Creating Shareholder Value:
BY Mutual Funds . . . or FOR Mutual Fund Shareholders?

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Before the
Annual Conference of the Investor Responsibility Research Center
Washington, DC
October 26, 1998

It is an extraordinary honor to be invited to give this keynote address as the IRRC begins its second quarter-century of service to the shareholders of America's publicly held corporations. In fact, as I understand it, I am the first senior executive of a mutual fund firm to be so honored. Clearly our industry—now representing the largest single pool of institutionally owned equities in the nation—has been conspicuous by its absence from participation in your annual conference.

While there are some valid reasons for why you might not have sought our participation in the past, there are—paradoxically enough—also some disturbing reasons why we might not have been particularly enthusiastic about participating in discussion regarding the creation of shareholder value in Corporate America. For reasons that I look forward to discussing with you today, our self-interested modesty—if that is not an oxymoron—is now at the inflection point of change.

The creation of "shareholder value" as the explicit focus of corporate strategy is largely a phenomenon of the 1990s. It has been driven, in part, by the leadership of large institutional investors, notably the states of Wisconsin and Florida, CALPERS, and the New York City funds, supported by the vigorous advocacy of the Council of Institutional Investors. The important research provided by the IRRC and others has also been invaluable. This handful of heroes fully deserves the accolades of America's shareholders who are—lest we forget—the *owners* of our publicly-held corporations.

Enhancing Corporate Value

As the responsibility to enhance economic value has become the prime article of faith in corporate America, it has often been codified in Mission Statements of Board of Directors. For example, the mission statement of the Mead Corporation, the Fortune 500 papermaker, on whose board I've served as an independent director for 20 years, states:

> The mission of the Board is to achieve long-term economic value for the shareholders. The Board believes that the Corporation should rank in the top third of peer companies in the creation of economic value . . . which is created by earning returns over full cycles which are higher than the cost of capital, usually reflected in total return to shareholders.

In Mead's case, total return is measured by Return on Total Capital, with our ROTC then compared with the average ROTC of both our peers and Corporate America in the aggregate. In addition to serving as the benchmark for the evaluation of corporate success by the Board, this joint measurement serves as the basis for Mead's incentive compensation system.

The focus of the Board—and Mead's Board is hardly unusual in this respect—is on the creation of additional economic value, measured by achieving an ROTC that exceeds the cost of capital. If we cannot earn the cost of capital for our shareholders, so the essential logic goes, why should they entrust us with it? As *Fortune* magazine put it: "The true cost of equity is what your shareholders could be getting in price appreciation and dividends if they invested instead in a portfolio about as risky as yours."

The idea that companies must recover their cost of capital is not new. According to a recent article in *The Financial Times*, the eminent British economist Alfred Marshall stated it clearly a century ago. "But," the article added, "it was not systematically applied to management until the 1980s." One current fashion is to cast the issue in the form of "economic value added," or EVA®.[1]

EVA® can be simply described as the amount by which the corporation's return on total capital exceeds the weighted market value of the corporation's cost of capital, measured by the capitalization-weighted average of the interest rate on its debt and the market return on common stocks as a group (adjusted to reflect the riskiness of its stock, using Beta, the conventional measure of the volatility of a company's stock price relative to that of the Standard & Poor's Composite Stock Price Index). In a simple example, if the return of the S&P 500 Index were 15%, a corporation with 100% of its capitalization represented by equity (i.e., without debt) and a Beta of 0.90 would have a cost of capital of 14%.[2] EVA, therefore, would depend on investing capital only in new projects earning, say, significantly more than 14%. While the *precision* of this statistical measure is subject to well-deserved skepticism, the *concept* represents rather elementary common sense.

Time Horizons and the Sources of Investment Return

But if we all can agree that the creation of shareholder value is the critical responsibility of the business corporation, a second important issue remains: how to measure value, and over what period? In the *long run* the returns on a corporation's shares in the stock market are determined by its investment fundamentals—earnings growth and dividend yields. For example, the real earnings and dividends (after inflation) of U.S. corporations have aggregated just short of 7% over the past two centuries, almost precisely equal to the real return of 7% in stock prices. Over the long pull, investment fundamentals, not market valuations, are the piper that calls the tune.

