"Big Money in Boston": *The Commercialization of the Mutual Fund Industry*

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This is a story about the radical change in the culture of the mutual fund industry. For more than 63 years, I have not only witnessed it—I've been an active part of it for almost that long. During that span, the fund culture has moved in a direction that has ill-served mutual fund shareholders. It's time to recognize that change and understand how it all happened.

The story begins a long time ago, in December 1949. Almost halfway through my junior year as an economics major at Princeton University, I read the December issue of *Fortune* magazine in the newly built Firestone Library. On page 116 was an article titled "Big Money in Boston." That serendipitous moment would shape my entire career and life.

The bold-faced type beneath the story's headline explained the story:

> But money isn't everything, according to the Massachusetts Investors Trust, which has prospered by selling the small investor peace of mind. It's invention: the open-end fund. The future: wide open.

In the pages that followed, the article described the history, policies, and practices of Massachusetts Investors Trust. Founded in 1924, MIT was the first and, by 1949, by far the largest open-end fund.[1] In its discussion of the embryonic industry's future, *Fortune* was optimistic that this tiny industry, "rapidly expanding and somewhat contentious, could become immensely influential … the ideal champion of the small stockholder in controversies with … corporate management."[2]

In those days, the term "mutual fund" had not yet come into general use, perhaps because mutual funds, with one notable exception, are *not* mutual. In fact, contrary to the principles spelled out in The Investment Company Act of 1940,[3] they are "organized, operated, and managed" in the interests of the management companies that control them, rather in the interests of their shareowners.[4] So *Fortune* relied largely on terms such as "investment companies," "trusts," and "funds."

THE PRINCETON THESIS—1951

That article was the springboard for my decision—made on the spot—to write my thesis on the history and future prospects of open-end investment companies. After intensely analyzing the industry, I reached some conclusions, as stated in my thesis, "The Economic Role of the Investment Company":

> Investment companies should be operated in the most efficient, honest, and economical way possible … Future growth can be maximized by

reducing sales charges and management fees … Funds can make no claim to superiority over the market averages [indexes] … The principal function of investment companies is the management of [their] investment portfolios. Everything else is incidental … The principal role of the investment company should be to serve its shareholders. (Bogle [1951])

Such idealism is typical of young scholars. But despite the passage of more than 63 years since I read that *Fortune* article, my idealism has hardly diminished. Indeed, likely because of my lifelong experience in the field, that idealism is even more passionate and unyielding today.

Following my 1951 graduation, Walter L. Morgan—my mentor and the founder of the Wellington Fund, an industry pioneer—offered me a job, largely on the strength of my thesis. I decided to join his small but growing firm, then managing a single fund, with assets of $150 million. Although I wasn't so sure at the time, it was the opportunity of a lifetime.

When I joined the fund industry in 1951, there were only 125 mutual funds, with aggregate assets of $3 billion. Ten large (for those days) firms dominated the field, accounting for almost three-fourths of industry assets (Exhibit 1). With assets of $438 million—a market share equal to 15% of industry assets—MIT was overpoweringly dominant, by far the industry's largest fund, and by far the lowest-cost provider, with an expense ratio of 0.42%.

Indeed, while "Big Money in Boston" focused on MIT, Boston itself was the center of the fund universe. The funds operated there dwarfed their peers. Boston was home base for 22 of the 50 largest funds, managing 46% of the industry assets. (New York funds then represented 27% of those assets, Minneapolis 13%, and Philadelphia only 7%.[5] See Exhibit 2).

Most firms, including Wellington, managed just a single fund. Some also had a second fund, usually tiny. For example, the five MIT trustees also managed Massachusetts Investors Second Fund (hardly a name that would appeal to today's mutual fund marketers), with assets of just $34 million, a tiny fraction of MIT's $472 million total.[6]

THE OLD MODEL, THE NEW MODEL

The idea of trusteeship—indeed, the so-called "Boston trustee"—dominated the industry's image, as a photo of the five MIT trustees in the *Fortune* story suggested. Chairman Merrill Griswold sat unsmiling in the center. The men wore dark suits with vests and sober demeanors, all looking, well, "trustworthy." The fund

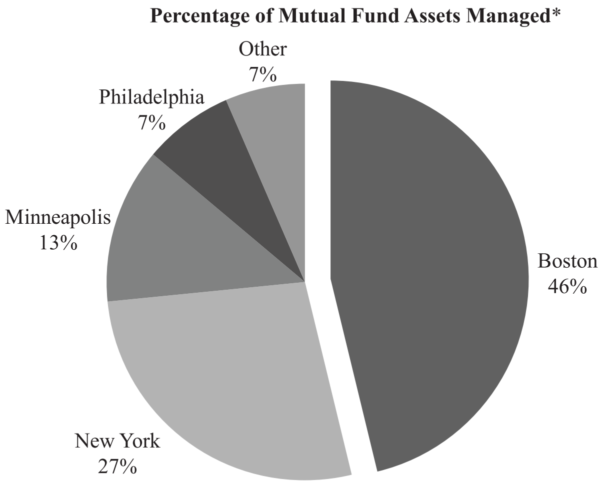
EXHIBIT 1
Mutual Fund Industry Assets, 1951

Rank	Fund Name	Total Assets* (million)	Notable Smaller Funds	Total Assets* (million)
1	MIT	$472	Eaton & Howard	$90
2	Investors Mutual	365	National Securities	85
3	Keystone Funds	213	United Funds	71
4	Tri-Continental	209	Fidelity	64
5	Affiliated Funds	209	Group Securities	60
6	Wellington Fund	194	Putnam	52
7	Dividend Shares	186	Scudder Stevens & Clark	39
8	Fundamental Investors	179	American	26
9	State Street Investment	106	Franklin	25
10	Boston Fund	106	Loomis Sayles	23
			T. Rowe Price	1
			Dreyfus	0.8
	Total	$2,239	Total	$537
	Percentage of Industry**	72%	Percentage of Industry	17%

**Includes associated funds.*

***Total industry assets: $3.1 billion.*

EXHIBIT 2
"Big Money in Boston"—1951



**By location of firm headquarters.*

industry's original operating model was much like that of MIT: Professional investors owned their own small firms, often relying on unaffiliated distributors to sell their shares. (In those days distribution was a profitable business.)

