As the founder of Vanguard way back in 1974, it’s a special honor for me to have this opportunity to discuss our truly mutual structure, and how it is at last beginning to reshape the mutual fund industry. And it seems particularly appropriate, for much like your organization, Vanguard is also a “cooperative.” Our vision, our mission, our principles, and our values are very much like yours. Paraphrasing CFC’s stated mission, “our goal is not to maximize our income, but to offer our shareholders affordable financial products and services, consistent with sound financial management.”

So-called mutual funds—they’re not really mutual at all—are quite different; they are largely corporate shells, diversified portfolios of stocks and bonds with no employees of their own. Their few corporate officers usually hold the same posts with the funds’ management company, which organizes the funds, operates them, and provides, in return for a substantial fee, essentially all of the services necessary for the funds’ existence. These services include administration; portfolio strategy and investment selection; and distribution of fund shares to the public. The fund is, from birth, a captive of its management company/adviser.

Fund management companies work under one of four different and distinct corporate structures. (1) Private ownership, usually dominated by the investment professionals who manage the funds. Until 1958, this form essentially constituted the entire fund industry. Then, our courts decided that private managers could go public. Today, only nine of the largest 50 fund management companies remain privately owned.
(2) **Public ownership**, with working control usually held by management company officials, but with public investors holding widely diffused amounts of the management company’s shares. Among those 50 major fund groups, ten firms (including T. Rowe Price and Franklin Templeton) operate under this public ownership structure.

(3) **Conglomerate ownership**, under which giant diversified financial firms (including Goldman Sachs and JP Morgan) operate their own mutual fund management companies, often to diversify revenue sources and earn generally steady fee income. In other cases, conglomerates have acquired existing fund management companies (including Massachusetts Financial Services and Putnam), often at substantial acquisition costs. With 30 of the largest 50 fund managers owned by conglomerates, this ownership model has become the industry standard.

(4) **Mutual ownership**, under which the shareholders of the funds actually own the management company, which operates on an at-cost basis. Only one mutual fund complex is truly mutual—Vanguard, the firm that I founded in 1974, then with assets under management of a mere $1.2 billion. While our structure has yet to be emulated or duplicated, Vanguard has become by far the largest firm in the industry, supervising $2 trillion in assets.

While the 40 fund management companies with public owners of one kind or another predominate the number of firms, their share of industry assets is smaller relatively smaller—about $6 trillion, less than half of the $12.5 trillion industry total. The 10 privately-held and mutual firms are disproportionately large, with these firms managing some $4.5 trillion.

Under each of the first three forms of ownership, to varying degrees, management companies face a profound conflict of interest. They wish to earn the highest possible return on their ownership stake, by gathering ever-larger pools of assets and steadily increasing their management fee revenues and profits. But this objective comes at the direct expense of the returns that they deliver to the mutual fund shareowners whom they are duty-bound to serve. For the publicly-owned and conglomerate-owned firms, the conflict of interest is, ironically, even more severe than for the privately-held managers. Arguably, they have a fiduciary duty to maximize the returns of both their own shareholders and their fund shareholders. To understand the severity of the problem, just consider the Biblical warning, “no man can serve two masters.”
No Easy Answers

I want to be clear that while such a direct conflict does not face a manager operating under the mutual (fund-shareholder-owned) structure, even today’s sole mutual manager (that’s us), inevitably faces issues of self-interest—for example, in executive compensation, in edifice-building, and in providing complete transparency. Such a mutual structure may be “a more perfect union” of the interests of both managers and shareholders, but it is not perfect, inevitably dependent on the character, the values, and the principles of the executives who control the organization at any moment in time.

These agency issues were well-recognized by Harvard Business School professor Michael C. Jensen, whose seminal 1976 paper described agency relationships and how and to whom the costs and rewards of corporate ownership are allocated. Since the relationship between the stockholders and the managers of a corporation fits precisely the definition of a pure agency relationship, it should come as no surprise to discover that the issues associated with the separation of ownership and control in the modern diffused-ownership corporation are intimately associated with the general problem of agency. The challenge of inducing an “agent” to behave as if he were maximizing the welfare of the “principal” is quite general. Quoting Dr. Jensen, “It exists in all organizations at every level of management in firms, in universities, in [yes] mutual companies, in cooperatives, in governmental authorities and bureaus, (and) in unions.”

It is impossible to deny the logic of the Jensen thesis that posits that managers rarely maximize the interests of the shareholders they are duty-bound to serve, and instead mainly look out for themselves. More important, its truth has been confirmed, over and over again, by actual experience in the functioning of our giant corporations and investment institutions.