Over the *short run*, however, the fundamentals are often overwhelmed by the deafening noise of speculation—the price at which the stock market values each dollar of earnings. This noise can be surprisingly durable. On a one year basis, as shown in the chart below, the gap between annual fundamental rates of return on stocks and their market return can be staggering, exceeding 10 percentage points (!) in more than two-thirds of the 125 rolling ten-year periods since 1872, and exceeding 5 percentage points in more than 8 out of 10 periods. On a ten-year basis, the gap shrinks considerably, almost never exceeding 10%, but exceeding 5% in one-fourth of all periods, and 2% in two-thirds. Over 25-years, however, the gap shrinks radically, exceeding 2% in fewer than one-quarter of all periods and never exceeding 5%.

[1] While it may seem anomalous that such common words can, in effect, be patented, EVA® is a registered service mark of Stern Stewart & Co. The logic of U.S. patent law never ceases to amaze me.
[2] Risk-free rate + Beta (stock market return – risk-free rate = cost of capital). Therefore: 5% + 0.9 (15% - 5%) = 14%.

Examining 125 Years of Market History

Holding Period	**Difference between Fundamental and Market Returns** +2%	+5%	+10%
1 Year	**94%**	**84%**	**68%**
10 Years	**62**	**27**	**3**
25 Years	**23**	**0**	**0**

Note: A 5% gap for example, would mean that if the fundamental return were 10%, the market return might be more than +15% or less than 5%.

One need look no further than the 1970s and 1980s to see that wide variations can take place during decade-long periods. As shown in the table below, during the 1970s the *fundamentals* of investment, measured by earnings growth and dividend yields on the S&P 500 Index, provided a return of 13.3% per year, but the total stock market return was but 5.9% annually. The *reduction* in valuation of –7.6% per year reflected a drop in the price-earnings ratio from 15.9 to 7.3 times. During the 1980s, by contrast, the fundamental return of 9.6% came hand in hand with a valuation increase of 7.8%, as p/e ratios more than doubled, from 7.3 to 15.5 times, bringing total annual return to 17.6%. While, measured in nominal terms, corporate America's performance was *worse* in the 1980s than in the 1970s in terms of fundamentals (+9.6% vs. +13.3%), it was far *better* in stock market terms (+17.6% vs. +5.9%). Turnabout, apparently, is fair play. For during the two decades combined, the fundamental return of 11.5% was virtually identical to the market return. The cacophony of speculation was, on balance, conspicuous by its absence.

The Golden Decade Follows the Tin Decade

	1970s	**1980s**	**1970 and 1980s**
Fundamental Return[1]	**13.3%**	**9.6%**	**11.6%**
Speculative Return[2]	**-7.6**	**+7.8**	**-0.1**
Market Return	**5.9%**	**17.6%**	**11.5%**
P/E Ratio – Start	**15.9X**	**7.3X**	**15.9X**
End	**7.3X**	**15.5X**	**15.5X**

[1] **Earnings Growth + Dividend Yield**
[2] **Annualized Impact of Change in P/E Ratio.**

We know—we *know*—that in the long-run, market returns represent the triumph of investment fundamentals—earnings and dividends—over speculation in the market's valuation of these returns. Yet I have no doubt that during recent years it is speculation that has been in the driver's seat. This trend would not have surprised the worldly wise Lord Keynes, who concluded (in the early 1930s) that the powerful role of speculation in the markets was based on ". . . the conventional valuation of stocks based on the mass psychology of a large number of ignorant individuals." Unable to offset the mass opinion, he predicted, professional investors would try to "foresee changes in the public valuation."

His conclusion has been reaffirmed—and then some! In the past three decades, expert professional investors have come to dominate the financial markets—managers of pension funds and mutual funds alike—have largely replaced ignorant individuals in the investment marketplace. Rather than endeavoring to place appropriate values on business enterprises, these pros are, in a real sense, focusing their professional careers on attempting to foresee changes in the public valuation of stocks. In the long run, of course, precious few will succeed in doing so.

The Consequences of Using Market Returns as the Standard

What is more, there are some deeply troubling aspects in the acceptance of the returns generated in the stock market as the sole ingredient of the cost of equity capital. The stock market—as recent wild fluctuations have demonstrated yet once again—is a fickle, flighty investment in the short run—"a tale told by an idiot, full of sound and fury, signifying nothing," to borrow a phase from the Bard. In the long run—as every intelligent investor, from Alan Greenspan to Peter Bernstein to Peter Lynch knows—it is the sum total of earnings and dividends that controls market returns. Nonetheless, in the short run it is the valuations that speculators place on these investment fundamentals that drive market returns—from day to day, and even from decade to decade, before the fundamentals finally reassert themselves and the market reverts to its long-term norm. But only until the next cycle begins.