But the industry culture was soon to radically change. In 1951—and in the years that immediately followed—the fund industry that I read about in *Fortune* was a profession with elements of a business. It would soon begin its journey to becoming a business with elements of a profession and, I would argue, not enough of those elements. The old notion of fiduciary duty and stewardship was crowded out by an overbearing focus on salesmanship, as management played second fiddle to marketing—gathering assets to manage. That is the industry that exists today.

What explains this profound change in mutual-fund culture?[7] There were four major factors: 1) gargantuan growth and new lines of business; 2) the widespread use of aggressive, higher-risk strategies, leading to less focus on long-term investment and more focus on short-term speculation; 3) the rise of product proliferation, with thousands of new funds formed each year, embracing aggressive share distribution as integral to the manager's interest in gathering assets and increasing fee revenues; and 4) the industry's conglomeratization, as publicly owned financial intermediaries acquired ownership of fund managers, a development that served the monetary interests of mutual fund managers but was a disservice to the interests of mutual fund shareholders.

Later, a fifth factor emerged that has the potential to take our industry back toward its heritage. This factor is the triumph of the index fund, which serves shareholders first and managers only second.

THE STUNNING GROWTH OF MUTUAL FUND ASSETS

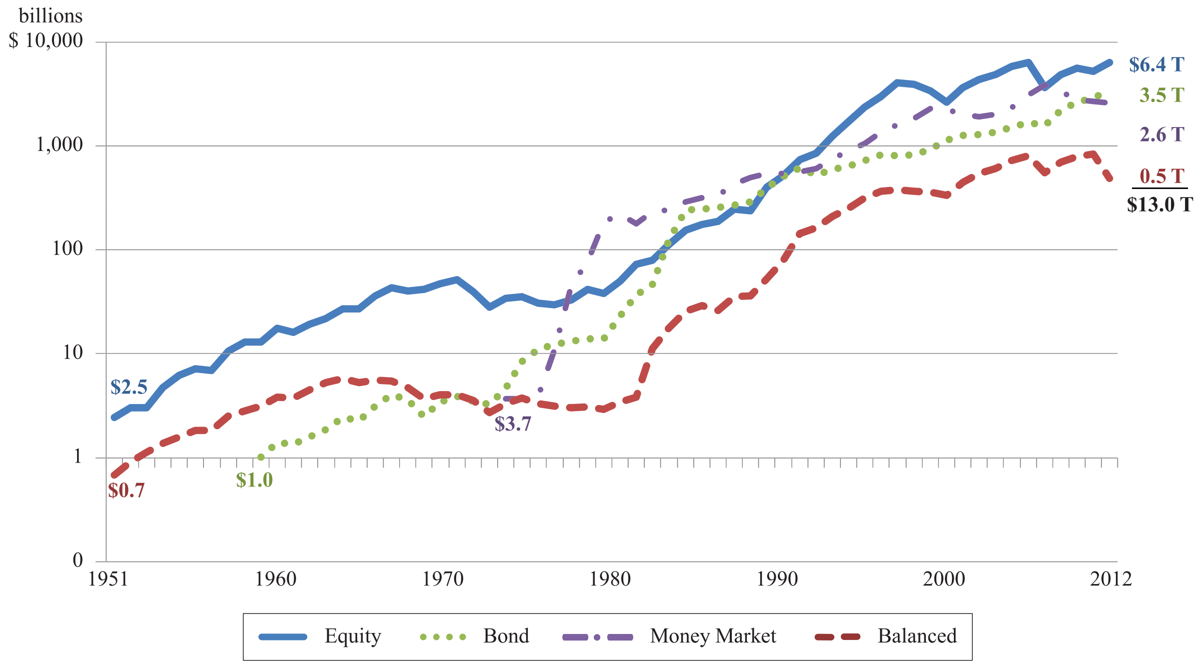
When I joined the industry in 1951, fund assets totaled just $3 billion.[8] Today, assets total $13 trillion, a remarkable 15% annual growth rate. When a small or even cottage industry becomes a behemoth, almost everything changes. Big business, as hard experience teaches us, represents not just a difference in degree from small business—simply more numbers to the left of the decimal point—but a difference in kind: more process, less human judgment, more conformity, less tolerance of dissent, more business values, fewer professional values.

For almost the entire first half-century of industry history that followed MIT's founding in 1924, equity funds were its backbone: some 95% of total assets. Equity fund assets topped $56 billion in 1972. After a great bear market, they tumbled to $31 billion in 1974, an unpleasant reminder of stock-market risk and investor sensitivity to market declines.

Recovering with the long bull market that followed, equity assets soared to $4 trillion in 1999. Despite two subsequent bear markets (which brought the market down by some 50%, twice), equity fund assets have now reached the $6 trillion level and are still the engine that drives the industry (Exhibit 3). The growth of balanced funds is spasmodic. Their important role in the industry dwindled during the mid-1960s and then, following the 1973–1974 bear market, was overwhelmed by the boom in bond funds. In recent years, the importance of balanced funds has grown. At the end of 2012, assets reached $500 billion.

During the 1950s, bond fund assets seemed stuck at around $500 million, with little growth during the next two decades. But in 1975, bond funds began to assert themselves. As the financial markets changed, so did investors' needs. Income became a high priority and bond fund assets grew nicely, reaching $250 billion in 1987, exceeding even the $175 billion total for equity funds. Bond funds then retreated to a less significant

E X H I B I T 3
Mutual Fund Asset Growth, 1951–2012



role during the 1990s. Today, following a long run of generous interest rates that tumbled in recent years, bond fund assets have risen to $3.5 trillion, or 26% of the industry total.

In the decade following the stock market crash of 1973–1974, the dominance of equity funds waned. Money market funds—the fund industry's great innovation of the mid-1970s—bailed out the industry, compensating for the shrunken equity fund base (Exhibit 4). They quickly replaced stock funds as the industry's prime driver. By 1981, money market fund assets of $186 billion represented an astonishing 77% of industry assets. Although that share has declined to 20% today, money market funds are still a formidable business line, with $2.6 trillion of assets. But given today's pathetic yields and the possibility of a new business model for money funds—one requiring that the rounded $1.00 net asset value that money market funds now report reflect their net asset values' daily variance with interest rate charges and credit quality—growing the assets of money market funds assets won't be easy.

