April 12, 2011

To: Principals and Veterans,

Three recent items to report to you:

(1) Text of my brief (for me) remarks on receiving the Tiburon CEO Summit Award, in which I review our industry position and describe the amazing and unpredictable events that led to our creation, without any one of which Vanguard would not exist today.

(2) A nice presentation of my op-ed for the *Financial Times* of London, describing the harsh realities of investing as compared to the bright illusions created by Wall Street (one of the major themes of *Don't Count on It!).*

(3) A copy of the cover and the text on the inside flap of a new book, *The House that Bogle Built: How John Bogle and Vanguard Reinvented the Mutual Fund Industry.* It begins with a revision of *John Bogle and the Vanguard Experiment,* published in 1996, and then follows with a chronicle of the past 15 years. While it includes interviews with me, Bill McNabb, and others, the opinions expressed are the author's own. While I have not read it, I've heard the book includes some controversial issues. I believe it's now in the book stores, as well as Amazon, Barnes & Noble, etc.

Thanks to each one of you for making this place such a fine haven for our clients, especially in these unpredictable and volatile markets.

Jack

At the Summit

Remarks by

John C. Bogle, Founder, The Vanguard Group

At the

Tiburon Summit XX

New York City, NY, April 13, 2011

I'm honored to be with you to receive the Tiburon Summit Award for my long service in the mutual fund industry. Of course I'm pleased to be here, but truth told—after being given fifteen extra years of life following my heart transplant in 1996—I'd be pleased to be *anywhere* this morning!

In a certain sense, I'll soon reach a certain summit of my own. On July 5, 2011, I'll complete sixty years of active participation in the mutual fund industry. It was on July 5, all those years ago, when I walked into the offices of my first post-college employer—Philadelphia's Wellington Management Company. I was nervous, green, and more than a little insecure, but ready to go to work with all the determination, ability, and enthusiasm I could command. I was on my way!

Little could I imagine the exciting, bumpy, and often unpaved road that lay ahead when, after reading my Princeton thesis on the mutual fund industry, Wellington founder Walter L. Morgan hired me. "Mr. Bogle," he generously wrote to our staff, "knows more about this business than we do." (It was nice to read, but it couldn't have been true.) In 1951, the firm was a (relatively) big fish in a (very) small industry. We ran but a single fund—the dominant business model of that era—the $120 million Wellington Fund, in an industry whose assets under management had only recently crossed the $3 billion mark. During the years that followed, the company grew rapidly. In 1974, Vanguard became Wellington's successor, and Wellington Fund, with assets now at $57 billion, remains one of our brightest stars. Combined with the assets of its now-170 siblings, that orphan of 1951 is part of a $1.65 trillion fund complex, the largest firm in a giant $12 trillion industry.

Note: The opinions expressed in this speech do not necessarily represent the views of Vanguard's present management

Such an outcome could never have been predicted. Indeed the odds against Vanguard's very existence were stupendous. Time after time Lady Luck smiled on me. If she had not done so along the way . . . well, listen to the story:

- IF I had not gained admission to Princeton (thanks largely to my two years at Blair Academy, a great independent school), there would be no Vanguard today.
- IF I had not majored in Economics and decided to choose a topic for my senior thesis that ignored the classical economists and traditional macroeconomics, there would be no Vanguard today.
- IF I hadn't opened FORTUNE magazine in December 1949, stumbled across page 116 which described the mutual fund industry as "tiny but contentious," and decided that the industry would be the subject of my senior thesis, there would be no Vanguard today.
- IF Mr. Morgan had not made me head of Wellington in 1965—when I was excessively immature, opinionated, and self-confident—I would not have undertaken a really foolish—okay, stupid—1966 merger with a "go-go" firm with a hot fund (now long gone) and paid too large a share of the firm's voting power, there would be no Vanguard today.
- IF my new partners had not fired me from my job at Wellington Management Company in January 1974, leaving me with the opportunity to create a new firm with a new mutual structure—designed, as I suggested in that ancient thesis, to be managed in the "most economical, efficient, and honest way possible"—there would be no Vanguard today.
- IF the independent directors of the Wellington Funds had not believed in the unprecedented new structure I proposed for the firm, and if senior independent director Charles D. Root, Jr. had not believed in me, there would be no Vanguard today.
- IF an aging book salesman had not stopped in my office to sell me some antique prints of the military battles of the Napoleonic wars (the Duke of Wellington, of course, was the hero), and if he had not shown me some prints from the naval battles of the same era, I would never have learned that HMS Vanguard was Lord Nelson's flagship at the historic Battle of the Nile, and there would be no "Vanguard" today.
- IF I hadn't read Paul Samuelson's 1974 article "Challenge to Judgment" in the first issue of the *Journal of Portfolio Management*—jogging my memory of my conclusion in my thesis—mutual funds "can make no claim to superiority over the market averages"—it's almost inconceivable that we would have started, in 1975, the world's first index mutual fund. Without indexing as the centerpiece of our investment philosophy and strategy, Vanguard would have existed and prospered, but would hardly command the dominant position in the industry that we hold today.

