"BIG MONEY IN BOSTON" . . .

The Commercialization of the "Mutual" Fund Industry

Remarks by

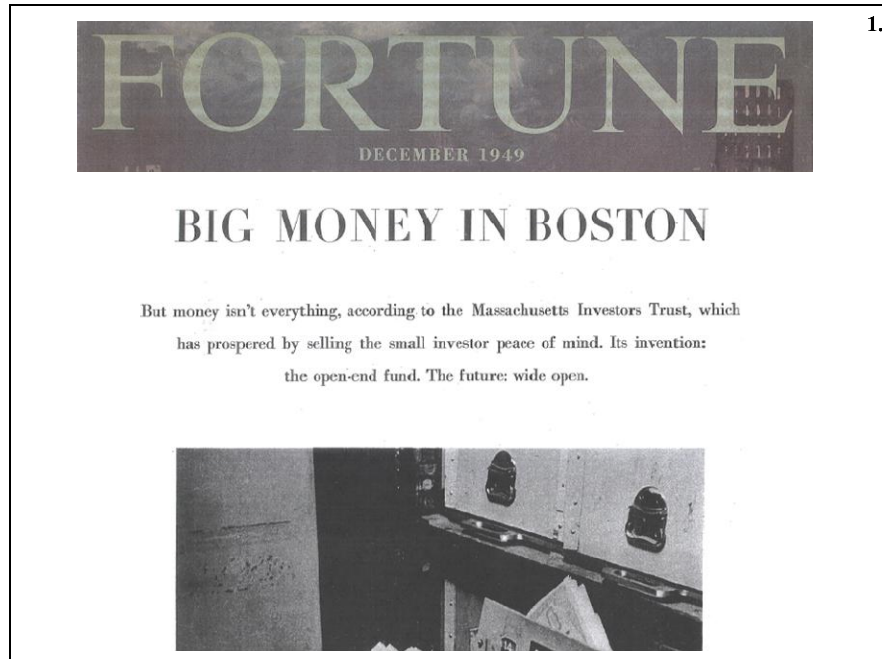
John C. Bogle, Founder and Former Chairman, The Vanguard Group[1]

Before

The Boston Security Analysts Society, Inc.

May 17, 2013

You could say, with accuracy, that I've been preparing to tell this story for more than 63 years, and I thought it only proper to tell it here in Boston. My preparation began in December, 1949, a long, long time ago. Then, almost halfway through my junior year at Princeton University, I was in the reading room of the newly built Firestone Library, trying to keep up with current developments in Economics, my major study. I was reading the December issue of FORTUNE magazine. When I turned to page 116, there was an article entitled "Big Money in Boston." **Exhibit 1.** That serendipitous moment would shape my entire career and life.


1.

FORTUNE

DECEMBER 1949

BIG MONEY IN BOSTON

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

[1] The opinions expressed in this speech do not necessarily represent the views of Vanguard's present management.

In ten fact-filled pages, "Big Money . . ." described the history, policies, and practices of Massachusetts Investors Trust. M.I.T. was the first and by far the largest "open-end fund," founded in 1924, a quarter-century earlier. In its discussion of the embryonic industry's future, FORTUNE was optimistic that this tiny—"pretty small change"—industry, "rapidly expanding and somewhat contentious, could become immensely influential . . . the ideal champion of the small stockholder in controversies with . . . corporate management."

In those ancient days, when the term "open-end" was used, it identified the type of investment company that redeemed its shares on demand.[2] 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."

1951 – The Princeton Thesis

That article was the springboard for my decision—made almost immediately—to write my thesis on the history and future prospects of open-end investment companies, with the title simplified to "The Economic Role of the Investment Company:" After an intense analysis of the industry, I reached some clear conclusions:

> *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]*

[2] The "closed-end" fund has a fixed number of non-redeemable shares outstanding.
[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 their officers, directors, investment advisers, and distributors."
[4] At the 1968 Federal Bar Conference on Mutual Funds, former SEC Chairman Manuel Cohen gave a speech entitled "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."

> *investment portfolios. Everything else is incidental . . . The principal role of the investment company should be to serve its shareholders.*

Over the centuries (or so it seems), such idealism has likely been typical of an inexperienced college senior. But, as you'll see this afternoon, 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, it is even more passionate and unyielding today.

Following my graduation in 1951, Walter L. Morgan, Princeton Class of 1920, read my thesis. Mr. Morgan—the great hero of my long career, and the founder of industry pioneer Wellington Fund, offered me a job. I decided to join his small but growing firm—managing but a single fund, with assets of $150 million. "Largely as a result of this thesis," he wrote to our staff, "we have added Mr. Bogle to our Wellington organization." Although I wasn't so sure at the time, it was the opportunity of a lifetime.

Here's a profile of the fund industry that I joined in 1951. **Exhibit 2.** There were but 125 mutual funds, with assets aggregating $3 billion. The field was dominated by a few large (for those days) firms, accounting for about two-thirds of industry assets. With assets of $472 million, M.I.T. was overpoweringly dominant, by far the industry's largest fund, and by far the lowest cost provider (expense ratio 0.42 percent). Indeed while "Big Money in Boston" focused on M.I.T., Boston itself was the center of the fund universe. **Exhibit 3.** The funds operated in this fair city dwarfed their peers—22 of the 50 largest funds, managing 46 percent of the industry's assets. (For the record, New York funds represented 27 percent of industry assets; Minneapolis 13 percent; and Philadelphia only 7 percent.)

Most firms, including Wellington, managed but a single fund, or a second fund that was usually tiny. For example, M.I.T. 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, only 7 percent of M.I.T.'s $472 million total.[5]

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[5] Five 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. During the 1960s, all had their moment in the sun, but none remain today.

2.

