What's Happened to the Mutual Fund Industry?

Remarks by
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I'm honored to be here with you investment professionals today, especially in this lovely city on this beautiful day. When your Board members learned that I would be in San Francisco to accept the Berkeley Award for Distinguished Contributions to Financial Reporting, they kindly invited me to meet with you during my visit. I was delighted to accept.

When I receive that special award tomorrow, my remarks will revolve around the theme of my book *The Battle for the Soul of Capitalism*, published by Yale University Press in October 2005. In that book, I discuss, among other things, the failure of our new "agency society" that has developed over the past five decades, supplanting our old "ownership society," now long gone and never to return. Today, financial institutions hold 68 percent of the shares of the stocks of all U.S. corporations, a dramatic change from 1950, when only 8 percent of shares were held by institutions and 92 percent were owned directly by individual investors.

A major part of that failure reflects the traditional "agency problem" described by economists—the fact that, paraphrasing Adam Smith, "corporate directors and managers of other people's money seldom watch over it with the same anxious vigilance that they watch over their own. Like the stewards of a rich man, they very easily give themselves a dispensation." This is as true of executive compensation in corporate America as it is of management fees in mutual fund America. The owners of both, alas, dine at the bottom of the food chain—the harsh reality of our business.

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

But another large part of the failure of our agency society relates to the change in the focus of our two largest financial institutions—mutual funds, now holding 30 percent of all stocks, and public and private pension funds, now holding nearly 20 percent—from the wisdom of long term investing to the folly of short term speculation. As I'll put it in my Berkeley speech tomorrow ("A Tale of Two Markets"), the principal strategy of our giant financial institutions is a focus on the illusory *expectations* market, rather than the *real* market of intrinsic business value. (If you're interested, that speech will be posted on my website next week, *www.johncbogle.com*.)

My remarks today will have a rather different focus. I want to examine two aspects of the mutual fund industry today, and express my deep concerns about these developments. Both reflect the on-going change in the focus of this industry that I've observed at first hand over 55 years, from stewardship to salesmanship, from asset management to asset gathering, and from long-term investing to short-term speculation. Given these changes, as you can doubtless imagine, my passionate belief in index investing is stronger than ever—that the core, even all, of an investor's portfolio—individual and institutional alike—should be represented by ownership of the total U.S. stock market, best accomplished through an index fund.

The Index Fund

While I'm confident that this room holds many skeptics about indexing, I'm equally confident that there is also a significant group here that agrees with my reasoning. This reasoning has almost *nothing* to do with "indexing" as such, and almost *everything* to do with simply owning U.S. business in its entirety, through a capitalization-weighted portfolio of our total stock market, and then holding that portfolio for Warren Buffett's favorite holding period: "forever."

Simply put, if an investor buys the market portfolio, pays no sales loads, no management fees, tiny operating costs, and no portfolio transaction costs, and holds it forever, that investor will capture virtually 100 percent of the stock market's annual return.

On the other hand, for the average investor buying actively managed funds, usually carrying sales loads, substantial management fees, heavy operating and marketing costs, huge costs of portfolio turnover (remember that the average equity fund now turns its portfolio over at an astonishing rate of 100 percent per year!), that investor's return will fall far short of the market's return. How far short? Well, those all-in mutual fund costs that I just enumerated presently come to something like 2 ½ percent of assets per year. Since the average mutual fund manager is, well, average—you heard it here!—the return of the average fund will, almost inevitably, fall short of the market's return by that amount.

