The Fox, The Hedgehog, and The Cave

In the New Millennium, Age-Old Principles for Mutual Funds

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On Receiving The Robert L. Gould Award
of the National Investment Companies Service Association

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The fact that I knew Bob Gould during the last decade of his wonderfully creative and productive life means that I accept this coveted award with the greatest humility. I well remember not only his achievements, but his camaraderie, and most of all his sort of whimsical, mysterious, all-knowing smile as we discussed Vanguard’s odd corporate strategy and our novel approach to shareholder service.

I’m not sure whether he twitted me about my statement, published in Forbes magazine in September 1985, that “we don’t intend to be the industry’s technology leader; we can’t afford to be.” But he did not live long enough to learn of a later quotation that I set in large type on a poster and placed in a dummy Forbes magazine at our Vanguard senior management meeting in June 1992: “We intend to be the industry’s technology leader; we can’t afford not to be.” And so Vanguard’s early conversion to information technology began. Late, to be sure, but I believe that, thanks to the brilliant leadership of Robert A. DiStefano in the development of our investment technology and Barbara Grozinski in the extraordinarily skillful application of that technology for our individual shareholders, our investor services are at the top of the fund shareholder ratings today.

I have read that Bob Gould had a passion for the mutual fund industry and for improving the quality of service provided to shareholders, and that he sought to develop and implement creative systems and methods to meet demands for new types of funds by a more sophisticated clientele. What Bob did as he sought to achieve these goals helped to set the stage for today’s nearly flawless mutual fund operating platform: well-engineered communication systems; transaction technology; record-keeping precision; a strong control environment; functional redundancy; and detailed contingency plans. In a real sense, the intelligent application of powerful computer technology has shaped the character and development of what Bob Gould must have envisioned 15 years ago as today’s modern mutual fund industry.

While I have fully recognized, advocated, and supported Vanguard’s massive information technology investment—in machines and systems and human beings alike—throughout the past quarter century, I’m far from being a creative force in that segment of what we have done. But I think few would disagree that I share Bob’s passion for this industry and for improving the quality of our shareholder services. My creativity, such as it may be, in seeking this goal, however, was quite different from his. I have sought to develop and implement not only new types of funds for the increasingly intelligent investors we serve, but a whole new client-focused approach not only to investor service, but to investment management as well.
I have taken Vanguard down the road less traveled by in an industry in which, I fear, group-think is the order of the day. Our departure from industry norms has taken us down a road that has led to considerable growth during the past decade, growth that I believe will not only be sustained, but perhaps even accelerated. So, as the fund industry approaches the new millennium, I would like to discuss my all-too-worldly business ideas on a far loftier philosophical plane that I hope befits the end of one era and the beginning of another, an era in which mutual fund shareholders will finally get the fair shake that they deserve.

My theme goes back to the words of two ancient Greek philosophers: a few fragments of the writings of Archilocus, set down around 670 BC; and a portion of Plato’s enduring classic, The Republic, written in about 370 BC. Archilocus has given us timeless wisdom applicable to mutual funds, wisdom that suggests, to me at least, that it’s high time for a major change in direction for this industry. Plato, on the other hand, gives us an allegory that makes it clear how difficult it will be to bring about that long-overdue change.

Let’s begin with Archilocus and the most famous fragment of his writing: “The fox knows many things. But the hedgehog knows one great thing.” This ancient saying has been interpreted to describe the philosophical contrast between the human pursuit of many different, even contradictory, goals related by no central principle, versus the search for a single overarching universal condition of human existence. My focus, however, will be limited to the two basic types of financial institution. The fox—that artful, sly, astute animal of the fields and the woods—survives by knowing many things about complex investment strategies and sophisticated marketing approaches. The hedgehog—that durable nocturnal animal that can curl into a ball, its sharp spines giving it almost impregnable armor—survives by knowing only one great thing: In the long-term, both investment success and business success are based on simplicity.

