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The Mutual Fund Industry Sixty Years Later: For Better or Worse?

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Over the course of the past 60 years, the mutual fund industry has undergone tremendous change. In 1945, it was a tiny industry offering a relative handful of funds, largely diversified equity and balanced funds. As 2005 begins, it is a multi-trillion dollar titan, offering thousands of funds with a dizzying array of investment policies and strategies. I've been actively engaged in this field for fully 55 of those years, going back to 1949 when I researched and then wrote my Princeton senior thesis about mutual funds, subsequently spending my entire career in the field.

The staggering increase in the size of the industry and in the huge expansion in the number and types of funds offered today are but the obvious manifestations of the radical change in the mutual fund industry. It has also undergone a multi-faceted change in character. In 1945, this was an industry engaged primarily in the profession of serving investors, striving to meet the standards of the recently-enacted Investment Company Act of 1940, which established the policy that funds must be "organized, operated, and managed" in the interests of their shareholders *rather than* in the interests of their managers and distributors. It was an industry that focused primarily on stewardship. Today, by contrast, the industry we see is a vast and highly successful marketing business, an industry focused primarily on salesmanship. As countless independent commentators have observed, asset-gathering has become the fund industry's driving force.

Beneath the surface of these broad changes lie a variety of specific developments. The stunning variety of equity funds has raised the industry's risk profile. The management mode, once largely by committee, is now overwhelmingly by portfolio manager. Portfolio turnover has taken a quantum leap upward. Once active corporate citizens, funds are now largely passive on governance issues. Fund investors hold their shares for far shorter periods. Those closely-held private firms that were once the industry's sole *modus operandi* have become an endangered species in an industry now largely under the aegis of giant financial conglomerates. And in 2003, an industry previously untouched by scandal found its very character called into question. Most important of all, the costs borne by fund investors have, by any measure, increased sharply.

Taken together, the changes in the industry, while costly to fund investors, have been highly profitable for fund managers. The aggregate market capitalization of all fund managers 60 years ago could be fairly estimated at $40 *million.* Today, $240 *billion* would be more like it. It is not that today's fund managers do not seek to deliver optimal returns to the fund's owners, as well as to provide a remarkable panoply of conveniences and investor services. Of course they do. But while the industry continues to be well stocked with conscientious, experienced, and able investment professionals, the changes in the industry's ethos have made that task increasingly difficult. The question is whether the remarkable change in this industry's character has impacted the effectiveness with which mutual funds serve their shareholders. *Have these changes been good for our investors or not?* The data clearly suggest that the answer to that question is in the negative.

This paper will review ten of the major changes that have taken place in the mutual fund industry over the past sixty years, and then evaluate the impact of those changes, not only on the returns earned by

the mutual funds themselves, but on the returns earned by their investors. It will close with some policy recommendations for the future.

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

The mutual fund industry has become a giant. From a base of $882 *million* at the beginning of 1945, fund assets soared to $7.5 *trillion* in 2004, a compound annual growth rate of 16 percent. If the industry had merely matched the seven percent nominal growth rate of our economy, assets would be just $50 *billion* today. (Such is the magic of compounding!) Then, 90 percent of industry assets were represented by stock funds and stock-oriented balanced funds. Today such funds compose about 57 percent of industry assets. Bond funds now represent 17 percent of assets, and money market funds—dating back only to 1970—constitute the remaining 26 percent. What was once an equity fund industry now spans all three broad categories of marketable securities—stocks, bonds, and savings reserves. This change has been a boon to fund investors and to fund managers as well.

So too has the number of funds exploded. Those 68 mutual funds of yesteryear have soared to today's nearly 8,200 total—nearly 1,000 money market funds; 2,100 tax-exempt and taxable, long-term and short-term bond funds; and 5,100 equity and balanced funds, offering a wide variety of investment objectives and policies designed to meet almost any imaginable investment goal. As funds have become, overwhelmingly, the investment of choice for our nation's families, fund choice, fund selection, and asset allocation are the watchwords of today's mutual fund industry,

Table 1. The Mutual Fund Industry: Growth in Funds and Assets

Number of Funds	1945	2004
Stock/Hybrid Funds	49	5,100
Bond Funds	19	2,100
Money Market Funds	n/a	970
Total	68	8,170
Total Assets	$882 mil	$7,500 bil

Source: Wiesenberger and Investment Company Institute.