Now let's assume that we're fortunate enough to enjoy future nominal returns in the stock market averaging 7 percent per year, roughly what reasonable expectations suggest for the coming decade. Let's also assume that the inflation rate will be about 2 ½ percent, leaving a 4 ½ percent real market return. If equity fund costs continue at today's 2 ½ percent rate (and there's no evidence that they are declining), they would confiscate about 60 percent of that *annual* real return. But don't stop there. *Compounded* over the long run—say, 50 years—$1,000 invested at 4 ½ percent (let's make it 4.4 percent to take into account the minimal costs of an index fund) would produce a real profit of $7,610. On the other hand, $1,000 invested at a return of 2 percent (net of that 2 ½ percent cost) would grow to just $1,682 in real terms. Rather than taking the road less traveled by and passively owning the entire market, the investor who travels the traditional road of active management would earn less than 25 percent of a stock market profit that is there for the taking. (The exact figure is 22 percent.)

My next book—yes, my sixth book is on the way, to be published by John Wiley & Sons next February—is titled *The Little Book of Index Investing. The Only Way to Guarantee Your Fair Share of Stock Market Returns.* It will focus on these issues, which I emphasize are simple, straightforward, and, I think, unarguable. Why? Because they are based on the simple facts; (1) that owning American business for the long term is a *winning* game; (2) that beating the market (before costs) is a *zero-sum* game; and (3) that beating the market after costs is a *loser's* game. I call these obvious principles "the relentless rules of humble arithmetic," in the long-ago words of Supreme Court Justice Louis D. Brandeis.

The Rise of the ETF

It is ironic that while mutual fund indexing continues to grow apace, the means by which investors index has taken a U-turn—a U-turn for the worse. *Classic* indexing has been overwhelmed by what I call indexing *nouveau*, represented by the ETF. When the first exchange traded fund was created in 1992, it seemed harmless enough. Those original "Standard and Poor's Depositary Receipts" (SPDRs), were quickly dubbed "Spiders," and they were a brilliant idea. Investing in the S&P 500 index, operated at extremely low cost and with high tax efficiency, and held for the long term, the Spiders held the prospect of providing ferocious competition to the traditional S&P 500 index fund (although the drag of brokerage commissions obviated their use by investors making small regular investments).

Most of the investors in the Spiders, however, were not long-term investors. They turned out to be active money managers, hedgers, and professional traders. Today, some 65 million shares of Spiders ($8.8 *billion* worth!) are traded every *day*, with an annualized turnover rate of some 3600 percent. Whether because of or in spite of this turnover, Spiders, with assets of some $80 billion, remain the largest of all ETFs.

In recent years, the flood of assets into ETFs has approached a stampede. ETFs have grown to be a huge part—$340 billion of the $900 billion index mutual fund asset base—a 38 percent share, up from just 9 percent as 2000 began and only 3 percent a decade ago. I remind you that all ETFs are index funds, just index funds that you can trade at will. Their amazing growth certainly says something about the energy of Wall Street's financial entrepreneurs, the focus of money managers on gathering assets, the marketing power of brokerage firms, and the willingness—nay eagerness—of investors to favor complexity over simplicity and action over inaction, continuing to believe, against all odds, that they can beat the market.

The charge into ETFs has been led, not by broad-index ETFs like the Spiders, but by ETFs indexed to narrow market segments. The diversity of the investment choices available is remarkable. Among today's 285 ETFs available today are twelve total stock market index funds (U.S. and international), such as the Spider; 66 focused on investment styles; 133 based on stock market sectors; and 56 concentrating their assets in particular foreign countries. There are also a handful of bond ETFs and a scattering of ETFs utilizing 2/1 leverage (doubling the swings in the stock market), tracking commodity prices and currencies, and other high-risk strategies. What's more, their growth is accelerating. A few weeks ago, a single fund manager filed 66 new ETFs—yes, 66—for SEC registration. (Did I say stampede?)

While ETFs account for about 38 percent of all index fund *assets*, since 1999 they have accounted for almost 70 percent of index fund *cash flow*—$280 billion of net new money, even larger than the $190 billion flowing into their classic cousins. What's more, the flow into style, sector, and foreign funds has overwhelmed the flow into the broad stock market index component. So far this year, the broad ETFs have been hit with $2 billion of cash *outflow*, a startling contrast to the $40 billion of cash *inflow* that's been poured into the less diversified groups. We've moved a long, long way from classic indexing.