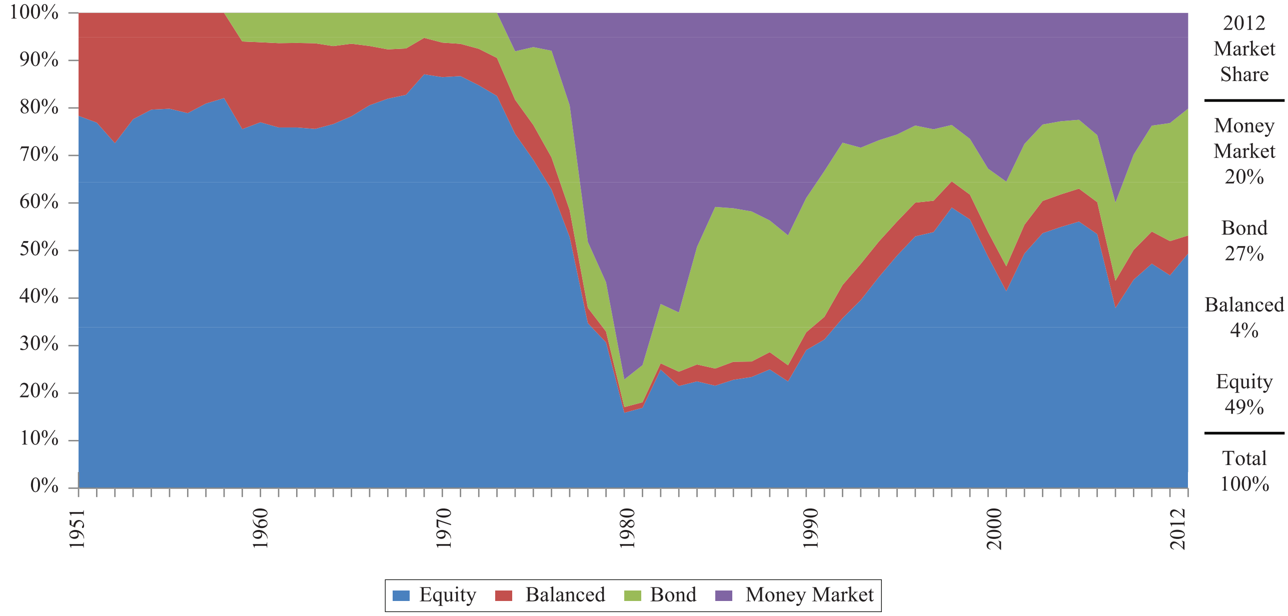
With the rise of bond funds and money market funds, nearly all of the major fund managers, which for a half-century had primarily operated as professional investment managers for one or two equity funds, became business managers, offering a smorgasbord of investment options. They became financial department stores, focusing heavily on administration, marketing, and, in this information age, shareholder services.

THE SEA CHANGE IN EQUITY FUND MANAGEMENT

In addition to the growth and changing composition of the mutual fund asset base, a second force also began to change industry culture: a sea change in the industry's investment operations. Equity funds were once largely supervised by conservative investment committees with a long-term focus and a culture of prudent investment, the original approach of the Boston trustees. That approach gradually gave way to individual portfolio managers, often operating with a short-term focus and a more speculative culture of aggressive investing.

This change from a group approach to an individual approach has fostered a surge in portfolio turnover. The turnover rate of actively managed funds has leaped from 30% in the 1950s and early 1960s to 150% in the past few decades.[9] Most fund managers were once investors, but now most seem to be speculators. Investors of all types embraced a new financial culture of ever-higher

Exhibit 4
Mutual Fund Industry Share by Asset Class—1951–2012



stock-trading activity. Institutional traders, of course, were simply swapping shares with one another, with no net gain for their clients as a group. Indeed, transaction costs meant that clients were guaranteed a loss, relative to the overall return of the stock market.

EQUITY FUND RISKS RISE SHARPLY

What's more, the traditional equity fund model of blue-chip stocks in market-like portfolios—and commensurately market-like performance, before costs—evolved into a new, more aggressive model. As measured by beta (the volatility of a fund's asset value relative to the stock market as a whole), the volatility of individual funds increased sharply.

This increase in risk is easily measured. The volatility of returns among actively managed equity funds increased sharply, from an average of 0.90 during the 1950s (10% less volatile than the market) to 1.11 during recent years (11% more volatile). That's a nearly 23% increase in the relative volatility of the average fund. In earlier eras, no equity fund had volatility above 1.11; in recent years, 38% of equity funds exceeded that level (Exhibit 5).

That shift toward higher volatility began during the late 1960s, when "hot" managers were treated like Hollywood stars and marketed in the same fashion. It has largely continued ever since. (Index funds are a rare and notable exception. An all-market index fund, by definition, has a beta of 1.00.)

But as fund performance inevitably reverts to the mean, aggressive managers who focused on changes in short-term corporate earnings expectations, stock price momentum, and other quantitative measures proved more akin to comets, soaring spectacularly into the sky, then flaming out. Too often, managers forgot about prudence, due diligence, research, balance sheet analysis, and other old-fashioned notions of intrinsic value and long-term investing.

Exhibit 5
Relative Volatility of Equity Mutual Funds

Relative Volatility*	1950–1956	2008–2011**	Difference
Over 1.11	0%	38%	+38%
0.95–1.11	34	37	+3
0.85–0.94	30	10	–20
0.70–0.84	36	6	–30
Below 0.70	0	9	+9

**S&P 500 = 1.00*

***Largest 200 Equity Funds*

Source: Wiesenberger 1950–1956; Morningstar 2008–2011.

Publicity focused on the success of these momentary stars, creating an accompanying buzz about the best funds for the year or even the quarter. Fund management companies and "hot" fund portfolio managers received huge fees and compensation. As a result, of course, the manager culture changed. Even a short-term performance dip became a career risk, so conventional wisdom dictated that managers should be agile and flexible, watching over their portfolios in real time.

Large numbers of aggressive funds were formed, and equity fund assets soared. Steady and deliberate decision-making was no longer the watchword. As managers tried to earn their keep through feverish trading activity, portfolio turnover leaped upward. Never mind that this seemed to improve fund performance only randomly and, because of advisory fees and trading costs, couldn't work for all managers as a group. As always, for each winner, there is a loser.

THE RISE OF PRODUCT PROLIFERATION

A turn toward product proliferation was closely linked to the change in the investment culture. Such proliferation reflects (in part) a fund company marketing strategy that says, "We want to run enough different funds so that at least one will always do well." An industry that used to sell what it made became an industry that makes what will sell. And in the mutual fund industry, what will sell—the latest investment fad, the hottest sub-sector—is too often exactly what investors should avoid. This problem began to take hold in the 1960s and soared as the great bull market of 1982 to 2000 created ever-higher investment expectations. That was especially true in the late 1990s, when technology stocks blossomed, then wilted. The number of funds exploded upward.

