Statement of John C. Bogle

Founder and Former Chief Executive of the Vanguard Group and President of the Bogle Financial Markets Research Center Before the United States Senate Governmental Affairs Subcommittee on Financial Management, the Budget, and International Security January 27, 2004

Good morning, Chairman Fitzgerald and members of the Subcommittee. Thank you for inviting me to speak today.

March 21, 2004, less than two months from today, will mark the 80th anniversary of America's first mutual fund. Organized in Boston, Massachusetts Investors Trust (MIT) was a Massachusetts trust managed by its own trustees, who held the power "in their absolute and uncontrolled discretion" to invest its assets. The trustees were to be compensated at "the current bank rate for trustees," 6% of the investment income earned by the trust.

Our industry began, then, with the formation of a truly *mutual* mutual fund, one organized, operated and managed, not by a separate management company with its own commercial interests, but by its own trustees; compensated not on the basis of the trust's *principal*, but, under traditional fiduciary standards, its *income*.

We use the word *Alpha* to describe the first event in a series, and the word *Omega* to describe the last event, the end of the series or its final development. To state what must be obvious, however, MIT's Alpha was followed by the development of a very different mode of fund organization. Today, the industry's almost universal *modus operandi* is not individual *funds* but fund *complexes;* they are managed not by their own trustees but by external corporations; they encompass not only investment management but also administration, operations, distribution, and marketing. The model of the 1924 Alpha *mutual fund*, then, has been replaced by the 2004 Omega mutual fund *complex*—a term that, all those years ago, would have somehow seemed jarring or inappropriate.

But "the national public interest and the interest of investors"—the focus of our industry's guiding statute, the Investment Company Act of 1940—precludes our acceptance of today's almost universally-accepted industry structure—today's Omega model—as the end of mutual fund development. Why? Because the reality is that this structure has been shaped, increasingly and almost unremittingly, to *serve* the interest of fund managers, a *disservice to* the public interest and the interest of fund shareholders.

Sharply rising fund costs have widened the shortfall by which fund returns have lagged the returns earned in the financial markets; the age-old wisdom of long-term investing has been importantly crowded out by the folly of short-term speculation; and "product marketing" has superceded investment management as our highest value. The recent fund scandals provide tangible evidence of the triumph of managers capitalism over owners capitalism in mutual fund America, an unhappy parallel to what we have observed in corporate America itself.

These developments are indisputable, and they fly in the face of the very language of the Investment Company Act: Mutual funds must be "organized, operated, and managed" in the interests of their shareowners rather than in the interests of their "investment advisers and underwriters (distributors)"—a policy now honored more in the breach than in the observance. It is high time for a *new* Omega, an industry structure that would, paradoxically enough, parallel the Alpha structure under which MIT was created nearly eighty years ago.

The Development of MIT

Almost from its inception, MIT was a remarkable success. While in its first few years the going was slow, assets had soared to $3.3 million by the end of 1926. As the boom of the late 1920s continued, it flourished. It earned a return of 88% for its investors in 1926-28, only to lose 63% of their capital in the bust that followed in 1929-1932. But as the market recovered, its assets grew apace—to $128 million by 1936, and to $277 million by 1949, the largest stock fund in the industry throughout that entire period. MIT would maintain that rank until 1975, when its assets reached a total of $1.15 *billion*—a truly amazing half-century of preeminence.

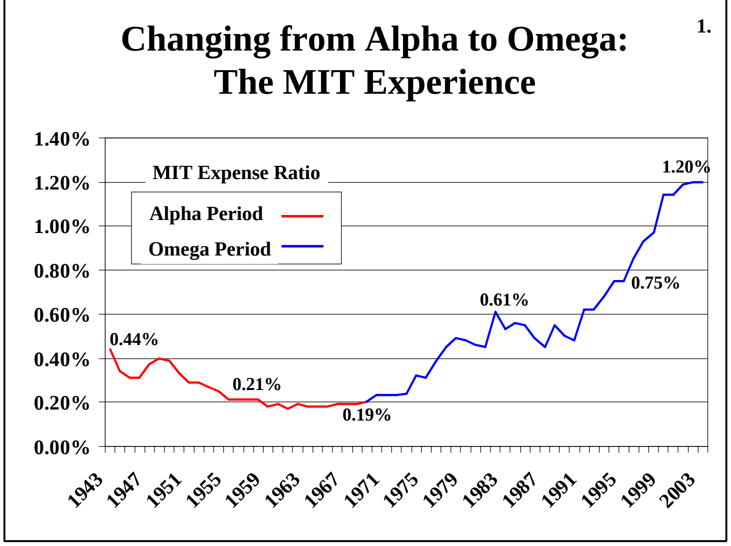
To its enviable status as both the oldest and largest mutual fund, MIT added the luster of consistently ranking as the lowest-cost fund. Its trustees soon reduced that original 6% fee to 5% of income, and then, in 1949, to 3.5%. Measuring its costs as a percentage of fund assets (now the conventional way we report expenses), the Trust's expense ratio fell from 0.50% in the early years to 0.39% in 1949, to a fairly steady 0.19% during 1960-1969. During that entire period MIT was publicly-offered through stock brokers by an underwriter originally named Learoyd-Foster, later to become Vance, Sanders & Co. Managed by its own trustees and unaffiliated with its distributor, the truly mutual structure of Massachusetts Investors Trust played a major role in its sustained leadership of the industry.

As 1969 began, then, MIT was an industry maverick. It stood for trusteeship, and did not engage in salesmanship. It kept its costs at rock-bottom levels. Its portfolio was broadly diversified and had little turnover. It invested for the long-term, and so did the shareholders who purchased its shares. And while virtually every other fund in the industry operated under the conventional structure with an external "management company" assuming full responsibility for its operations, investment advice, and share distribution in return for an *asset*-related—not *income*-related—fee paid by existing investors and a share of the sales loads paid by its new investors, MIT held to its own high standards and prospered—a success story, in its own way, for the idea that mutuality worked.

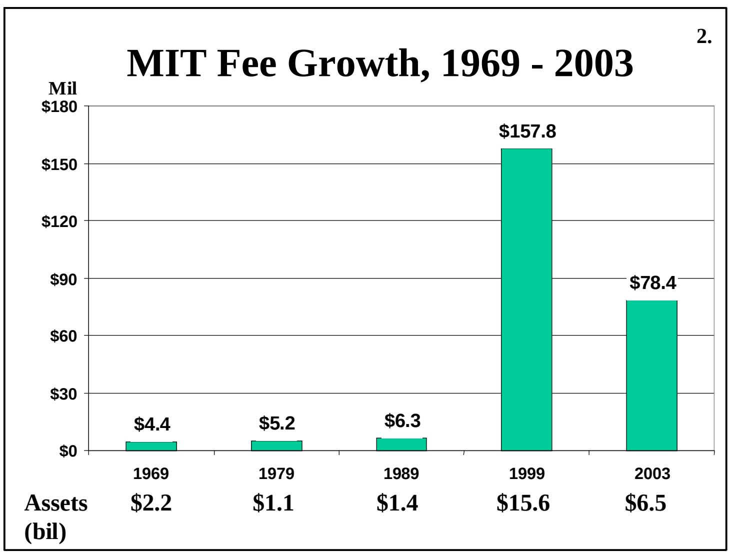
MIT – From Alpha to Omega

During 1969, however, the structure changed. The trustees solicited proxies from the shareholders of MIT (and its sister fund, Massachusetts Investors Growth Stock Fund—originally named "Massachusetts Investors Second Fund") for the approval to "demutualize" and adopt the conventional external management structure. When the shareholders approved the proposal, the Trust became a member of a fund family that adopted the name "Massachusetts Financial Services" (MFS). If MIT was a fund that for nearly a half-century had stood for something unique, in 1969 it became one of the crowd.