What About the Original Paradigm?

Of course I'm concerned about this trend. The ETF is simply an index fund designed to facilitate trading in its shares, dressed in the guise of the *traditional* index fund. Think of the differences: First, if long-term *investing* was the original paradigm for the classic index fund that I designed more than 30 years ago, surely using index funds as trading vehicles can only be described as short-term *speculation*. Second, if the broadest possible diversification was the original paradigm, surely holding discrete—even widely-diversified—sectors of the market offers less diversification and commensurately more risk. Third, if the original paradigm was minimal cost, it's clear that holding market sector index funds that are themselves low-cost obviates neither the brokerage commissions entailed in trading them nor the tax burdens incurred if one has the good fortune to do so successfully.

And as to the fourth and final, quintessential aspect of the original paradigm—assuring, indeed guaranteeing, that you will earn your fair share of the stock market's return—the fact is that an investor who *trades* ETFs—and especially sector ETFs—has nothing even resembling such a guarantee. The typical ETF investor has *absolutely no idea* of what relationship his or her investment return will bear to the return earned by the stock market itself. But, after all of the selection challenges, the timing risks, the extra costs, and the added taxes, I'd bet on a substantial shortfall.

All-stock-market ETFs are, in my view, the *only* instance in which an ETF can replicate, and possibly even improve on, those four paradigms of the original index fund. *But only when they are bought and held for the long-term*. Truth told, however, their use by long-term investors is minimal. The Spiders are marketed to day traders. As the advertisements say, *"Now you can trade the S&P 500 all day long, in real time."* (I'll leave to wiser heads why any normal human being would want to do that.) I can't help likening the ETF—a cleverly designed financial instrument—to the to the renowned Purdey shotgun, supposedly the world's best. It's great for big-game hunting in Africa. But it's also excellent for suicide. I suspect that too many ETFs will prove, if not suicidal to their owners in financial terms, at least wealth-depleting.

We know that ETFs are largely used by traders. That 3600 percent annual turnover of Spider shares, for example, is a mere 240(!) times the turnover of just 15 percent in the shares of that original Vanguard 500 Index Fund in recent years. At 6000 percent per year, the share turnover for the NASDAQ Qubes is even higher. Trading in other types of ETFs is also remarkably high. The shares of the larger sector fund ETFs are typically turned over at an average annual rate of some 200 percent per year (an average holding period of just six months), with the most popular ones running turnover rates from 578 percent to 735 percent, all the way up to 7,100 percent (Russell 2000 iShares) and 8500 percent (SPDR Energy shares). Could there be speculation going on here?

Of course, specialized ETFs are diversified, but only in their narrow arenas. Owning the semi-conductor industry is not diversification in any usual sense, nor is owning the South Korean stock market. While it may well be more rational to speculate in these diversified portfolios than to speculate in individual stocks, please mark me down as one who believes any kind of speculation in stocks is finally a loser's game.

Expected Returns for ETFs vs. Returns for ETF Investors

The net result of these differences is that sector ETFs as a group are virtually certain to provide returns that fall well short of the returns delivered by the stock market. Perhaps 1 percent to 3 percent a year is a fair estimate of these all-in costs, many times the 10 to 20 basis-point cost of the best classic index funds. It is not a trivial difference. For no matter how often derided or ignored, the tautology remains that sector funds must and will earn a net return equal to the gross return of that sector, less intermediation costs.

But whatever returns each sector ETF *itself* may earn, the *investors* in those very ETFs will likely, if not certainly, earn returns that fall well behind them. For there is abundant evidence that the most popular sector funds of the day are those that have recently enjoyed the most spectacular recent performance, and that such "after-the-fact" popularity is a recipe for unsuccessful investing. "HANDLE WITH CARE" should be the first warning on the ETF label (though I have yet to see it used). Or perhaps "CAUTION: PERFORMANCE-CHASING AT WORK."

