The Power of Words, Ideas, Ideals, and Books

“Common Sense on Mutual Funds”

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It’s an extraordinary honor for this mere businessman-author to find himself before an audience that has had (or will shortly have) the opportunity to listen to such distinguished and truly creative authors as Frank McCourt, Scott Turow, Joyce Carol Oates, and P.D. James. Unlike any of these award-winning writers of fiction, I ply my writing trade in the mundane fields of the financial markets.

Despite my far lesser task of producing prose that is largely expository and explanatory, writing comes not easily to me. While I’ve been at it, arguably, for a full half century, I still prepare a written outline, seek out appropriate anecdotes and interesting illustrations, endeavor to prove my points with statistical evidence from the past, and, when the opportunity arises, add a modest rhetorical flourish. But the real work begins—perhaps this is so for all authors—when I sit down at a table with a lined pad before me, frighteningly blank, and touch pen to paper. Back and forth goes my pen, line after line, until the first chapter is complete, and on and on, chapter after chapter, the beginning, the middle, and the end, finally complete.

Alas, my first drafts are rarely pretty, for my gift for writing is limited. I compensate by editing . . . and editing—first mercilessly, then for continuity, finally for style, and often as many as eight times. And after the deadline arrives and the copy goes to the printer, the first proofs return, only to be edited again. The second proofs get the same treatment, albeit lighter. Publishers, you rightly suspect, do not care at all for this practice, but best to make the book as good as you can before it is published for the world to see. Even as nearly all—if not all—human endeavors, writing is hard work. Or at least that is so in my case.

I can fairly date the beginning of my major concern with writing to the autumn of 1945, when, in my junior year at Blair Academy, I studied under my first truly challenging master of English by the name of, believe it or not, Henry Adams. He was an inspiring teacher, who in my senior year was succeeded by Marvin Garfield Mason, an even more memorable character. Mr. Mason seemed somehow to sense a grain of writing potential within me, for he marked my weekly themes with the enthusiasm of the devil himself, his red pencil flying across my every phrase, or so I recall it today. What he drummed into me, most of all, was what Macaulay wrote about Dr. Johnson: “The force of his mind overcame his every impediment.”

Thanks to those two masters under whose tutelage I served, I was well prepared for the challenge of Princeton University. And during my first two years there, I became a passable—no more than that!—writer of themes and papers and examinations. But it was the writing of my senior thesis that became the magnum opus of my writing career up to that time. And, as it turned out, the genesis of my long career in the mutual fund industry. For, determined to write my thesis on a subject which no previous thesis had ever tackled—there went Adam Smith, Karl Marx, and John Maynard Keynes!—in December 1949 I
stumbled across an extensive article in *Fortune* magazine that would change my life. The article described the mutual fund industry as “tiny but contentious.” While I had never before even heard the term “mutual fund,” I decided on the spot that this industry should be the topic of my thesis. I entitled it, “The Economic Role of the Investment Company,” and so, just 50 years ago last December, my long journey in this industry began.

**The Power of Libraries . . . and Words**

I must add that I came across that article in the reading room of the splendid, then-newly opened Firestone Library at Princeton. In that library, I spent hour after hour studying during my college years, did my economic research, and wrote my 140-page tome in the tiny carrel each senior was given for his work. To this day, libraries are an important concern of mine, and I was thrilled to present Blair’s splendid-new Timken Library with a full set of the 20-volume second edition of the Oxford English Dictionary when it was published a few years ago.

I love the English language, and I look at my own OED II virtually every day, not only to make sure I get my words just right, but to enjoy learning from whence all those words come. Every word comes from **somewhere**! Indeed, in my chapter “On Leadership” in *Common Sense on Mutual Funds*, I devote several pages to describing the power of the right words to “shape the way investors look at us, and the way we look at ourselves.” (*Employee*, for example is banned in favor of *crewmember*; *customer* is banned in favor of *client*; and *product* is banned in favor of *mutual fund*.) I know that all of you here this evening share my passion for the words of our splendid mother tongue, and urge you to pass that passion along to others, and to support your local libraries with the same passion.