Mutual Fund Industry Assets, 1951

Rank	Fund Name	Total Assets* (million)
1	M.I.T.	$472
2	Investors Mutual	365
3	Keystone Funds	213
4	Tri-Continental	209
5	Affiliated Funds	209
6	Wellington Fund	194
7	Dividend Shares	186
8	Fundamental Investors	179
9	State Street Investment	106
10	Boston Fund	106
	Total	$2,239
	Percentage of Industry**	72%

Notable Smaller Funds	Total Assets* (million)
Eaton & Howard	$90
National Securities	85
United Funds	71
Fidelity	64
Group Securities	60
Putnam	52
Scudder Stevens & Clar	39
American	26
Franklin	25
Loomis Sayles	23
T. Rowe Price	1
Dreyfus	0.8
Total	$537
Percentage of Industry	17%

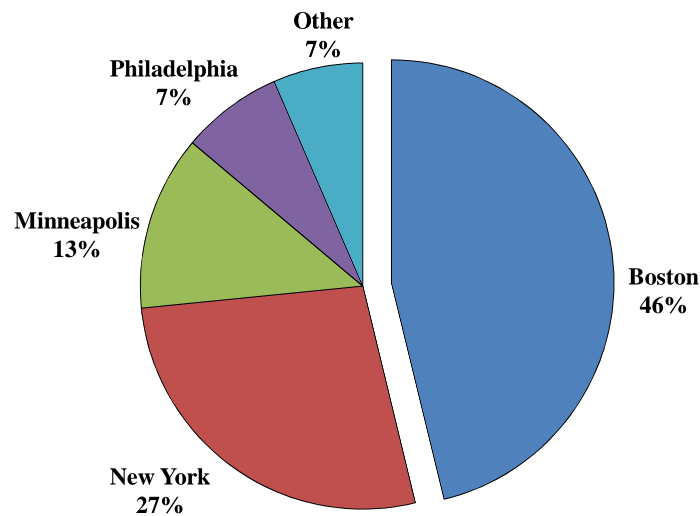
*Includes associated funds.

**Total industry assets: $3.1 billion.

3.

"Big Money in Boston"—1951

Percentage of Mutual Fund Assets Managed*



*By location of firm headquarters.

The Old Model . . . the New Model

The idea of trusteeship—indeed the so-called “Boston trustee”—dominated the industry’s image, as this photo of the M.I.T. trustees in 1949 suggested. **Exhibit 4.** The original fund industry operating model was much like M.I.T.’s: professional investors who owned their own small firms, and often relied on unaffiliated distributors to sell their shares. (In those days distribution was a profitable business.) But the industry culture changed, and changed radically. 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*. But soon it began its journey to become a *business* with elements of a *profession* (and, I would argue, not enough of those elements). Some 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 where our industry remains today.

From left to right: George Whitney, L. Sherman Adams, Chairman Merrill Griswold, Dwight Robinson, and Kenneth Isaacs.

What explains this profound change in the culture of mutual funds?[6] I’d argue that these were the major factors: (1) Gargantuan growth. (2) Widespread use of aggressive, higher-risk strategies, leading to less focus on long-term investment and more focus on short-term

[6] This subject is one of the major themes of *The Clash of the Cultures: Investment vs. Speculation*, the book that I’ll be signing for each of you following this talk.

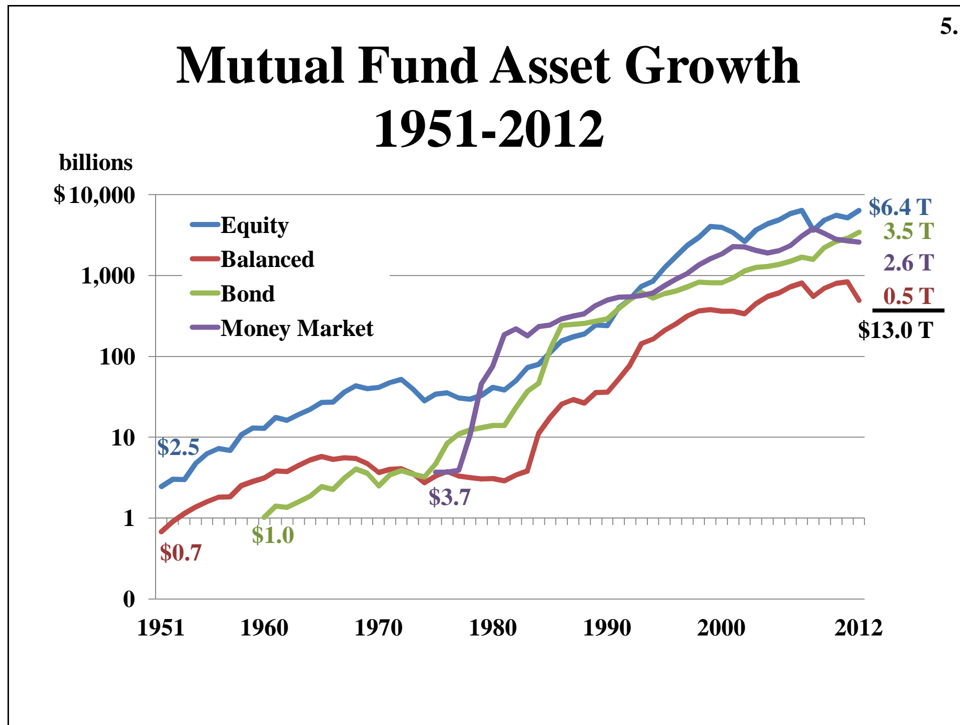
speculation. (3) The rise of "product proliferation" with thousands of new funds formed each year, embracing aggressive share distribution as integral to the manager's interest in gathering assets and increasing fee revenues. (4) The conglomeratization of the mutual fund industry, a change that served the monetary interests of mutual fund *managers* and a disservice to the interests of mutual fund *shareholders*, and finally, (5) the triumph of the index fund, which did precisely the opposite; shareholders first, managers second. Let's take a look at each of these changes.