The Foxes—Truly A Skulk

Turning first to investment strategy, clearly the foxes hold sway in the mutual fund industry today. The skulk—and the crowd of fund foxes is large indeed—holds to the idea that investing is complicated and complex, so much so that to achieve investment success individual investors have no choice but to employ professional portfolio managers, and even to rely on professional manager-pickers to choose them. Only these experts, or so it is said, can possibly steer investors through the complex system that constitutes the maze of the global financial markets. In seeking to invest successfully, the industry’s managers present powerful credentials, including excellent education, years of experience, and cunning strategies. They hover over their portfolios by the hour, constantly monitoring them, buying and selling stocks with astonishing frequency, not only as a company’s products and prospects change, but as its market price jumps up and down.

Alas, however, even for the relative handful of mutual funds that have been able to make these active, opportunistic, and costly strategies work—of course, it would be absurd to imagine they could work for funds as a group—the fees and other costs charged by the fund managers were almost always so high as to consume any long-term value added, even by the most cunning of the portfolio manager-foxes. Fund shareholders have been left with annual returns averaging only about 85% of the annual returns realized in the great bull market we have enjoyed.

The reason for this shortfall is largely fund costs. The all-in costs of the fund foxes now approach 3% per year on average: ½% from management fees and expenses, up to 1% or more from the
costs of churning the portfolio, plus at least another ½%-plus annually for investors who pay sales commissions. Now, let’s think long-term instead of short-term. Let’s assume that the long-term market return of 11% per year persists, and conservatively set the total amount gathered by the managers, dealers, and brokers at 2½% per year. That leaves an investor return of 8 ½%. The positive impact of compound interest that magnifies long-term returns, unfortunately, also magnifies the negative impact of costs, so that an assumed 2½% annual cost would consume 31% of the investor’s capital in a decade, 47% in a quarter century, and—believe it or not—68% of the investor’s capital in 50 years, an investment lifetime. The investor, who puts up 100% of the initial capital and assumes 100% of the investment risk, receives but 32% of the long-term pre-tax return. The financial foxes, who put up none of the initial capital and assume none of the risk, receive the remaining 68%.

To make matters worse, these foxy strategies provide even worse results for the 30 million fund investors who pay taxes. High portfolio turnover creates enormous tax inefficiencies, exacerbated by the fact that many foxy managers realize capital gains even on a short-term basis, taxable at the full income tax rate. During the bull market, believe it or not, the federal government has confiscated nearly as much of the market’s gains as have the foxy managers. To use a gambling analogy, visualize actively trading stocks as gambling in a casino, where after each round of betting, the croupiers rake their share off the table: The fund managers, the brokers who execute the funds’ near-complete turnover of their portfolios in a single year, the mutual fund marketplaces, the funds-of-funds inspired by Bernie Cornfeld, and finally the federal and state governments. There are lots of croupiers! With the hyperactive level of mutual fund portfolio trading, and with mutual fund shares traded like stocks and sold on the basis of hot past performance that doesn’t repeat itself, the analogy to the casino is hardly far-fetched. And the outcome is just as predictable. Precious few mutual funds beat the market. Just as Lord Keynes warned, “When the capital development of a country becomes the by-product of a casino, the job is likely to be ill-done.” The job has been ill-done for fund investors.

The Hedgehog Strategy

Enter the hedgehog. The one great thing the hedgehog knows is the strategy of buying businesses and holding them, ideally, forever. This is the strategy followed by the king of the hedgehogs, America’s most successful investor, Warren Buffett. He has achieved his preeminence by buying substantial interests in a few well-chosen large businesses and holding them, if not “forever” (his favorite holding period), for a very long time. Contrast this strategy with the typical mutual fund strategy, not owning businesses but trading pieces of paper.

Few investors are going to be Warren Buffetts, so let’s consider the closest thing to his hedgehog-like strategy available to us mere mortals. What fills the bill is buying a participation in every publicly-held business in America, and holding it forever. Yes, an all market index fund. Managed with virtually no portfolio turnover and operated—as it must be—at minimal cost, such an index fund is simply a hedgehog that enjoys three priceless certainties: (1) a certain participation in the growth of corporate America; (2) certainty that the crafty investment foxes as a group must earn the market’s annual return before costs, but deliver only about 85% of the return after costs; and (3) a certainty that, given its own minimal costs, it will deliver 98% of the market’s annual return to its investors. Clearly, just as the performance data show, the one great thing that characterizes the hedgehog approach—pristine simplicity—is the winning strategy.