During those hours in Firestone Library in 1949-1951, my thesis took shape. While it seems problematical, as some have generously alleged, that it laid out the design for what Vanguard would become, many of the practices I specified then would, 50 years later, prove to lie at the very core of our success. “The principal function of mutual funds is the management of their investment portfolios. Everything else is incidental . . . Future industry growth can be maximized by a reduction of sales loads and management fees . . . Mutual funds can make no claim to superiority over the market averages.” And, with a final rhetorical flourish, funds should operate “in the most efficient, honest, and economical way possible.” Were these words an early design for a sound enterprise? Or merely callow, even sophomoric, idealism? I’ll leave it to you to decide. But whatever was truly in my mind all those years ago, the thesis clearly put forth the proposition that mutual fund shareholders must be given a fair shake. Since our outset in 1974, that is what Vanguard has been all about. And, I can assure you, it works!

My next wonderful piece of good fortune came my way when fellow Princetonian—class of 1920—Walter L. Morgan, who founded Wellington Management Company and Wellington Fund in Philadelphia in 1928, read my thesis. He was impressed enough to offer me a job after my graduation from college in 1951. While I should have leapt at the chance offered to me by this great man—and my good friend until his death at age 100 in 1998—I agonized about the risks of going into what was then a tiny business. But, my courage strengthened by the conclusion in my thesis that the industry’s future would be bright, I finally accepted the offer. And a good thing, too!

By 1965, Mr. Morgan had made it clear that I would be his successor. At that time, the company was lagging its peers, and he told me to do whatever it took to solve our problems. Young and headstrong (I was then but 36 years of age), I put together a merger with a high flying group of four “whiz kids” who had achieved an extraordinary record of investment performance over the preceding six years. (Such an approach—believing that *past* performance has the power to predict *future* performance—is, of course, antithetical to everything I believe today.) Together, we five whiz kids whizzed high for a few years, and then we whizzed low. The speculative fever in the stock market during the “Go-Go Era” of the
mid-1960s died, and in the early 1970s was followed by a 50% market decline. The once happy partners had a falling out, and in January 1974 I was fired from what I had considered “my” company.

**In the Business and Out . . . And In Again**

But without both the 1951 hiring, which providentially brought me into this industry, and the 1974 firing, which abruptly took me out of it, there would be no Vanguard today. Nonetheless, removed from my position as head of Wellington Management Company, I decided to pursue an unprecedented course of action. The Wellington Management Company directors who fired me comprised a minority of the Board of Wellington Fund itself, and I went to the Fund Board with a novel proposal: Have the Fund, and its then-ten associated funds, declare their independence from their manager. It wasn’t *exactly* the Declaration of Independence telling King George III to get lost, as it were, in 1776. But *fund independence*—the right to operate in the interest of their own shareholders, free of conflict and outside domination—was at the heart of my proposal.

Thanks largely to the determination of a key Wellington Fund director, a Philadelphian named Charles D. Root, Jr., the Fund Board, after seven months of heated debate, accepted my proposal by the narrowest of margins. Perhaps because there are so few true leaders in our corporate society, such leadership by an independent director is rare in America today. I can assure you that it was even rarer all those years ago. But happen it did, yet another happy accident, and the design of the new firm—a firm that would be owned, not by outsiders, but by the funds themselves—was finally accepted by the Board during the summer of 1974.