1. The Stunning Growth of Mutual Fund Assets

When I joined the industry in 1951, fund assets totaled just $3 billion[7]. Today, assets total $13 *trillion*, a remarkable 15 percent annual growth rate. When a small industry—dare I say a cottage industry?—becomes something like 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.

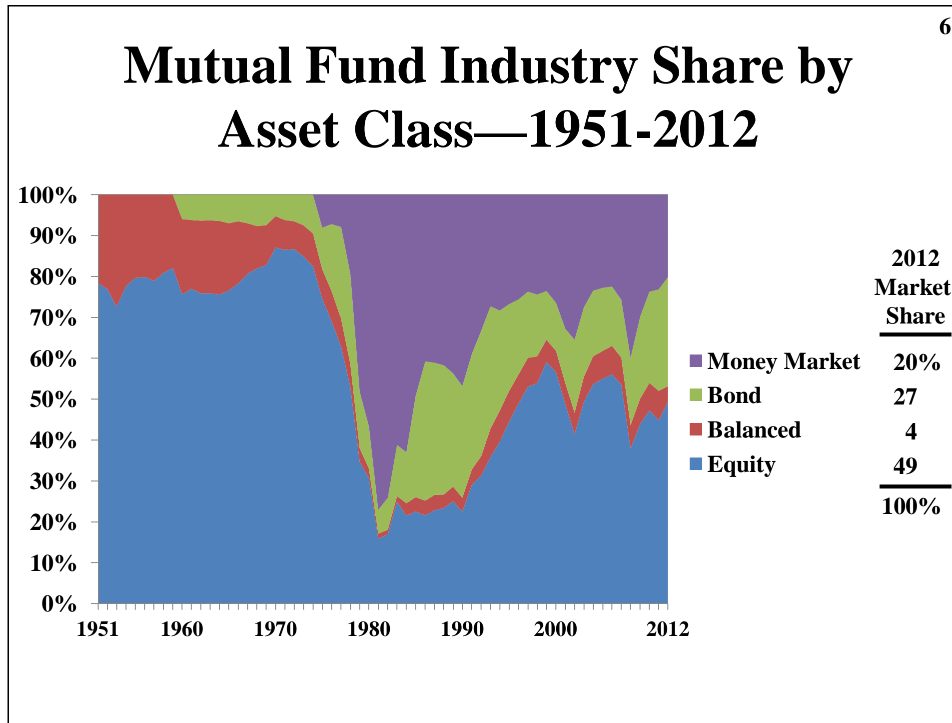
For the first half-century of industry history, equity funds were our backbone. Equity fund assets topped $56 billion in 1972, and then, after a great bear market, tumbled to $31 billion in 1974. Recovering with the long bull market that followed, equity assets soared to $4 trillion. Despite two subsequent bear markets (off some 50 percent, twice), equity fund assets have reached the $6 trillion level, still the engine that drives the industry. **Exhibit 5.** The data on balanced funds is sort of spasmodic; suffice it to say that their important role in the industry dwindled during the 1960s (reflecting the coming of the "Go-Go" era) and, after the bear market (being overwhelmed by the boom in bond funds).

[7] OK. I recognize that $3 billion in 1951 would be equivalent to $28 billion in 2013 dollars.



During the 1950s, assets of bond funds seemed stuck at around $500 million, with little growth during the next two decades. But, following the 1973-1974 bear market, bond funds began to assert themselves. As the financial markets changed, so did investors' needs; income became a high priority. After that unpleasantness in the stock market, bond fund assets grew nicely, reaching $250 billion in 1987, actually exceeding the $175 billion total for equity funds. Bond funds then retreated to a less significant role during the 1990s. But today, following years of generous interest rates that were to tumble in recent years, bond fund assets have risen to $3.5 trillion, 25 percent of industry assets.

As the dominance of equity funds waned, money market funds—the fund industry's great innovation of the mid-1970s—bailed out the industry's shrinking asset base. **Exhibit 6**. They quickly replaced stock funds as the prime driver. By 1981, money fund assets of $186 billion represented fully 77 percent(!) of industry assets. While that share has declined to 20 percent today, it is still a formidable business, with $2.6 trillion of assets. But given today's pathetic yields and the possibility of a new business model for money funds (which will actually reflect their floating net asset values), it 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, financial department stores that focused heavily on administration and marketing.

2. The Sea Change in Equity Fund Management

The growth and changing composition of the mutual fund asset base leads me to the second force in changing this industry culture. Over time, we have witnessed a sea change in the industry's investment operations. The *modus operandi* of our equity funds, once supervised by conservative investment committees with a long-term focus and a culture of prudent investment—that original M.I.T. 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 the average active fund has leaped from the 30 percent

rate of the 1950s and early 1960s to the 140 percent rate of the past three decades.[8] While most fund managers were once investors, they now seem to be speculators. The new financial culture of ever-higher trading activity in stocks was embraced by investors of all types. Then institutional traders, of course, were simply swapping shares with one another, with no net gain for their clients.

What's more, the old equity fund model of blue-chip stocks in market-like portfolios—and commensurately market-like performance (before costs, of course!)—evolved into a new, more aggressive model. The relative volatility of individual funds increased, measured in the modern era by "Beta," the volatility of a fund's asset value relative to the stock market as a whole. This increase in riskiness is easily measured. **Exhibit 7**. The volatility of equity fund returns increased sharply, from an average of 0.84 (16 percent *less* volatile than the market) in the 1950s to 1.11 during recent years (11 percent *more* volatile). That's a 30 percent increase in the relative volatility of the average fund. In the earlier era, *no* equity fund had volatility above 1.11; during recent years, 38 percent of equity funds exceeded that level.