And so we have a "double whammy." The near-inevitably of counterproductive market timing (emotions), as investors bet on sectors as they grow hot—and bet against them when they grow cold—combined with those heavy trading commissions and fees (expenses). Together, these two enemies of the equity investor—emotions and expenses—are sure to be hazardous to your clients' wealth, to say nothing of consuming giant globs of their time that could easily be used in more productive and enjoyable ways.

All things considered, the burgeoning growth of ETFs is an *entrepreneur's* dream come true. They offer the excitement of a new idea, massive publicity, and the marketing flexibility of the fund industry's asset gatherers to focus on whatever sectors are hot and whatever strategies have paid off in the recent past, all the better to attract the capital of performance-hungry investors. Not only do ETFs generate soaring assets and soaring fees to the managers, but active trading in ETF shares generates heavy sales commissions for brokers.

But is it too much to ask whether these index funds nouveau are an *investor's* dream come true? Will investors really benefit from the ability to trade ETFs "all day long, in real time?" Is less diversification really better than more diversification? Is trend-following a winner's game, or a loser's game? Are ETFs truly low-cost when we combine their expense ratios—much lower than actively-managed funds, but generally many times higher than the leading traditional index funds—with the sales commissions paid to brokers on each transaction? Is buy-and-sell (often with great frequency) *really* a better strategy than buy-and-hold?

In each case, I don't think so. In a real sense, the ETF, is a *trader to the cause* of classic indexing. I urge investment professionals to stay the course with the proven strategy. *While I can't say that classic indexing is the **best** strategy ever devised, I can assure you that the number of strategies that are **worse** is infinite.*

Creating Indexes that Beat the Market. The New Paradigm?

In the remainder of my remarks today, I'd like to focus on the current controversy surrounding "fundamental" indexing. Since the inception of that first index mutual fund in 1975, investing in passively-managed, broadly-diversified, low-cost, stock and bond index funds has proved to be both a remarkable artistic success and a remarkable commercial success. The ability of index funds to provide returns to investors that have vastly surpassed the returns achieved by investors in actively-managed mutual funds, with remarkable consistency, clearly illustrates that artistic success.

Given that record, the commercial success of indexing is hardly surprising. Assets of the traditional classic stock index funds have grown from $16 *million* in 1976 to $445 million in 1986, to $68 billion in 1996, to $369 *billion* in 2006—seven percent of the assets of all equity mutual funds. (I'm excluding here the index funds *nouveau* represented by ETFs.) Assets of bond index funds have also soared—from $132 *million* in 1986, to $6 billion in 1996, to $62 *billion* in 2006, seven percent of the assets of all taxable corporate and Treasury bond funds.

And classic indexing has become a competitive field, with managers engaged in fiercely competitive price wars, slashing their expense ratios to draw the assets of investors who are smart enough to realize that price—and price alone—*is* the difference. This trend is great for index fund *investors*. But it slashes profits to index fund *managers* and discourages *entrepreneurs* who start new fund ventures in the hopes of enriching themselves by building fund empires.

So how can promoters take advantage of the proven attributes that underlie the success of the classic index fund? Why, create new indexes! Then claim that they will consistently outpace the broad market indexes that up until now have pretty much defined how we think of indexing. And then charge a higher fee for that potential extra reward.

Now think about this reality. The only way to *beat* the market portfolio, obviously, is to *depart* from the market portfolio. And this is what active managers strive to do—*individually*. But *collectively*, of course, they can't succeed. For their trading merely shifts ownership from one holder to another. In all of that swapping of stock certificates back and forth, however it may work out for a given buyer or a given seller, the only certainty is that it enriches our financial intermediaries.

The traditional money manager, in effect, puts forth this argument. "I'm smarter than the others in the market. I can discover undervalued stocks, and when the market discovers them and they rise in price I'll sell them. Then I'll discover other undervalued stocks and repeat the process all over again. I know that the stock market is highly efficient, but, through my intelligence, my expert analysts, my computer programs, and my trading strategies, I can spot temporary inefficiencies and capture them, over and over again."

