“Uneasy Lies the Head that Wears the Crown”

Remarks by
John C. Bogle, Vanguard Founder
On Receiving
the First FUSE Research Network Award
For Lifetime Impact and Commitment to Investors
Boston, Massachusetts
October 26, 2010

Recent reports trumpeting Vanguard’s coronation as the world’s largest mutual fund manager was, for me, more a time for reflection than a time for celebration of the ascent to industry leadership of that little company that began in 1974 with $1 billion in assets under management and just 28 crewmembers. Even more, it was a time to place our firm’s achievement in the context of the mutual fund industry’s now-76-year history.

Which firms preceded us in holding the industry’s asset-size crown? How long did they wear their crown? Why did they lose it? Who took it from them? Where do they rank today? My research led me to one clear conclusion: Uneasy lies the head that wears the crown.*

The first fund firm to wear the crown was Massachusetts Investors Trust, America’s first mutual fund. Founded in 1924, MIT held the crown from its inception through 1953, a remarkable reign of 29 years of leadership. At its peak, MIT’s share of industry assets (including the assets of its sister fund, Massachusetts Investors Growth Fund) reached 15 percent in 1950.

* Shakespeare wrote this phrase in a short soliloquy by Henry IV, in Part II of the play that bears his name. He was to wear the crown of England for only fourteen years, dying in 1413.

Note: The opinions expressed in this speech do not necessarily represent the views of Vanguard’s present management
In 1954, MIT (now part of Massachusetts Financial Services, or MFS) lost its crown to Investors Diversified Services, (IDS) which became part of American Express, and then spun off as Ameriprise Funds, and just recently (through a merger), Columbia Funds. (No, I’m unable to rationalize how this kind of trafficking in mutual fund advisory fee contracts advances the interests of shareholders of the mutual funds involved.) IDS also wore the crown for a long time—24 years—through 1978, reaching a peak market share of 14 percent of industry assets.

I’m confident that this audience knows who ultimately took that crown away from IDS.* Fidelity’s stunning ascent to industry leadership began in 1979, and it would hold that lead through 2005, a remarkable 26-year record of durability, with its market share peaking at a 13 percent share of industry assets. (You may be puzzled, as am I, why it took the financial press another four years to recognize Vanguard as Fidelity’s successor. Perhaps this oversight is explained by the fact that the firms were neck-and-neck in 2006-07-08, with Vanguard sometimes ahead by as little as $3 billion, rounding error at these trillion-dollar levels.)

In any event, Vanguard now firmly holds the undisputed crown of industry leadership. Our 13 percent market share is rapidly approaching the share level of the previous title-holders. The Vanguard-Fidelity rivalry, however, is rather complex. While our $1.468 trillion asset total exceeds Fidelity’s $1.219 total by more than $200 billion, the assets of Vanguard’s long-term funds (stock and bond funds, excluding money market funds) of $1.3 trillion exceeds the $800 billion total of our long-time rival by fully $500 billion. This is not to say that Fidelity now plays second fiddle to Vanguard in all respects. Measured by profits, they are (I think) first in the industry and we are last. Fidelity Management and Research reported operating income last year of $2.5 billion,

*There were two interlopers during this long sequence. Merrill Lynch and Dreyfus were the largest fund managers for a brief period during the late 1970s and early 1980s. In both cases, their leadership was attributable to their almost monoline dependence on money market funds, which represented 75 percent or more of their asset base.
while The Vanguard Group, manager of the Vanguard funds, earned precisely zero. (As the only mutual mutual fund organization, all of our profits are, in substance, returned to our shareholders.)

History has not been kind to those earlier monarchs of the mutual fund kingdom. The MFS market share, which peaked at 15 percent all those years ago, has now fallen below 1 percent. The IDS/Columbia market share also peaked at 15 percent and is now less than 2 percent. And Fidelity’s market share has fallen from 13 percent in 1999 to 11 percent today.

What explains these declines? As I look at this history, I date the decline of MFS from 1969, when it abandoned its original unique mutual structure (similar, but not identical to Vanguard’s) in favor of private ownership of its management company. The firm was sold to Sun Life of Canada in 1982; it joined the performance-chasing game; and it saw its composite expense ratio rise from 0.19 percent to 1.20 percent, more than a six-fold rise. IDS operated during the golden age of captive sales forces, capitalized on its huge (insurance-oriented) client base, but ultimately failed to develop a strategy for a world in which giant brokerage firms and no-load funds would dominate fund marketing. As for Fidelity, I see it as a firm heavily oriented toward the superior performance of their funds (especially Magellan) during and beyond the short-lived “Go-Go Era” of the late 1960s, achieved when the firm was managing some $3.2 billion of equity assets, but not repeated when those equity assets approached $1 trillion. (Not that managing even a small asset base makes superior returns easy to achieve!)

Costs Matter

Vanguard faces lots of challenges, but they do not include those problems that I have just touched on—conglomerate ownership; failed marketing strategy; a model built on delivering high performance (with commensurately high risks.) As a truly mutual mutual fund firm, we are independent; focused on the interests of our fund shareholders, and with an incredible—and sustainable—cost advantage. Vanguard’s fund expense
ratios average 0.23 percent. The average mutual fund charges 1.19 percent—more than five times as much!