When I entered the industry in 1951, there were just 125 mutual funds, dominated by a few leaders. Today, there are a total 5,091 equity funds, 2,262 bond funds, 595 money market funds, a mind-boggling total of 7,948 traditional mutual funds, and 1,446 exchange-traded index funds, which are generally also mutual funds. If you have difficulty choosing among such a staggering number of investment options, just throw a dart! It remains to be seen whether this quantum increase in investment options, ranging from the simple and prudent to the complex and absurd, will serve the interests of fund investors. I have my doubts, and so far the facts seem to back me up.

THE GOOD NEWS AND THE BAD NEWS

The good news is that many of these new funds are bond funds and money market funds, potentially offering investors a new range of sound investment options. The bad news is that, in the industry's equity fund sector, the massive proliferation of so many untested strategies (and often untested managers) has resulted in confusion for investors. "If you want to win, just pick the right fund or manager" seems to be the instruction. But how could investors or their advisers possibly know in advance which funds or managers will win? How many advisers stoked the expectation that it would be easy to succeed and difficult to fail?

The proliferation of fund products was followed (unsurprisingly!) by nearly all of today's largest fund groups, resulting in a quantum increase in the number of funds that each group offers. In 1951, industry leaders offered an average of 1.7 funds each. Today, these firms offer an average of 117 funds each (Exhibit 6). Fidelity once managed just a single fund; the firm now manages 294 funds. Vanguard also began the period with a single fund (Wellington) and is now responsible for 140 funds. Shareholders can only hope that each member of their funds' boards of directors is serious about the fiduciary duty to know and to evaluate all of the relevant data for those funds and for the scores of other funds under the boards' aegis.

With all of that product proliferation, the fund industry has come to suffer an unprecedented fund failure rate. In the 1960s, about 1% of funds disappeared each year, and about 10% in a decade. By 2001–2012, however, the fund failure rate had soared seven-fold to 7% per year, or to 90% over that period. Of some 6,500 mutual funds in existence during that time, 5,500 have been liquidated or merged into other funds, almost always into members of the same fund family, albeit funds with more imposing past records.

Assuming (as I do) that this failure rate will persist over the coming decade, by 2023 approximately 3,500 of today's 5,000 equity funds will no longer exist—one fund death per business day. The mutual fund industry proudly insists that its mutual funds are designed for long-term investors, but how can one invest for the long term in funds that may exist only for the short term?

Soaring Costs for Fund Investors

Another result of proliferation is the soaring (and truly absurd) rise in fund costs. Despite the five-thousand-fold growth in fund assets—and which has brought enormous economies of scale—expense ratios (annual fund expenses as a percentage of fund assets) have leaped upward.

Consider eight of 1951's major fund managers that survive today, each operating under the conventional industry model, each actively managing their fund portfolios. (Public shareholders own five of these management companies; only three remain privately held by firm insiders.) From 1951 to 2012, the average expense ratios of the funds managed by these eight giants soared by 84%, from an average of 0.62% to 1.15% of assets. The four largest fee increases came from firms that were publicly owned, as shown in Exhibit 7.

By contrast, the only mutually owned firm (Vanguard, which adopted that model at its inception in 1974) actually drove expenses down—from 0.55% to 0.17% of assets, a drop in unit costs of 69%. When funds that operate under the original industry business model see expense ratios rise by 84%, and the expense ratio of the one fund group that operates under a new business model falls by 69%, it is at least possible that there's a message there.

The data in Exhibit 7 reflect the unweighted, average expense ratios of each manager's funds. We can only approximate asset-weighted ratios, but we can still conclude that the aggregate dollar fees paid to these eight firms rose from $58 million in 1951 (measured in 2012 dollars) to $26 *billion* in 2013—a four-hundred-fold jump in the fees that investors pay to fund managers. Expense ratios seem small. Actual expenses are another story.

With that staggering increase in managers' resources to improve stock selection, price discovery, and portfolio strategy, it's reasonable to expect that fund managers would earn better returns for their shareholders, relative to stock-market indices. Alas, there is no evidence whatsoever that this has been the case.[10] None.

Exhibit 6
Assets and Number of Funds—1951 and Today

Major Mutual Fund Groups

	1951			2013	
Original Name	Total Assets (million)	No. of Funds Managed	Current Name	Total Assets (billion)	No. of Funds Managed
MIT	$472	2	MFS	$128	80
Investors Mutual	365	3	Columbia	162	116
Affiliated	209	3	Lord Abbett	97	38
Wellington	194	1	Vanguard	2,136	140
Eaton & Howard	90	2	Eaton Vance	107	139
Fidelity	64	1	Fidelity	1,372	294
Putnam	52	1	Putnam	59	76
American	27	2	American	994	33
T. Rowe Price	1	1	T. Rowe Price	375	106
Dreyfus	0.8	1	Dreyfus	228	152
Total/Average	$1,475	1.7	Total/Average	$5,658	117

Note: In 1951, 12 of today's 20 largest firms did not exist or did not manage funds, including BlackRock, PIMCO, State Street Global, and JP Morgan.

Exhibit 7
Mutual Fund Expense Ratios—1951 and 2012

Conventional Industry Model	1951	2012	Change
MIT/MFS (C)	0.42%	1.33%	+220%
Investors Mutual/Columbia (C)	0.56	1.23	+121
Eaton Howard/Eaton Vance (SH)	0.64	1.32	+108
Putnam (C)	0.66	1.31	+98
Fidelity (P)	0.63	1.04	+65
T. Rowe Price (SH)	0.50	0.81	+62
Affiliated/Lord Abbett (P)	0.75	1.14	+53
American (P)	0.84	0.98	+17
Average	0.62%	1.15%	+84%
New Industry Model			
Wellington/Vanguard (M)	0.55%	0.17%	–69%

Note: Ownership Type: (C) conglomerate, (SH) public shareholders, (P) private, (M) mutual.

THE CONGLOMERATIZATION OF THE FUND INDUSTRY

April 7, 1958: A Date That Will Live in Infamy

The beginning of publicly owned management companies played a major role—perhaps *the* major role—in changing the nature and structure of our industry. This baneful development began with an unfortunate decision by the U.S. Court of Appeals, Ninth Circuit (San Francisco) that affirmed the right of a fund adviser (Insurance Securities Incorporated, or ISI) to sell a controlling interest in its stock at a premium to its book value. The Securities and Exchange Commission (SEC) argued that the transaction was a sale of the responsibilities of trusteeship, and hence a violation of fiduciary duty. The date of that decision, April 7, 1958, was a date that will live in infamy for mutual fund shareholders.