Well, those eight "ifs" are surely a lot! And if, at any one of those junctures (and, truth told, more than a few others), the coin had landed on "tails" rather than "heads," the industry would, I think, look rather different then it does today. But please be clear: I'm not saying that this industry needs Vanguard. Rather, I believe that *every* industry needs *a* Vanguard—a firm that says, "I see what you're doing, but I have a different design that will serve consumers better, with better products and services, and at lower prices."

Whatever the case, Vanguard has become the world's largest manager of mutual funds, with a market share of industry assets recently reaching 16 percent, yes, again, a summit that, by a wide margin, no fund firm seems to have reached before.[1] And we continue to grow apace, accounting for some 40 percent of industry cash flow during the past five years. (I doubt that such a dominant share is sustainable.)

In 1976, indexing was *heresy.* "Indexing is un-American!" said a famous poster of that time, and our index fund was known as "Bogle's Folly," with a market share of just 0.1 percent of equity fund assets. Today indexing is dogma, the widely accepted core standard for evaluating investment performance, and having a 25% share of equity fund assets. What's more, index mutual funds accounted for $688 billion of the $672 billion total cash flow into all equity mutual funds over the past five years. Yes, 102 percent of cash flow, as actively-managed equity funds suffered a cash *outflow* of $16 billion during that period.

Yet we remain—and I have reason to believe that I remain—a sort of outlier in an industry that has yet to accept (or even seriously copy) the Vanguard model. There's both pain and pleasure in that, as Walter Bagehot, founding editor of the London *Economist* pointed out a century and a half ago. On the one hand, "one of the greatest pains in human nature is the pain of a new idea." On the other, "a great pleasure in life is doing what people think you cannot do."

I'm not at all sure there aren't more deserving recipients of the Tiburon CEO Summit Award than yours truly. I haven't served as Vanguard's CEO for many years, though perhaps I qualify in my role today as CEO, as it were, of Vanguard's Bogle Financial Markets Research Center. But the fact is that, without knowing them until a few days ago, I've spent 60 years in my quest to meet the standards that Tiburon's Managing Principal Chip Roame told me represent the criteria for this award.

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[1] Data based on assets in long-term mutual futures, and excluding money market funds.

1) **Focusing on Consumers**. Serving our fund clients has been the dominant theme of my long career. While I have been criticized for choosing the title "On Human Beings" for the final chapter of both editions (1999 and 2009) of my *Common Sense on Mutual Funds: New Imperatives for the Intelligent Investor,* I can't help but wonder what those critics think is the purpose of our careers. Perhaps we have forgotten that our duty is to serve "those honest-to-God, down-to-earth human beings" who have entrusted their savings to us, "each one with their own hopes and fears and financial goals," phrases that I have used more than once!
2) **Challenging Conventional Wisdom**. Whether it is Vanguard's unique mutual structure, our focus on rock-bottom costs, our index-oriented investment strategies, or our mission—to guarantee investors their fair share of whatever returns our financial markets provide—or our conviction that short-term speculation is a loser's game and long-term investment is a winner's game, we've challenged the conventional wisdom time and time again. If the cause is worthwhile—as ours is—fighting the good battle is, for me, what life is all about.
3) **"Giving Back."** We all have the obligation to "give back" to our industry, to our investors, to our communities. My way to give back has been driven by speaking—at gatherings of investors, at industry forums, at academic institutions, at college commencements—and by writing books. *Don't Count On It!* is my ninth book, following *Enough.*, *The Battle for the Soul of Capitalism, Character Counts,* and others. I'm not about to stop "giving back," even in these later years of my life.

I close with this proverb recounted by Mario Cuomo—a member of my pantheon of American heroes—in last Sunday's *New York Times Magazine*: An Arab traveler comes across a sparrow in the desert, laying on his back, with his claws outstretched to the sky. The traveler asks what the bird is doing, and the bird replies that he has heard the sky is about to fall and he wants to be ready to hold it up. "You foolish creature," says the Arab, laughing. To which the bird replies, with resignation, "one does what one can."

And so I continue to do what I can, to work toward building a better financial world in which institutional money managers honor their fiduciary duty to the clients they serve, focusing on investment rather than speculation, on prudence and due diligence, and at last honor both their rights and responsibilities for good corporate governance; a brave new world in which fund investors get a fair shake. Our financial sky, truth told, is not in very good shape, and I'm doing my best to hold it up. If you tell me it's going to fall anyway, well, I'll just try a little harder.