Whether each of these events was fortuitous, or accidental, or Heaven-sent, I’ll leave for you to decide. But another was about to happen. The new firm needed a *name*. In September, not a moment too soon, a dealer in antique prints had come by my office with some small engravings from the Napoleonic War era, illustrating the military battles of the Duke of Wellington, for whom Mr. Morgan had named his first mutual fund all those years before. When I bought them, he offered me some companion prints of the British naval battles of the same era. Ever enticed by the sea and its timeless mystery, I bought them, too. Delighted, the dealer gave me the book from which they had been removed. After he left, I browsed through it, even as I had browsed through *Fortune* 25 years earlier. I came to the saga of the historic Battle of the Nile (recently designated by *The New York Times* as the greatest naval battle of the millennium). There, in 1798, Lord Nelson sank Napoleon’s fleet, ending his dream of world conquest. I paused, and noticed Nelson’s triumphant dispatch “from the deck of HMS Vanguard,” his victorious flagship. The naval tradition of the name “Vanguard,” together with the leading-edge implication of the noun *vanguard*, was more than I could resist. And two weeks later, on September 24, 1974, “The Vanguard Group, Inc.” was born—in a profound sense, the child of fortune.

**The Power of Ideas**

But, truth told, there is more to Vanguard than this incredible series of happy accidents. For the firm is, above all, driven by the power of a few simple ideas. So let me take you now to the character and nature of the company that had just come into existence. Our basic idea was to have the mutual funds themselves responsible for their own governance and administration—after all, that’s what independence was all about for the funds in 1974 even as it was for the colonies in 1776. By taking this step, we broke new ground in the fund industry. Not only would we operate the funds at cost, but we would operate them at the lowest possible cost, disciplined and sparing in every expenditure, always asking ourselves: “Is this expenditure necessary?” Or, to put it another way: “If this were my own money rather than the shareholders’ money, would I spend it?” (Happily for our investors, I really hate to spend my own money!)
In many businesses, all of this cost discipline could be merely a finicky policy or a harmless diversion. But in investing, cost matters. It doesn’t stretch reality to point out that in most respects the stock market is a casino. A casino in which the investor-gamblers swap stocks with one another, a casino in which, inevitably, all investors as a group share the stock market’s returns, no more, no less. But only until the rakes of the croupiers descend. Then, what was a fruitless search by investors to beat the market before costs—a zero-sum game—becomes a negative-sum game after the costs of investing are deducted—a loser’s game.

And the way the mutual fund game is played today carries heavy costs and entails lots of croupiers, each wielding a wide rake. The cost of sales commissions when (most) funds are purchased. The opportunity cost when stock funds hold cash reserves in rising markets. The cost of fund management fees, operations and marketing—all those television advertisements you see. The transaction costs expropriated by brokers and investment bankers when fund managers buy and sell the stocks in fund portfolios. The cost—and it is huge—of the excessive taxes to which fund shareholders are subjected unnecessarily, the result of the incessant, often mindless, turnover of fund portfolios—now nearly 100% per year. One can only be reminded of Pascal’s words: “All human evil comes from this, man’s inability to sit quietly in a room.”

How much do costs matter? Hugely! Taking into account sales charges, management fees, operating expenses, and portfolio turnover, the average mutual fund deducts about 2½% per year from investor returns. Assuming—an arbitrary assumption indeed—that the manager is able to match an annual stock market return of, say, 12½% before costs, the shareholder would receive a net return of 10% after costs. Result: 20% of the investor’s return is consumed by costs in one year, 29% in a decade, and fully 45% of the return is consumed in a quarter century.

Nearly one-half of the cumulative return generated by the stock market has been confiscated by the costs incurred by the typical mutual fund. And that’s before taxes. In a market returning 12 ¼% annually, excess taxes generated by unnecessary turnover could easily reach 2% per year, further slashing that 10% after-cost return to an 8% after-tax return. Now, the croupiers have consumed 36% of the investor’s return in a year. With compounding, it leaps to 48% in a decade and—I’m glad you’re sitting down!—fully 68% in a quarter century. That leaves but 32% of the market’s return remaining for the investor, who put up 100% of the capital and took 100% of the risk. Yes, costs matter.