That seminal event, now long forgotten, changed the rules of the game.[11] It opened the floodgates to publicly owned management companies, providing fund managers with the huge potential rewards of entrepreneurship, inevitably at fund shareholders' expense.

From 1924 through the 1950s, all but one[12] of the industry's 50 largest fund management companies were operated primarily by investment professionals, either through a partnership or a closely held corporation. But within a decade after the court's decision, scores of mutual fund management companies went public, selling their shares but usually letting their managers retain voting control.

It was only a matter of time until U.S. and international financial conglomerates acquired most of these newly publicly owned firms, and many of the industry's privately owned firms as well. These acquiring firms, obviously, are in business to earn an appropriately high return on their capital, and they looked at the burgeoning fund industry as a goldmine for managers. (It was!) But that high return came at the expense of return on the capital entrusted to them by the mutual fund investors whom they were duty bound to serve.

Conglomerate and Public Control of 40 of the 50 Largest Fund Managers

As shown in Exhibit 8, the dimension of that change has been extraordinary. Among today's 50 largest mutual fund complexes, only 9 remain private; 40 are publicly held, including 30 owned by financial conglomerates. The only different ownership model is Vanguard's genuinely mutual fund structure, in which fund shareholders own the fund management company.

All the public fund management companies have external owners, and these owners face an obvious potential conflict of interest that has deeply concerned me for at least four decades. As I said to Wellington's officers in 1971, when public shareholders largely owned our firm:

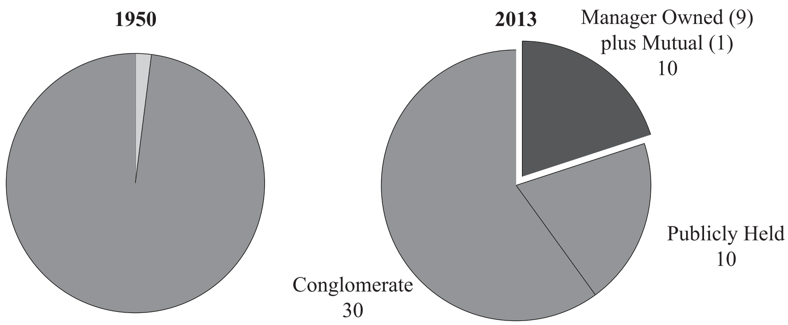
> I reveal an ancient prejudice of mine: All things considered ... it is undesirable for professional enterprises to have public stockholders ... The pressure for earnings and earnings growth engendered by public ownership is antithetical to the responsible operation of a professional organization. (Bogle [1971])

Despite the far-reaching consequences of its unfortunate birth, conglomeratization has been the least recognized of all of the changes that have beset the mutual fund industry. Ownership by financial conglomerates has now become the dominant industry model. In 1951, when there was only a single conglomerate owner, assets of most funds totaled $1 million or less, hardly enough to whet the appetites of hungry acquisitors. But not all of today's giant firms have heeded the call of the conglomerates. All three of today's largest fund complexes—Vanguard, Fidelity, and American Funds—have remained independent. These three firms alone manage $4.4 trillion, or about 30% of all mutual fund assets.

While most of the private firms have grown organically, many of the public firms have grown by acquisition, a pattern hardly unfamiliar to corporate America's business behemoths. For example, Ameriprise Financial (manager of the Amerprise/Columbia Funds) has acquired 12 previously independent fund managers. BlackRock obtained its entire fund asset base through its acquisition of Barclays Global Investors in 2009, Merrill Lynch Asset Management in 2006, and State Street Management and Research Corporation, previously owned by Met Life, in 2005. (The last acquisition was followed by the liquidation of the industry's second oldest fund, State Street Investment Corporation. I still mourn its demise as a death in the family.) Franklin

E X H I B I T 8

Ownership of 50 Largest Mutual Fund Management Companies—1950 and 2013



1950	
Privately Held	49
Publicly Held	1
Total	50

2013	
Privately Held	10
Publicly Held	40
Total	50

Resources, another huge firm, is the product of the 1992 merger of giant Franklin Group and the equally large Templeton Group. And so on.

"Trafficking" in Management Contracts

Opening the doors to public ownership produced exactly what the SEC was concerned about a half-century ago in the ISI case: "trafficking" in management contracts, and the likelihood that it would dramatically erode the sense of fiduciary duty that largely characterized the industry during its early era. Product proliferation hardly helped. So I reiterate: How can an independent fund director feel a fiduciary duty to each of the hundred or more fund boards on which he or she serves?

The problem is summarized in Matthew 6:24: *No man can serve two masters*. Yet when a management firm is owned by a giant conglomerate, or even by public owners, the conflict of interest is palpable. Even when a conglomerate internally builds a fund management company, the conglomerate's goal is to earn the highest possible return on invested capital. That's the American way! The firm maximizes fees by gathering assets and creating new products. It resists reductions in fee rates that would allow fund shareholders to benefit from economies of scale.

Fund shareholders, of course, have precisely the opposite interests. They benefit from lower fee rates, which increase their returns, dollar for dollar. Think of it this way: the officers and directors of financial conglomerates have a fiduciary duty to increase the returns their corporate shareholders earn. Yet they also have a fiduciary duty to maximize the returns their mutual fund shareholders earn. As Matthew says, this obvious conflict in serving two masters will cause them "to love the one and hate the other," and it seems obvious that the fund manager is the master who gets the love. There can be only one resolution to this profound conflict: a federal statute that prohibits the ownership of fund managers by holding companies.[13]

THE TRIUMPH OF INDEXING

Another Date That Will Live in Infamy: December 31, 1975

If April 7, 1958 is a date that will live in infamy for mutual fund shareholders, then December 31, 1975, is a date that will live in infamy for mutual fund managers. That is the date that Vanguard—a tiny, brand-new mutual fund firm that had begun operations only seven months earlier—filed the declaration of trust for a new mutual fund that promised not to engage in active management. Originally named First Index Investment Trust, it was the world's first index mutual fund.