COMPANIES & MARKETS

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John Bogle Wall Street's delusions on historical performance **Page 34**

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Markets & Investing

John C Bogle
INSIGHT

Beware Wall Street's delusion on historical performance

As investors plan for accumulating wealth, they place too much trust in numbers, apparently equating the precision of hard numbers with reality.

But numbers are pale reflections of reality, shaped to validate the views of those who produce them, often based on invalid premises, and are easily subject to manipulation.

This reliance on numbers underlines one of the principal problems of today's financial markets: the idea that shareholder value is represented by stock price. Not so. The value of a stock is represented by the discounted value of its future cash flow. Yet market participants have come to believe that the momentary precision reflected in the price of a stock is more important than the eternal imprecision of measuring the intrinsic value of a corporation. Prices can rise far above their intrinsic values – or far below – but the pendulum finally centres on fair value.

This focus on stock prices has led us down a primrose path that leads us to accept illusion as reality. Even if we accept the belief that past market returns are an accurate representation of reality, the idea that future returns will centre round the past is an illusion.

Numbers are shaped to validate the views of those who produce them and . . . are easily subject to manipulation

Over the past century, for instance, the US stock market has provided an average annual return of about 9 per cent – 4.5 per cent from dividend yields and 4.5 per cent from earnings growth. But today's dividend yield is only about 2 per cent, meaning that a critical component of the stock market's return has been slashed by more than one half.

Now let's combine that 2 per cent yield with an estimated future earnings growth rate of 5 per cent. Why 5 per cent? Simply because earnings growth of US corporations has rather consistently paralleled the historical growth of the economy (measured by gross domestic product). Combining the two tells us that reasonable expectations for nominal returns on stocks over the coming decade are likely to centre around 7 per cent, several percentage points below the long-term norm. As writer and poet Samuel Taylor Coleridge warned: "History . . . is but a lantern on the stern, which shines only on the waves behind us."

These returns are conventionally measured in nominal terms, and are almost certain to overstate the painful reality for investors building long-term wealth. Consider the results of that historical nominal return of 9 per cent, compounded over 50 years: a $10,000 initial investment would grow to $743,000 (including reinvested dividends). But after adjustment for 4 per cent inflation during that period, only 5 per cent would remain in real terms. So, in spendable dollars, accumulated wealth would tumble to $115,000. Amazing!

Share prices can rise far above their intrinsic values – or far below – but the pendulum finally centres on fair value

But whatever the future returns of the stock market prove to be, investors should not count on receiving it. Of course, investors as a group must and will earn whatever returns the market delivers. But only before the deduction of the costs they incur. Remember: gross return, minus the costs of investing, equals the net return shared by market participants. Over an investor's lifetime, that difference is powerful.

In US mutual funds, for example, using an all-in cost of only 2 per cent annually (including expense ratios, estimated portfolio turnover costs, and sales loads) would reduce that 5 per cent real return to 3 per cent, bringing the final accumulation to $44,000, some $700,000 below our first calculation. (Assuming that the investment is part of a tax-deferred retirement plan, I have excluded taxes, which otherwise would subtract perhaps another 1 or 2 percentage points of return.) These real numbers destroy the illusion created by Wall Street's disingenuous presentation of historic stock returns.

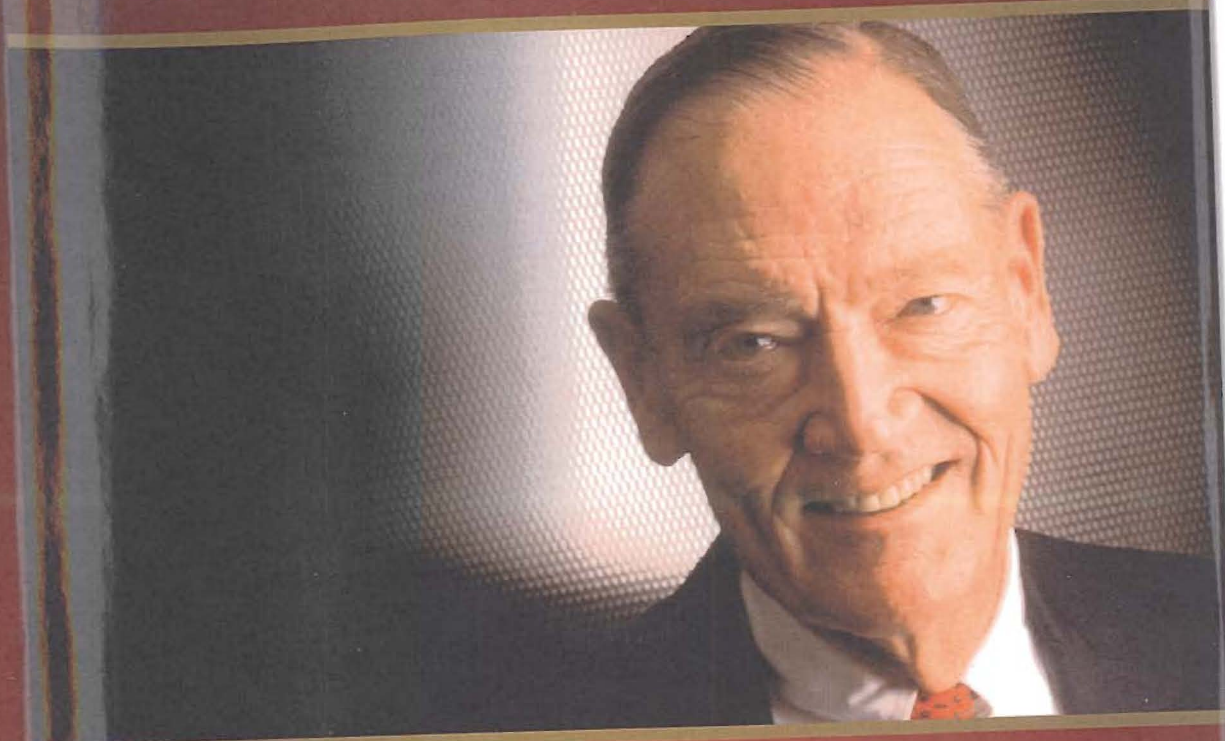
Combined, these three errors have an impact that is hardly trivial. Counting on historical stock market returns to repeat themselves is one error; counting in nominal dollars rather than real dollars is another; and counting on capturing the gross returns of the stock market rather than net (after-cost) returns is yet another.

