Marketing Mutual Fund Shares in the 1980's

Remarks by John C. Bogle, President
The Vanguard Group of Investment Companies
At a Meeting of
The National Investment Company Service Association

March 10, 1977

While I am pleased to be with you this afternoon, I must confess to being somewhat apprehensive as well. For I recognize that the steps we at Vanguard have just taken to almost totally restructure our distribution system—to prepare for the 1980's, if you will—are hardly the stuff of which popularity contests are made, to say nothing of "won."

Further, I am hesitant—for reasons of propriety, caution, and competition (and not necessarily in that order)—to take you through the precise reasons *why* we have done what we did. But I would emphasize that we have taken two distinctive steps:

1) As of three weeks ago, to convert all of our continuously-offered funds to no-load status.
2) Effective (hopefully) May 1, to "internalize" all distribution activities under the aegis of the Funds themselves, rather than our external adviser, Wellington Management Company; and at the same time to reduce our aggregate investment advisory fees from about $7 million to $5 million per year.

It may surprise you to know that, while the first of these two steps is what has received all the attention so far, it is not all clear to me *which* of the two steps—if either—will have the most significant implications for the industry in the years ahead.

I am also hesitant—for reasons of propriety, caution, and competition (and again, not necessarily in *that* order!)—to lay out our future marketing strategy in great detail. But I can convey to you my profound conviction that *what* we have done (the no-load decision and the decision to internalize distribution) is apt to prove less significant in determining our future marketing success—or failure—than *how* we respond to truly awesome business challenge that lies before us.

But under the rather broad umbrella provided by the title of my remarks this afternoon, "Marketing Mutual Fund Shares in the 1980's," I can give you some insights into both our decision-making process and our marketing strategy. Such a title, of course, gets me safely through the shoals and reefs of 1977-79—and if you had the conversations I have had with perhaps 50 individual broker/dealers—chief executives, mutual fund managers, registered representatives—in the past three weeks, you would surely see why that would be "a consummation devoutly to be wished." (I should say that they were all tough conversations, but totally fair and honest.)

But, in a different way, such a speech title also has the considerable advantage of providing a long-term perspective regarding the future of an industry—and an excellent, efficient, capable, accomplishing industry this one is—that has been beleaguered beyond belief over the past ten years. In that span, the stock market has gone "nowhere" on balance. The Dow Jones Average was "about to break 1,000"—it did not—in January, 1966, and you know where it is today. We have suffered two stock market debacles (1970 and 1973-74). We have also experienced half a dozen major regulatory policy pronouncements (the SEC Institutional Investor Study; the NASD Sales Charge rule and "Anti-Reciprocal" rule; the SEC Statement on the Future Structure of Securities Markets; the SEC Distribution Policy statement; the change to negotiated brokerage commission rates). Indeed, one can only add, as did the King in "The King and I," "etcetera, etcetera, etcetera."

During this troubled decade, we have also had a lot of redemptions and not nearly as many sales; and an industry that has changed from almost exclusively a purveyor of equity securities to an industry of diversified investment products. Witness the fact that bond funds (including corporate bond funds, bond-oriented income funds, and the new municipal bond funds) have risen from only 5% of industry sales in 1966 to 55% in the past three months—an 11-fold increase. If money market funds are included, of course, the income fund shares of industry sales would be far higher.

We've also been in an industry where—for whatever reason, and there are many—the distribution system has undergone some considerable metamorphosis. Sales by broker-dealers, the backbone of the industry (traditionally accounting for 70%-75% of all fund sales), were down to a 57% share for all of 1977, and have been running about 35%--well under half, for the first time in memory, if not in history—in the past three months. On the other hand, no-load fund sales were only 5% of the industry in 1966, but had risen to 26% last year, and to about 43% in the past three months. To be sure, the change in our industry's product line—especially the municipal bond funds—has a good bit to do with these recent trends. But that does not make them any less relevant; quite to the contrary!

And of course as you, above all, here today know, the operational or service side of the business has also been revolutionized in the past decade. Bombs away to "green eyeshades" and manual operations, and up with sophisticated, computerized shareholder accounting systems! This change has been absolutely essential to our industry's ability to provide new products and services—whether daily dividends in a money market fund, exchange privileges in a fund family, checkomatic accounts, or special shareholder accounting services to an employee savings plan. And such systems, to state the obvious, will also be critical to *any* marketing system—whether offering new and better services and more complete information to shareholders, monitoring the productivity of a given marketing program, or whatever—in the years ahead.

I give this perhaps overly long preamble about where we have been only because if we want to know where we are going we had best start from where we are. (Please forgive the Pennsylvania Dutch circumlocution!) So now let us jump to the 1980's, and speculate on what mutual fund marketing might look like in three specific areas: (1) pricing structure, (2) product line, and (3) principal markets.