The vehicles through which mutual funds are purchased have also changed. Funds are the underlying securities in variable annuities, and, thanks to favorable federal tax legislation, funds are now held not only directly by investors, but also in individual retirement accounts and in profit-sharing and employee savings plans. Assets in these tax-deferred plans total now $2.7 trillion, or nearly 40 percent of industry assets[1].

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

Yet stock funds remain the industry's talisman and driving force. As their number soared, so did the variety of objectives and policies they follow. In 1945, 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 with that of the stock market itself. Today such middle-of-the-road funds represent a distinct minority of the total, and most other categories entail higher

[1] Source: ICI's *2004 Mutual Fund Fact Book*

risks. Only 579 of the 4,200 stock funds measured by Morningstar now closely resemble their widely-diversified blue-chip ancestors.[2]

What's more, the industry now also boasts 455 specialized funds focused on narrow industry segments, from technology to telecommunications (particular favorites during the late stock market bubble), and 686 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. Among the thousands of stock funds, there must now be one for every purpose under heaven.

Sixty years ago, an investor could have thrown a dart at a broad listing of stock funds and had *three* chances out of *four* to pick a fund whose return was apt to closely parallel that of the U.S. stock market. Today, he has just *one* chance out of *seven*. For better or worse, the selection of mutual funds has become an art form. Indeed, it is not unfair to say that over the years choosing a mutual fund has come to require the same assiduous analysis as selecting an individual common stock. Indeed, most investors now hold portfolios of *funds* rather than yesteryear's portfolios of *stocks*.[3]

One curious counterpoint to this trend is worth noting. Unmanaged index funds essentially representing the entire U.S. stock market (through the Wilshire Total Stock Market Index or the Standard & Poor's 500 Index) didn't enter the field until 1975, but have accounted for more than one-third of equity fund cash inflow since 2000, and now represent fully one-seventh of equity fund assets.[4] Such funds may be said to provide the nth degree of diversification.

Table 2. Stock Funds:
Number and Type

	1945		2004*	
Category	**# of Funds**	**% of Total**	**# of Funds**	**% of Total**
Large Cap Blend	**38**	**77%**	**579**	**14%**
Other Div. Eq.	**-0-**	**—**	**2,484**	**59**
Specialized	**11**	**23**	**455**	**11**
International	**-0-**	**—**	**686**	**16**
Total	**49**	**100%**	**4,204**	**100%**

*Includes all equity funds covered by Morningstar.
Source: Wiesenberger and Morningstar.

3. From Investment Committee to Broadway Stardom

The vast change in fund objectives and policies have been accompanied by equally vast changes in how mutual funds are managed. In 1945, the major funds were managed almost entirely by investment committees. 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, and then the recent "new economy"

[2] Today's accepted terminology for 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 14% of the Morningstar all-equity-fund total.
[3] A sign of the times: As the public interest moved from individual stocks to stock funds, *The New York Times* took appropriate action. On June 30, 1999, the daily mutual fund price listings were moved ahead of those of the New York Stock Exchange and NASDAQ. Several years later, only the fund listings remained in the main financial section.
[4] Source: Strategic Insight.

bubble, brought us hundreds of more aggressive "performance funds," and the new game seemed to call for free-wheeling individual talent. The term "investment committee" virtually vanished, and "portfolio manager" gradually became the industry standard, the model for some 3,387 funds of the 4,194 stock funds currently listed in Morningstar. ("Management teams," often portfolios overseen by multiple managers, are said to run the other 807 funds.)