These are not just arithmetic errors; they have powerful real-world implications. Individual investors who rely on the historical stock market returns presented by mutual fund marketers will be shocked at the paltry amounts they've accumulated in their retirement accounts. Corporations too will face the same shock as shortfalls in pension plan accumulations will have profoundly negative implications for their financial statements.

My message is that we should treat numbers with great caution. We should remember that those who present numbers are rarely without bias and that the past is rarely prologue. It is not that we should not be counting; rather we should be counting with scepticism, and with all the perspective and wisdom that we can muster.

John C Bogle is the founder of Vanguard. His latest book is 'Don't Count on It! Reflections on Investment Illusions, Capitalism, "Mutual" Funds, Indexing, Entrepreneurship, Idealism, and Heroes'

How John Bogle and Vanguard Reinvented the Mutual Fund Industry



The HOUSE that BOGLE BUILT

LEWIS BRAHAM

The HOUSE that BOGLE BUILT

BRAHAM

$28.00 USD

Arguably the greatest shareholder advocate in the history of Wall Street, John Bogle not only created the first index mutual fund but has become the primary voice for change in an industry plagued by excess and complacency. Bogle stumbled upon mutual funds by accident in 1949 as a college student at Princeton. In his junior year, he read a *Fortune* article about the burgeoning fund industry that sparked his interest, and he wrote his now famous senior thesis about it.

What began as an intellectual pursuit would turn into Bogle's life mission. *The House That Bogle Built* chronicles the years of Bogle's development from college whiz kid into a titan of the mutual fund industry and shareholder advocate—highlighting his creation of the Vanguard Group and the Vanguard 500 Index Fund and his frequent battles to shake up the status quo. It takes you through the two decades he spent running Vanguard, until his forced retirement in 1999, and discloses what he thinks about the fund industry today.

Bogle has always stood out for his extraordinary talents in math, analysis, management, and investing. But his most noteworthy trait is his most basic: his humanity—in an industry not exactly famous for placing people over profit. It's Bogle's dedication to clients' interests above all else that has earned him the reputation as the "conscience" of the investing industry.

In his ninth decade of life, Bogle is remarkably candid about the role he plays at Vanguard today—and about his opinion of Jack Brennan, his successor. "How do you keep Vanguard a place where judgment has at least a fighting chance to triumph over process?" he asks. Skeptical but never

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(continued from front flap)

defeatist, Bogle maintains a retired-but-active status at the company, keeping a close watch over those now at the helm of Vanguard.

The House That Bogle Built reveals one of the investing world's most fascinating and complex figures. A dogged advocate of shareholder democracy, he was a self-confessed "dictator" at Vanguard. A brilliant mathematician, he is more interested in people than numbers. Fiercely competitive, he bemoans the cut-throat approach that drives his industry of choice. Always, though, Bogle places the good of the client before anything else—a practice that has become steadily rarer in his business.

The House That Bogle Built provides an insightful look at the past, present, and future of one of today's largest industries, through the eyes of one of its most influential pioneers.

LEWIS BRAHAM is a journalist whose work has appeared in a number of business publications, including *BusinessWeek, SmartMoney,* and *Bloomberg Markets.* He resides in Pittsburgh, Pennsylvania.

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