John Bogle's Dim View of the Asset-Management Industry

To Vanguard's Bogle, asset management has become an extractive industry

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Vanguard's John Bogle wants the asset-management industry to return to traditions of stewardship.

Just as Warren Buffett is the walking embodiment of value investing, John Bogle is index-investing incarnate. Founder and former CEO of the Vanguard Group, Bogle has spent decades preaching the virtues of the low-cost index funds he helped pioneer nearly 40 years ago.

Alas, the last half of Bogle's 60-year career has been marked by the rise of casino finance and a Masters of the Universe ethos that has infected the once -staid world of asset management. Bogle's new book, *The Clash of the Cultures*, laments the crowding out of investing by speculation, a development that has enriched fund managers but left lots of households backfilling their 401(k)s.

[See 4 Steps to Lock Down Your Portfolio for the Election.]

Even before the crash of 2008, the asset-management industry had become (arguably) a self-serving enterprise, sucking up excessive management fees in exchange for the promise of performance that, in the long run, it is mathematically certain not to achieve. Part of *Clash* dwells helpfully on concept of "mean reversion," key to understanding why most attempts to "generate alpha," as the industry calls beating the market, are ultimately futile. Hint: It's roughly the same reason that the house always wins.

We spoke with Bogle recently about his new book and about investing more broadly. An edited transcript:

The rise of speculation and short-termism in asset management seems to have paralleled similar developments throughout finance. Is there a link, or am I conflating disparate ideas?

No, you're right in both cases. The asset-management business, on the mutual-fund side, is an asset-gathering business. Managers want to maximize their revenues. And that means that salesmanship takes the front seat and stewardship takes the back seat. Both are still there, as I say in the book. But we used to be a profession with elements of business, and now we're a business with elements of professionalism. I think it's a very bad change for the investor.

What in particular has changed the nature of asset management?

When you go from being a little cottage, mom-and-pop industry to being in essence the largest financial institution in America—more assets even than the banks—everything changes. Your focus changes, your objectives change—and that's really the underlying cause of this. The mutual fund is an excellent, outstanding investment idea, but the bigger it gets, the more [fund companies] start to think about the marketing front. You start thinking about your competitors instead of yourself. When market share is the goal—I call it in the book "the Great God Market Share"—you've gone in the wrong direction. So, part of it's just plain getting big.

Think of the difference between running a mutual fund—that's your profession—and all of a sudden you're running as many as 350 mutual funds. When I started in this business, this was a one-fund business, pretty much, or perhaps a two-fund business—you might have a balancec fund and a stock fund. That's all there was. Now we've subdivided components, all for marketing reasons. There's no reason to think anybody can pick the best sectors of the market in advance.

[See The Phony Debate About Active and Index Funds.]

Given the ratio of fees to performance, is it too harsh to say that the asset-management business is largely a rent-seeking business?

No, that's not too strong a statement. It's exactly what we are: We're extracting rents from society at large and basically shifting them from investors to money managers, brokers, marketers, administrators, accountants. And all that is rather unnecessary. An index fund really doesn' have to do much, and, equally important, the investor doesn't have to do much. The investor who just buys and holds the index fund forever will do fine. I occasionally get letters from a handful of people who bought [the Vanguard 500 Index fund (symbol: VFINX)] at the initial offering, saying "It's unbelievable! It works!"

Since the 2008-09 crash, people have migrated from actively managed funds into index funds. But once memories fade, will investors again become vulnerable to industry pitches that active management adds value?

No self-respecting intellectual, academic, or independent person could possibly believe that. What happens is something a little bit different. There's always going to be a firm that does an outstanding job, and then they will fall from grace. You get caught up in this idea that it's easy to beat the index. There's always somebody who can say "look at how easy it is; here's what I've done." Look in chapter 9 [of *The Clash of the Cultures*] at those charts on reversion to mean. If you don't get the message there, you're a very unwise investor.

Has the switch to defined-contribution plans from defined-benefit plans been good for workers or bad?

On balance, I would say bad. The 401(k) was designed as a thrift plan, not a retirement plan, therefore it has the flaws I identify in the book: It's easy to get out of the plan when you change jobs, spend it all, start all over again. Also, it's been inflicted on people: When a company say it's going to give you a defined-contribution plan instead of a defined-benefit plan, they don't ask for your approval. They just do it. It's more expensive, we know that, because individual funds cost much more than institutional funds. Individuals by and large are less intrigued by indexing than pension funds. The biggest pension plan in America—the thrift savings plans of the United States government—is indexed. So, you can make it work but you've got to keep the employees there. We have to revise the system.

[See Index Funds That Go Outside the Box.]

What's your response to PIMCO chief Bill Gross's assertion that the "cult of equity is dying," and that investors should no longer expect 7 percent returns? Is he making faulty assumptions about how accurately the stock market reflects the real economy?

I think the love affair with equities, which were growing at 18 percent a year for two decades, in the 80s and 90s, is certainly over. That was the romance. That was a fling. What follows is marriage—marriage for a lifetime. If [Gross meant] investors will stop owning equities, I think that's absurd. Somebody's going to own them. If it's not investor A, it's going to be investor B.

But Bill is not so far from where I am on future returns. They're not going be up to the past levels, because we don't have the same circumstances as in the past. It was very nice to get these returns when you bought stocks for 10 times earnings, but in the long run, we know that total returns represent the total of dividend yield and earnings growth. I say the return of a portfolio that's half stock and half bonds should be in the general range of a nominal 5 percent. If I take inflation out, that's a 2.5-percent real return. That's not far from where Bill is.

Tags: investing, mutual funds