7.

Relative Volatility of Equity Mutual Funds

Relative Volatility*	1950-1956	2008-2011**	Difference
Over 1.11	0 %	38 %	+38 %
0.95-1.11	34	38	+4
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**
****Sample of the Largest 200 Equity Funds**

[8] Note: The turnover measures that I'm using represents the total portfolio purchases and sales of equity funds each year as a percentage of assets, not the traditional—if inexplicable—formula that is in general use today: the lesser of purchases and sales as a percentage of assets.

That shift toward higher volatility began during the "Go-Go Years" of the late 1960s, when "hot" managers were treated like Hollywood stars and marketed in the same fashion. It has largely continued ever since. (The creation of index funds was a rare and notable exception. An all-market index fund has Beta of 1.00.) But as the inevitable "reversion to the mean" in fund performance came into play, these aggressive manager *stars* proved more akin to *comets*—speculators who too often seem to soar into the sky and then flame out—focused on changes in short-term corporate earnings expectations, stock price momentum, and other quantitative measures. Too often, they forgot about prudence, due diligence, research, balance sheet analysis, and other old-fashioned notions of intrinsic value and long-term investing.

With all the publicity focused on the success of these momentary stars, and the accompanying publicity about "the best" funds for the year or even the quarter, along with the huge fees and compensation paid to fund management companies and the huge compensation paid to fund portfolio managers of the "hot" funds, of course the manager culture changed. But even a short-term failing in performance became a career risk, so it became best to be agile and flexible, and watch over the portfolio in, as they say, "real time."

As equity fund assets soared, more aggressive funds proliferated, and 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 it seemed to improve fund performance only randomly, and because of advisory fees and trading costs couldn't work for all managers as a group. For each winner there is a loser.

3. The Rise of "Product Proliferation"

Closely linked to the change in the investment culture was the turn toward product proliferation. Such proliferation reflects a strategy for fund management companies that, in essence, says "We want to run enough different funds so that at least *one* will always do well." It began to take hold in the fund industry in the Go-Go Years, but soared as the great bull market of 1982-2000 created ever higher investment expectations. The number of funds exploded. When I entered the industry in 1951, there were but 125 mutual funds, dominated by a few leaders.

Today, the total number of equity funds comes to a staggering 5,091. Add to that another 2,262 bond funds and 595 money market funds, and there now are 7,948 traditional mutual funds, plus another 1,446 exchange-traded index funds (which are generally mutual funds themselves). 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 interest of fund investors. I have my doubts, and so far the facts seem to back me up.

The good news is that many of the new funds were bond funds and money market funds. The bad news is that in the equity fund sector of the industry, the massive proliferation of so many untested strategies (and often untested managers) have resulted in confusion for investors. "If you want to win, just pick the right fund or manager" they seem to say. But how could investors or their advisers possibly know *in advance* which funds or managers would win, and which would give rise to the expectation that it was easy to succeed and difficult to fail?

The proliferation of fund "products" was followed (unsurprisingly!) by nearly all of today's largest fund groups. **Exhibit 8**. It shows the number of funds that industry leaders offered in 1951. Nothing could make the amount of proliferation clearer than the quantum increase in the number of funds offered today. The ten largest firms offered as average of 1.7 funds in 1951; today, the top ten firms offer an average of 117 funds. (Fidelity once managed just a single fund; the firm now manages 294 funds. Similarly, Vanguard also began the period with a single fund, and is now responsible for 140 funds. One can only trust that each member of the board of directors—in both cases—takes seriously his or her fiduciary duty to know and to understand each one of the scores of funds under the board's aegis.)

8.

Number of Funds—1951 & Today

Major Mutual Fund Groups

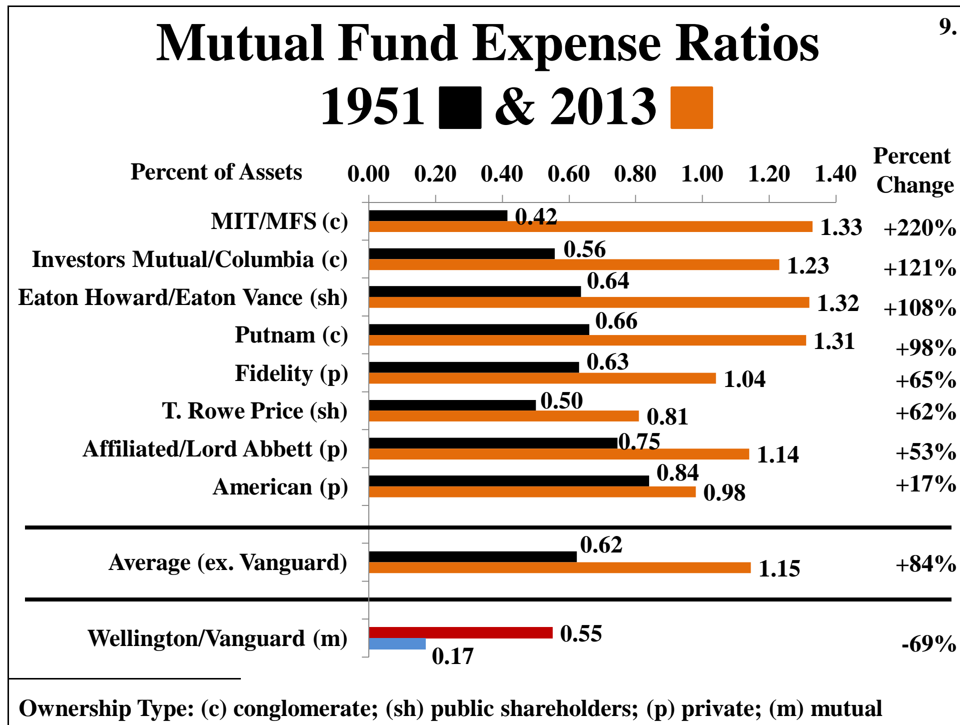
	1951			2013	
Original Name	Total Assets (million)	No. of Funds Managed	Current Name	Total Assets (billion)	No. of Funds Managed
M.I.T.	$472	2	MFS	$128	80
Investors Mutual	365	3	Columbia	162	116
Affiliated	209	3	Lord Abbett	97	38
Wellington	194	1	Vanguard	2,136	140
Eaton & Howard	90	2	Eaton Vance	107	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: 12 of today's 20 largest firms did not exist (or did not manage mutual funds) in 1951, including BlackRock, PIMCO, State Street Global, and JP Morgan