Was that change from Alpha to Omega good or bad? We can say unequivocally that, in terms of the fees it generated for its managers, it was *good*. We can also say unequivocally that in terms of the costs borne by its shareholders, it was *bad*. That 0.19% expense ratio in 1968 doubled to 0.39% in 1976, and doubled again to 0.75% in 1994, continuing to rise to 0.97% in 1998 and to 1.20% in 2003. **Exhibit 1**. And that old limit of 3.5% of income the trustees put into place in 1949? It was long gone. In 2002, in fact, MIT's expenses consumed precisely 80.4% of the trust's income.



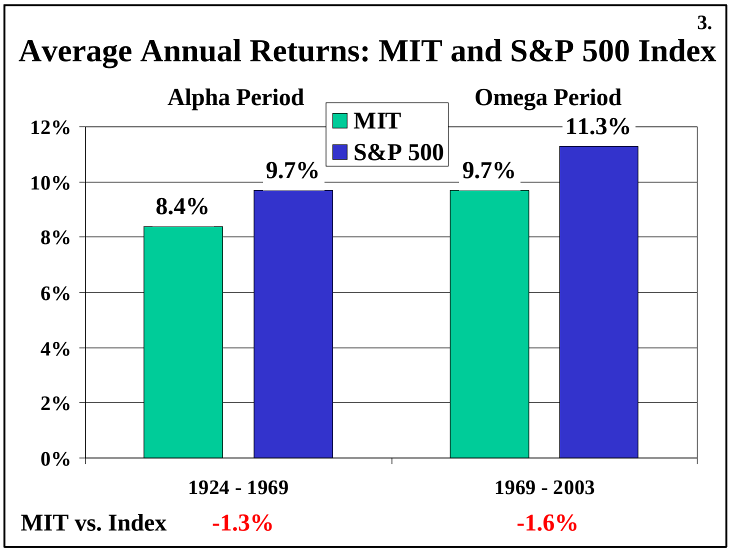
But these ratios greatly *understate* the increase in the Trusts' costs. For even as its assets were growing, so were its fee *rates*, resulting in enormous increases in the *dollar amounts* of fees paid. With assets of $2.2 billion in 1969, MIT's management fees (including some relatively small operating expenses) totaled $4.4 million. **Exhibit 2.** Even a decade later in 1979, although the Trust's assets had *declined* by 50% to $1.1 billion after the 1973-74 market crash and the troubled times faced by the fund industry, fees had actually *risen* to $5.2 million. In 1989, with assets at $1.4 billion, fees continued to rise, to $6.3 million. And in 1999, when assets soared to $15.6 billion, fees totaled $158 million. While the Trust's assets had grown *seven-fold* since MIT demutualized in 1969, its fees had increased *36 times* over. (Assets slumped to $6.5 billion last year, with fees totaling nearly $80 million.)



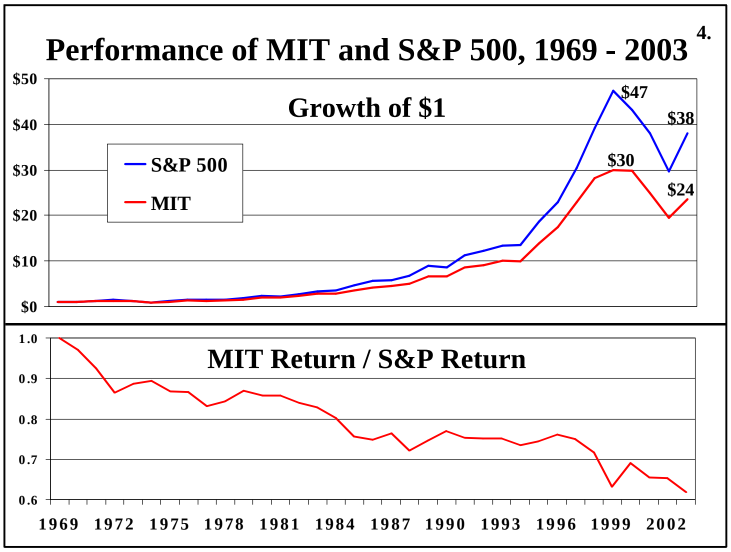
MIT's Long-Term Investment Record

What effect did the new structure have on MIT's shareholders? It is not difficult to measure. For MIT was the prototypical mutual fund, widely-diversified among about 100 blue-chip stocks and, unsurprisingly, provided returns that closely paralleled those of the Standard & Poor's 500 Stock Index (a 90-stock index until 1957), with an average correlation (R^2) of 0.94 that has remained remarkably steady over its entire 80-year history. Given the tautology that the gross return of the stock market, minus the costs of financial intermediation, equals the net return earned by market participants, it would be surprising if the rising costs that followed MIT's demutualization was not accompanied by a deterioration in the returns enjoyed by its shareowners.

No surprise, then. The Trust's relative returns declined. During its mutual era (1925-1969), the Trust's average annual return of 8.4% lagged the Index return of 9.7%, by 1.3% per year. **Exhibit 3.** (Because the Index return ignores the real world costs of investing, of course, that shortfall may not be surprising.) But *after* demutualization (1969-2003), its average annual return of 9.7% lagged the Index return of 11.3% by 1.6% per year—an 0.3% reduction that exactly matches the increase in its average expense ratio from 0.3% in the 1925-1969 period to 0.6% in 1969-2003. (The ratio has risen to an estimated 1.2% in 2003, suggesting a much wider lag in the years ahead.)



This increase in the shortfall in MIT annual returns during the Trust's 34-year Omega period may seem trivial. But it is not. **Exhibit 4.** Thanks to the miracle of compounding *returns*, each $1 initially invested in the Standard & Poor's Index at the end of 1969 would have been valued at $38 at the end of 2003. Confronted by the tyranny of compounding *costs* over that long period, however, each $1 invested in Massachusetts Investors Trust would have had a final value of just $23.60—a 38% loss of principal in relative terms.