Its birth was, curiously, the product of a divorce. In 1966, as head of the long-established Wellington Management Company, I bet the firm's future on a merger. We joined with a small Boston firm, Thorndike, Doran, Paine, and Lewis, run by four aggressive equity managers. The firm operated a hot fund named Ivest, managed a growing pension business, and had investment talent that, I believed, could more effectively manage the portfolio of our faltering Wellington Fund.

I was young, foolish, and (even worse!) I was wrong. The merged firm prospered, but only for a while. As 1973 began, the stock market began its terrible 50% crash. Ivest Fund failed, as did two of its Boston sister funds. Wellington Fund's performance continued to deteriorate. Indeed, it was a disaster—the worst performer among all balanced mutual funds in 1967–1977. Our new business model faltered, and then it failed. In the merger, I ceded substantial voting power to the new managers, and it was they who fired me as the leader of Wellington Management. On January 24, 1974, I was replaced by their leader, Robert W. Doran.

I leave it to wiser heads than mine to explain the perverse logic involved in that outcome. But I know that it was the most heartbreaking moment—until then, the only such moment—of my entire career. I decided to fight back. "Fired with enthusiasm" by Wellington Management Company, I continued in my role as chairman of the board of Wellington Fund and its 11 sister funds. There was a considerable overlap in board membership between the funds and the manager, but the funds, as required by law, had a majority of independent directors. As far as I know, such a power struggle had never before occurred in our industry. I doubt that its counterpart will ever recur.

The Mysterious Question Mark

That's too long and complex a story for this article. (For more detail, it's chronicled in *The Clash of the Cultures*, Bogle [2012].) But the outcome was a mighty near thing. Even *The New York Times* couldn't figure out what was happening. In the early edition of the newspaper on March 14, 1974, the *Times* headline read "Ex-Fund Chief to Come Back." In the late edition, however, the original headline now ended with a question mark. A few excerpts from the article:

> John C. Bogle, who was forced out of his $100,000-a-year job as president and chief executive officer of the Wellington Management Company in late January, is expected by his associates to try to fight his way back at the next board meeting, scheduled to be held within a week. Mr. Bogle is understood to believe that this may be the appropriate time for the funds to "mutualize," or take over, their investment advisers. (Sloane [1974])

But the "?" silently described the struggle that was going on.

Six months later, the fund board, like King Solomon, made its decision: cut the baby in half, more or less. The Boston office would continue as the funds' investment adviser and distributor. The Philadelphia office, under my direction, would run the funds' administrative, accounting, record-keeping, and compliance activities, as well as evaluating the performance of our adviser and distributor, which was then the Wellington Management Company. For the first time in industry history, mutual funds would be independent of their management company, free to operate solely in the interests of their own shareholders.

Vanguard Is Born as a Truly Mutual Fund Company

The fund board accepted my recommendation to operate as a truly mutual organization, with the new firm owned by the funds themselves and providing its services to shareholders at cost. The board also approved my choice of a name for the new firm. The Vanguard Group of Investment Companies was born on September 24, 1974.[14] We were overseeing just $1.4 billion in fund assets.

As I considered Vanguard's priorities in the years ahead, I recalled the fund industry analysis I'd presented in my senior thesis. I decided to buttress my conclusion that mutual funds can "make no claim to superiority over the market averages." I documented the failure of mutual fund managers generally to outpace the market, as measured by the S&P 500, during the previous three decades. The math clearly demonstrated the continued superiority of index funds. I was also inspired by powerful encouragement from Nobel laureate Paul Samuelson [1974], expressed in his essay "Challenge to Judgment." As a result, Vanguard formed the world's first index mutual fund.

Despite the persuasive data, our board was skeptical. Its mandate to the warring partners precluded Vanguard from providing investment advisory services to the funds. But when I explained that an index fund required no adviser, the board reluctantly agreed. That day "changed a basic industry in the optimal direction," as Samuelson wrote in his 1993 foreword to my first book.[15] It was indeed the beginning of a far better direction, one aimed at placing the interests of mutual fund shareholders front and center.

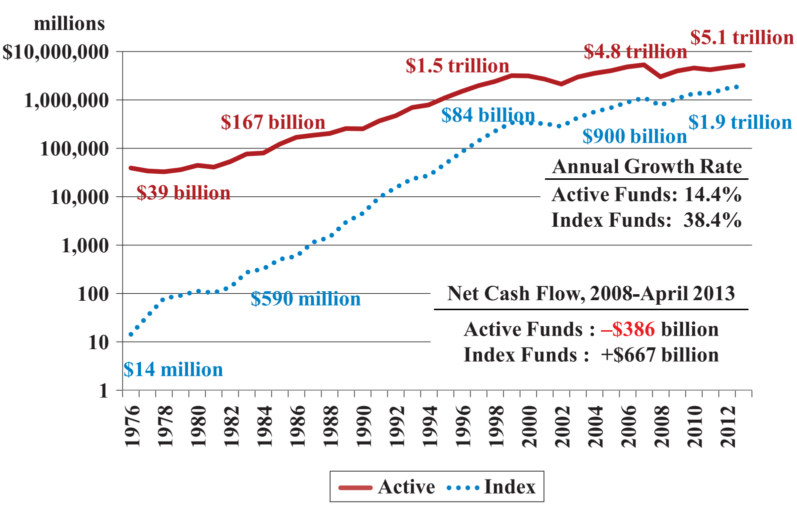
The initial public offering of First Index Investment trust took place on August 31, 1976. It was a flop. Despite a target of $150 million, the underwriters raised initial assets of only $11 million. The fund barely grew for years, and industry leaders scorned it publicly. ("You wouldn't settle for an 'average' brain surgeon, so why would you settle for an 'average' mutual fund?" quipped a rival fund company's CEO.)[16] A Midwest brokerage firm flooded Wall Street with posters, illustrated by an angry Uncle Sam using a large rubber stamp to cancel the index fund's stock certificates. Its headline screamed, "INDEX FUNDS ARE UN-AMERICAN. HELP STAMP OUT INDEX FUNDS!"

To make matters worse, during the index fund's early years it appeared to lag the average fund manager's returns, largely because of flaws in the data. The fund attracted few additional assets. Even with the acquisition of a $40 million actively managed Vanguard fund, First Index didn't cross the $100 million mark until 1982.[17] It wasn't until 1984 that a second index mutual fund joined the industry. By 1990, the total assets of five index funds had reached $4.5 billion, only about 2% of equity fund assets. The indexing experiment was stumbling.

