Finance in Philadelphia
Leadership, Decline, Renaissance

Remarks by

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It's a great honor to join you today. I've loved Philadelphia ever since my peripatetic family moved here in 1945 when I was sixteen years of age. Just as Temple President Russell Conwell promised, I found my "Acres of Diamonds" right here in my new backyard. Given what's happened since then, my debt to our City of Brotherly Love is beyond repayment. But today I'll try to make a small down payment.

The Birth of a Nation - 1776

I'll begin with a brief history of the ever-changing role of Philadelphia's financial community over the course of American history. That history should make us all proud of yet one more aspect of our city's claim to fame, beginning with the proclamation of the Declaration of Independence by our Founding Fathers in 1776. In 1787, at the constitutional convention at Independence Hall, the delegates approved our Constitution, which was then ratified by each of the several states. It became the law of our land in 1791.

Our city's role in the nation's finances began with leadership, was followed by decline, and in turn has been followed by its renaissance among America's largest financial institutions, all chronicled in my remarks. At the outset, it fell to Philadelphia merchant Robert Morris to finance the American Revolution. Without his substantial financial backing, there was simply no way that the Revolutionary War could have been fought, nor could the United States have come into being. In the early stages of the Revolutionary War, the Continental Congress was broke. Morris opened his own deep pockets to fund the

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

effort. Incredibly, then, it was private financing that enabled General George Washington to pay his troops and shelter them during the war, including that frigid winter of 1777-1778 at Valley Forge. Morris also paid the bills so that Washington could move his troops to Yorktown, the great battle that won the war in 1781.

Yet for all his matchless sacrifice and patriotism, Robert Morris was riding for a fall. Overextended financially by his real estate acquisitions after the war, his creditors had him arrested, and he was sentenced to debtor's prison from 1798 to 1801.[1] (It is said that George Washington showed his appreciation by lunching with him in the Prime Street Prison.) Humiliated and broke, Morris died on May 9, 1806.

But in 1781, when he founded the Bank of North America, Morris sparked Philadelphia's long era of leadership in banking. With the support of Alexander Hamilton, Morris's bank was succeeded by The First Bank of the United States. When its charter expired in 1811, Philadelphia merchant Steven Girard acquired its assets, forming the Girard Bank in May 1812. Like Morris during in the Revolutionary War, French-born Girard stepped up to finance the war of 1812, purchasing an astonishing 95 percent of our nation's war bonds. Both his bank and his business interests flourished, earning him the moniker, "America's First Tycoon."

When the Second Bank of the United States was rechartered by the federal government in 1816, another Philadelphian played the leading role. He was Nicholas Biddle, who had lobbied for its rechartering and became its president. But when Biddle applied for a charter extension in 1832, President Andrew Jackson—no lover of national banks—blocked the move, and its charter expired in 1836. National banking was in essence placed "on hold" for the next 25 years, during which a system of state banks and mutual savings banks was created.

Savings and Insurance

As America grew, more and more citizens acquired the means to save, but the available options for working people were limited. In Philadelphia, in 1816, the Philadelphia Savings Fund Society was formed, a mutual company operated for the benefit of its depositors. By the 1920s, it had become the second largest savings bank in the nation, the paradigm of Quaker thrift and simplicity.

[1] I am indebted to libertystory.net for these excerpts describing the life of Robert Morris. My source for the other information covering the 19th century and early 20th century was Wikipedia, a source not generally accepted by the academic community.

Philadelphia also led the early growth in the field of insurance—life as well as property and casualty. Reflecting the spirit of Benjamin Franklin and his community-minded approach to entrepreneurship, Franklin founded two mutual companies—the Union Fire Company in 1736, and The Philadelphia Contributionship in 1752—still flourishing today.

Perhaps inspired by Franklin's example, most of the insurance companies formed in Philadelphia—and in the nation—were established as mutual (i.e., policyholder-owned) enterprises. Among them were Provident Mutual, formed in 1832 by a group of Quakers; Penn Mutual in 1847; and Fidelity Mutual around 1839. They rose to the top ranks among their peers across the nation. Today, it's hard to imagine that for a mere century and a half, virtually all of our insurance companies (including giants Metropolitan Life and Prudential Insurance) were operated as mutual companies, organized to serve their policyholders. Today only a handful of mutual insurance companies remain. "Mutuality" seemed like an idea whose time had gone. (But, as we'll see later, a new kind of mutual company would spark Philadelphian's financial renaissance.)

The Civil War Era

When the Civil War came to America in 1864, Philadelphia rose again, with two figures playing key roles. One was Jay Cooke, who had founded his private banking house in 1861. At the urging of Treasury Secretary Salmon P. Chase, Cooke took on the task of distributing $500 million of U.S. Treasury notes after the Treasury itself had failed to do so. Cooke's 2500 agents scoured the country for buyers and the issue was actually over-subscribed. Later, to provide funds to supply and pay Union soldiers during the final months of the war, he used the same mass distribution force and raised another $830 million for the government.