Because of these periodic swings between optimism and pessimism, between greed and fear, the considerable success of corporate managers in building earnings and dividends at a 13% annual rate during the 1970s was translated into a shabby total market return of less than 6%. While corporate managers were *less* successful in the 1980s, providing a return from earnings and dividends of less than 10%, investor emotions took a 180° turn and valuations more than doubled, carrying the market to an outstanding 17% return.

The reliance on market returns as the ultimate standard gives rise to an important issue in corporate governance: the emergence of stock options as the driving force in executive compensation. During the second half of the 1990s, this system has provided huge rewards to managers of corporations whose stocks have soared to new heights in the great bull market. Leaving aside the issues of paying executives on the basis of what often prove to be market whims, and accounting for option costs without diluting reported earnings, there is the critical question of what to do when the law of gravity in the financial markets—reversion to the mean—strikes, and stock prices tumble, even in the face of uninterrupted earnings growth.

When this happens, it must not be unheard of for management to tell the directors: "our options are so far underwater that we have no incentive to improve. We need motivation; we need out team to stay; we need to enhance shareholder value. So please reprice the options." And the directors are apt to do just that. It is a perverse sort of argument, but the practice is taking hold. Nearly 10% of the 1500 large companies tracked by IRRC have repriced options in the past two years. And given the precipitous drop in the prices of so many stocks in recent months, repricing seems certain to expand in the months ahead.

Repricing is clearly an emerging corporate governance issue. Necessary as it may—or may not—be, this creation of wealth without risk (a nice way to live!) clearly dilutes shareholder value. I believe that institutional shareholders should take a firm stand with the companies whose shares they own, demanding that such repricings be submitted to shareholders for approval. At the same time, the terms and conditions of repricing should be monitored, for repricing schemes range from "grossly unfair" to "reasonable under the circumstances." We should oppose the former and accept, however reluctantly, the latter. The time is now—well before the 1999 proxy season—for institutional investors to communicate their position to the directors and managers of their portfolio companies.

The whole stock option process, moreover, based as it largely is on simple price appreciation, needs serious reconsideration. Why shouldn't options be related to the extent to which the corporation earns returns in excess of its cost of capital, or to its performance relative to its peers, or even to the performance of its shares relative to the stock market as a whole? Targets that are too easy to hit result in the disproportionate sharing of corporate value between the corporation's management and its shareholders, and distort our financial system.

I hope that institutional investors and individual investors alike will recognize the folly of applauding corporate managers solely on the basis of evanescent market returns, without due regard for the hard work involved in generating the underlying investment fundamentals that are required to deliver returns that exceed that cost of capital over the long run.

The Rise of the Institutional Investor

The fact that *market* return seems to have taken the place of fundamental *investment* return in measuring shareholder value has had important implications for corporate governance. Surely the fact that shareholders must be served is as it should be, but the responsibility of focusing on the nature of returns, and the time-frame over which they should be measured, will devolve largely on the institutional investor.

Today, institutional investors have the power to make a difference in corporate governance. When the 1950s began, institutions controlled less than 5% of all U.S. equities. Pension funds were just coming into being, and mutual funds, then the largest institutional investor, accounted for just 2% of the stock market's value. By the time that 1970 rolled around, the institutional share had risen to 27%, growing to 43% in 1990. Today, institutional investors own more than 70% of all U.S. stocks. In fact, the 100 largest financial institutions alone now own more than half of all U.S. corporate equities, valued at about $5 trillion. It is this handful of firms that can be the force that controls Corporate America.

The latent power represented by these institutions has the potential to reverse the trend toward the separation of corporate ownership and control that so concerned Adolf Berle and Gardiner Means in the early 1930s.[3] As then-Comptroller Ned Regan of New York told this convocation a year ago, financial institutions have "sent a wake-up call to American business." He described this wake-up call as the third such call to rouse corporate CEOs, following the force of global competition, and then the explosion in corporate takeovers. The call from institutional investors, eager to enhance returns and bound by their fiduciary duty to prudently maximize returns for their beneficiaries and shareholders, may well be the final wake-up call that American business needs to receive. Final call or not, it surely has a ring whose intensity has risen measurably over the years, and it is now a call that can not be ignored by Corporate America.