As to pricing—and this may surprise you—I foresee far *less* of a pure dichotomy than there is today between "load" funds and "no-load" funds. To the contrary, there will probably be any number of "variations on a theme." The focus will move away from today's simple distinction: a maximum sales charge of 7 ½ % to 8 ½ %, or none; take your choice. Rather, there will be an evaluation of *total price*—or total *cost effectiveness* over time—including any initial sales charges, annual fund operating and advisory expenses, and perhaps specific account maintenance and service charges. Thus, there may be these four kinds of broad groupings:

1) Traditional no-load funds—without sales charges, and having relatively moderate expense ratios, with distribution efforts limited to a reasonable amount of advertising and perhaps a modest direct institutional sales program.

2) No load with external cost add-ons—just like No. 1, except that an independent distribution force exists, and is compensated by advisory fees (an analogy might be the "timing services" that are operating today) or "per ticket" service charges.

3) "Quasi-no-load funds" with active retail sales forces. I emphasize the "quasi," for while the sales charge is eliminated as such, expense ratios rise significantly, to encompass direct charges against fund assets sufficient to provide adequate commission compensation to salesmen—whether they are "captive" (as in the IDS proposal to the SEC) or broker-dealer.

4) "Sales charge funds"—as we have today, where the sales commission is paid in front, and fund expenses are in the moderate range. The elementary simplicity and, for that matter, fairness of this system is undeniable.

The full development of this multi-faceted structure will presumable require SEC approval of an "asset charge" for distribution—but that will come by 1980, just as Section 22(d) (requiring a fund to maintain a uniform offering price) will probably go by then. But, *total cost over time*—the aggregate accumulation of any initial sales charge plus the sum of annual Fund operating expenses over the years—will become a key factor in marketing, depending in part of *what products* are being distributed in the 1980's, and in part *to whom* they are being marketed.

(Before I turn to "product line" and "principal markets," I should note my view that more imaginative ways of pricing operational services will develop by the 1980's. For example, I wonder if it is not time to consider "externalizing" the shareholder account fee. It is difficult for me to conceptualize why a single investor who owns, say, $2 million of a $200,000,000 fund's shares, should pay for 1% of its transfer agency costs. Why should he pay, say $2,000 per year, when the cost of handling that single account is $5. This concept has obvious implications for future marketing strategy.)

Turning to the 1980's product line, it will inevitably relate directly to the pricing structure. This is hardly a subtle point. When we were strictly an equity-oriented industry, the sales charge and expense ratio did not appear to be critical or differentiating factors. If they were high, they got lost in a matrix of good performance and bull markets. And if they were low, it really did not help all that much if performance was bad. In short, our equity products were perceived as "differentiated"—if you could pick a fund that "performed," the cost did not really matter.

That perception is, to say the least, no longer universally valid. Thus, we have "index funds" which put forth the general proposition that consistently low operating and transaction costs is a valid approach toward above-average results. And, in the 1980's, this low cost strategy, which assures *relative* performance that is highly predictable, will spread beyond index funds based on the Standard and Poor's 500 Stock Index. Indeed, I suspect that a "growth stock index fund" awaits only the development of a growth stock index. If these changes come to pass, of course, they will make life difficult for what has be come known as "closet" index funds—those stock funds which behave much like an index, and emphasize substantially the same stocks, but cannot match its performance because of high portfolio turnover and high operating costs.

An even clearer example of the relationship of product line and price can be seen in the income fund segment of the industry. It has now, I think, been proven beyond doubt that money market funds cannot be sold with a sales charge. The same proposition seems to have gained considerable validity in the municipal bond field (though the generally high level of annual operating costs are, in my view, somewhat oppressive to the "bottom line" yield). And it seems to be creeping into the general bond and income fund arena too, where the most marketable products, in the 1980's, will probably have a lower or even no sales charge, and will also have to have lower operating expenses, simply in order to do what they are required to do—provide investors with a maximum net yield on purchase price.

Turning now to the *markets* of the 1980's, those that each individual fund group seeks to penetrate should be an important determinant of its product and pricing strategy. Thus, I believe that today's outmoded market "shotgun" will be replaced by something more akin to a rifle. In terms of marketing to individuals, strategy may range from a high service-cost, high sales-cost approach to those investors who need to be educated, motivated, and sold, to a low cost appeal to those self-motivated investors who acquire information on their own. We now know that there is an important differentiation between the individual market for no-load funds, on the one hand, and dealer-distributed funds on the other, in some important demographic areas. For example, the buyer of a no-load fund is significantly older, better educated and more apt to have a professional career, and has higher annual income and substantially larger assets than the buyer of a dealer-distributed fund. That does not make one type of fund "better" or "worse" than the other, but it does suggest some interesting strategy implications—especially since *every one* of those five demographic trends will continue through the 1980's. For the figures tell us—with some considerable assurance—that America itself will continue to have a population that is growing in age, education, professional status, real income, and asset accumulation—the same five areas in which no-load funds have found their greatest relative strength.