The accomplishments of Jay Cooke during the Civil War—so clear a parallel to Robert Morris in the American Revolution and Steven Girard in the War of 1812—were by no means over. His firm financed the Northern Pacific Railway, only to run out of money. Cooke declared bankruptcy in 1873. Happily for this financier/patriot, a sentence in debtors prison was not in store. (Remarkably, such debtors prisons remain in many of our several states.)

The Gilded Age

After Jay Cooke's time, yet another Philadelphian also rose to national financial leadership. He was Anthony J. Drexel, the senior partner of Drexel & Co. In 1871, he formed Drexel, Morgan & Co. in New York, with a then-youthful J.P. Morgan as his junior partner. The partnership was the leading financier of the nation's burgeoning railroad system, and created the first national capital market for rail and industrial corporations. Drexel Morgan underwrote the pay of the entire U.S. Army in 1877 (talk about history repeating itself!). After Drexel's death in 1893, the firm was renamed J.P. Morgan & Co., which soon bailed out the U.S. Government during the Panic of 1895. That original Morgan firm was the direct predecessor of today's giant JP MorganChase. And it all began in Philadelphia.

When the era of the "Robber Barons" and the Gilded Age arrived, Philadelphia's impact on American finance had ebbed. Neither the most notable giants of that era (Andrew Carnegie is the best example) nor the most notable hucksters were Philadelphians. The center of Corporate America shifted to Cleveland, Ohio, of all places, strategically situated between burgeoning Chicago and the steel city of Pittsburgh. At the same time, the center of Financial America moved from Philadelphia to New York. The wealth and power of our commercial banks and investment banks alike grew to keep pace with the growing needs of their corporate clients.

How the Mighty Have Fallen

So it was Philadelphians who were the essential drivers of the era following the birth of our new republic, the United States of America. These Philadelphians had made our city the financial capital of the nation. But as America's population soared and the Louisiana Purchase added vast new territory, as the west was won, and as the Industrial Revolution flourished, our city's role in finance, while still vital, gradually diminished.

It took more than a full century for this decline to reach its sad conclusion, exemplified by the fate of these investment icons of yore:

- The Girard Trust was merged with Mellon Bank in 1983, and then sold to Citizens Bank two decades later. It is now known only to historians.
- PSFS converted from mutual to public ownership in 1983. As a long-time trustee of the bank, I witnessed firsthand its acquisition of other banks and finance companies, as it became a financial conglomerate. While our federal regulators had approved the odd accounting for an early merger; they later reversed their ruling. This reversal, along with over-expansion, forced the venerable

PSFS into receivership in 1992. After 176 years of serving our community, its assets were sold to Mellon Bank. Nothing remains but its PSFS logo, in 27-foot-high red neon letters—PSFS—atop the Loews hotel, illuminating Philadelphia's night sky.

- Unable to compete with world financial centers in New York and London, our national banks no longer exist as independent entities. Century-long-dominant Philadelphia National Bank is but one example of this fall from grace. It merged to create CoreStates Bank in 1990, was then acquired by First Union Bank, which combined with Wachovia National Bank in 2001, which was in turn acquired by Wells Fargo Bank in 2008, its last vestiges now gone.
- Our mutual insurance companies met a similar fate. Penn Mutual has moved from its proud tower on Independence Square to more modern facilities in the suburbs. Provident Mutual, greatly downsized, sold its magnificent neo-classical headquarters at 46th and Market Streets to the Philadelphia Police Department as a command center. Fidelity Mutual, balance sheet broken, was released from court oversight in 1992 but continues to operate, a shadow of its former self.

The Renaissance Begins—Leadership in Investment Management

But Philadelphia leadership in finance was hardly over. I now turn to the recent era. While the earlier history I've recounted is based largely on my research, the history that I'll now discuss is based upon my firsthand experience. This era begins with Philadelphia's early leadership in the rising profession of financial analysis and investment management, and later the rise of a Greater Philadelphia firm that has become the unquestioned leader of the huge U.S. mutual fund industry. (You may be familiar with the firm I'll soon discuss!)

When I joined Wellington Fund in 1951, right after my graduation from Princeton University, I became a new member of a vibrant investment community. Its leaders were largely drawn from our then-powerful trust companies, whose senior officers were among the most respected security analysts in our nation. I came to know these men by their works and often personally. In those days, the profession of security analysis was in its infancy.

I best remember F.W. Elliott Farr, senior vice president of the Girard Bank, and the "Grand Old Man" of Philadelphia finance, an acute and irreverent proclaimer of wise investment policy. Another was S. Francis Nicholson, a 40-year veteran of Provident National Bank who ran their Investment Department, developing what became known as the "value approach" to portfolio selection.