The coming of the age of portfolio managers whose tenure lasted only as long as they produced performance moved fund management from the stodgy old consensus-oriented investment committee to a more entrepreneurial, free-form, and aggressive (and less risk-averse) investment approach. Before long, moreover, the managers with the hottest short-term records were publicized by their firms, and, with the cooperation of the media, turned into "stars," as 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 but a moment in time before flaming out. Even after the devastation of the recent bear market and the stunning fact that the average manager now lasts for only five years, the portfolio manager system remains largely intact, and the continuity provided by the latter-day investment committee is but a vestige of memory.

Table 3. Equity Fund Management Modes

	1945 (e)	2004
Committees	**47**	**0**
Single Port. Manager	**2**	**3,387**
Management Team	**0**	**807**
Total	**49**	**4,194**

Source: Wiesenberger and Morningstar.
No manager listed for ten 2004 funds.

4. Investment or Speculation?

Together, the coming of more aggressive funds, the burgeoning emphasis on short-term performance, and the move from investment committee to portfolio manager has had a profound impact on mutual fund investment strategies, most obviously in soaring portfolio turnover. In 1945, mutual fund managers didn't *talk* about long-term investing. They just *did* it. That's what trusteeship is all about. But over the next sixty years, 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 1945 and 1965 annual portfolio turnover averaged a steady 17 percent, suggesting that the average fund held its average stock for about six years. But turnover then rose steadily; fund managers now turn their portfolios over at an average rate of 110 percent annually. Result: Compared to that earlier six-year standard that prevailed for some two decades, the average stock is now held by the average fund for an average of just eleven months.

Turnover *rates* don't tell the full story of the role of mutual funds in the financial markets. The *dollars* involved are enormous. For example, at a 100 percent rate, today's managers of $4 trillion in equity assets would sell $4 trillion of stocks in a single year, and then reinvest that $4 trillion in other stocks, $8 trillion in all. Even as more competitive (and increasingly electronic) markets have slashed *unit* transaction costs, however, it's difficult to imagine that such turnover levels, in which trades often take place between two competing funds, can result in a net gain to fund shareholders collectively.

If a six-year holding period can be characterized as long-term investment, and if an eleven-month holding period can be characterized as short-term speculation, mutual fund managers today are not investors. They are speculators. I do not use the word "speculation" lightly. Nearly seventy years ago,

Lord Keynes contrasted *speculation* ("forecasting the psychology of the market") with *enterprise* ("forecasting the prospective yield of an asset"), and predicted that the influence of speculation among professional investors would rise as they emulated the uninformed public, seeking to anticipate changes in the public opinion rather than focusing on earnings, dividends, and book values.

In my 1951 thesis on the mutual fund industry, I was bold enough to disagree with Lord Keynes' baleful prediction. As funds grew, I opined, they would move away from speculation and toward enterprise, focusing, not on the momentary, short-term price of the share, but on the long-term intrinsic 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 could not have been more wrong. Mutual funds, once stock *owners*, became stock *traders*, moving far away from what Warren Buffett describes as his favorite holding period: *Forever*.

Table 4. Equity Fund Portfolio Turnover Rates*

Year	Rate	Year	Rate
1945	24% (e)	1980	60%
1950	25	1985	96
1955	14	1990	90
1960	14	1995	77
1965	20	2000	108
1970	39	2003	110
1975	37	2004**	112

*Unit-weighted average, with each fund counted as a single unit. Unless noted otherwise, averages listed throughout are unit-weighted rather than asset-weighted.
**2004 data are for all funds that had reported as of October 31.
Source: NYSE and Morningstar.

5. Mutual Funds Become Corporate America's Largest Shareholders

Sixty years ago, funds owned only slightly more than one percent of the shares of all U.S. corporations. Today, they own nearly 25 percent. They could wield a potent "big stick," but, with few exceptions, have failed to do so. With their long record of passivity and lassitude on corporate governance issues, fund managers must accept a large share of the responsibility for the ethical 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.

Yet it wasn't always that way. In the old days, when mutual funds were responsible owners, the 1949 *Fortune* article that inspired my ancient thesis described them as "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." Indeed, in 1940, the SEC called 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."

It was not to be. Once an own-a-stock industry, funds became a rent-a-stock industry. The change in the industry's focus from investment to speculation can hardly be unrelated to its failure to observe the responsibilities of corporate citizenship. 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 a company's 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.