The Powerful Idea of the Index Fund

The power of the idea that costs are crucial quickly brought Vanguard to the two major mutual fund innovations with which I’ve been most closely identified—one very well known, the other barely known at all. Well-known—indeed it seems almost folklore now—is the very first investment idea we put into practice, the very first step in the development of our corporate strategy: Our pioneering formation of the first index mutual fund in mid-1975. Only months after we began operations, I began to develop the rationale for the index fund. A quarter century earlier, the concept of an index fund had received at least tangential focus in my Princeton senior thesis. (Remember, “mutual funds can make no claim to superiority over the market averages.”) And by the mid-1970s, the academic financial journals had published several articles outlining the case for an index fund. In order to prove that the gambling casino theory that I mentioned earlier worked in practice, I calculated by hand the annual returns generated by the average mutual fund during the previous 30 years, and then compared them with the returns of the Standard & Poor’s 500 Index. The Index won by an annual pre-tax margin of 1½%—virtually identical to the actual costs assessed by the mutual fund croupiers during that earlier, lower cost era. Viola! Practice confirmed theory. By December 30, 1975, we had incorporated the industry’s first index fund.
Why was it that Vanguard, rather than some other fund firm, was the pioneer? Many financial firms must have recognized, just as easily as I did, the mathematics of the marketplace that define investment success by the apportionment of returns between investors and managers, even as between gamblers and croupiers. But external fund managers had a powerful vested interest in maintaining their own extraordinarily high profitability. We alone had an internally managed structure, and a mission to be the lowest-cost provider of financial services in the world. So even if 100 mutual fund firms had grasped the opportunity of a lifetime that indexing presented at the same instant we did, 99 would have prayed that the cup of indexing pass quickly from their hands.

But, as fate would have it, as the evidence in favor of indexing began to mount, one firm had just been formed that—like the suspect in a good murder mystery—had both the opportunity and the motive to seize the day, and take the first step that would one day re-landscape the way we look at investing. We recognized our opportunity. Then, only force of will—persistence, patience, and determination, along with a healthy dollop of missionary zeal—were required. Implementation, after all, has always been far tougher than ideation! But we implemented with zeal, watched acceptance follow, and have seen indexing move from heresy to dogma.

**The Powerful Idea of the Multi-Series Bond Fund**

No comparable sea change was required in our second major innovation—the idea of managing bond funds with a new and different strategy. This powerful idea came less than a year after we formed our index fund, and had precisely the same basis—the knowledge that, in any given sector of the financial market, managers as a group must lose by the amount of the aggregate costs of the croupiers. Since we had both the mission and the structure to provide our services to investors at the lowest possible cost, we were again the pioneer. Again, the intersection of both opportunity and motive!

In June 1976, Congress had passed a law making it possible to offer municipal bond mutual funds. The first such funds were traditional actively-managed bond funds, charging high costs. Ever the contrarian, I was deeply skeptical that any manager could consistently forecast interest rates with accuracy, and thus significantly outpace the famously efficient bond market over the long run. This powerful, but simple, idea that resulted from this insight presented Vanguard with the opportunity to change, not merely the structure of fixed-income management in mutual funds, but its very nature. Given our low operating expenses, we were in a position to offer a municipal bond fund that could deliver to our investors the highest net yields in the field, winning the performance derby not by genius, but by combining minimal cost with a less active approach to bond management.

But how would we deal with the question of managing bond maturities? The proverbial light-bulb went on: An idea so simple and so obvious as to defy description. We created not a single “managed” municipal bond fund—as was the accepted custom of the day—but three separate series: A long-term fund; a short-term fund (essentially the first tax-exempt money market fund); and—you guessed it!—an intermediate-term fund. Each would own high-grade tax-exempt bonds, rigorously maintain its defined maturity range, employ professional managers, and minimize portfolio turnover. And the shareholders would be rewarded with top performance.