Institutions have the power to make their will be done. The three principal classes of investors a lone—mutual funds, state retirement plans, and corporate pension funds—hold fully 40% of the market value of the nation's publicly held corporations today, eight *times* their 5% share in 1980. But the relationship of the holdings of these three groups of institutions has changed substantially during this period. As shown in this table, fifteen years ago, long after mutual funds had relinquished their leadership, corporate pension funds held sway, holding 68% of these institutional assets. But that share has since been cut by one-half, to 34%. State and local retirement plans have increased their share from 17% to 25%. Fastest growing of all has been the group's previously deposed leader, for mutual funds have leaped from 15% to 41% of the group's aggregate, and now represent its largest single unit.

[3] "The Modern Corporation and Private Property."

	Corporate Retirement Plans		State and Local Retirement Plans		Mutual Funds		Total	
	$ Billion	**Percent**	**$ Billion**	**Percent**	**$ Billion**	**Percent**	**$ Billion**	**Percent**
1983	**$350**	**68%**	**$90**	**17%**	**$79**	**15%**	**$519**	**100%**
1990	**562**	**51**	**293**	**27**	**249**	**23**	**1,104**	**100**
1993	**938**	**45**	**531**	**25**	**634**	**30**	**2,103**	**100**
1996	**1422**	**37**	**956**	**25**	**1,514**	**39**	**3,892**	**100**
1998*	**2005**	**34**	**1,482**	**25**	**2,396**	**41**	**5,882**	**100**

***First Quarter**

The response to corporate governance issues by the trustees and managers of these three institutional asset pools has traditionally been so different in degree that it can easily be mistaken as a difference in kind. The *public* funds have been, dare I say, in the vanguard of corporate activism, while the *private* funds—corporate pension plans and mutual funds—have been conspicuous by their absence from the fray.

The Changing Focus of Institutional Voting Activism

It is relatively easy to understand why the private investment sector stood back when significant institutional activism emerged in the early 1970s. Most of the early issues related to proxy proposals by small shareholders on social and ethical issues—minority hiring, pollution, recycling, and the like. Many institutional managers had either a sort of "ho-hum" reaction to these proposals, or a view that it was up to the corporations managers to resolve them. So far as I know, none of these proposals ever received a significant portion of shareholder votes.

In the late 1970s, however, the first issue to receive compelling public attention arose: South Africa. The rigorous separation of races under the doctrine of apartheid caught the investment world's attention, and shareholder proposals that corporations divest themselves of business interests in the Union of South Africa were rife. Without, I think, adequate consideration of whether U.S. corporation were part of the problem—or, instead, could be part of the solution—this pressure, especially from public funds and college endowment funds, caused many corporations to withdraw from South Africa, even as it brought others to adopt the Sullivan Principles for acceptable practices in doing business there. Ever quick to spot an investment opportunity, many institutional managers ducked the issue by offering "South-Africa-Free" portfolios. (Even index fund managers offered "S&P 500 Lite" portfolios.) Changes in South Africa, however, have now made this issue substantially moot.

But as we moved into the 1980s, issues of corporate performance, corporate governance, executive compensation, and mergers and takeovers rose to the fore. These issues get to the heart of the question of the corporation's determination to enhance shareholder value, and the extent to which shareholders can influence corporate policy, strategy, and management. These issues are not going to vanish any time soon.

The institutional community has had a split response to these new, bottom-lined-related, issues. On the one hand, the members of all three pools—private plans, public funds, mutual funds—have generally proved ready to respond at a moment's notice to a merger proposal, or a takeover bid offering a steep premium over the current market value. "Analysis of long-term prospects be damned, let's tender first and ask questions afterward," was the implicit response.

On the other hand, the large public funds, almost alone, became corporate activists, seeking greater management focus on the creation of shareholder value, and in some cases placing proposals in the proxies of corporations whose managements appeared not to get the message. The large public funds—with long-term investment horizons, low portfolio turnover, and a market indexing orientation—also took initiatives with managements of corporations deemed to be under-performing in the stock market, even demanding changes in boards of directors. The record would seem to confirm, in particular, that the handful of large state retirement plans that I applauded at the outset have enjoyed some success when they have undertaken initiatives to influence the policies of major corporations.