The Wellington Group – From Omega to Alpha

Even as MIT was abandoning its Alpha mutual structure in favor of an externally-managed Omega structure in 1969, the stage was being set for another firm to take precisely the opposite action. Philadelphia's Wellington Group—eleven associated mutual funds with assets of some $2.4 billion (over $1 billion behind the then-combined total of $3.5 billion for MIT and its sister growth fund)—was operated by Wellington Management Company, then largely owned by its executives but with public shareholders as well. Its stock had recently sold at an all-time high of $50 per share, nearly three times its initial public offering price of $18 in 1960. Despite the travail that followed the demise of the Go-Go years, the stock market was again rallying, on the way to its then all-time high early in 1973, and the company was prospering.

With the so-called "currency" that its public stock had made available, Wellington Management had merged with the Boston investment counsel firm of Thorndike, Doran, Paine and Lewis, Inc., in 1967. TDP&L was also the manager of Ivest Fund, a "go-go" fund that was one of the industry's premier performers during that era of speculation, and it soon became a major generator of the Wellington Group's capital inflows. And yet, even as MIT had just gone in the opposite direction, the Wellington CEO (and also the Chairman and President of Wellington *funds*)[1] was pondering whether this Omega structure was the optimal one for the funds' shareholders, and whether a change to the recently-vanished Alpha structure would improve both the lot of its fund shareholders as well as the firm's competitive position in the industry.

In September 1971, he went public with his concerns. Speaking at the annual meeting of the firm's partners, he talked about the possibility of mutualization, beginning his remarks with a 1934 quotation from Justice Harlan Fiske Stone: "Most of the mistakes and major faults of the financial era that has just drawn to a close will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that 'a man cannot serve two masters' . . . Those who serve nominally as trustees but

[1] It was I who served in these positions, but I feel more comfortable using the third person format. This combination of seemingly conflicting roles, was then, and remains now, the industry norm.

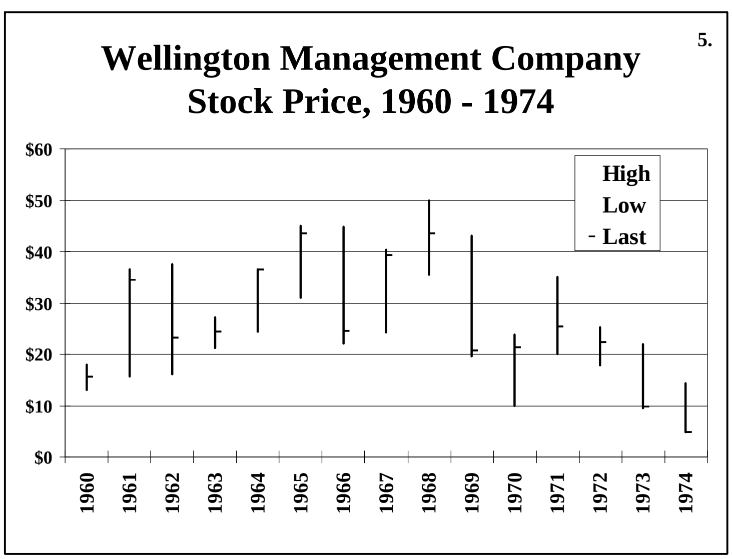
consider only last the interests of those who funds they command suggest how far we have ignored the necessary implications of that principle."

The Wellington CEO endorsed that point of view, and revealed what he described as "an ancient prejudice of mine: *All things considered, it is undesirable for professional enterprises to have public shareholders*. Indeed it is possible to envision circumstances in which the pressure for earnings growth engendered by public ownership is antithetical to the responsible operation of a professional organization. Although the field of money management has elements of both a business and a profession, any conflicts between the two must, finally, be reconciled in favor of the client."

He then tranced on some ideas about how such a reconciliation might be achieved: (1) "a mutualization, whereby the funds acquire the management company;" (2) "internalization, whereby the active executives own the management company, with contracts negotiated on a 'cost-plus' basis, with incentives for both performance and efficiency, but without the ability to capitalize earnings through public sale;" and (3) limited internalization, with funds "made self-sustaining with respect to administration and distribution, but with external investment mangers."

Omega to Alpha

Within three years, the CEO was put in a position in which he would not only *talk the talk* about mutualization, but would *walk the walk*. Even before the 1973-74 bear market began, Wellington's business had begun to deteriorate and the cash *inflows* of the Wellington funds, $280 million in 1967, had by 1973 turned to cash *outflows* of $300 million. The speculative funds created by the firm were suffering serious capital erosion, and most would be merged out of existence before the decade was out. Assets of the conservative Wellington Fund flagship had tumbled from $2 billion in 1965 to less than $1 billion, on the way to $480 million in 1980. Earnings of $2.52 per share in 1968 would drop to $1.14 in 1974, and the stock price had fallen to $9.75 per share, on its way to a low of $4.87. **Exhibit 5.** This concatenation of dire events was enough to cause the happy partnership formed by the 1967 merger to fall apart, and Wellington Management Company's CEO got the axe on January 23, 1974. But he remained as chairman of the funds, with their largely separate (and independent) board of directors.



Shortly before the firing, the handwriting was on the wall, as it were, suggesting the nature of the change that might be in store. On January 12, 1974, the CEO had submitted a proposal to the *mutual fund* board of directors to mutualize the funds, and operate under an internally-managed structure. "I propose," he wrote, "to have the Wellington Group of mutual funds acquire Wellington Management Company and its business assets . . . The Funds would pay an estimated $6 million (the adjusted market capitalization of the company's stock[2]) and would receive liquid and fixed assets of $4 million, with the remaining $2 million representing the 'going concern' value (or goodwill) of the enterprise . . . Wellington Management would become a wholly-owned subsidiary of the funds and would serve as investment adviser and distributor on an 'at-cost' basis, resulting in estimated savings of $2 to $3 million per year."

One need only understand the stunningly high profit margins of the investment management business in order to imagine a less-than-*one-year*(!) payback of the net acquisition cost of $2 million. While Wellington's stock price had tumbled, and its fee revenues had declined, the firm's pre-tax profit margin nonetheless remained at a healthy 33%. (Revenues $9.6 million, expenses $6.4 million, profits $3.2 million). While the fund chairman openly acknowledged that such a conversion to mutual status was "unprecedented in the mutual fund industry," the cautious fund board was interested enough to ask him to expand the scope of his proposal and undertake "a comprehensive review of the best means by which the funds could obtain advisory, management and administrative services at the lowest reasonable costs to the fund shareholders." The board also asked Wellington Management Company to produce a similar study.

By March 11, the chairman's first report was completed. Entitled "The Future Structure of the Wellington Group of Investment Companies," the report offered seven structural options, of which the board decided to focus on these four:

1. **Status Quo—the continuation of the existing relationships.**
2. **Internal Administration—administration by the funds themselves; distribution and investment advice from Wellington Management.**
3. **Internal Administration and Distribution—with only investment advice from Wellington.**
4. **Mutualization—acquisition by the funds of all of Wellington's fund-related activities.**

The Future Structure study spelled out the ultimate objective: *Independence.* The goal was "to give the funds an appropriate amount of corporate, business, and economic independence," the chairman wrote, noting that such a structure was clearly contemplated by the Investment Company Act of 1940. But such independence, his study added, had proved to be an illusion in the industry, with "funds being little more than corporate shells . . . with no ability to conduct their own affairs . . . This structure has been the accepted norm for the mutual fund industry for more than fifty years."