Table 5. Mutual Fund Ownership of U.S. Stocks

Year	% of Equities Owned	Year	% of Equities Owned
1945	1.4%	1980	3.0%
1950	3.1	1985	5.2
1955	3.3	1990	8.1
1960	4.8	1995	16.0
1965	5.7	2000	22.4
1970	6.2	2003	23.1
1975	4.9	2004*	24.9

Source: NYSE, Wilshire Associates,
and the Federal Reserve Flow of Funds Report.
*2004 data are as of June 30.

6. Shareholder Holding Periods Tumble

The change in this industry's character has radically affected the behavior of the mutual fund shareholder. Sixty years ago, shareholders bought shares in broadly diversified funds, and held them. In the 1950s, and for a dozen years thereafter, fund redemptions (liquidations of fund shares) averaged 6 percent of assets annually, suggesting that the average fund investor held his or her shares for 16 years. Like the managers of the funds they owned, shareholders were investing for the long pull.

But as the industry introduced new 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. By 2002, the redemption rate had soared to 41 percent of assets, an average holding period of slightly more than three years. The time horizon for the typical fund investor had tumbled by fully 80 percent. Much of this reduction in investor holding periods, we now know, resulted from the pervasive use of market timing strategies by investors. Following the market timing scandals that were revealed late in 2003, however, fund managers tightened up their controls limiting fund trading, and the shareholder redemption rate has tumbled to about 25 percent in 2004; nonetheless, an average holding period of just four years.

As the old "buy and hold" mantra turned to "pick and choose," *freedom of choice* became the industry watchword, and "fund supermarkets," with their "open architecture," made it easy to move quickly from one fund to another. The cost of these transactions was hidden in the form of access fees for the shelf-space offered by these supermarkets. These fees are paid by the funds themselves, so that swapping funds seems to be "free," tacitly encouraging shareholders to trade from one fund to another. But while picking tomorrow's winners based on yesterday's performance is attractive in theory, there are no data that suggest that the strategy works in practice. Quite the contrary!

Table 6. Annual Turnover of Equity Fund Shares			
Year	**Shares Redeemed as % of Assets**	**Year**	**Shares Redeemed as % of Assets**
1945	**10.1%**	**1980**	**22.8%**
1950	**12.5**	**1985**	**36.5**
1955	**6.4**	**1990**	**38.2**
1960	**5.1**	**1995**	**29.3**
1965	**6.1**	**2000**	**39.6**
1970	**6.2**	**2002**	**41.0**
1975	**9.7**	**2004**	**24.8**

Source: Wiesenberger and Investment Company Institute.
2004 data are through September, annualized.

7. New Funds Created . . . Old Funds Vanish

Part of this astonishing telescoping of holding periods can be laid to opportunistic, gullible, and emotional fund investors, as well as a change in the character of our financial markets (especially in the boom and bust during the stock market bubble of 1997-2002). But by departing from the industry's time-honored tenet "we sell what we make," and jumping on the "we make what will sell" bandwagon, and creating new funds to match the market fads of the moment, this industry must also assume much responsibility for the soaring investment activity of fund investors.

The 1990s was a banner decade for fund formation, with 1,600 new general equity funds alone coming into existence, more than twice the 720 funds that were in existence at the decade's outset. And the new funds typically carried higher risks than their predecessors. As "new economy" stocks led the market upward in the latter part of the decade, mutual fund managers formed 494 new technology, telecom, and internet funds, and aggressive growth funds favoring these sectors[5].

Not only did the industry create those funds, it marketed them with unprecedented vigor and enthusiasm, both through stockbrokers and through advertising. At the market's peak in March 2000, the 44 mutual funds that advertised their performance in *Money* magazine bragged about amazing returns averaging +85.6 percent during the previous twelve months. During 1998–2000 equity funds took in $650 billion of new money—well over a *half-trillion dollars*—overwhelmingly invested in the new breed of speculative, high-performance aggressive growth funds[6]. Most of the money, of course, poured into those winners of yesteryear *after* they led the market upward. They would also soon lead the market on its subsequent downward leg, with their shareholders suffering losses of hundreds of billions of dollars.