The Silence of the Mutual Funds

During those corporate battles, mutual fund managers in general (Michael Price being a rare exception) were well behind the lines. Few, if any, make proxy proposals. Many, if not most, performed their proxy voting on a rote basis, failing to carefully attend to the issues raised and automatically voting in favor of management recommendations.[4]

There are lots of reasons. First, improving shareholder value is a long-term proposition, and most mutual funds are short-term investors. The industry's annual rate of portfolio turnover is 85%, suggesting an average holding period of about 1.2 years for a given security. (The average turnover rate for the highest quartile of funds is 196%--barely a six-month holding period—while the large state retirement funds are estimated to have turnover in the 10% to 20% range.) As Columbia Law School Professor Louis Lowenstein expressed it in a recent article, mutual fund managers "exhibit a persistent emphasis on momentary stock prices. The subtleties and nuances of a particular business utterly escape them."

Happily, there is every reason for this situation to improve. For there is, by definition, one type of equity strategy that is ironbound to invest for the long term. This strategy precludes both the short-term "I don't care" approach, and the longer-term but threadbare "If I don't like the management, I sell the stock" approach. It is called market indexing, and mutual fund investors are increasingly embracing this approach. A decade ago, index funds, then as now largely targeted to the S&P 500 Index, represented barely 1% of equity fund assets. Today, thanks to a combination of excellent Index performance and strong cash flow, index funds now represent nearly 8% of equity fund assets. Given that this year index funds are accounting for fully 25% of equity fund cash flow, it would not be unreasonable to expect index fund assets to reach a 15% share of mutual fund assets well within the next decade.

With that penetration, index mutual funds would be on their way to approaching the present 22% share that indexed equities represent in public and private pension plans. This number, however, has grown at a snail's pace; in 1990, the index share was 20%. Thus it may be that, through index mutual funds, the fruition of the long-delayed participation of the public in the indexing strategy will add considerable weight to the dominant role that indexing now plays in the retirement plan world. Since the growth in indexing by retirement plans since 1990 has been glacial (up only from 20% to 22%), it is not a moment too soon for the average investor to adopt this remarkably successful investment strategy, and at the same time add momentum to its growth.

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[4] Note: Vanguard, I acknowledge, has rarely played an activist role, although John B. Neff, long-time portfolio manager of Vanguard Windsor Fund, was a vocal critic of a number of corporate proposals, and unstinting in writing to the boars of directors involved, alas, without notable success. Our own procedures entail a thorough examination by our staff of all issues raised in the proxies we receive (our funds own shares in some 5000 U.S. companies), and we vote them in accordance with principles approved by the Directors of the Vanguard Funds. These principles include generally leaving social responsibility issues to the corporation's board, opposing barriers to mergers or takeovers, and supporting competitive compensation packages unless excessive dilution is involved. We rely heavily on the work of the IRRC. My impression is that only a minority of mutual funds follow such thorough procedures. TIAA-CREF also has excellent voting procedures, and is a more active participant in governance issues than is Vanguard.

Indexing strategies now represent 17% of the total assets of the combined institutions, up from 12% in 1985 and 16% in 1990, yet even now only about 8% of the market value of *all* equities (including individuals, endowments, and bank trust accounts owning stocks directly) is committed to this approach. Surely much more growth lies ahead. The chart below highlights this growth:

	Private and Public Pensions		**Mutual Funds**		**Total Pensions and Funds**		**U.S. Stock Market**	
	Indexed Dollars	**% of Assets**	**Indexed Dollars**	**% of Assets**	**Indexed Dollars**	**% of Assets**	**Total Dollars**	**% Indexed**
1985	**$90.6**	**14.7%**	**$.6**	**.5%**	**$91.2**	**12.4%**	**$2,195.0**	**4.2%**
1990	**172.7**	**20.2**	**4.9**	**2.0**	**177.6**	**16.2**	**2,957.6**	**6.0**
1993	**293.0**	**19.9**	**23.3**	**3.4**	**316.3**	**15.1**	**4,791.0**	**6.6**
1997	**672.0**	**21.9**	**141.7**	**7.2**	**813.7**	**17.0**	**10,271.0**	**7.9**

Once investors adopt the market-indexing strategy, they hold stocks in the same companies, in effect, forever. So the *only* way to add economic value becomes the exercise of the same governance responsibility as would characterize the sole owner of a private business: the shareholder comes first. It is hard to imagine that the trend toward indexing will not mean that all institutions—including mutual funds—will become far more assiduous, not only in their voting policies and in making proxy proposals where necessary, but in expressing their informed opinions to corporate directors and managers.