It is difficult to be very proud of such an elemental idea. Yet the simple notion of the three-tier bond fund proved to be remarkably powerful. Indeed, it is now firmly established as the industry norm, for tax-exempt and taxable bond funds alike. In its obviousness, its elemental simplicity, and its reliance on rock-bottom costs, the three-tier fixed-income strategy we pioneered in 1976 had the same genesis as our 1975 pioneering of the index stock fund: The banal insight that it is the costs of investing that determine the gap between the returns the stock and bond markets provide and the returns investors as a group receive. Conclusion: To the victors—the shareholders of the lowest cost funds—belong the spoils.
It is Vanguard’s stock indexing and bond management investment strategies—and the reputation we have earned for their efficient implementation—that have accounted for the lion’s share of our growth. Fully $370 billion of the assets we manage today—two-thirds of our total—is accounted for by funds following those two powerful strategic ideas. Of course, success hardly came overnight. After a full decade, for example, the assets of our first index fund (we now have 28 index funds, keyed to various stock and bond market measures), totaled less than $500 million, compared to more than $105 billion today. With our missionary zeal and our focus on simple investment strategies and investor education, we have, I think, begun to make the mutual fund industry a better place for investors to entrust their hard-earned dollars.

The Power of a Book: Common Sense on Mutual Funds

Our mission is to change, not only the focus of the mutual fund industry, but its very structure. I had no doubt that a book that put the words and ideas I have relied on would have the power to bring this change all together in a cogent way. Such a book—a new and I hope better-written (and longer!) senior thesis—could not only articulate and reinforce my message, but deliver it to intelligent investors all over the globe. And so I wrote my second book on the subject of mutual fund investing. Emboldened by the power of Thomas Paine’s *Common Sense*, I called it *Common Sense on Mutual Funds*. In it, I aim to do two things: First, to help readers become more successful mutual fund investors, and second, to chart a course for change in the mutual fund industry.

While, just as a typical book, it is designed to be read sequentially it is in fact a series of 22 essays, each of which can be read independently. The first three parts of the book are purely about investment issues, encompassing (1) investment strategy, including the nature of financial market returns and asset allocation; (2) investment choices, including index funds, investment styles, and stock, bond, and global funds; and (3) investment performance, including the powerful role that reversion to the mean plays in the financial markets, tax-efficiency (and tax-inefficiency), and the effect of *time* on return, risk, and cost.

The final two parts of the book turn a critical eye to industry issues that have played a key role in the disappointing past records of mutual funds of all types. Part four, “On Fund Management” describes the industry’s deviation from its original principles, discusses the ascendancy of marketing over management as our talisman, rails at the failure of fund directors to uphold shareholder interests, and suggests the positive implications of the change in industry structure that I discussed a few moments ago. This subject matter, of course, is unusual stuff for a book on fund investing, but the subject of part five, “On Spirit,” is even more unusual. Here, I conclude that a mutual *structure*, as helpful to shareholders as it may be, is not enough. Irrespective of their structure, the firms in this industry need a mutual *attitude* toward serving investors, an attitude conspicuous only by its virtual absence today. So in part five, I take the liberty of describing the mutual values and spirit that, as Vanguard’s founder and leader, I have endeavored to inculcate in our enterprise.

Common sense is the theme that suffuses each of the book’s subjects. Not only common sense as you and I understand it today, but *Common Sense* as Thomas Paine used it in his pamphlets some 225 years ago, presenting sentiments to the citizens of the Colonies “not yet sufficiently fashionable to procure their general favor . . . offering nothing more than simple facts and plain arguments,” and asking the reader to “generously enlarge his views beyond the present day.” In my own book, I present similar sentiments—and equally simple facts and plain arguments—to mutual fund investors.

Except for the final section, the book is *not* about Vanguard. It *is* largely about my deeply held convictions on how to invest successfully in mutual funds. While my ideas have been modified to a
degree by my half-century of observing the financial markets, the more important point is that they have been reinforced, annealed in the crucible of experience and time. In the early years, I forthrightly described our structure as “the Vanguard experiment” in mutual fund governance. After 25 years, I guess it’s fair to say it’s an experiment no more. From $1 billion at our founding, the assets we hold in stewardship for investors have grown to more than $500 billion, and we’ve done our best to earn a reputation for integrity, fair-dealing, and sound investment principles that is second to none in this industry. Our staggering growth—which I never sought—has come in important part as a result of the simple investment ideas and basic human values that are the foundation of my personal philosophy. And I have every confidence that they will long endure at Vanguard, for they are the right ideas and right values, unshakable and enduring, even eternal.