"The issue we face," he bluntly concluded, "is whether a structure so traditional, so long accepted, so satisfactory for our infant industry as it grew during a time of less stringent ethical and legal standards, is really the optimal structure for these times and for the future—or whether the funds should seek the greater control over their own destiny so clearly implied by the word *independence*." While the fund chairman clearly preferred his original proposal of mutualization, he was prepared to begin with less, concluding the study with these words, "perhaps, then, the issue is not *whether*, but only *when* the Wellington Group will become completely independent."

As it would soon turn out, he would have to be content with less than full mutualization. After much study, even more contention, and debate that sometimes seemed to be endless, the board made its

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[2] Under the proposal, the Funds would acquire only Wellington's *mutual fund* business. Its counseling business would have been returned to the pre-merger partners.

decision on June 11, 1974. It chose the least disruptive option, #2, establishing the funds' own administrative staff under the direction of its operating officers, who would also be responsible, as the board's counsel, former SEC Commissioner Richard B. Smith wrote, "for monitoring and evaluating the external (investment advisory and distributors) services provided" by Wellington Management. The decision, the counselor added, "was *not* envisaged as a 'first step' to internalize additional functions, but as a structure that . . . can be expected to be continued into the future."

Enter Vanguard

Late in the summer, to the chairman's amazement and disappointment, the board agreed that Wellington Management Company would retain its name. While Wellington Fund would also retain *its* name, a new name would have to be found for the administrative company. In September, he proposed to call the new company "Vanguard" and, after more contention, the board approved the name. The Vanguard Group, Inc. was incorporated on September 24, 1974. Early in 1975, the SEC cleared, without apparent difficulty, the funds' proxy statements proposing the change; the fund shareholders approved it; and Vanguard, a wholly-owned subsidiary of the funds operating on an at-cost basis, began operations on May 1, 1975.

But no sooner than the ink was dry on the various agreements, things began to change. With the funds controlling only one leg—and, arguably, the least important leg—of the operations/investment management/distribution tripod on which any fund complex rests, the chairman began to have second thoughts. As he would later write, "It was a victory of sorts, but, I feared, a Pyrrhic victory . . . I had realized all along that the narrow mandate that precluded our engaging in portfolio management and distribution services would give Vanguard insufficient power to control its destiny . . . Why? Because success in the fund field is *not* driven by how well the funds are administered. Though their affairs must be supervised and controlled with dedication, skill, and precision, success is determined by what kinds of funds are created, by how they are managed, by whether superior investment returns are attained, and by how—and how effectively—the funds are marketed and distributed. We had been given one-third of the fund loaf, as it were, but it was the least important third. It was the other two-thirds that would make us or break us."

The next one-third of the loaf was seized quickly. The newly-named Vanguard Group's entry into the investment management arena came in a groundbreaking way. Only a few short months after the firm began operations, the board of the funds approved the creation of an index fund, modeled on the Standard & Poor's 500 Stock Index. It was incorporated late in 1975. When its initial public offering was completed in August 1976, it had raised a disappointing $11 million. But the world's first index mutual fund had come into existence. It is now the largest mutual fund in the world.

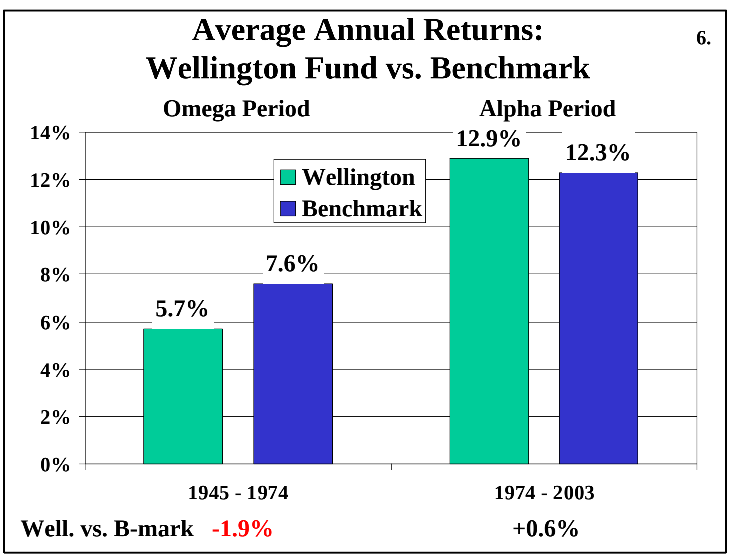
Only five years after that halting entry into what was, arguably, equity investment management, the firm assumed full responsibility for the management of Vanguard's bond and money market funds. A decade later, Vanguard began to also manage equity funds that relied on quantitative techniques rather than fundamental analysis. A variety of external advisers continue to manage Vanguard's actively-managed equity and balanced funds, now constituting some $180 billion of the Group's $700 billion of assets. (Wellington Management continues to manage Wellington Fund, as it has throughout the fund's now-75 year history.)

Improved Returns in a Full-Fledged Alpha Complex

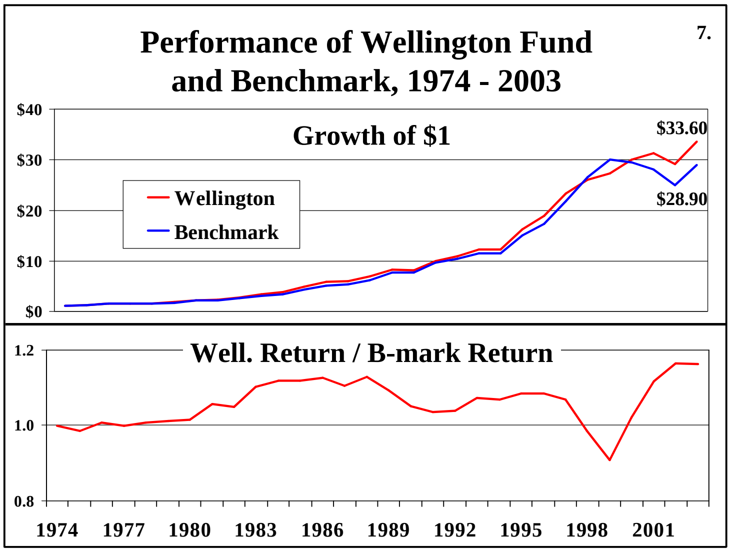
The final one-third of the mutual fund loaf was acquired only five months after the index fund IPO had brought investment management under Vanguard's aegis. On February 9, 1977, yet another unprecedented decision brought share distribution into the fold. After yet another contentious debate in a politically-charged environment, and by the narrowest of margins, the fund board accepted the chairman's recommendation that the funds terminate their distribution agreements with Wellington Management, eliminate all sales charges, and abandon the broker-dealer distribution system that had distributed Wellington shares for nearly a half-century. Overnight, Vanguard had eliminated its entire distribution system, and moved from the seller-driven, load-fund channel to the buyer-driven, no-load channel. Narrow as the mandate was, it set the fledgling organization on a new and unprecedented course.