But the mutual fund industry is still largely driven by a marketing system that places a premium on short-term performance, which leads to an incentive system in which rewards go to fund managers who have achieved outstanding past returns. (High fund returns yield more fund assets, and more assets generate higher fees to advisers.) Inertia ("we've never *done* it that way") is inevitably part of the forbearance problem, too. While the costs of greater attention and thoroughness would be trivial to any but the smallest fund groups, the benefits of activism are apparently deemed too uncertain for most funds to undertake the effort.

Another issue our industry faces in a more active stance—and it is an important one—is that of potential conflicts of interest. When a fund group is selected to run a corporation's $1 billion-plus retirement or thrift plan, and issues regarding shareholder value, or even a hostile takeover attempt, arise, the fund manager may well be tempted to consider the interests of the corporation's management rather than the fund's shareholders. As one example, in the early 1990s, one large fund organization (not, I hasten to add, Vanguard) that was among the most vocal critics of a tough Pennsylvania anti-takeover bill, switched sides and became a supporter. The target corporation, a strong advocate of the bill, promptly retained the fund firm to manage its 401(k) thrift plan. Whether it was a mere coincidence or an isolated example, it surely sends up a warning flag.

Mutual Funds: The Artillery or the Target?

In addition to the reluctance of the fund industry to actively participate in corporate management generated by our short-term focus, our inertia in governance issues, and the conflicts of interest we face, there is all too likely a final factor that may dissuade mutual funds from an activist-investor stance. This issue gives me a neat transition to the final section of my speech: corporate governance and shareholder value issues in the fund industry itself. Taking a "people who live in glass houses shouldn't throw stones" stance, we would prefer not to advise the companies in our portfolios about governance when our own houses are so fragile. We may not mind being the artillery of shareholder activism, but we don't want to be its target.

In short, a challenge *by* mutual funds to Corporate America to create economic value is problematic unless we can crate greater economic value *for* our own mutual fund shareholders. Our responsibility to do so is particularly large since the traditional mutual fund governance system is, as far as I can determine, a unique exception to the rules under which ordinary business and financial corporations are governed. In our business, the fund corporation is merely a corporate shell, a holding company for marketable stocks and bonds which delegates virtually all of its activities—from the choice of its very name, its investment strategy and policies, and its administration, distribution, and portfolio management—to an external corporation.

The process begins when the fund's manager sets its own fee for managing the fund. It is duly approved by the fund's independent directors, unaffiliated with, but appointed by, the manager. The result, as you might expect, lives up to Warren Buffett's aphorism, "negotiating with one's self seldom produces a barroom brawl." To those who are unfamiliar with our industry, this structure must seem bizarre and rife with potential conflicts of interest. And so it is, especially since the ownership of mutual funds is so diffused among investors of relatively modest means. As a result, the kind of institutional intercession we see in Corporate America is conspicuous only by its absence.

The industry, however, advances powerful arguments that the system effectively serves mutual fund shareholders. It is the shareholders, after all, who *elect* the directors, who in turn assume a fiduciary duty to protect them. Excessive or not, the costs, like the past returns and potential risks, are fully disclosed. Shareholders can vote against a fee increase, and, if they aren't satisfied with the fund, they can redeem their shares without cost (leaving aside capital gains taxes and sales loads). All of this is quite true in principle. But in practice, does the mutual fund governance system work effectively to serve shareholders?

The Inevitable Failure to Earn the Cost of Capital

The best way to answer that question is to return to the issue of the creation of economic value with which I began these remarks. Whether or not the fund governance system works effectively depends upon the extent to which mutual funds earn the cost of capital for their shareholders. Doing so, of course, would require that funds earn for their shareholders at least what they could otherwise "be getting in price appreciation and dividends if they had invested instead in a portfolio about as risky," using the words from *Fortune* that I cited at the outset.

A business corporation, as I have noted, calculates its cost of capital based on its debt-equity ratio, but since 100% of a given mutual fund corporation's capital is equity, its cost of capital is the return of the stock market (adjusted for the fund's relative risk). *Given that standard, mutual funds as a group must fail to earn their cost of capital*. The record is clear on that point. Measured over the past 50 years, the average equity mutual fund has carried a volatility risk quite similar to that of the market, but has *lagged* the market return by about 1 ½% annually over the long term, and about 2 ¼% over the past 15 years.