After the fall, the rife formation of opportunistic new funds began to unwind, and record numbers of funds went out of business, usually merged into other better-performing funds in the same family. During 1994-2003, fully 1,900 funds vanished, largely members of the new breed of funds that focused on the stocks of the new economy. While the conservative equity funds of six decades ago were, as the saying goes, "built to last," their aggressive new cousins seemed "born to die." The 10 percent to 20 percent failure rates that characterized the decades of the 1950s to the 1980s (except for the 1970s, in the aftermath of the 1973–1974 bear market) reached 36 percent during the 1990s. A decade hence, should present fund dissolution rates continue, some 2,800 of today's equity funds—more than one-half—will no longer exist.

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[5] Source: Strategic Insight.
[6] Source: ICI's *2004 Mutual Fund Fact Book*

Table 7. Formation and Liquidation of Equity Funds				
Decade	**Number of New Funds**	**Fund Creation Rate**	**Number of Dying Funds**	**Fund Failure Rate**
1950s	**28 (e)**	**38%**	**10 (e)**	**13%**
1960s	**211**	**88**	**37**	**21**
1970s	**123**	**34**	**202**	**61**
1980s	**534**	**110**	**78**	**17**
1990s	**1,604**	**125**	**462**	**36**
2000s*	**980**	**52**	**1,045**	**56**

*Figures for the 2000 decade represent the first four years annualized. Creation and failure rates for each decade are summed annual rates.
Source: CRSP database, author's estimates.

8. The Costs of Fund Ownership

In 1945, the average expense ratio (total management fees and operating expenses as a percentage of fund assets) for the largest 25 funds, with aggregate assets of but $700 million, was 0.76 percent, generating aggregate costs of $4.7 million for fund investors. Six decades later, in 2004, the assets of the equity funds managed by the 25 largest fund complexes had soared to $2.5 trillion. But their average expense ratio had soared by 105% to 1.56 percent, generating costs of $31 *billion.*[7] While their assets rose 3,600-fold, costs rose 6,600-fold. (The dollar amount of direct fund expenses borne by shareholders of *all* equity funds has risen from an estimated $5 *million* annually in the 1940s to something like $35 *billion* in 2004, or 7,000-fold.) Despite the substantial economies of scale that exist in mutual fund management, fund investors have not only *not* shared in these economies, they have actually incurred higher costs of ownership.

Table 8. The Direct Costs of Fund Ownership— 25 Largest Fund Managers			
	1945	**2004**	**Change**
Total Assets (bil)	**$0.7**	**$2,500**	**3,600x**
Fees and Op. Expenses* (e)	**$4.7 mil.**	**$31 bil.**	**6,600x**
Avg. Exp. Ratio	**0.76%**	**1.56%**	**+105%**

*Excluding portfolio transaction costs, sales charges, and opportunity costs.
Source: Wiesenberger, Strategic Insight.

Some of that enormous rise in the average expense ratio is a result of the inclusion of 12-b(1) marketing expenses, in part replacing traditional front-end sales charges. And while management fee reductions that fully reflect the economies of scale are virtually non-existent, investors have increasingly chosen no-load funds and low cost funds. But when we add portfolio transaction costs—an inseparable part of owning most funds— to expense ratios and sales charges, and fees paid to financial advisers to select funds (also partly replacing earlier front-end loads), the costs of mutual fund ownership remain a substantial impediment to the ability of equity fund investors and their shareholders to capture the returns generated by the stock market.

[7] Asset-weighted expense ratios were used in calculating total costs.