With the rise of all of that product proliferation, the fund industry has come to suffer a rate of fund failures without precedent. Back in the 1960s, about 1 percent of funds disappeared each year, about 10 percent over the decade. By 2001-2012, however, the failure rate of funds had soared seven-fold, to 7 percent per year, during that entire period, 90 percent. With about 6,500 mutual funds, 5,500 have been liquidated or merged in other funds, almost always into members of the same fund family (with more imposing past records!). Assuming (as I do) that such a failure rate will persist over the coming decade, some 3,500 of today's 5,000 equity funds will no longer exist—the death of more than one fund on every business day. While the mutual fund industry proudly posits that its mutual funds are designed for *long-term* investors, how can one invest for the *long term* in funds that may exist only for the *short term*?

Another implication of proliferation is the extraordinary (and, again, truly absurd) rise in expense ratios. Just consider eight of the major fund managers of 1951 that survive today. **Exhibit 9.** Despite the quantum growth in the assets they manage, the expense ratios of their funds have soared—from an average of 0.62 percent of assets to 1.15 percent, or by 84 percent. (Note that four of the largest fee increases came in firms that were publicly-owned.) By contrast, the only mutually-owned firm (of course, Vanguard) actually drove expenses *down* from 0.55 percent to 0.17 percent, a drop in unit costs of fully 69 percent. *Look*. When the expense ratios of

funds that operate under the original industry model *rise* by 84 percent, and the expense ratio of one fund group that operates under a new business model *falls* by 69 percent, it is at least possible that there's a message there.



The data in the chart are comprised of fund expense ratios unweighted by assets. While weighted ratios can only be approximated, one can conclude that the aggregate fees paid to these eight firms rose from $58 *million* in 1951 (measured in 2012 dollars) to $26 *billion* in 2013—more than a four-hundred fold jump in the cost of fund management. One might have hoped that all those dollars available to improve the quality of stock selection and investment strategy would have improved the returns earned by fund shareholders. Alas, there is no "brute evidence" whatsoever that such is the case. None.

4. The Conglomeratization of the Fund Industry

April 7, 1958—A Date that will Live in Infamy. Part I

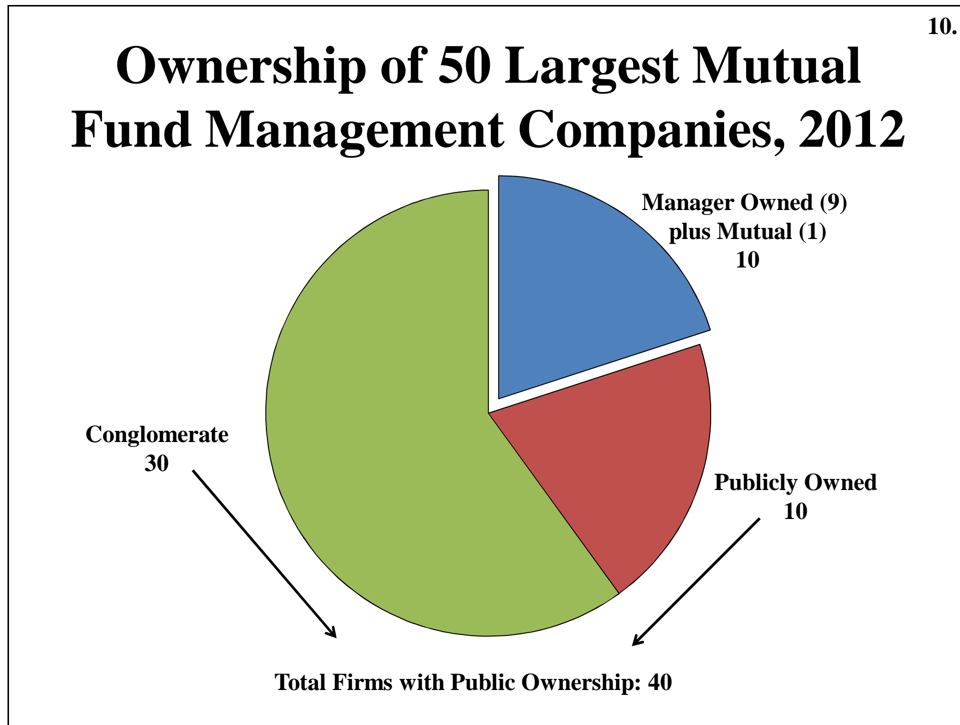
In my opinion, the coming of public ownership of management companies played a major role in changing the nature and structure of our industry. This baneful development began

with an unfortunate decision by the U.S. Court of Appeals, Ninth Circuit (in 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 SEC argued that the transaction was a sale of fiduciary office, and hence a violation of fiduciary duty. The date of that decision, April 7, 1958, then, was a date that will live in infamy. That seminal event, now long forgotten, changed the rules of the game. It opened the floodgates to public ownership of management companies; providing the huge rewards of entrepreneurship to fund managers, inevitably at the expense of fund shareholders.

