Opening Statement of John C. Bogle

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and Government Sponsored Enterprises
U.S. House of Representatives
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"Mutual Fund Industry Practices and their Effect on Individual Investors"

Good morning, Chairman Baker. Thank you for inviting me to speak to the Subcommittee. I hope that my experience in the mutual fund industry will be helpful in considering the issues before you. My career in this business spans more than 53 years, most recently as founder and chief executive of The Vanguard Group of Investment Companies, and since 2000 as president of its Bogle Financial Markets Research Center. While I am no longer in a position to speak for Vanguard, my comments reflect the principles and values which I invested in Vanguard when it was created in 1974.

Since the day it began, Vanguard has operated under a *mutual* structure in which our management company is owned by the shareholders of the mutual funds we manage and operated on an *at-cost* basis in their behalf. Our unique form of organization, combined with our intense focus on minimizing investor costs, has enabled us to emerge as the lowest-cost provider of services in our field. The expenses of the average Vanguard fund today come to just 0.26% of assets, a *reduction* of nearly 65% since we began in 1974. (Chart 1) The expense ratio of the average mutual fund, on the other hand, was 1.36%, fully 49% higher than in the late 1970s. How much does this difference matter? Our cost advantage of 1.10%, applied to our fund assets of $550 billion, now results in *annual* savings for our fund shareholders of some $6 billion.

Lower costs lead to higher returns. For what investors *must* earn, and *do* earn, is whatever returns the financial markets are generous enough to provide, *minus* the costs of financial intermediation. The returns earned by mutual funds *as a group* inevitably equal the market returns less the costs funds incur. This relationship is most obvious in money market funds. (Chart 2) Over the past five years, 10 percent of money funds with the lowest costs earned a gross return of 4.80%, incurred costs of 0.37%, and provided a net yield of 4.43%. The highest-cost funds earned 4.67%, deducted 1.74%, and provided a net yield of 2.93%. Result: just by owning the lower-cost group, investors could have increased their income by more than 51%.

While less obvious, the same relationship prevails in equity mutual funds. Over the ten-years ended June 30, 2001, for example, the risk adjusted annual return for the low-cost quartile of equity funds was 13.8%, three full percentage points above the 10.8% return of the higher-cost quartile. (Chart 3) This relationship appears to be universal, prevailing in each one of the nine Morningstar "style boxes"—large-cap growth funds, small-cap value funds etc.—and with remarkable consistency around the three percentage point level.

In the long run costs make the difference between investment success and failure. Over the past two decades, for example, the stock market provided an annual return of 13.1%, compared to the 10.0% return reported by the average equity fund. (Chart 4) For the full period, $10,000 invested in the market itself grew by $105,000, while the same amount invested in the average equity fund grew by just $57,000,

barely half as much. That 3.1 percentage point difference is largely a reflection of the costs that fund investors incur. So, yes, costs matter.

While The Investment Company Institute has reported that the cost of equity fund ownership is now about 1.3% per year, that figure not only understates fund expenses and sale charges, but ignores such obvious costs as portfolio turnover and others. I estimate that true equity fund costs are at least 100% above the ICI figure. (Chart 5)

If we look at costs in *dollar*—rather than *expense ratio*—terms, it is easy to find examples of costs run amok. For example, in 2000 the actual costs of providing portfolio management services for the Vanguard money market funds came to $15 million. (Chart 6) Yet another firm's money market funds—with about the same $65 billion asset base—paid their investment manager an astonishing $257 million dollars for performing essentially the same services. It is high time we had a government-sponsored economic study that "follows the money" in the mutual fund industry.

That such a fee was approved by the fund's director's suggests a monumental shortfall in the shareholder protections sought by The Investment Company Act of 1940, which clearly states that, "the interests of investors are adversely affected . . . when investment companies are organized, operated, (or) managed in the interest of (their) . . . investment advisers," rather than in the interests of their shareholders, or when investment companies are, "not subjected to adequate independent scrutiny."

Fund independent directors in actuality have only two important responsibilities: Obtaining the best possible investment manager and negotiating with that manager for the lowest possible fee. Yet their record has been absolutely pathetic, for they follow in a zombie-like process that makes a mockery of stewardship. Able but greedy managers have overreached and tried to dip too deeply into the shareholders' pockets, and directors haven't slapped their hands. They have failed as well in negotiating management fees. "Independent" directors, over more than six decades, have failed miserably. I didn't write that indictment, for I would not have the temerity to express my views so strongly. The words were those of Warren Buffett in the most recent Berkshire Hathaway report.

One reason for the failure of directors is that the head of the firm's management company is typically the chairman of the fund's board as well. As Mr. Buffett has observed, "negotiating with oneself seldom produces a barroom brawl." So we need to require that the fund chairman be an independent director. Would it matter? Well, since Vanguard began in 1974, the fee rates that our Wellington Fund has paid to external adviser Wellington Management Company have been reduced six times, and last year's management fee on this $22 billion fund was just 0.04% (four basis points) of assets, or $8.5 million. Without these reductions, the fee would have been $92.2 million. Active fee negotiations saved the fund shareholders nearly $85 million, savings that have catapulted the fund's returns to its owners over fully 90% of its balanced fund peers.

To awaken investors to the critical importance of lower costs, we need information that encompasses *all* of the costs of fund ownership, presented forthrightly in fund prospectuses and annual reports, and we need to show in each annual statement the dollar costs that each investor incurs. At the same time, we need to empower independent directors to live up to the standards of the law of the land and protect the interests of the fund shareholders they are honor-bound to represent.

These steps will surely drive fund fees down, and will enable this industry to serve investors far more effectively in the years ahead. Thank you.

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