9. The Rise of Fund Entrepreneurship

Sixty years ago, the mutual fund industry placed its emphasis on fund management as a profession—the trusteeship of other people's money. Today, there is much evidence that salesmanship has superseded trusteeship as our industry's prime focus. What was it that caused this sea change? Perhaps it's that trusteeship was essential for an industry whose birth in 1924 was quickly followed by tough times—the Depression, and then World War II. Perhaps it's that salesmanship became the winning strategy in the easy times thereafter, an era of almost unremitting economic prosperity. But the most powerful force behind the change was that mutual fund management emerged as one of the most profitable businesses in our nation. *Entrepreneurs could make big money managing mutual funds.*

The fact is that in 1958, but 13 years after the publication of the inaugural issue of the *Financial Analysts Journal*, the whole dynamic of entrepreneurship in the fund industry changed. Until then, a trustee could make a tidy profit by managing money, but could not *capitalize* that profit by selling shares of the management company to outside investors. The SEC held that the sale of a management company represented payment for the sale of a fiduciary office, an illegal appropriation of fund assets. If such sales were allowed, the SEC feared, it would lead to "trafficking" in advisory contracts, a gross abuse of the trust of fund shareholders.

But a California management company challenged the SEC's position. The SEC went to court, and lost. As 1958 ended, the gates that had prevented public ownership since the industry began 34 years earlier came tumbling down. A rush of initial public offerings followed, with the shares of a dozen management companies quickly brought to market. 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.

The IPOs were just the beginning. Publicly-held and even privately-held management companies were acquired by giant banks and insurance companies, eager to take the new 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 alone, and the ownership of some fund firms has been transferred numerous times. Today, among the 50 largest fund managers, only eight remain privately-held, plus mutually-owned Vanguard. Six firms are publicly-held, and the remaining 35 management companies are owned by giant financial conglomerates—22 by banks and insurance companies, six by major brokerage firms, and seven by foreign financial institutions.

It must be obvious that when a corporation buys a business, fund manager or not, it expects to earn a hurdle rate on its capital. So if the cost of an acquisition were $1 billion, and the hurdle rate were 12 percent, the acquirer would require at least $120 million of annual earnings. In a bull market, that may be an easy goal for a mutual fund firm. But when the bear comes, we can expect some combination of (1) cutting management costs; (2) adding new types of fees (distribution fees, for example); (3) maintaining, or even increasing, management fee rates; or even (4) getting the buyer's capital back by selling the management company to another owner. (The SEC's "trafficking" in advisory contracts writ large.)

It would be surprising if this shift in control of the mutual fund industry from private to public hands, largely those of giant financial conglomerates, had *not* accelerated the industry's change from profession to business. Such staggering aggregations of managed assets—often hundreds of billions of dollars under a single roof—surely serves both to facilitate the marketing of a fund complex's "brand name" in the consumer goods market and to build its market share. On the other hand, conglomeration seems unlikely to make the money management process more effective, nor to drive investor costs down, nor to enhance the industry's original notion of stewardship and service.

Table 9. Ownership of the Fifty Largest Fund Organizations, 2004	
Ownership Type	**Number of Firms**
Mutual	**1**
Private	**8**
Public, Independent	**6**
Major Brokerage	**6**
Financial Conglomerate	**22**
Int'l Conglomerate	**7**
Total	**50**

Source: Author's calculations from public news reports.

10. Scandal Taints the Industry

For 78 years—from its start back in 1924 through 2002—the mutual fund industry had been free of major taint or scandal. But as asset gathering became the name of the game; as return on managers' capital challenged return on fund shareholders' capital as the preeminent goal; as conglomeration became the dominant structure; and as stewardship took a backseat to salesmanship, many fund managers were not only all too willing to accept substantial investments (and other unrelated but profitable activities) from short-term investors and allow those investors to capitalize on price differentials in international time zones, but to abet and even institutionalize these practices.

To improve their own earnings, managers put their own interests ahead of the interests of their fund shareholders, allowing short-term traders in their funds to earn illicit higher returns at the direct, dollar-for-dollar cost of their fellow long-term investors. First brought to light by New York Attorney General Eliot L. Spitzer in September 2003, the industry's first major scandal went well beyond a few "bad apples"; firms managing a total $1.6 trillion of fund assets have been implicated, including some of the oldest, largest, and once-most-respected firms in the industry. What is more, it exemplified the extent to which salesmanship had triumphed over stewardship.