The reason that mutual funds as a group have earned only about 85% of their cost of capital is the heavy costs that they incur—not only operating expenses and advisory fees, but portfolio transaction costs. As a group, their professional managers, despite their expertise, have failed to outperform the market *before* the deduction of costs. So their costs doom them to below-market returns. And their costs have been rising, as advisory fees move ever upward, as new fees (such as 12b-1 marketing fees) are added, and as portfolio turnover escalates. The expense ratio for the average equity fund has risen from about 1.0% in the early 1960s to 1.6% now. During the same period, industry-wide portfolio turnover has risen from less than 20% to nearly 90%. The "double whammy" represented by this rise in total costs appears primarily responsible for the rise to more than 2% in the shortfall of annual fund returns relative to their cost of capital.

How Effective Are Fund Directors?

The mutual fund governance system, it seems to me, bears considerable responsibility for these problems. If directors of funds that fail to earn their cost of capital by a wide margin believed, as corporate directors do, that earning the cost of capital for shareholders is valid policy goal, they might at least consider terminating their manager and getting a new one. While they are legally free to do so, such an action has virtually *never* transpired. Or they could get to the root of the problem by reducing advisory fees. But in fact they persist in increasing them, and in adding yet new types of fees, even as the evidence of this proposition is crystal-clear: *the shortest route to top-quartile investment performance is bottom-quartile expenses.*

What is more, even in the face of compelling evidence that portfolio turnover has a neutral impact at best on pre-tax fund returns to shareholders and a devastating impact on their after-tax returns, directors apparently accept without challenge today's high turnover mania. Why do they not press managers to reduce turnover if there is no evidence that demonstrates that all of our industry's feverish and costly transaction activity benefits shareholders? Why don't they demand that the adviser make available low-cost, passively managed index funds, which have, for obvious reasons, outpaced high-cost, actively managed funds? Yet few of the major fund groups have been willing to do so. Low-cost index funds, in fact, have earned net returns equal to about 99% of the cost of capital, a remarkable margin over the 85% ratio for the average managed fund.

Faced with the cost of capital as a standard—measured with such surpassing ease in the mutual fund field—and the clear reasons for the persistent shortfall of most mutual funds, where *are* the independent directors? While this industry describes them as watchdogs for the fund shareholders, Warren Buffet calls them "cocker spaniels" and *The New York Times* depicts them as "empty suits." Suffice it to say that the record is bereft of evidence that directors of any mutual fund have taken affirmative action when the fund has persistently failed to earn its cost of capital, even when the margin is wide. It's not a record of which this industry should be proud.

Paradoxically, however, even as we display no interest whatsoever in using tough standards of corporate governance for our own shareholders, we increasingly apply them to the corporations in our portfolios. A few years ago, the chairman of one giant fund complex lectured the directors of corporations whose shares were held in his fund's portfolios. He said that his funds wanted "directors who will mind the store for us, making sure management's doing a good job . . . If not, the board has to fire, rehire, and pay new managers . . . We should have intelligent national laws that spell out directors' accountability to shareholders . . . (We need) boardrooms that are responsible to shareholders' interests and not rubber stamps for the Chairman's agenda.

What can one say other than, "physician, heal thyself." I simply can't imagine that even the most vigorous defender of the peculiar governance structure of the mutual fund industry would dare to say that our own governance standards meet the stern and valid test laid down by this fund leaders, even as we begin to apply these standards to Corporate America with increasing vigor. Yet state corporate law makes no distinction between the duties of corporate directors and fund directors. Federal law, in fact, imposes an added responsibility on the shoulders of fund directors, an explicit directive that funds must be organized, operated, and managed in the interests of directors, officers, or investment advisers.[5]

[5] Investment Company Act of 1940, Section 1(b)(2)

Creating shareholder value as the pre-eminent priority of corporate management is a sound concept, an article of faith in the financial system of the United States, now spreading all over the globe. Only the mutual fund industry seems to be immune from the process. It is high time for this issue to be raised, and high time that we focus on the principle of earning the maximum possible portion of our cost of capital for our shareholders. They deserve no less. For they are our *owners*.

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