What would the flourishing of Vanguard into a full-fledged Alpha complex—its full mutualization—mean to its fund investors? First, it would mean far lower fund operating expenses, with the group's weighted expense ratio tumbling from an average of 0.67% in 1975 to 0.26% in 2002—a reduction of more than 60%. Second, it would mean that the earlier 8½% front-end load—and the performance drag on shareholder returns inevitably entailed by that initial sales charge—would be forever removed. And since gross returns in the financial markets, minus costs, equal the net returns earned by investors, this slashing of costs was virtually certain to enhance shareholder returns.

And that's just what Vanguard's change from Omega to Alpha did. What followed over the subsequent 29 years was a major enhancement in the *absolute* returns (sheer good luck!) and the *relative* returns earned by Wellington Fund. Specifically, this balanced fund provided an annual return of 12.9% from 1974-2003, actually *outpacing* the 12.3% annual return of its unmanaged (and cost-free) benchmark—35% Lehman Aggregate Bond Index, 65% Standard & Poor's 500 Stock Index, an allocation comparable to Wellington's—and by a wider margin the 11.1% rate of return earned by the average balanced fund. **Exhibit 6.** During the comparable prior period (1945-1974) under the Omega structure, the Fund's return of just 5.7% had actually *lagged* the benchmark return of 7.6% by a full 1.9 percentage points per year.



Part of that near-miraculous 2.5 percentage point *annual* improvement in relative returns—a staggering margin—was related to lower costs. The Fund's average expense ratio, low enough in the earlier period at 0.56%, fell 20% to 0.45%, and the sales charge drag was eliminated. But the largest part of the improvement arose from a 1978 change in the Fund's investment strategy, in which the *Fund's* management directed its reluctant adviser to return Wellington to its traditional conservative, incomeoriented policies from which it had strayed during the late 1960's and 1970s. Result: by the end of 2003, each $1 invested in Wellington Fund in 1974 would have grown to $33.60. **Exhibit 7.** The same investment in the balanced index benchmark, on the other hand, would have grown to just $28.90. (A similar investment in the average balanced fund would have grown to just $20.96—about 40% *below* Wellington's value.) The lower chart presents a stunning contrast with the lower chart on Exhibit 4 on page 6.



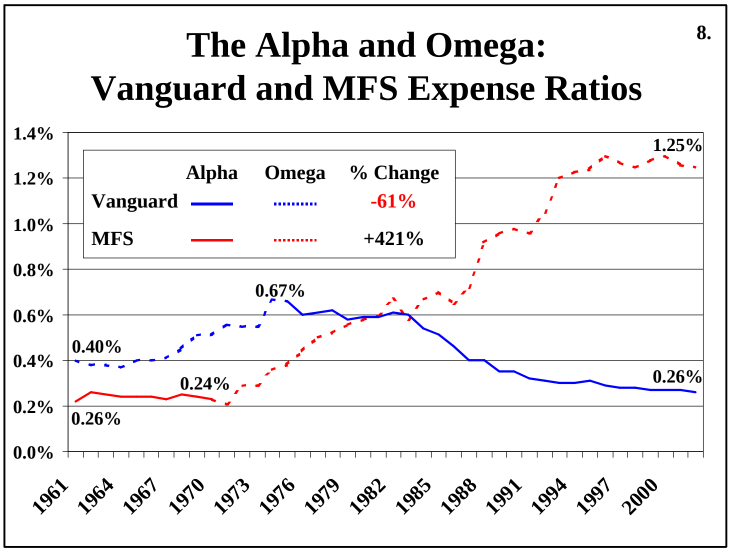
Other than the direct impact of costs, it is not easy to characterize "cause and effect" in the attribution of investment performance. While Wellington Fund's return to its conservative investment tradition was a major benefit, the new Alpha structure itself, under which Wellington Management became an external investment adviser that *had* to perform in order to retain its independent client, could well have itself provided a major benefit. While we can't be certain, the development of the arms-length relationship that is part of the Alpha model clearly did no harm.

Alpha vs. Omega: Lower Costs and Higher Market Share

Whatever the case, we do know that there is a powerful and pervasive relationship between expense ratios and fund net returns. We know, for example, that the correlation coefficient of the ten-year returns of individual equity funds and their costs is a remarkably impressive *negative* 0.60. We also know that during *each* of the past two decades the returns of the equity funds in the *low-cost* quartile have consistently outpaced the returns of funds in the *high-cost* quartile by an enormous margin of about 2½% per year. *The higher the cost, the lower the return*. And it is crystal clear that the Alpha model of fund operations is, well, cheap, while the Omega model is dear.

The contrast in costs could hardly be sharper than in the two fund complexes we have just considered. Both were dominated by a single mutual fund until the 1960s, before becoming more and more diversified fund complexes thereafter. Both had roughly comparable assets under management up until the 1980s—in the hundreds of millions in the 1950s, then the billions in the 1960s and 1970s, growing to the tens of billions in the 1980s. Then their paths diverged. While Massachusetts Financial Services enjoyed solid asset growth to some $94 billion at the market's peak in 2000, Vanguard grew even faster, then overseeing some $560 billion of assets.

Late in their Alpha period, the asset-weighted expense ratio of the MFS funds averaged less than 0.25%. Under its new Omega model, the MFS ratio jumped to 0.67% in 1984, to 0.92% in 1988, to 1.20% in 1993, and to 1.25% in 2002, an *increase* of 421% for the full period. **Exhibit 8.** By way of contrast, late in their Omega period the Vanguard funds' ratio averaged about 0.60%. Under its new Alpha structure, the Vanguard ratio tumbled to 0.54% in 1984, to 0.40% in 1988, and to 0.30% in 1993, continuing to drop in 2002 to just 0.26%, a *reduction* of 61% from the pre-Alpha rate.