Does it matter? Think about it: over the past decade, our funds, largely passive rather than active, have earned net returns that outperformed 82 percent of their peers in the various fund objective categories in which we compete. I do not believe that any large fund manager has matched that figure. But our gross returns—before the deduction of our lower expense ratios and our competitors’ far higher ratios—exceeded those of just 51 percent of our peers—a hair above average. Yes, costs matter.

I don’t think I’m hyperbolizing when I use the phrase sustainable cost advantage. I simply can’t see how any of our peers could possibly reduce their expense ratios in the aggregate to anything like 0.23 percent, where we are today—let alone the even lower expense ratios we’re likely to establish in the coming years. As the industry leader, we have huge economies of scale; we’ve worked hard to achieve excellence in shareholder services; we employ state-of-the-art technology; we have a solid leadership team, and our 12,000 able crewmembers include thousands of veterans who revel in passing along the human values and the investment strategies that have carried us to our present industry position.

**How to Compete?**

Could others compete with us on costs? I don’t see how. Among our large management company peers, the average expense ratio is about 1 percent. To reduce that ratio to 0.5 percent would be transformative, changing almost everything they do, including slashing—even eliminating—the profits they either earn for themselves, or share with public shareholders, or—most likely, given the predominant fund industry structure today—earn for the U.S. and international financial conglomerates and banks that own them lock, stock, and barrel. And even if our peers did succeed in cutting expenses by half, the costs their fund shareholders pay would remain more than 100 percent above Vanguard’s.
So perhaps their strategy should be—I apologize for thinking like a business school professor here—to keep prices high on those funds in which costs are not particularly visible (i.e., funds that are not “closet” index funds); and to cut prices for their largest shareholders, particularly on funds where costs are the obvious differentiator in providing superior returns—obvious at least to the intelligent adviser or intelligent investor—index funds, bond funds, and money market funds.

But this strategy has already been tried by several of our peers, and it has failed. Why? Because ever since 1992, when we introduced our first high-minimum-investment, minimal-expense-ratio Admiral shares, we’ve cut prices to stay a step ahead of the competition. As I said to our Vanguard crew in 1992, “the Admiral concept is (based on) the obvious insight that, since the costs of handling a shareholder account are relatively fixed, larger investors generate substantial economies of scale . . . (It is) our way of firing a shot across the enemy’s bow—letting our rivals know that they’d better get ready for even tougher price competition.”

That 1992 strategy, to state the obvious, lies at the root of the continuing expansion of our Admiral franchise, most recently in lowering the asset threshold for individual index fund investors from $100,000 to $10,000, with expense ratios running as low as 0.07 percent (seven basis points). By year-end, the assets of Admiral investors at Vanguard will likely top $450 billion, fully 30 percent of our asset base.

**Maintaining Leadership**

How long will Vanguard’s leadership last? Who really knows? But we’ve got a lot going for us in the years ahead:

1. Our rock-bottom costs will endure, and the idea that lower costs lead to higher returns will never go away. The math is simple and certain—gross returns for investors as a group, less the costs of financial intermediaries (and taxes), equals
the net returns that investors actually earn—and too powerful, too meaningful, and far too important to ignore.

2. Focusing on providing market returns and assuming market risks (but no more) is the obvious strategy for the low-cost provider—simplicity, and delivering to clients their fair share of what ever gains, or losses, the markets deliver. (The correlations of our funds average about 96 with their best-fit targets—call it “commoditization” if you will—compared with about 87 for our peers.) Our passive funds—index funds and virtual index funds, including nearly all of our bond funds—account for about 85 percent of our asset base.

3. It’s only a matter of time until investors recognize the bite that expenses take out of fund dividend yields, especially in today’s low-yielding markets. The 2.0 percent gross yield of the average equity fund, reduced by an expense ratio that averages 1.3 percent, slashes the yield to a pathetic 0.7 percent. How long will intelligent investors allow two-thirds of their dividends to be eaten up by expenses?

4. The no-load (direct distribution) segment of the industry has yet to fully realize its marketing potential. Amazingly, load funds currently represent fully 62 percent of industry sales volume, even higher (this surprised me!) than it was way back in 1996 (57 percent). Will investors continue to invest in bond funds in which the load consumes the first two years of income? I doubt it. What’s more, many account executives are leaving the commission-driven broker field to form their own investment adviser firms, focused on no-load funds. That trend, I believe, will continue, and even accelerate.

5. ETFs (exchange traded funds) are sort of a wild card. For most ETFs, low cost is a big selling point, but giving investors the ability to trade in a nanosecond seems even a bigger one. (Too bad, since the actual returns realized by investors in 162 of the 173 ETFs with 5-year records have fallen short of the returns of the index of their choice by an average of 30 percent—amazing!) But Vanguard’s low cost is now making a huge impact, and our share of net cash inflow this year is the largest in the field (36 percent). Whatever the future of ETFs, they seem more of an opportunity than threat to Vanguard.
Together, these advantages seem powerful and durable, and I believe that Vanguard is on the right side of history to maintain our leadership position, to wear the crown for a long time. What we’ll need is the wisdom to stick to our founding values; to revel in our mutual structure; to avoid marketing fads; to beware of complacency; to remember where we came from, and to do nothing to violate the remarkable level of trust that our clients have placed in us.

Even then, I can’t guarantee that we’ll remain the market leader over the next quarter-century, for what keeps resonating deep within my mind and spirit is that unsettling phrase: Uneasy lies the head that wears the crown. So let’s all get together 25 years from now in 2035—heck, maybe I should be more realistic and say (optimistically!) 2015—and see who is wearing the crown of leadership.