Perhaps it goes without saying that Vanguard is the industry’s principal hedgehog. While indexing need not be the only hedgehog strategy (witness Warren Buffett), it works, and we are the only firm that is deeply and fiercely committed to index funds. But our conventionally-managed funds also
follow hedgehog-like strategies. The goal is not necessarily to index—though that is clearly the most assured route to closely approaching 100% of the market’s rate of return—but to parlay a combination of very low cost, modest portfolio turnover, long-term focus, consistent style, and management competence—not thaumaturgy or legerdemain—into solid investor returns. Thereby exists the last, best chance to outpace the market index.

The Hedgehog as Businessman

Let me now turn to my second contrast between fox and hedgehog: From the mutual fund industry’s investment conduct, to its business conduct. Here the foxy strategy of entrepreneurs and promoters relies on guileful but expensive marketing, hot products, and drum-beating about past performance (when it is good), while the hedgehog strategy emphasizes patience, prudence, and stewardship. The hedgehog strategy entails a sort of “if-you-build-it-they-will-come” approach, which works only if standards are established to assure that those who do come are served in a first-class fashion.

Since, in the long run, the rewards of investing are determined by the allocation of market returns between the fund shareholders and the managers and distributors, the hedgehog business strategy begins with low cost. The most assured, direct route to low cost is a corporate structure that is truly mutual: The fund shareholders own the management company that administers the funds and operates on an “at-cost” basis, with each fund paying its share of corporate expenses. Expenses must be held to the bare minimum, the marketing budget modest, and the cost controls stringent—an approach that, to use a brutal but accurate word, is “cheap.” Any large fund complex could easily operate in this mutual hedgehog mode, but of course only one does. Vanguard is, well, unique. The net result is savings for our shareholders that currently exceed $4 billion per year, a huge enhancement in return that in itself adds up to an extra percentage point or more, which often means the difference between “average” and “superior” long-term return relative to peer funds.

At the same time, the clients of the hedgehog firm must also be provided with an excellent level of service, distinguished not only by efficiency and automation, but by how they are treated. The hedgehog’s secret—and it is hardly very complex—is what I have said to our crew 1,000 times over: “Let’s treat our clients as human beings—honest-to-God, down-to-earth human beings with their own hopes, fears, and financial goals.” Simply put, that means serving our clients in the same manner as we would like to be served by the honest stewards of our own assets. Wouldn’t anyone want that? Wouldn’t you? In this era of complexity, the hedgehog calls for simplicity. In this era of impersonality, for the human touch. In this era of deception and image, for candor and substance. In this era of hyper returns, for emphasis on risk. In this era of process, for judgment. Finally, in this era of focus on what is called, charitably, modern marketing, the hedgehog calls for focus on prudent management.

The hedgehog’s mission of service requires good communications, advanced technology, and financial controls, for all are conditions necessary to achieving success. But important as they are, they are not conditions sufficient for truly superior investor service. The one great thing the business strategy of the hedgehog recognizes is the primacy of the individual human being.

Looking to the New Millennium

Beginning with our creation of the first index mutual fund nearly a quarter-century ago, I’ve been expressing these contrarian views with increasing bluntness and fervor. They’ve been proven out by growing evidence that clearly affirms that fund costs shape fund returns, that indexing works, that style
consistency is crucial, that high portfolio turnover is counter-productive, and that the soundest strategy is not short-term speculation, but long-term investment. Every month, market share data confirm that fund investors increasingly accept these ideas, even as the foxes in the fund industry seem increasingly antagonized by them. But I have yet to see even one of the foxes take the other side, let alone with a compelling, fact-founded rebuttal. There is no debate. Silence, it seems, is golden. Perhaps so…

Yet facts are facts. And given the brute evidence of the past, I’d now like to set some new directions for the future as we move into the 21st century, directions for the foxes in the mutual fund industry that will serve investors and, in the long run, serve fund managers:

- Return to prudent management and fiduciary duty, rather than opportunistic marketing and commerce, as our guiding lights.
- Emphasize a client-focused approach to serving human beings, rather than simply gathering assets.
- Redirect the mutual fund strategy toward long-term investing—owning business and holding them over the years—and away from short-term speculation—trading pieces of paper held for not much larger than a single year.
- If index funds are anathema, at least capitalize on the advantages that have given index funds their edge in providing optimal market-related returns to investors—lower fees and costs, lower turnover, higher-tax efficiency, and fully-invested equity portfolios that don’t time the market.
- Consider a mutual investor-owned structure—or something that approaches it—for management companies. Funds that required parental support when they were born have now reached their majority. They should be treated as dependent children no longer. There is no reason funds can not directly offer entrepreneurial incentives to managers—at least within reason.
- Take action willingly now. Recognize that time is money for fund investors, and “when you give, give with an open hand.”
- Managers that act promptly may avoid a decidedly unpleasant later confrontation by fund directors (who may yet honor their fiduciary duty to shareholders—I can dream can’t I?), by the derivative bar, by the Securities and Exchange Commission, by Congress, or even by their own fund shareholders. Or by all of the above.

Perhaps surprisingly, I also have a few directions for the hedgehogs:

- If you’re style is out of style—and your conviction unshaken—remember reversion to the mean, and stay the course.
- If you’re an indexer, don’t get complacent. While the tide is going your way now, it’s just too good to persist. You remember reversion to the mean, too.
- Reduce your focus on the Standard and Poor’s 500 Index as the basic indexing standard. Given its extraordinary and unrepeatable margin of superiority over the past five years, S&P 500 Index Funds have clearly drawn huge assets from short-term investors who buy hot past performance, as well from long-term investors who recognize the merits of low-cost, tax-efficient investing in high grade stocks. Begin to implement formalized redemption-in-kind procedures. When the giant growth stocks with their lofty price-earnings multiples revert to, and below, the market mean, as they inevitably will, substantial redemptions could follow. Protect the long-term shareholders.
- Remember that while the return on the all-market index fund—the best index standard—will always outpace the returns of all actively-managed accounts as a group, that may not always appear to be the case, since half of all mutual funds are small and mid cap funds. Make sure your investors are aware of this difference.

And to foxes and hedgehogs alike:
Think about ways to slow down the high turnover of your fund shareholders. Redemption fees work.

Remind your shareholders about risk—in plain English. When risk is least obvious, it is most in prospect.

Remember that “we never had it so good,” but also that trees don’t grow to the sky.

In all, the foxes need to adopt some of the simple strategies of the hedgehog, and the index hedgehogs need some humility.

As the millennium rolls into our lives, the mutual fund industry cries out for change, but change that serves its investors. But change in the prevailing ethos of the day is always hard to accomplish. To suggest how difficult it will be to move from the many things the fox knows to the one great thing the hedgehog knows, I close with the wisdom of Plato. In The Republic, Plato presents “The Allegory of the Cave,” describing men shackled to the same spot in a cave, with blinders that limit their vision to a distant light in front of them, rather than the fire burning behind them at a higher elevation:

Then . . . one prisoner is freed from his shackles; he walks, looks toward the light, and is pained by the glare and unable to see the objects whose shadows he used to see. He comes into the sunlight, dazzled by a new vision and unable to see what he called realities only moments earlier. He returns to the dark cave, and is laughed at for his vision. But he has seen the reality of beauty and justice, and knows the idols and shadows for what they are.

For me, the freed prisoner has recognized that the foxes are the shadows and the idols, and the hedgehogs are the reality and the truth. But each of you, like the other prisoners in the cave, will have to decide that for yourselves.

Clearly, leaving the darkness of the cave—the safety and comfort of the place one has known—is difficult, unpleasant, and challenging, and the first prisoner who does so will be laughed at. I, more than most investors, know that. But Plato’s allegory is a powerful symbol of the need for a new vision—a vision of true shareholder service that includes not only the information technology that lies at our fingertips, but a focus on a longer-term investment horizon, a cost structure that doesn’t eviscerate shareholder returns, and the needs of the human beings for whom we serve as stewards and trustees. As mutual fund managers and directors come to see the light—and realize that our current notions of serving shareholders are but shadows of the ideal—this industry and the mutual fund investors we serve will, finally, escape the darkness of the cave.