Summing Up the Past Sixty Years: For Better or Worse?

Clearly, the mutual fund industry of 2005 is different not only in degree, but in kind, from the industry of sixty years earlier—infinitely larger and more diverse, with more speculative funds focused on ever-shorter investment horizons; less aware of its responsibility for corporate citizenship; with funds that are held by investors for shorter time periods; more focused on asset-gathering and marketing; increasingly operated as a business rather than a profession; with, despite the awesome increase in its asset base, far higher unit costs; and culminating with a scandal that crystallizes the extent to which the interest of the managers has superceded the interest of fund shareholders. Way back in 1967, when he concluded that, "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," Nobel Laureate Paul Samuelson was smarter than he could have imagined.

It's a fairly simple statistical matter to determine how well the investor—the intemperate customer on the other side of the bar in that saloon, using Dr. Samuelson's formulation—has been served, first by the old industry, then by the new. While equity fund shareholders have of course made substantial profits during the industry's modern era, the profits have been but a small fraction of what they could have captured simply by buying and holding a low-cost all-U.S-stock-market index fund.

- During the first two decades of the past sixty years, 1945-1965, the annual rate of return of the average equity fund was 13.2 percent, compared to 14.9 percent for Standard & Poor's 500 Stock Corporate Index, a shortfall of 1.7 percentage points,

doubtless largely accounted for by the then-more-moderate costs of fund ownership. The average fund delivered 89 percent of the market's annual return.

- During the past two decades, 1983-2003, the annual rate of return of the average equity fund was 10.3 percent, compared to 13.0 percent for the S&P 500 Index, a shortfall of 2.7 percentage points. The average fund delivered just 79 percent of the market's annual return.

Table 10. Mutual Fund Returns vs. The Stock Market		
	1945 – 1965	**1983 – 2003**
Stock Market Return*	**14.9%**	**13.0%**
Avg. Eq. Fund Return	**13.2**	**10.3**
Shortfall	**1.7**	**2.7**
Fund Share of Market Return	**89%**	**79%**

Source: Lipper. Return in the second period was reduced by 0.3% to reflect estimated survivor-bias.
*S&P 500

That a consistent gap exists between equity fund returns and stock market returns should not be a surprise. For in the long run, the record is clear: equity mutual funds are commodities (with relatively low survival rates at that) differentiated largely by their costs. After all, with fund managers competing among themselves in selecting stocks, aggregate equity fund returns must inevitably parallel those of the equity market itself, and thus fall short of those returns by the amount of their management, marketing, and turnover costs.

While we lack the data to account with precision for the gap between stock market returns and equity fund returns, both the twenty-year differentials between the return of the average fund and the index in the old era and the new, as well as the increase in the spread, appear to be largely, if not entirely, due to fund costs. For example, in the 1945-1965 period, equity fund expense ratios averaged about 0.8%, and the cost of portfolio turnover (averaging about 16% per year) added perhaps another 0.8%; a 1.6% total, very close to the 1.7% performance lag. In the 1983-2003 period, the average expense ratio was about 1.4%, portfolio turnover (90% annually on the average, but at much lower unit trading costs) added an estimated 1.0%, for a 2.4% cost, again very close to the 2.7 percent performance lag. (Since funds are rarely fully invested in stocks, opportunity costs may well account for the remaining differences between the cost and the shortfall.[8])

So 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 equity *fund* has earned.[9] But the average equity fund *shareholder* has fared far worse. Based on our studies comparing traditional time-weighted (per share) returns and dollar-weighted (investor) returns over the past decade, the average fund *investor* earned an annual return fully 2.4 percentage points *less than* the average *fund*.

[8] If stock returns average 12% and Treasury bills average 4%, the 8% spread on an average 5% cash position would represent an opportunity cost of 40 basis points.
[9] Federal and state income taxes represent yet a further toll on the returns earned by taxable fund shareholders. High portfolio turnover generates considerable tax inefficiency; during the past 15 years, equity fund after-tax returns lagged pre-tax returns by 2.2% per year—an additional burden that nearly *doubled* the confiscatory impact of the other fund costs.

