10.0%, compared to 13.1% for the S&P 500 Index, a shortfall of 3.1 percentage points, largely accounted for by the now-far-higher levels of fund operating and transaction costs. The average fund delivered just 76% of the market's annual return.

It is the increase in *costs*, largely alone, that has led to that substantial reduction in the share of the stock market's return that the average fund has earned. But it is the change in the industry's *character* that has caused the average fund *shareholder* to earn far less than the average *fund.* Why? First, because shareholders have paid a heavy *timing* penalty, investing too *little* of their savings in equity funds when stocks represented good values during the 1980s and early 1990s. Then, enticed by the great bull market and the wiles of mutual fund marketers as the bull market neared its peak, they invested too *much* of their savings. Second, because they have paid a *selection* penalty, pouring money into "new economy" stocks and withdrawing it from "old economy" stocks during the bubble, at what proved to be precisely the wrong moment.

The result of these two penalties: While the stock market provided an annual return of 13% during the past 20 years, and the average equity *fund* earned an annual return of 10%, the average fund *investor*, according to recent estimates, earned just 2% per year. It may not surprise you to know that, compounded over two decades, the 3% penalty of costs is huge. But the penalty of character is even larger—fully another 8 percentage points. *$1 compounded at 13% grows to $11.50; at 10%, to $6.70; and at 2%, to just $1.50.* A profit of just fifty cents!

The point of this exercise is not precision, but direction. It is impossible to argue that the totality of human beings who have entrusted their hard-earned dollars to the care of mutual fund managers has been well-served by the myriad changes that have taken place from mutual funds past to mutual funds present. What about mutual funds yet to come? My answer will not surprise you. It is time to go back to our roots; to put mutual fund shareholders back in the driver's seat, to put the interests of shareholders ahead of the interests of managers and distributions, just as the 1940 Investment Company Act demands.

We must return to our focus on broadly-diversified funds with sound policies, sensible strategies, long-term horizons, and minimal costs. Some of the steps we must take are relatively painless—reducing turnover costs, by bringing turnover rates down to reasonable levels, for example—and some would be very painful—reducing management fees and sales commissions, and cutting our operating costs. But such cost reductions are necessary if we are to increase the portion of the stock market's return earned by our *funds*.

To enhance the share of our *fund* returns earned by our own *shareholders*, on the other hand, we need to reorder our "product line" strategies by taking our foot off the marketing pedal, and pressing our foot down firmly on the stewardship pedal, giving the investor better information about asset allocation, fund selection, risks, potential returns, and costs, all with complete candor. After the market devastation of the past three years, I have no doubt that is what shareholders will come to demand. After all, as an article in the current issue of *Fortune* notes, "people won't act contrary to their own economic interests forever."

Fifty-plus years ago, the headline in that *Fortune* article read: **The Future: Wide Open**. So it was then. I leave you with the same headline today. **The Future: Wide Open**. For it remains wide open. But if we go "Back to the Future," returning to our original character of stewardship and prudence, and focusing above all on serving our shareholders "in the most efficient, honest, and economical way possible," the future for this industry will be not just bright, but brilliant.

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