Frank E. Block, whose investment career included serving as senior vice president at the Girard Bank, was notable for his early work on the relationship between corporate book values and market prices. Morton Smith, also an investment leader during his 55-year career at Girard, rose to become its president. A prescient skeptic about the "go-go" years of speculation in the stock market (1965-1969), Smith noted that while "the old music had died, the show will go on." And it has, of course. But only after three painful interludes, each with a 50 percent decline in the stock market. ("The more things change, the more they remain the same.")

Not all of these leaders were bank trust officers. At Wellington, investment head A. Moyer Kulp, the paradigm of the Quaker trustee, led the move to organize a professional society of qualified securities analysts. He became the chairman of the new entity—the organization of Chartered Financial Analysts (CFA), now an almost-mandatory qualification for those who are serious about pursuing a career as a financial analyst.

These men were hardly flawless, but they were professional trustees, fiduciaries seeking the best interests of the clients whose assets were committed to their care. They were among the most prolific contributors to the investment discourse of the era, and their essays peppered the pages of the *Financial Analysts Journal.* Yes, New Yorker Benjamin Graham, professor at Columbia (and Warren Buffett's mentor) was the unequivocal giant of that era, eloquently writing about investment strategy and the dynamics of the stock market. But right behind him stood Philadelphia's cadre of influential investment managers.

More Change Comes

Most of that old leadership has vanished, with new leadership arising in a new field. Yes, those old trust departments have nearly vanished from the Philadelphia area, and few leaders of their stature have emerged. But with the rise of independent firms managing the investments of giant pension funds, a few leaders stood out, such as Paul F. Miller, Jr., my longtime friend, a brilliant and articulate investment thinker, and contributor to the *Financial Analysts Journal*. Miller rose to become president of, yes, Drexel, Harriman, Ripley & Company at age 42, only to leave his lofty position to lead the formation of Miller, Anderson and Sherrerd in 1969. This new institutional money manager quickly became a success, leading, for better or worse (better for its partners; worse for its clients) to its acquisition by Morgan Stanley for a cool $350 million in 1996. The MAS name is now gone, as is its early distinction.

Another Philadelphian who starred during the recent era was John B. Neff, legendary manager of Vanguard's Windsor Fund. Under his aegis (1964-1995), Windsor's deep value strategy earned an annual return of 14 percent for the fund, a solid 3 percentage points ahead of the 11 percent return on the Standard & Poor's 500 stock index. The consummate investment professional—articulate, opinionated, and seeking values where others feared to tread—John Neff is the paradigm of the contrarian investor.

Today, I see few advisory firms in our area that aspire to reach those old heights, including not merely business success, but a steady and wise contribution to the thought leadership of the investment profession. Philadelphia's top candidate may well be Theodore ("Ted") Aronson, founder of advisory firm AJO, with $20 billion of assets under management, now among our region's largest managers of institutional accounts. Or sort of the largest, for I've saved the region's giant money manager for last—a manager not of private accounts but of mutual funds.

It may be Greater Philadelphia's greatest financial leadership success story of the modern era: the unquestioned leadership of the "mutual fund" industry, now the largest aggregation of America's savings, responsible for $15 trillion of investor assets.[2] Mutual funds now hold 33 percent of the shares of all of America's public corporations—arguably *de facto* control, so far unexercised.

The Rise of Vanguard

That new leader—that elephant in the financial room—is Vanguard. Founded here in 1974, Vanguard manages some $2.4 trillion of fund assets, 18 percent of the industry's stock and bond asset base. Please be clear: I'm not here to brag about that huge number. Actually, I'm well aware of the perils of huge size, and the challenges of managing such a large firm. (After all, the title of my seventh book is *Enough.*) About 10,000 of our crewmembers are located around our Valley Forge headquarters, with the other 5,000 in North Carolina, Arizona, London, Melbourne (Australia), Hong Kong, and a few other sites.

I recount our history to you today not only because Philadelphia has become the heart of the fund industry, but, even more important to me, its soul. I also want to deliver a message to you business folk and entrepreneurs in this room—a message for all of you in whatever business you ply your trade—of how determination, pig-headedness, common sense, and vision (plus, as always, healthy doses of luck)

[2] When I joined the industry in 1951, it represented only 1 percent of the major savings institutions of the day. That share now exceeds 50 percent.

can overcome failure and tragedy, and finally lead to triumph. (At least for the moment—remember all those fallen idols of Philadelphia's past leadership in finance.)