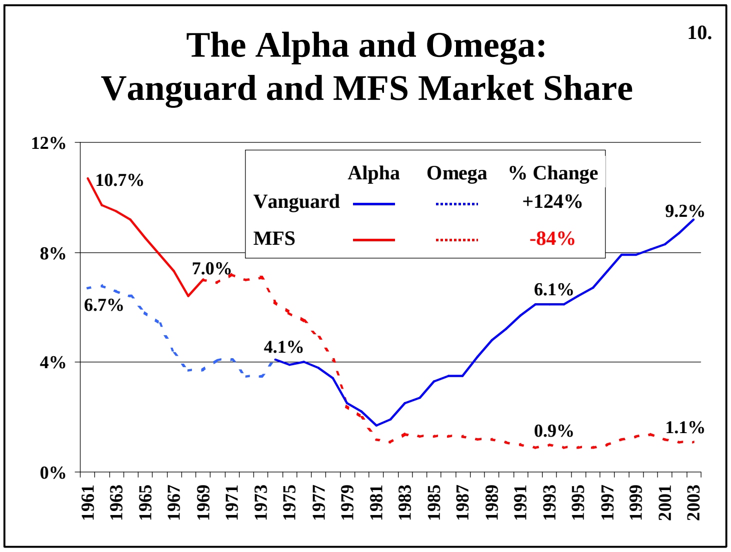


These ratios may seem diminutive and trivial, but they are not. They entail hundreds of millions, even billions, of dollars. In 2003, the assets of the Omega MFS funds totaled $78 billion, and their 1.25% expense ratios, including management fees, 12b-1 fees, and operating costs, totaled $975 million. Had their earlier 0.25% ratio prevailed, those costs would have been just $195 million, a remarkable $780 *million*(!)saving. **Exhibit 9.** Again by way of contrast, assets of the Alpha Vanguard funds totaled $667 billion in 2003; with expenses of $1.7 billion, the expense ratio was 0.26%. Had the earlier 0.60% ratio under its Omega structure prevailed, Vanguard's expenses would otherwise have been $4.0 billion, representing $2.3 *billion* of additional costs that would have been incurred by its fund shareholders.

The Manifestation of the Alpha Benefit 9.

	MFS	Vanguard
2003 Assets	**$78 B**	**$667 B**
Omega Exp. Ratio	**1.25%**	**0.60%**
Fees Generated	**$975 M**	**$4,000 M**
Alpha Exp. Ratio	**0.25%**	**0.26%**
Fees Generated	**$195 M**	**$1,700 M**
Savings Under Alpha Structure	**$780 M** (projected)	**$2,300 M** (actual)

Even as Vanguard, under its Alpha structure, did *good* in building value for its fund shareholders, it did *well* in implementing its business strategy. Assets under management have grown from $1.4 billion in 1974 to nearly $700 billion currently, and its share of mutual fund industry assets has soared. While a late entry into the money market business resulted in a plunge in its market share from 3.5% in 1974 to 1.7% in 1981, the rise since then has been unremitting, consistent, and powerful. **Exhibit 10.** As 2004 begins, Vanguard's share of industry assets stands at 9.2%—by far the largest market share increase achieved by any mutual fund firm.



The growth of MFS assets, too, has been awesome—from $3.3 billion in 1969, when it abandoned its original Alpha structure, to $78 billion currently. But its original 7.0% market share began to shrink within a few years after the change, falling to just 1.1% in 1982, where it remains today. To the extent that we can measure it, then, under the Omega strategy—which is of course the strategy that is pervasive in the industry—the MFS transition from its original roots has not only resulted in increased costs and reduced returns for its fund shareholders, but proved to be a losing strategy in the highly competitive mutual fund marketplace.

Nonetheless, the Omega strategy does have something very important going for it: It is immensely profitable for the funds' *managers*. Immediately after its demutualization in 1969, MFS remained a private company, with its profits divided among its own executives and employees. But in 1981, in a curious twist, the firm sold itself to Sun Life of Canada, which remains its owner today (MFS executives now hold about 8% of its stock). According to Sun Life's financial statements, the pre-tax earnings of MFS during the five year period 1998-2002, totaled $1,924,000,000, certainly a splendid return on their initial (but undisclosed) capital investment—a near $2 billion gold mine for the Sun Life shareholders.

Tested in the Crucible

Both the Alpha fund model and the Omega fund model have been tested over almost the entire 80-year history of the industry. (1970-1974 was the only period in which no Alpha model existed.) The 45-year preeminence that MIT achieved from 1924 to 1969, to say nothing of the flourishing of Vanguard almost from the day it was created, hardly suggest major flaws in the Alpha model. Yet the economics of the business remain a major stumbling block to the creation of new Alpha organizations. If funds are run at cost, after all, there are no profits for the management company owners. It is hardly surprising, then, that Vanguard's structure has yet to be copied, or even imitated.

It is a curious paradox that the transformation of MFS from the Alpha model to the Omega model was accomplished with apparent ease. Vanguard's conversion from Omega to Alpha, however, was fraught not only with contention and debate, but with regulatory opposition. While the internalization of the *administration* of the Wellington funds was straight-forward, and even the internalization of the *management* of the index fund raised no regulatory eyebrows, the decision to internalize *distribution* was a bombshell. It was opposed by a Wellington Fund shareholder, who called for—and received—a formal SEC administrative hearing, which, was said to be the longest hearing in the history of the Investment Company Act, lasting, if memory serves, something like ten full days in court, and a long period of examination by the regulators. Finally, in July 1978, after considering the issues, the Administrative Law Judge who presided at the hearing made his decision on our application for the Vanguard funds to jointly assume financial and administrative responsibility for the promotion and distribution of our shares: *Rejection*! We were back to square one.

At issue was a long history during which the SEC had successfully argued that funds could not spend their own assets on distribution. (Clearly all major fund complexes were making such expenditures, but it was successfully, if problematically, argued that the managers were paying the distribution costs out of their own profits.) Shortly after we made the no-load decision in February 1977, we had asked for an exemption that would allow the funds to spend a limited amount (a maximum of 0.20% of net assets) on distribution. While our argument in favor of this plan was somewhat technical, it came down to the fact that while we would spend $1.3 million on distribution, we would simultaneously slash by $2.1 million the annual advisory fees paid to Wellington Management for that purpose: Assuming responsibility for distribution would result, not in a cost to the funds' shareholders, but in a net *savings* of $800,000 per year.

Happily, the SEC had allowed us to temporarily pursue our distribution plan pending Commission and fund shareholder approval. So Vanguard had in fact been running the distribution system since 1977. Despite his rejection of our plan, the judge gave us the opportunity to amend it, and after making a few technical changes, we resubmitted it early in 1980. With this sword of Damocles suspended above us during this long period, we blithely pursued our distribution activities. The threatening sword was finally removed on February 25, 1981, when the Commission at last rendered its decision.

The decision was a home run for Vanguard! Far better than any characterization I could use to describe the decision, the Commission's words speak for themselves:

> "The Vanguard plan is consistent with the provisions, policies and purposes of the Act. It actually furthers the Act's objectives by ensuring that the Funds' directors, with more specific information at their disposal concerning the cost and performance of each service rendered to the Funds, are better able to evaluate the quality of those services.
>
> "The plan will foster improved disclosure to shareholders, enabling them to make a more informed judgment as to the Funds' operations. In addition, the plan clearly enhances the Funds' independence, permitting them to change investment advisers more readily as conditions may dictate. The plan also benefits each fund within a reasonable range of fairness.