In my personal experience over a 61-plus year career I’ve run the gamut of these structures: First, nine years at a privately-held firm; second, fourteen years at the publicly-held firm it became after a public offering of its shares in 1960; and, after being fired from the firm in 1974, 38 years with Vanguard, the mutual company I founded later that year. I understand well the pros and cons of these four structures, for I have had considerable experience in each.

That 1974 change radically altered the way I ran the new business (which I did until 1996) with an unprecedented mutual structure. The ability to take the long view; the (near) immunity to setting targets on earnings for Wall Street, and then having to meet them (by fair means or foul); freedom from
having Wall Street security analysts with only a superficial knowledge of the business telling me how to run it; and, above all, freedom from of the pressures on marketing, with company growth remaining secondary to serving shareholders “with management operating in the most efficient, honest, and economical way possible.” (A quote directly from my 1951 Princeton senior thesis on the mutual fund industry and its proper role in our economy.) Simply put, the mutual structure provided the freedom to focus, not on the _ephemeral and volatile price_ of a corporation’s _stock_, but on building the _enduring intrinsic value_ that a corporation must provide to its clients over the long term, and offering excellent products and services at the lowest possible prices.

**Strategy Follows Structure**

Importantly, the mutual “at-cost” _structure_ largely dictated the _strategies_ that we would follow. Here’s how _mutual_ mutual fund management companies differ from others, in seven key areas:

1. **Profit Strategy**
   - Mutual firm—Maximize return on capital _for fund shareholders_.
   - Manager Ownership—Serving two masters: conflicting mandates to maximize returns—management company stockholders vs. mutual fund shareholders.

2. **Pricing Strategy**
   - Mutual—The lower the cost, the higher the return to shareholders.
   - Manager—Whatever the traffic will bear.

3. **Service Strategy**
   - Mutual—Service excellence, offered at cost.
   - Manager—Service excellence, but costs must be increased in order to achieve it.

4. **Risk Management Strategy**
   - Mutual—Low portfolio risks and costs, but still providing competitive income yields.
   - Manager—Reaching for higher yields, with higher risks, to compensate for their higher costs.

5. **“Product” Strategy**
   - Mutual—_Sell what you make:_ Middle-of-the-road funds; defined market segments; _love_ index funds.
   - Manager—_Make what will sell:_ Aggressive funds and fad funds; hope for home runs; _hate_ index funds. (Why? Low—if any—profit to managers.)
6. Marketing Strategy
   - Mutual—Demand pull. Minimal effort; low expense commitment.
   - Manager—Supply push. Spend aggressively to gather assets.

7. Time Horizon Strategy
   - Mutual—Long-term, value oriented; increase intrinsic values for fund shareholders; free from Wall Street pressures.
   - Manager—Short-term and focused on price of the manager’s stock; subject to the whims of Wall Street.

How Has It All Worked Out?

The mutual structure—an experiment in mutual fund governance that has now had those strategies in place for more than 38 years—has yet to be emulated or copied. Vanguard’s structure remains unique in the annals of mutual fund history. How has it all worked out? The numbers tell the story.

While I have no intention to “plug” the Vanguard line-up of mutual funds before this audience, I do believe you have a right to know whether our journey, so far, has been a productive one. So, let’s look at three facts:

1. Since our humble beginning with $1.4 billion of assets, today’s assets under management is now approaching $2 trillion—a compound annual growth rate of 21 percent. (Chart 5) As you can see, that growth has been almost a straight line, virtually uninterrupted.
(2) Of course, we were part of a burgeoning fund industry, whose assets rose from $50 billion to $12.5 trillion, thanks largely to (a) the greatest two-decade bull market in U.S. history (1980-2000); (b) to the development of the money market fund; and (c) the huge increase in tax-deferred investment options such as the IRA and the tax-deferred thrift plans. But Vanguard grew far faster, (Chart 6) and our market share of 6 percent of industry stock and bond fund assets—at declining slightly through the late 1980s—has grown in each of the 26 years since, to today’s 17.4 percent. As far as I can tell, the previous highs in asset share for the industry’s largest firms regularly topped out at between 10 percent and 13 percent. So we are breaking new ground on industry dominance.

*Includes only firms with two or more years of leadership.*
(3) Remarkably, our present share seems likely not to level off, but to increase at an even more rapid rate. Since 2008, we have accounted for almost 80 percent of the industry’s total cash flows, (Chart 7) including 170 percent of equity fund flows, driven largely by the rapidly-growing acceptance of index funds and the increasingly-recognized importance of low costs, which, simply put, divert the allocation of stock market returns away from the money managers and croupiers of Wall Street, and into the pockets of the nation’s families who are investing their hard-earned dollars to secure their retirement.

Yes, our mutual structure is different from yours, but we remain as one in the notion that cooperative forms of structure, finally, are so often the most effective ways of meeting the needs of our clients and customers. In the years ahead, this concept can only grow in importance.