I wish I had more time today to deal with the *institutional* markets of the 1980's, and their relationship to pricing and product strategy. Let me simply state my conclusion that these markets—pension, endowment, corporate, foundation—should become *extremely important* to our industry's future growth. Why? Because a mutual fund group—especially one with a nominal or no sales charge, *and* with a low expense ratio—offers extraordinary opportunity to such institutions, from the largest to the smallest, in terms of simplicity, efficiency, liquidity, and flexibility—to say nothing of investment performance.

One of the great canards of recent years is that mutual funds are somehow "second class citizens" when it comes to performance results. I would like to take a moment to put that ridiculous apprehension to rest right now, because as we approach the 1980's the information explosion will mean that institutional investors will be even more informed—if that is possible—about relative performance than they are today. And the simple fact is that mutual funds have a significantly better record than *any type of adviser* to corporate pension accounts. The Becker Securities survey, for example, shows that the equity securities managed for pension funds by *banks* had a compound rate of total return over the past decade of 3.7% (net off estimated expenses); by insurance companies, the figure was 3.6%; by private *investment counselors*, the figure was 3.3%. One the same basis, the average annual return of common stock *mutual funds* was 5.4%—or something like half again as good!

We at Vanguard will be presenting, in the coming months, a much more comprehensive analysis of mutual fund performance vs. the results of other institutional managers. For the summary figures above can only hint at the magnitude and consistency of mutual fund superiority. The common stock mutual funds also, for example, beat each of the other institutional management groups in the 1973-74 bear market, and beat each one again in the 1975-76 bull market. And the *balanced* mutual funds—how long has it been since anyone mentioned *that* group—have shown the same degree of superiority (perhaps to an even greater degree) over the *total* pension fund returns provided by the banks, and the insurance companies, and the private counseling firms. In each case, I should note, the results were achieved with a surprisingly similar balance between stocks and bonds (about a 70/30 ratio).

To sum up, there will be a broad range of different markets and sub-markets out t here during the 1980's. I reemphasize that, in my perception, these markets will continue to exist for the traditional dealer-distributed funds; they will continue to exist for no-load funds. And I hope you will agree with me that the distinction between the two groups is a *marketing* issue, and not a *moral* issue. What is important for each fund group is to make sure that its marketing strategy—whichever it selects—is an integrated one. That is, it should embody an internally consistent pricing policy, product line, and target markets—implemented in such a way that they *reinforce* one another, rather than fragment the overall marketing approach.

By now, I hope the broad outlines of our Vanguard strategy are clear; it involves:

- a direct appeal to "consumerism" and the differentiated individual market that exists f or no-load funds;
- a direct attack on the institutional market, competing both on a cost and performance basis.
- an on-going program to reduce our costs of operation and keep them down, both through expense reductions and new pricing methods.
- policy and operating control by the Funds themselves, acting in their own interest, of all administrative, shareholder service and distribution activities.
- working with our own adviser, at arm's length and with complete independence, hopefully enhancing the long-term investment performance results of our Funds.
- a broad product line, with innovations as required. (For example, our index fund, and an innovative concept of the municipal bond fund, which we are now just developing.)
- Finally, operational facilities that will assure our ability to service shareholders effectively and efficiently, to expand the range of our services, and to control our marketing efforts.

We do not believe our precise strategy would necessarily be right for anyone else in the industry. We do believe that it is right for us. But it comes only by relinquishing our marketing relationships—but maintaining our execution and research relationships—with the brokerage community that we worked with for many decades. I regret that departure, above all. However, as constituted today, the economics of marketing funds through broker-dealers are troublesome indeed—given the pressures on sales charges and dealer discounts, and the end of reciprocal brokerage. This distribution system is still a perfectly good one, but our judgment was that it is simply too much to expect it to generate, for perhaps 25 major fund groups, enough sales volume to at least offset liquidations—and that, of course, is the name of the game.

Further, any business, especially a business in as troubled an environment as this one has been, has an obligation to make the very best judgments it can to survive and to grow; to say nothing of its obligation to provide efficient, economical and productive services, and good investment performance for existing shareholders. As we move into the 1980's, time will surely tell whether our very risky judgment was right or wrong. And time will also tell whether we were correct when, by doing what we have done, we ignored that familiar advice from Lord Keynes:

> "Worldly wisdom teaches that it is better for reputations
> To fail conventionally, than to succeed unconventionally."