> "Specifically, the Vanguard plan promotes a healthy and viable mutual fund complex within which each fund can better prosper; enables the Funds to realize substantial savings from advisory fee reductions; promotes savings from economies of scale; and provides the Funds with direct and conflict-free control over distribution functions.
>
> "Accordingly, we deem it appropriate to grant the application before us."

The decision was unanimous. We had at last formally completed our move from the original Omega model under which we had operated for nearly a half-century, to a full-fledged Alpha mutual fund model. Our joy was profound and unrestrained, and our optimism about the future was boundless.

An Elementary Principle, Too Often Ignored

The Commission's decision, in its own blunt words, was based on *"one of the 1940 Act's basic policies: that funds should be managed and operated in the best interest of their shareholders, rather than in the interests of advisers, underwriters, or others."* And that would also seem to be the most elementary principle of the common law as it relates to fiduciary duty and trusteeship. And yet it must have been obvious to the Commissioners that while they had just approved our Alpha model, the entire rest of the industry was operating under an Omega model in which the advisers and underwriters—the funds' management companies—were in the driver's seat.

Fully 15 years earlier, in fact, the SEC had vigorously recommended legislative changes that were designed to restore a better balance of interest between shareholders and managers. In *Public Policy Implications of Investment Company Growth*, a report to the House Committee on Interstate and Foreign Commerce dated December 2, 1966, the Commission pointedly noted that "internally managed companies which had their own staff had significantly lower management costs than externally managed funds compensated by fees based on a fixed percentage of the fund's assets."

After considering the level of fund fees ($130 million a year seemed large in 1966; but by 2003, fees had soared to $32 *billion*), the far lower fee rates paid by pension plans and internally managed funds, the then-average 48%(!) pre-tax profit margin earned by publicly-held management companies, and the effective control advisers held over their funds, as well as "the absence of competitive pressures, the limitations of disclosure, the ineffectiveness of shareholder voting rights, and the obstacles to more effective action by the independent directors," the SEC recommended the adoption of a "statutory standard of reasonableness," which it described as a "basic fiduciary standard that would make clear that those who derive benefits from their fiduciary relationships with investment companies cannot charge more for services than if they were dealing with them at arm's length."

The SEC described reasonableness as "a clearly expressed and readily enforceable standard that would measure the fairness of compensation paid for services furnished by those who occupy a fiduciary relationship" to the mutual funds they manage. This standard "would *not* be measured merely by the cost of comparable services to individual investors or by the fees charged by other externally managed investment companies . . . (but by) the costs of management services to internally managed funds and to pension funds and other non-fund clients . . . (and) their benefit to fund shareholders . . . (including) sustained investment performance."

"The Commission is not prepared to recommend at this time the more drastic statutory requirement of compulsory internalization and the performance of services at cost," the SEC report added, for it "might be more costly for smaller funds . . . or could be insufficient to provide an adequate full time staff . . . (and) might prove a determent to the promotion of new investment companies." Accordingly, the Commission believed that, "an alternative to the more drastic solution of compulsory internalization should be given a fair trial." If the standard of reasonableness does not "resolve the problems in management compensation that exist . . . *then more sweeping steps might deserve to be considered.*"

Alas, the Commission's "reasonableness" proposal was never put to the test. The industry fought hard, and lobbied the Congress vigorously. Finally, five years later, in the Investment Company Amendments Act of 1970, the Commission had to settle for a weak provision in which the investment adviser was charged with "a fiduciary duty with respect to the compensation for services," with damages limited to the actual compensation received, and with no definition of what might constitute reasonableness. And even 33 years later, "more sweeping steps" have yet to be considered.

In its 1966 report, the SEC had also expressed concerns about the growing trend of sales of management companies to other firms at prices far above book value, transfers the Commission opined, that have "some elements of the sale of a fiduciary office, (which is) *strictly prohibited under Common Law*." It also expressed a concern about earlier "widespread 'trafficking' in advisory contracts." The Commission recommended that the sale of a management company could not take place if it came with "any expense or implied understanding . . . likely to impose *additional* burdens on the fund." (Italics supplied.) The implication that funds were *already* bearing heavy burdens would have been lost on few observers, and even that protection was diluted in the subsequent legislation.

Had the initial SEC recommendations prevailed, they may well have aborted the accelerating trend toward higher fund expense ratios that today seems endemic in the fund industry. The *unweighted* expense ratio of 0.87% for the average equity fund that concerned the Commission in 1965 has risen by 86%, to 1.62%. (For those who think that *asset-weighted* expense ratios are a better test, the increase was from 0.51% to 0.95%—the same 86% increase!)

But we deceive ourselves when we look at fee *rates* instead of fee *dollars*. When applied to the burgeoning assets of equity funds ($26.3 *billion* in 1965 and $3.36 *trillion* in 2003), equity fund expenses have leaped from $134 million in 1965 to an estimated $31.9 billion in 2003. **Exhibit 11**. That fund expenses have risen 238-fold(!) since 1965, nearly double the 128-fold increase in equity fund assets. In a field in which, as today's lone Alpha fund complex demonstrates, the economies of scale in fund operations are truly staggering, it is a truly astonishing anomaly.

Where are the Economies of Scale? **11.**

	1965	2003	Change
Total Equity Assets	**$26.3 B**	**$3,361 B**	**+128 x**
Average Exp. Ratio	**0.87%**	**1.62%**	**+86%**
Wtd.* Exp. Ratio	**0.51%**	**0.95%**	**+86%**
Fees Generated	**$134 M**	**$31,900 M**	**+238 x**

Weighted by fund assets.
Fees generated uses weighted average.

Further, the SEC's 1966 concern about trafficking in advisory contracts could hardly have been more prescient. Although a number of fund management firms had gone public with IPOs by then, the large majority remained privately-held. Today, only *six*(!) privately-held firms remain (seven if we include Vanguard) among the largest 50 fund managers. Another seven are publicly-held, and fully 36 are owned by giant financial conglomerates, from Sun Life and Marsh and McLennan, to Deutsche Bank, and AXA, to Citicorp and J.P. Morgan. With these consummate *business* firms in control, it is small wonder that the idea of fund management as a *profession* is gradually receding. Using the words I used in my 1971 speech, these firms are "the financial heirs of the (original mutual fund) entrepreneurs . . . if it is a burden to (fund shareholders) to be served by a public enterprise, should this burden exist in perpetuity?"

Apparently the burden *should.* For such trafficking takes place with the tacit consent of fund directors, who seem all too willing to ignore the burdens imposed on funds that are part of giant conglomerates—firms whose overriding goal is a return on *their* capital, even at the expense of the returns on the *fund shareholders'* capital. When such transfers are proposed, fund directors could easily insist on fee reductions—or even mutualization—but they have *never* done so. In a recent sale (for $3.2 billion!) of a large fund manager to Lehman Brothers, the earlier fee structure remained intact. So far, at least, the directors seem disinclined to act even when a scandal-ridden firm is on the auction block (Strong Management) or is already part of a conglomerate (Putnam, which has delivered nearly $4 billion of pre-tax profits to Marsh and McLennan over the past five years.) The idea that "the burdens of public ownership *should* exist in perpetuity" has yet to be challenged.