From 1924 through the 1950s, as I recall, every single one of the industry's largest fund management companies was managed primarily by investment professionals, either a partnership or a closely-held corporation. But within a decade after the District Court's decision, scores of mutual fund management companies would go public, selling their shares (but usually retaining 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 (one could even concede, appropriately), are in business to earn a 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 the return on the *capital entrusted to them* by the mutual fund investors that they were duty bound to serve.

The dimension of that change has been extraordinary. **Exhibit 10.** Among today's 50 largest mutual fund complexes, only nine remain private. 40 are publicly held, including 30 owned by financial conglomerates. The only different ownership model is the single *mutual* mutual fund structure—Vanguard's— in which the fund management company is owned by the fund shareholders. All of the public fund management companies have external owners, and obviously face a potential conflict of interest. As I spoke to Wellington's officers in 1971 (when our firm had public shareholders):

> *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.*



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. Financial conglomerates now own about two-thirds of the major fund management companies, and with the publicly-traded firms, more than 80 percent. However, for whatever one wants to make of it, each of today's three largest fund complexes—Vanguard, Fidelity, and American Funds—has remained independent. These three firms alone manage $4 trillion, or some 30 percent of all mutual fund assets.

While the private firms largely have grown organically, many of the public firms have grown by acquisition, a pattern hardly unfamiliar to the business behemoths of Corporate America. For example, The Amerprise/Columbia Funds have acquired fully a dozen previously independent fund managers. BlackRock obtained substantially all of its fund asset base through its acquisition of Barclays Global Investors in 2009, acquiring Merrill Lynch Asset Management in 2006, and its even earlier acquisition of State Street Management and Research Corporation previously owned by Met Life. (That acquisition was followed by the demise of industry pioneer State Street Investment Corporation, from my perspective a "death in the family.") Franklin Resources, another huge firm, is the product of the 1992 merger of giant Franklin Group and the giant Templeton Group. And so on.

So yes, opening the doors to public ownership produced exactly what the SEC was worried 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. And product proliferation hardly helped. So I reiterate: How can an independent fund director feel a fiduciary duty to the hundreds of fund boards on which he or she serves?

What's the problem? It's summarized in Matthew 6:24: "No man can serve two masters." Yet when a management firms is owned by a giant conglomerate (or even by public owners), the conflict of interest is palpable. When a conglomerate buys (or builds internally) a fund management company, the acquirer's goal is to earn the highest possible return on that capital. That's American way! The idea: maximize fees by gathering assets and creating new products, and resist reductions in fee rates that would enable fund shareholders to benefit from the economies of scale.

But fund shareholders, of course, would benefit from lower fee rates, which would 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 earned by their corporate shareholders; they also have a *fiduciary duty* to increase returns to their mutual fund shareholders. As Matthew suggested, this obvious conflict in serving two masters will cause them "to love the one and hate the other," and I think that this audience knows which master gets the love. There can be only one resolution to the conflict: a federal policy that prohibits the ownership of fund managers by holding companies.

5. The Triumph of Indexing

December 31, 1975 – A Date that will Live in Infamy. Part II

If April 7, 1958 is "a date that will live in infamy" for mutual fund *shareholders*, then surely 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 less than

seven months earlier—filed with the State of Delaware the Declaration of Trust for a new mutual fund that promised *not* to engage in the practice of 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. (Now there's a paradox!) In 1966, as head of the long-established Wellington Management Company, I bet the firm's future on a Boston firm—Thorndike, Doran, Paine, and Lewis—run by four aggressive equity managers operating a hot "Go-Go" fund named *Ivest*, managing a growing pension business, and having investment talent that, I believed, could more effectively manage the portfolio of our faltering Wellington Fund.

Yes, I was young and foolish, and (even worse!) I was wrong. But for a time, the merged firm prospered, yet only until the "Go-Go" era came to its inevitable end. As 1973 began, the stock market began its terrible 50 percent crash, even worse for Ivest Fund, which never did recover. (It no longer exists.) Worse, Wellington Fund performance was also a disaster—the worst performing of *all* balanced funds in 1967-1977. Our new business model faltered, and then failed. In the merger, I had 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—actually the *only* such moment—of my entire career. I decided to fight back. Fired by Wellington Management Company—actually "fired with enthusiasm"—I continued my role as chairman of the board of Wellington Fund and its eleven sister funds. There was some 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, if you will, had never before occurred in our industry, and I doubt that it will ever occur again.

That's too long and complex a story for today. (For more detail, it's chronicled in *The Clash of the Cultures.*) But it was a mighty near thing, which even *The New York Times* couldn't

figure out. In the first edition of the newspaper on March 14, 1967, the *Times* reported that this "ex-Fund Chief" would "fight his way back." But in the next edition, it added a question mark. **Exhibit 11**. In essence, what finally happened six months later was that the fund board, in a King-Solomon-like decision, decided to cut the baby in half (more or less). "Boston" would continue as investment adviser to and distributor of the funds. "Philadelphia," under my direction, took on the responsibility of running the funds' administrative, accounting, record-keeping, and compliance activities, as well as the responsibility for evaluating the performance of our adviser and distributor (then, of course, Wellington Management Company).

11.

THE NEW YORK TIMES,

People and Business

Ousted Fund Man to Come Back

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, who holds 28 per cent of the voting securities of Wellington—an investment adviser and underwriter for 12 mutual funds—continues to serve as president of the funds, which pay annual fees of 0.25 per cent to 0.50 per cent of total assets to Wellington. He could not be reached for comment yesterday, but he is understood to believe that this may be the appropriate time for the funds to "mutualize," or take over, their investment advisers.