In recent years, something new has been added to that argument. Financial entrepreneurs who believe, I'm sure sincerely (if with a heavy dollop of self-interest), that they can create indexes that will beat the market. They believe not only that they can discover vast undervalued sectors of the market, but that those sectors will remain permanently undervalued. *Interesting!* To this end, they have developed new methods of weighting portfolio holdings that they vow will outperform the traditional market-cap-weighted portfolio that represents the holdings of investors as a group.

New Ways to Weight Stock Portfolios

This "new breed" of indexers—although they are not, in fact, indexers, but active strategists—focuses on weighting portfolios by so-called "fundamental" factors. Rather than weighting by market cap, they use a combination of factors such as corporate revenues, cash flows, profits, or dividends. (For example, the portfolio is weighted by the dollar amount of dividends distributed by each corporation, rather than the dollar amount of its market capitalization.) They argue, fairly enough, that in a cap-weighted portfolio, half of the stocks are overvalued to a greater or lesser extent, and half are undervalued.

The traditional indexer responds: "Of course. But who really knows which half is which." The new fundamental indexers unabashedly answer, "we do." *They claim to know which is which.* And—this will not surprise you—the fundamental factors they have identified as the basis for their portfolio selections actually *have* outpaced the traditional indexes in the past. (We call this "data mining." For you can be sure that no one would have the temerity to promote a new strategy that has *lagged* the traditional index fund in the past.)

The members of this new breed are not shy about their prescience. They claim variously, if a tad grandiosely, that they represent a "new wave" in indexing, a "revolution" that will offer investors better returns and lower volatility, and a "new paradigm." Indeed, they describe themselves as "the new Copernicans," after the fellow who concluded that the center of our solar system was not the earth, but the sun. They compare the traditional market-cap weighted indexers (like me, I guess) with the ancient astronomers who attempted to perpetuate the Ptolemaic view of an earth-centered universe. And they assure the world that we're at the brink of a "huge paradigm shift" in indexing. Well, I'm not so sure!

Interestingly, the choice of the ETF structure—rather than the standard mutual fund format—by these confident entrepreneurs would seem to belie the fact that their "fundamental indexing" approach may take decades to prove itself, if indeed it does so at all. Yet by choosing the ETF format, they imply even more strongly that actively buying and selling their new fundamental funds will lead to even larger short-term profits than buying and holding them.

Of course they come armed with vast statistical studies that prove how well their methodologies have worked in the past. But think for a moment about the realities: in mutual fund investing, *the past is not prologue*. Yet these new paradigmists casually ignore that truism. For example: "Dividend indexes *outperform* capitalized-weighted indexes." (Not, "have outperformed in the past.") "The fundamental index *adds* more than twice as much incremental return." (Not, "has added in the past.")

Investors (and managers, too) love to believe that the past is prologue. It would make life so easy. But it is no accident that these new index funds are being introduced only *after* their strategies have seen their best days. Since the stock market bubble burst in 2000, for example, value stocks outpaced growth stocks (the market-cap index holds both) over the subsequent four years, and for dividend-paying stocks the pattern is about the same.

Think About Implementation Costs

Even including this recent advantage, the long-term margins of superiority achieved by these theoretically-constructed back-tested portfolios are not large—between 1 and 2 percentage points per year over the cap-weighted S&P 500 Index. How much of that edge would have been confiscated by their expense ratios? (The lowest is 0.28 percent; the average is about 0.50 percent; the highest that I've seen is 1.89 percent.) How much would have been confiscated by their extra portfolio turnover costs compared to the classic index funds? How much would have been confiscated by extra taxes paid by shareholders when that turnover results in gains? Even if the modest margins claimed in the past were to repeat—which I believe is highly unlikely—these back-tested hypothetical returns, ignoring fund expenses, sales charges, and portfolio turnover costs, would be significantly eroded if not totally erased by those costs.