It Is Time For Change

It is time for change in the mutual fund industry. We need to rebalance the scale on which the respective interests of fund managers and fund shareholders are weighed. Despite the express language of the 1940 Act that arguably calls for *all* of the weight to be on the side of fund shareholders, it is the managers' side of the scale that is virtually touching the ground. To get a preponderance of the weight on the shareholders' side, we need Congress to mandate: (1) an independent fund board chairman; (2) no more than a single management company director; (3) a fund staff or independent consultant that provides objective information to the board; and (4) a federal standard that, using the Act's present formulation, provides that *directors have a fiduciary duty to assure that* "funds are organized, operated, and managed in the interests of their shareholders" rather than in the interests of "their advisers and distributors." (The italicized language would be added to the statute.)

As I wrote five years ago in *Common Sense on Mutual Funds*, changes such as these would at long last allow independent directors "to become ferocious advocates for the rights and interests of the mutual fund shareholders they represent . . . they would negotiate aggressively with the fund adviser . . . they would demand performance-related fees that enrich managers only as fund investors are themselves enriched . . . They would challenge the use of 12b-1 distribution fees . . . and no longer rubber-stamp gimmick funds cooked-up by marketing executives . . . becoming the fiduciaries they are supposed to be under the law."

Alternatively, and perhaps even more desirably, I then argued, the industry may require "a radical restructuring—the mutualization of at least part of the mutual fund industry . . . Funds—or at least large fund families—would run themselves; and the huge profits now earned by external managers would be diverted to the shareholders . . . they wouldn't waste money on costly marketing companies designed to bring in new investors at the expense of existing investors. With lower costs, they would produce higher returns and/or assume lower risks. But regardless of the exact structure—(a new) conventional form or a truly mutual form—an arrangement in which fund shareholders and their directors are in working control of a fund will lead . . . to an industry that will enhance economic value for fund shareholders." And it is in that direction that this industry must at last move.

How to Get from Omega to Alpha

During its 45 years of existence, the Alpha operating model instituted by MIT nearly 80 years ago worked well for its shareholders. Similarly, during Vanguard's soon-to-be 30 years of existence, our Alpha model has resulted in amazingly low costs for shareholders, and generally superior returns compared to peer funds, to say nothing of a spectacular (and unmatched) record of asset growth and enhanced market share. As an illustration of a demonstrably winning strategy for fund shareholders, our Alpha model has met the test of time.

Of course, we have enjoyed an advantage some of our rivals have described as "unfair." Since the fund shareholders own Vanguard—lock, stock, and barrel—*none* of their investment returns have had to be diverted to the owners of a management company—private, public, or financial conglomerate, whatever the case may be. Put another way, our structure has been an essential element in the returns that our shareholders have enjoyed. It shouldn't surprise anyone, for as the economist Peter Bernstein has observed, "What happens to the wealth of individual investors cannot be separated from the structure of the industry that manages those assets."

With MIT long since having abandoned the Alpha model, Vanguard alone has remained to test it. With this single exception, it is the Omega model that prevails. *But I simply cannot accept that today's model can be, as the word "Omega" suggests, the final stage of the mutual fund industry's development*. That this model has ill-served fund investors could hardly be more obvious. This industry's present high level of operating and transaction costs have led—as they must—to a lag in the returns of the average equity fund of some three percentage points per year behind the stock market itself over the past two decades, with similar cost-related lags for the industry's bond funds and money market funds. And our focus on asset-gathering and marketing has helped to create an even larger lag—at least *another* six or eight percentage points behind the returns of the stock market itself, there for the taking—for the average equity fund *shareholder*.

I have no illusions that a return of industry to its original Alpha model will be easy—not in the face of the powerful forces that are entrenched in this industry and whose economic interests are at stake. But I believe that this is the direction in which shareholders, competition, regulation, and legislation will move. While we won't get all the way to that goal in my lifetime, and maybe not even in my children's, I'm certain that investors will not ignore their own economic interests *forever*.

However, if Congress acts to impose on fund directors the responsibilities that so many of us believe they have always held but rarely exercised, I see no reason that full mutualization should be mandated by law. As long as advisory firms are owned by managers who act responsibly and put the interests of their fund shareholders first, and who make manifest their dedication to that proposition in their actions—self-imposed limits on fees and on marketing activities, focus on long-term investment strategies, and superior service to their shareholders—mutualization hardly need be considered. On the other hand, when a fund complex reaches a certain size or age—when it has become more *business* than *profession*—it is high time to demand that mutualization—the Alpha model—be placed on the board agenda, and honestly and objectively considered. It won't be easily done, of course, and literally *no one* in this industry knows as well as I do the obstacles that may be faced in reaching that goal. But if there is a will, there will be a way.

Structure, Strategy, and Spirit

Yet please understand me: While the Omega structure has caused many of the mutual fund industry's serious shortcomings in serving our shareholders, the Alpha structure is hardly a panacea that will cure them. For a mutualization *structure* in which interests of fund shareholders are placed front and center is, in and of itself, not enough. Without the proper *strategy*, such a structure will lead nowhere. In the ideal, the strategy of mutualization would emphasize low operating costs and more, well, Spartan operations, a minimization of the dead weight of marketing costs, and investment policies for stock, bond, and money market funds alike that focus on the wisdom of long-term investing rather than on the folly of short term speculation.

Strategy, alas, does not necessarily follow structure. One need only look at the life insurance field to see how its sensible mutual structure, finally, came to fail. With their heavy emphasis on sales and their apparent lack of concern about costs, nearly all of the giant mutual life insurance companies relinquished the *strategy* of service to policyholders long before they abandoned their original Alpha *structure*, and this dominant industry of a half-century ago has lost much of its earlier appeal to American families.

But even more than *structure* and *strategy* to get today's Omega mutual fund industry back to its Alpha origins, we need the *spirit* of mutuality—a spirit of trusteeship, a spirit of fiduciary duty, an all-encompassing spirit of *stewardship*—a spirit of service to the 90 million shareholders who have entrusted the mutual fund industry with their hard-earned dollars. As the recent scandals show, we need regulation to curb our avarice. As our record since the publication of the SEC's 1966 report has made clear, we need legislation to improve our governance structure, a major step towards the ideal Alpha structure whose development I have described today. But no regulation, no legislation, can mandate a spirit of trusting and being trusted. Trust must come from within the character of the organization—whether Omega or Alpha—and those firms that evince the spirit of trust will ultimately dominate the mutual fund field. Our industry's future depends on the simple recognition that the management of Other People's Money is a loyal duty and solemn trust.

Note: The opinions expressed in this speech do not necessarily represent the views of Vanguard's present management. Much of the material in this statement was included in a presentation before the Boston College School of Law on January 21, 2004.