But as Thomas Paine reminded us, "the harder the conflict, the more glorious the triumph." And just as Samuelson predicted, indexing would change the fund industry in the optimal direction. Index fund assets leaped to $100 billion by 1996, to $1 trillion by 2006, and to about $2 trillion today (Exhibit 9). During the past five years, investors liquidated approximately $386 billion in actively managed equity funds and poured $667 billion into passively managed index equity funds, reflecting a $1 trillion-plus shift in investor preferences. Today, assets of passively managed equity index funds are equal to almost 40% of the assets of their actively managed peers, their superiority confirmed by scores of independent academic studies. Index fund growth seems certain to continue, even accelerate, from today's massive total.

EXHIBIT 9

Growth in Assets of Equity Funds—Active vs. Index



"THE MORAL HISTORY OF U.S. BUSINESS"

Those two days of infamy, one in 1958 and one in 1975, were polar opposites. Conglomeratization placed a heavy cost burden on the returns earned by mutual fund investors; indexing, with its miniscule costs, provided an automatic boost to returns.

Here we have two subtle lessons for fund investors and their managers. The first reflects a diminution of the fiduciary's power; the second reflects a clear buttressing of the concept of fiduciary duty. Could there be a lesson here about financial ethics and stewardship? Is the moral culture of our financial system involved? Will our society demand that business success be harmonized with social purpose?

Ironically, that provocative question was raised in the very same issue of *Fortune* in which "Big Money in Boston" appeared. The lengthy essay was titled "The Moral History of U.S. Business" [1949]. American business leaders, the article noted, "do not work for money alone. A dozen nonprofit motives lie behind their labors: love of power or prestige, altruism, pugnacity, patriotism, the hope of being remembered through a product or institution, etc. American business leaders in general have offered few pure specimens of economic man … It is relevant to ask," *Fortune* added, "what are the leader's moral credentials for the social power he wields."

The essay presented a brief history of the values of U.S. business leaders, beginning in Colonial America. Benjamin Franklin,[18] for instance, considered his business the foundation of all else he did. He set himself a course of conduct using his favorite words, "industry and frugality," which he described as "the means of producing wealth, and thereby securing virtue." *Fortune* also cited:

> … the generic features of the businessman of that era, as described in Lives of American Merchants in 1844. Speaking of William Parsons, a New Yorker of probity, the book declared: "the good merchant is not in haste to be rich … He recollects that he is not merely a merchant, but a man, and that he has a mind to improve, a heart to cultivate,[19] a character to form. The good merchant, though an enterprising man and willing to run some risks, yet is not willing

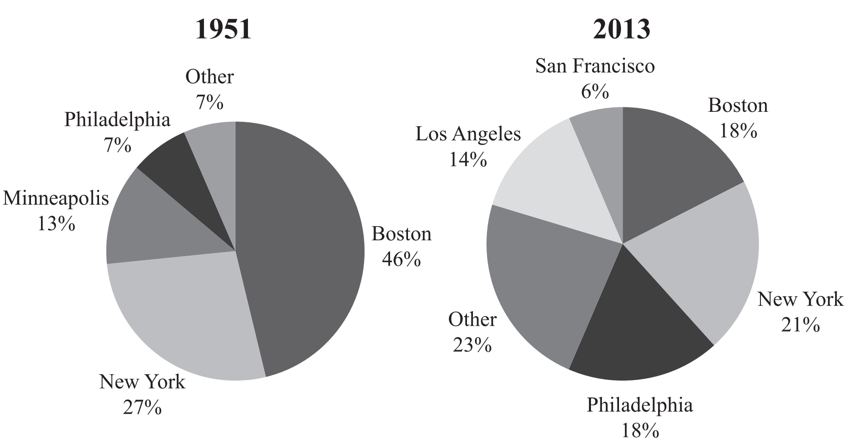
> to risk everything, nor put all on the hazard of a single throw … Above all, he makes it a matter of conscience not to risk in hazardous enterprises the property of others entrusted to his keeping ... He is careful to indulge in no extravagance, and to live within his means … Simple in his manner and unostentatious in his habits of life, he abstains from all frivolities and foolish expenditures …

The spirit of character, prudence, and rectitude, described in a book written more than 150 years ago, is worthy of careful consideration by today's mutual fund officers and directors. It is that spirit that must animate the values and conduct of the professional investors and financial institutions that now dominate the field of money management.

PURITAN BOSTON AND QUAKER PHILADELPHIA[20]

More than six decades after I read that *Fortune* article, there's still "Big Money in Boston." Although it's no longer the industry center, Boston firms manage about \$2.2 trillion of industry assets, or 18%, well down from that 1951 peak of 46%. Almost one-half of that loss has been offset by Philadelphia's gain: from 7% to 18% (Exhibit 10). Significant changes have come, not only in the center of the industry's geographic core, but also in the business models of many firms.

EXHIBIT 10
Big Money in Boston—Still Huge, No Longer Dominant



Note: Percentage of mutual fund assets by location of firm headquarters.

How did Boston lose and Philadelphia gain so much? In both cases, it came down to choices about firms' business models and strategies. The fund industry now has four business models: mutual, private ownership, public ownership, and conglomerate ownership. Those structures play an important role in shaping a firm's investment strategy (notably active money management versus passive indexing). In his introduction to my 1999 book *Common Sense on Mutual Funds*, economist and author Peter L. Bernstein clearly articulated this distinction.

> … What happens to the wealth of individual investors cannot be separated from the structure of the industry that manages those assets. Bogle's insight into what the structure means to the fortunes of those individuals whose welfare concerns him so deeply is what makes this book most rewarding. (Bogle [1999])

In 1969, MIT abandoned its highly successful original business model, with its sharp focus on prudent trusteeship and low costs. It became the nucleus of a new, profit-seeking firm privately owned by its trustees, Massachusetts Financial Services (MFS), which managed the funds' affairs and distributed their shares. In 1976, its relatively new owners sold MFS (at a healthy profit) to a publicly owned Canadian insurance company.[21] The firm's once rock-bottom costs have soared from a low of 0.17% in 1961 to 1.33% for the MFS funds in 2012, an astounding increase of 700%. These fees are now among the highest in the industry. Its once-record market share—15% of industry assets in 1949—has tumbled to just 1%. The company has yet to offer investors an index fund.

Nevertheless, the firm has been a gold mine for the financial conglomerate that acquired it. Since 1995, Sun Life has earned almost \$4 billion in profits from its ownership of MFS. Readers can decide whether or not the SEC conclusion's about the implications of trafficking in management contracts—trafficking in fiduciary duty—was justified.