Table 11. Return of the Stock Market, the Average Fund, and the Average Fund Investor, 1983 - 2003		
	Annual Return	**Growth of $1**
Stock Market Return	**13.0%**	**$11.50**
Avg. Eq. Fund Return	**10.3**	**7.10**
Gap Between Avg. Fund and Market	**2.7%**	
Est. Eq. Fund Investor Return*	**7.9%**	**4.57**
Gap Between Avg. Investor and Avg. Fund	**2.4**	
Total Gap Between Avg. Investor and Market	**5.1%**	

*Author's calculation, based on an analysis comparing *time-weighted* returns to the *dollar-weighted* returns earned by the fund investors for 600 general equity funds.

The change in the industry's *character* bears a heavy responsibility for the fact that the average fund shareholder earned so much less than the average fund. First, because shareholders investing in equity funds 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 aggressive growth funds investing in the "new economy" during the bubble, all the while withdrawing it from value funds favoring the "old economy," at precisely the wrong moment.

While the stock market provided an annual return of 13 percent during the past 20 years, and the average equity *fund* earned an annual return of 10.3 percent, the average fund *investor* (assuming that the 2.4 percentage point shortfall prevailed for the full period) would have earned just 7.9 percent per year. Compounded over two decades, the 2.7 percent penalty of *costs* was huge. But the penalty of *character* was almost as large—another 2.4 percentage points. *$1 compounded at 13 percent grows to $11.50; at 10.3 percent, to $7.10; and at 7.9 percent, to just $4.57, at best a modest reward for assuming the risks of equity investing in an era in which the stock market provided returns that were well above long-term norms.*

Where Do We Go From Here?

The point of this statistical examination of the returns earned by the stock market, the average fund, and the average fund owner is not precision, but direction. It is difficult to argue that, in the aggregate, the tens of millions of our citizens who have entrusted their hard-earned trillions to the care of mutual fund managers have 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 should not surprise you. It is time to go back to our roots; to put mutual fund shareholders back in the driver's seat, to return to the principles of the 1940 Investment Company Act, and demand that funds be "organized, operated, and managed" in the interest of their shareholders rather than the interests of their managers and distributors.

Some of the steps that must be undertaken would be relatively painless for fund managers—reducing turnover costs, by bringing turnover rates down to reasonable levels, for example—and some would be rather painful—reducing management fees and sales commissions, and cutting operating and marketing costs. Since there is no reason to expect that today's $7½ trillion fund industry can increase the portion of the market's returns earned by their funds by suddenly finding the ability to provide market-

superior returns (after all, fund managers are essentially competing with one another), such cost reductions are the only realistic way to enhance the returns of the average *fund.*

To enhance the share of *fund* returns earned by fund *shareholders*, on the other hand, the industry needs to reorder its "product line" strategies, focusing again on broadly-diversified funds with sound objectives and reasonable policies, take its foot off the marketing pedal, and press down firmly on the stewardship pedal. At the same time, the industry must give investors better information about asset allocation, fund selection, risks, potential returns, and costs, all with complete candor. To do otherwise will doom the industry to a dismal future. For whatever the profession, finally, the client must be served. Whatever the business, finally, the customer must be served. As an article in a recent issue of *Fortune* noted, "investors won't act contrary to their own economic interests forever."

The need for change is obvious; the steps that must be taken equally so. It is high time for the mutual fund industry to return funds present to funds past, to restore the industry to its original character of stewardship and prudence. If funds come yet again to focus above all on serving shareholders—serving them "in the most efficient, honest, and economical way possible," as I wrote in my thesis 54 years ago—the future for this industry will be not just bright, but brilliant.

Mr. Bogle, whose Princeton University thesis was entitled "The Economic Role of the Investment Company," joined Wellington Management Company in 1951, leading it from 1965 until 1974. He founded The Vanguard Group that same year, serving as CEO until 1996 and Senior Chairman until 2000. Since then, he has served as President of Vanguard's Bogle Financial Markets Research Center. The opinions expressed in this article do not necessarily represent the views of Vanguard's present management.

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