**Economics and Idealism**

In retrospect, I believe that idealism—the dream of a better world; fairness to one’s fellow human beings; focus on simplicity; emphasis on stewardship; a belief in the power of words and ideas and books—has driven my long life and exciting career. Happily, we’ve proved that the link between idealism and economics is a powerful one. Indeed, both Vanguard’s structure and the index fund concept are classic examples of the fact that enlightened idealism is sound economics.

Even a casual reading of my ancient thesis would, I think, reflect that pervasive idealism. To this day, I use quotations from it to define the genesis of my views, from the forces that move financial markets (both enterprise and speculation, in Lord Keynes’ timeless formulation), to the forces that fail to move fund managers to behave as responsible corporate citizens (“The Silence of the Funds,” as it were). But the highest manifestation of this idealism comes in my long-standing view that the central principle of the mutual fund business should be, not the marketing of financial products to customers, but the stewardship of investment services for clients.

I’m happy to report that my 55-year chronicle of putting pen to paper—a story that begins at Blair in 1945 with schoolmasters Adams and Mason, continues in 1949 at Princeton’s Firestone Library and my thesis, rolls on to 1951 with Walter Morgan and Wellington, then to 1975 with Chuck Root and Vanguard, and to 1999 with “Common Sense on Mutual Funds”—is not yet over. Even as we meet this evening, another story—more words, indeed another book—is being written. McGraw-Hill Publishing Corporation came to me a few months ago and proposed that Volume One of its forthcoming series, “Great Ideas in Finance,” be entitled *Bogle on Investing* and consist of selections from the scores of speeches I’ve given over the years, using—yes!—my Princeton senior thesis as the centerpiece. It may be some sort of poetic justice that, a half-century after it was written, this modest, unassuming precursor of the idealism and economics that would lead to Vanguard’s remarkably fortuitous formation will at last see the light of day—yet one more link in the long chain of words, ideas, and books that I’ve recounted this evening.

**The Inspiration of William Penn**

On this grand occasion, right here in our great home state, it seems only fair to attribute considerable credit for our growth to being here in Pennsylvania. William Penn’s remarkable American commonwealth has been the source of fine governance and hospitality to business, the home of a splendid labor force, and the historic nexus of Vanguard’s loyal shareholder base. What is more, we have been well-served by practicing the kind of simplicity William Penn cherished when he came to his newly-chartered lands in 1621. Penn’s own words come precisely close to describing how we have conducted Vanguard’s affairs:
Method goes far to prevent trouble in business: for it makes the task easy, hinders confusion, saves abundance of time; and instructs those that have business depending, both what to do and what to hope.

And so, even as William Penn looked at Pennsylvania as his “Holy Experiment” for human rights and perfect freedom, I began Vanguard as an experiment—though hardly a holy one—in what to do and what to hope. Our ideas and methods would test whether a mutual fund enterprise—a unique enterprise that is of, by, and for the shareholders—could succeed in a competitive, dog-eat-dog industry. With the Quaker-like simplicity of our investment philosophy and the characteristic stubbornness, candor, and thrift of William Penn in our business strategy, I believe that, so far, we’ve met that test. For that belief that the economic functioning of a business enterprise cannot be separated from the ideals it holds high has worked splendidly in practice.

But there are things that can make even a successful business better—even more focused on service to our fellow human beings—and I want to close these remarks by acknowledging, more than ever at this stage of my long life, my aspiration to live the remainder of my days by these words of William Penn:

I expect to pass through this world but once. Any good therefore that I can do, or any kindness I can show to any fellow creature, let me do it now. Let me not defer or neglect it, for I shall not pass this way again.

Comforted and inspired by those wonderful words, I shall press on with my own words, my ideas, my ideals, and my books. May their power long outlive their author!

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