QUAKER THRIFT AND SIMPLICITY

The change in MIT's business model left a void that Vanguard filled. With a bow to the legendary Quaker thrift and simplicity,[22] Vanguard's new mutual structure incorporated rock-bottom costs: The firm's expense ratio of 0.17% (less than one-fifth of one percent) in 2012 is but one-eighth of MFS's unit costs. Vanguard's index fund, which simply buys and holds the 500 stocks of the S&P 500 and delivers their returns to investors, has been the prime force in the firm's rise to industry leadership.

Now overseeing $2.2 trillion in assets, Vanguard's remarkable growth is a reflection of the triumph of indexing, and investors' realization that lower fund costs lead to higher fund returns. In 2012, Vanguard's share of assets in stock and bond mutual funds set an all-time industry high of 17%. The firm has accounted for more than 70% of industry cash flow since 2010, and continued growth in market share seems likely.

It seems only a matter of time until a serious challenger emerges. The challenge is simple: operate at far lower costs, manage more index funds, tone down the marketing, and run the funds with the interests of shareholders as the highest priority. Given that building earnings for public stockholders is the priority for so many management companies, however, it won't be easy.

A FINAL WORD FROM ADAM SMITH

Which should be the higher priority for a fund manager: the interests of fund shareholders or the interests of management-company owners? In *The Wealth of Nations,* Adam Smith gave us an unequivocal answer:

> … the interest of the producer ought to be attended to, only so far as it may be necessary for promoting that of the consumer. The maxim is so perfectly self-evident, that it would be absurd to attempt to prove it … *[T]he interest of the consumer … [must be] the ultimate end and object of all industry and commerce.* (Smith [1776])

Even as I wish our fund peers well—especially those in Boston, the industry's birthplace—the challenges facing the industry's present business model are enormous. The Vanguard way, of course, is not the only way. But whichever way others choose, I believe in the central principle that has informed my long career. It all began with the incredible good luck of stumbling on that 1949 magazine story. In the thesis it inspired, I came to essentially the same conclusion that Adam Smith arrived at in 1776: "the principal role of the investment company should be to serve its shareholders." In the years ahead, that principle must become the watchword of our industry.

ENDNOTES

This essay provided the basis for a speech that I delivered to The Boston Security Analysts Society on May 17, 2013. The opinions expressed in this essay do not necessarily represent the views of Vanguard's present management.

[1]MIT was an open-end fund, redeeming shares on demand. A closed-end fund has a fixed number of nonredeemable shares outstanding.

[2]*Fortune*'s optimism arose from the fact that in the late 1940s, funds played a role in a number of corporate management changes. Today, however, that promise has yet to be fulfilled. Despite holding virtual control over corporate America—mutual funds now collectively own more than one-third of U.S. stocks—they lack the spirit and the will to perform this central role in corporate governance.

[3]Section 1(b)(2): Mutual funds must be "organized, operated, and managed" in the interests of their shareholders rather than in "the interests of directors, officers, investment advisers … underwriters, brokers, or dealers."

[4]At the 1968 Federal Bar Conference on Mutual Funds, former SEC Chairman Manuel Cohen gave a speech titled "The 'Mutual' Fund," putting quotation marks around the word mutual, since "its salient characteristics raise the serious question whether the word 'mutual' is an appropriate description."

[5]Minneapolis is the headquarters of the giant Ameriprise/Columbia Funds (originally named Investors Diversified Services, formed in 1894). In 1951 (and in 2012), the firm accounted for virtually all of the fund assets located there.

[6]Five smaller fund managers of that era operated multiple funds, each providing a wide selection of investment objectives and specialized portfolios—often 20 or more—focused on a variety of single industries. Designed for market timing, at first they grew with the burgeoning industry. All had their moment in the sun during the 1960s, but not one remains today.

[7]This subject is one of the major themes of my 2012 book, *The Clash of the Cultures: Investment vs. Speculation.*

[8]$3 billion in 1951 is equivalent to $28 billion in 2013 dollars.

[9]The turnover measure I'm using represents the total portfolio purchases plus the total portfolio sales of equity funds each year as a percentage of assets, not today's conventional—if inexplicable—formula: the lesser of purchases and sales as a percentage of assets.

[10]In his 1974 article "Challenge to Judgment," published in the first edition of *The Journal of Portfolio Management*, Nobel laureate Paul Samuelson noted that academics had not been able to systematically identify superior active fund managers, and said that the burden of proof belonged to the proponents of active management, to produce "brute evidence to the contrary."

[11]Ironically, ISI went out of business decades ago, its records lost in the dustbin of history.

[12]IDS (today, Ameriprise/Columbia) was the lone exception. See endnote 5 for additional detail.

[13]The ICI still appears not to understand this distinction. It recently defended the industry by acknowledging, "both fund advisors and fund board directors are fiduciaries and therefore must act in the best interests of a fund and its shareholders." But they ignore the obvious conflict that advisors and boards have conflicting fiduciary duties to the shareholders of the management companies.

[14]One could easily argue that "the date which will live in infamy" for fund managers was Vanguard's precedent-breaking formation on September 24, 1974. It replaced the industry's business model with a truly mutual model, a model that was virtually essential in the creation of our index fund.

[15]*Bogle on Mutual Funds* (John Wiley & Sons, 1993).

[16]Fidelity Chairman Edward C. Johnson III doubted Fidelity would follow Vanguard's lead. "I can't believe," he told the press, "that the great mass of investors are [sic] going to be satisfied with just receiving average returns. The name of the game is to be the best." Today Fidelity oversees some $140 billion of index fund assets.

[17]In 1980, the trust's name was changed to Vanguard 500 Index Fund.

[18]Franklin began his life in Boston, but in his youth moved to Philadelphia and spent his entire career there.

[19]As some readers may know, I was the beneficiary of a heart transplant in 1996, so I've been cultivating a new heart for the past 17 years.

[20]*Puritan Boston and Quaker Philadelphia* is the title of a book by E. Digby Baltzell [1979], describing the contrasting cultures of the two cities.

[21]Similarly, staunch old Putnam Management Company was bought from its manager/trustees by U.S. insurance giant Marsh and McLennan in 1970 and resold in 2008, for almost $4 billion, to yet another Canadian conglomerate. Its fund assets have stumbled from $250 billion in 1999 to $60 billion today.

[22]Although I believe profoundly in Quaker principles, I'm not a member of the Society of Friends.

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