A sentence in Wellington's quarterly report to stockholders, now in the mail, says that "directors of each of the funds [have] initiated a review and study of the various means by which these funds can best obtain management, advisory and underwriting services." When asked to comment on this statement and reports of Mr. Bogle's plans to attempt a return, a Wellington spokesman said that "inside and outside counsel have agreed that no one will comment."

John C. Bogle

THE NEW YORK TIMES, THURSDAY, MARCH 14, 1974

People and Business

Ex-Fund Chief to Come Back?

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John C. Bogle

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. 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 on an "at-cost" basis. In yet another contentious vote during the long process in making our decision, the board also approved my choice of a name for the new firm: *Vanguard.* "The Vanguard Group of

Investment Companies" was born on September 24, 1974.[9] As I took on my new job, I was once again, "fired with enthusiasm." (Again! Think about that!)

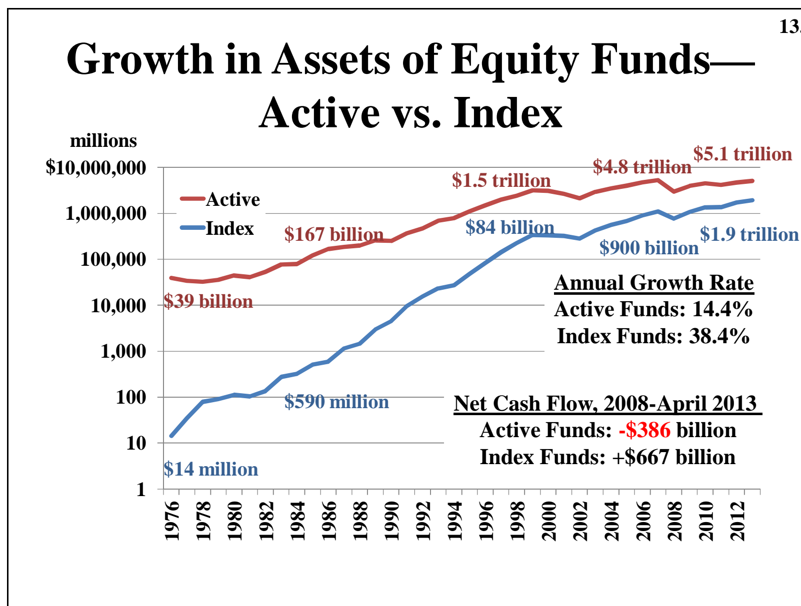
Recalling the analysis of the fund industry that I had presented in my senior thesis, and buttressed by my research data (in those days, using a hand calculator and a slide rule), I documented the failure of mutual fund managers generally to gain "superiority over the market averages" (using the Standard & Poor's 500 Index) during the previous three decades. Equally important, I was inspired by powerful encouragement from Nobel Laureate Paul Samuelson. Result: We formed the world's first index mutual fund.

Our board was skeptical, for 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 acceded to my recommendation. That day of infamy for mutual fund managers *"changed a basic industry in the optimal direction,"* as Dr. Samuelson wrote in his 1993 foreword to my first book.[10] It was the beginning of a far better direction, one aimed at placing front and center the interests of the mutual fund shareholders.

The IPO for our index fund took place on August 28, 1976. It was a flop. The underwriters raised only $11 million of initial assets. It 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?")[11] A midwest brokerage firm flooded Wall Street with posters screaming "INDEX FUNDS ARE UN-AMERICAN. Help Stamp Out Index Funds!" **Exhibit 12**.

[9] One could easily argue that "the date that will live in infamy" for fund managers was Vanguard's precedent-breaking formation on September 24, 1974. For it replaced the industry's business model with a truly mutual model that was virtually essential to the creation of our index fund. More about that later.
[10] *Bogle on Mutual Funds*, John Wiley & Sons, 1993.
[11] Fidelity's 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." Fidelity now oversees $126 billion of index fund assets.

To make matters worse, during the index fund's early years it appeared to lag the returns of the average fund manager (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.[12] Indeed, it wasn't until 1984 that a second index mutual fund joined the industry. By 1990, total assets of, by then, five index funds reached $4.5 billion, only about 2 percent of equity fund assets. **Exhibit 13**. The experiment in indexing was stumbling.



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

But as Thomas Paine reminded us all those years ago, "the harder the conflict, the more glorious the triumph." And just as Paul Samuelson predicted, indexing changed the fund industry in the optimal direction. Index fund assets leaped to $100 billion by 1996, and to $1 trillion by 2006, and to more than $2 trillion today. So, no, I don't think that the word *triumph* in the subtitle of this section is hyperbolic. Consider that during the past five years, investors have liquidated some $386 billion of their actively-managed equity funds and poured $667 billion into passively-managed index equity funds—a *$1 trillion-plus* shift in investor preferences. Today, assets of passively-managed equity index funds are equal to almost 40 percent of the assets of their actively-managed peers, their superiority confirmed by scores—perhaps hundreds—of independent academic studies, *and denied by none*. Index fund growth seems certain to continue, and likely even accelerate, even from today's massive total.

"The Moral History of U.S. Business"

The polar nature of those two days of infamy—one in 1958 and one in 1975—the first placing a heavy burden of costs on the returns earned by mutual fund investors, the second an automatic boost in the returns that they earn—can be said, I think, carry a subtle lesson for fund investors and their managers. For the first reflects a diminution of the power of the fiduciary, the second reflects a clear buttressing of the concept of fiduciary duty.

Could there be a lesson here about financial ethics and stewardship? Are the morals of our financial system involved? Will our society demand that business success be harmonized with moral purpose? Ironically, that provocative question was raised in that very December 1949 issue of FORTUNE in which "Big Money in Boston" appeared. The lengthy essay was entitled, "The Moral History of U.S. Business." **Exhibit 14**. 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."

14.

The Moral History of U.S. Business

Six generations have sought to harmonize their business success with moral purpose. From Franklin to the "Gospel of Service" the answers have varied but the quest goes on.