When managers of traditional active equity funds claim to have a way of uncovering extra value in our highly- (but not perfectly-) efficient U.S. stock market, investors will look at their past record, consider the manager's strategies, and then invest or not. These new index managers are in fact active managers. But they not only claim prescience, but a prescience that gives them confidence that most sectors of the market (such as dividend-paying stocks) will remain undervalued for as far ahead as the eye can see. But, if these factors *are* underpriced, why won't investors, hungry to capitalize on that apparent past inefficiency, bid up prices until the undervaluation no longer remains? Put another way, if these promoters of the purported new paradigms actually have been *right* in the past, won't they therefore be *wrong* in the future?

The Lessons of History

I recommend skepticism about these purported "new paradigms." I've witnessed too many new paradigms over the years. None has persisted. The "concept" stocks of the Go-Go years in the 1960s came, and went. So did the "Nifty Fifty" era that soon followed. The "January effect" of small-cap superiority came, and went. Option-income funds and "Government plus" funds came, and went. In the late 1990s, high-tech stocks and "new economy" funds came as well, and even today the asset values of the survivors remain far below their peaks. Intelligent investors should approach with extreme caution a claim that *any* new paradigm is here to stay. That's not the way financial markets work.

We do know that traditional low-cost all-market-cap-weighted index funds guarantee that you will receive your fair share of stock market returns, and virtually assure that you will outperform, over the long term, 90 percent or more of the other investors in the marketplace. Maybe this new paradigm of "fundamental" indexing—unlike all the other new paradigms I've seen—will work. But maybe it won't, too.

I urge you investment professionals not to be tempted by the siren song of paradigms that promise the accumulation of wealth that will be far beyond the rewards of the classic index fund. Don't forget the prophetic warning of Carl von Clausewitz, military theorist and Prussian general of the early 19th century, "the greatest enemy of a good plan is the dream of a perfect plan." *Put your dreams away,* I would warn investors, *and stick to the good plan represented by the classic index fund.*

Wrapping Up

Let me conclude with a stunning example of the effectiveness of traditional indexing, and then offer a few final words. At a recent dinner celebrating the 30th anniversary of the initial public offering of "First-Index Investment Trust" (now Vanguard 500 Index Fund), the counsel for the fund's underwriters reported that he had purchased 1000 shares at the original offering price of $15.00 per share—a $15,000 investment. The value of his holding that evening a few weeks ago (including dividend reinvestment), he proudly announced, was $461,771. Now there's a number that requires no comment. (Well, maybe one comment. Of the 360 equity mutual funds then in existence, only 211 remain today.)

I hope that my bluntness today about the merits of classic all-market index funds has not pushed you beyond your tolerance. But if you aren't persuaded by what such index funds have accomplished during their 30-year history, at least reflect on the underlying reasons for their success; no more than common sense, simplicity, and the relentless rules of humble arithmetic, broad diversification, low expense ratios, no sales loads (and no aggressive marketing), and minimal portfolio turnover, held by investors for the long-term and guaranteed to give them their full share of whatever returns the financial markets are generous enough to provide.

If you disagree with my broad characterization of what the mutual fund industry has become—to the detriment of its shareholders—at least focus your efforts on that relatively small handful of fund organizations that have been investors rather than marketers; that have kept fees and turnover low; that have resisted the lure of asset gathering and of creating new funds for every purpose; and don't consider their funds as "products," made by "manufacturers," to be sold to "consumers." (These are the words that are increasingly used as this profession of yore has gradually mutated into the business of today. I'll bet most of you here today hate those words as much as I do!)

There is, in this intriguing field that we share, something call "the greater good." It is putting service of our investor clients above service to ourselves. And that should be the underlying principle for any investment firm and any investment professional who wants to make the field of investing a worthwhile lifetime endeavor.