It is not exactly news that American businessmen, by and large, 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.

Which of the various non-pecuniary motives has been strongest in American business? It is hard to say and, until recently, it was bootless to ask. What gives the question pertinence now is the fact that the corporation, which the businessmen control, is going through a profound change in role in American society. It is graduating from a merely economic institution to one that consciously accepts wide social and

impose his spiritual discoveries on his store, his tailoring business, and his law practice. So modest that he would not let his face be pictured, he fought one of the greatest battles of any American against slavery, argued eloquently the dangers of money getting, and stressed the public responsibility of business not by speeches but by conduct. Behind him was the teaching of such Quakers as William Penn, who believed that merchants should be "tenants of the public," and that they should deal only in such practices and such goods as aided all men in following the light.

John Woolman wrote and talked against slavery, but above all he made his own business free of slavery. One day he decided he could not write wills transferring slaves. "As writing is a profitable employ," he wrote, "and as offending sober peo-

The essay presented a brief history of the values of business leaders, beginning in Colonial America. Here we meet Benjamin Franklin,[13] who looked upon his business as 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,*[14] *a character to form. The good merchant, through 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*

[13] Paradoxically, he began his life in Boston, but lived in Philadelphia and spent his entire career there.

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

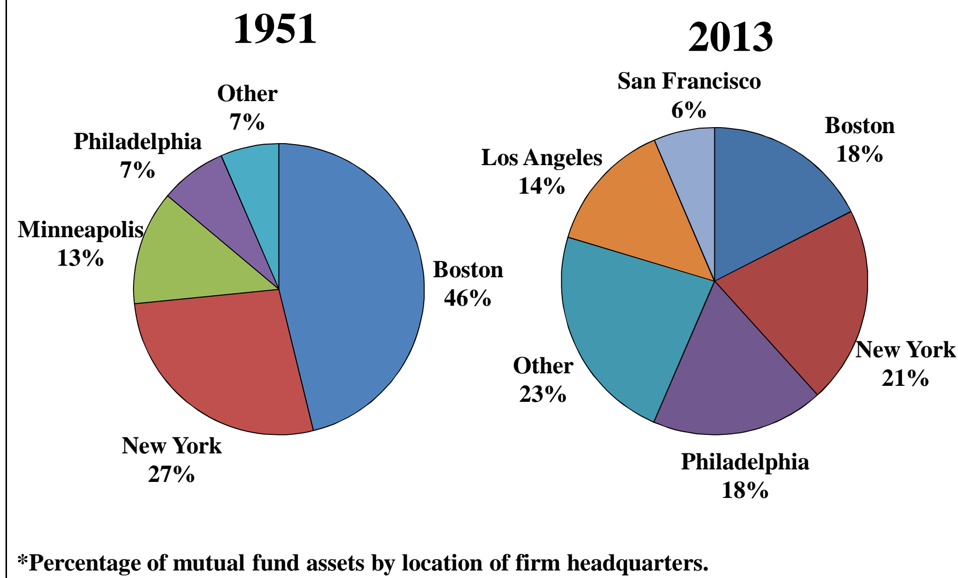
> *no extravagance, and to live within his means . . . Simple in his manner and unostentatious in his habits of life, he abstains from all frivolities and foolish expenditures . . .*

It is this spirit of rectitude, I hope, that will again come to animate the values and conduct of our industry.

Wrapping Up

Yes, six-plus decades after I read that FORTUNE article, there's still "Big Money in Boston" today. While no longer the center of the industry, Boston firms manage about $2.2 trillion of industry assets or 18 percent, well down from that 1951 peak of a dominant 46 percent. **Exhibit 15**. Whether we like it or not, there have been some significant changes, not only in the center of the industry's core, but in the business model of many firms.

First, the old M.I.T. is no longer the embodiment of pure trusteeship, bereft of a marketing agent for the fund. In 1969 it became the nucleus of a new privately-owned fund complex (Massachusetts Financial Service) whose funds were managed and distributed by a profit-seeking firm. More than incidentally, in 1976 MFS was purchased from its fairly new owners by a publicly-owned Canadian insurance company. The firm's one-time market share of 14 percent of industry assets is now 4 percent. Since 1995 alone, Sun Life has earned almost $4 billion of profits from its ownership of MFS, a goldmine, as I mentioned earlier, for the financial conglomerate. (MFS was put up for sale in 2007, but "after a strategic review," Sun Life decided not to sell.)



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. You decide whether or not the SEC conclusion about the onset of trafficking in management contracts was justified!

The change in the business model of M.I.T.—that old exemplar of Puritan Boston—left a void that was filled by Vanguard—in Quaker Philadelphia. The vaguely accidental creation of Vanguard's index fund has been the prime force in its rise to industry's largest firm. Now overseeing $2.2 trillion of assets, the firm's remarkable growth is a reflection of the triumph of indexing and of the pervasive realization that lower fund costs lead to higher fund returns. Vanguard's share of industry assets has set an all time industry high of 15 percent. Since 2010 the firm has accounted for more than 70 percent of industry cash flows. (Don't worry, that share will surely decline.) But it seems only a matter of time until a serious challenger emerges. The challenge is *simple*: just manage more index funds, and operate at far lower costs. But, given the priority of building earnings for the public stockholders of so many management companies, it won't be *easy*.

But I wish all of our fund peers well—especially those in Boston, the industry's birthplace. And I wish all of you here today success in following the central principle that has informed my long career. It all began with the incredible good luck—against all odds—of stumbling upon that 1949 story that began on page 116 in FORTUNE magazine, "Big Money in Boston." That principle inspired my Princeton thesis, where I concluded, "The principal role of the investment company should be to serve its shareholders." That principle should become the watchword of our industry in all the years ahead.