Big Money in Boston

The story begins with my Princeton senior thesis, inspired by an article in *Fortune* magazine in December 1949, entitled "Big Money in Boston."[3] Mutual fund pioneer and Wellington Fund founder Walter L. Morgan liked my work and gave me my first job. (I agonized over my choice between little Wellington and giant Philadelphia National Bank. Little did I know . . .)

When I joined the mutual fund industry in 1951, assets totaled just $2 ½ billion. A remarkable 15 percent annual growth since then has carried the industry to its present $15 *trillion* total. Giant size, of course, is a mixed blessing. When a small or even a 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 power (alas, not always used to serve society); more process, less human judgment; more conformity, less tolerance of dissent; more business values, fewer professional values. Yes, bigness can produce economies of scale, but keeping a firm's humanity and its duty to serve wisely remain big challenges.

When I fortuitously began my long career, Wellington Fund was Wellington Management Company's sole mutual fund, with assets under management of just $140 million. Today, Wellington Fund's assets total $80 billion, one of the 170 mutual funds overseen by The Vanguard Group. While I look at my career as being with a single firm, in fact I was employed by Wellington Management and its mutual funds from 1951 until January 23, 1974—a period of almost 23 years. I headed the firm during the final nine years of that period, and then I was fired (yes, axed) by my Boston partners, whose firm merged with Wellington through an opportunistic combination that I had stupidly engineered in 1966.

[3] For an in depth look at the change in this industry from then until now, my recent essay in the Fall 2013 issue of the *Journal of Portfolio Management,* "Big Money in Boston: The Commercialization of the Mutual Fund Industry," is posted on my blog, www.johncbogle.com.

As soon as my former partners seized power, they sought to move the firm to Boston. But I was bound and determined to block their plan and keep the firm here. Moving from my beloved Philadelphia was out of the question. Against staggering odds, I was able to restore my career by creating Vanguard and regaining control over most of the firm's activities. After a painful battle, with the outcome in doubt, the new firm was incorporated on September 24, 1974, and Wellington Fund, along with its ten sister funds, were under Vanguard's aegis. (How that reversal of fortune came to pass is a complicated story, far too long for these remarks, but it is also told in that Fall 2013 issue of *Journal of Portfolio Management* cited earlier.) The rest is history.

Vanguard—Marching to a Different Drummer

I find it almost unimaginable that I'll celebrate my fortieth year at Vanguard this September. Whatever we've been able to accomplish during those four decades is the result of that 1974 shift in the Vanguard/Wellington structure. It was that structure that opened the door for a series of unique innovations designed to reshape the governance structure and the investment strategy of our firm. (That's a complicated story, far too long for these remarks, but it is told more fully in that *Journal of Portfolio Management* essay that I mentioned earlier.)

These four unprecedented innovations sparked our renaissance:

- **One**—Vanguard was formed as a *mutual* mutual fund company (shades of old Philadelphia), owned by our fund shareholders, and operating on an "at-cost" basis.
- **Two**—Our creation of the world's first index mutual fund, designed simply to give its investors their maximum possible share of the stock market's return (for better or worse).
- **Three**—Our novel design for bond funds with "defined maturities," either short, intermediate, or long in duration. Each segment has different trade-offs between yields and risks, enabling individual investors to fine-tune their portfolios.
- **Four**—The abandonment of a "supply-push" distribution strategy, relying on a nationwide network of broker/dealers. We replaced it with the creation of a "demand-pull" strategy, eliminating all sales commissions. Vanguard was the first firm to convert to this "no-load" fund strategy.

While our new bond fund strategy reshaped that segment of the industry almost overnight, the mutualization concept, the index fund, and the conversion to “no-load” were almost universally scorned. Such is the fate of new ideas—first scorned, then accepted, and finally copied. It took patience, determination, and a thick skin, but it was accompanied by irrepressible hope and confidence, along with joys and sorrows, and, during the difficult early days, more than a few tears.

Big Money in Philadelphia

Behind the story of Vanguard’s rise—from our controversial beginning to our dominant role in today’s mutual fund industry—lies the most basic set of values about the proper way to serve the investor/savers of our nation. How did it happen that “Big Money in Boston”—where fully one-half of all fund assets were managed in 1949—became, by 2010, “Big Money in Philadelphia”? Basically, it came down to the sharply different business models and investment strategies followed by the fund industry giant of yesteryear and the industry giant of today.

Boston’s Massachusetts Investors Trust (MIT) was the principal subject of that 1949 *Fortune* article. A mutual fund that was managed by its own trustees, MIT was the oldest and by far the largest, and the lowest-cost, firm in our field. Its $470 million asset base in 1951 accounted for 15 percent of industry assets, more than 2 ½ times Wellington’s $190 million (a 6 percent market share). Today, the assets of Massachusetts Financial Services (now MIT’s parent company) total $155 billion, a share of only 1 percent of the assets of all stock and bond mutual funds. During the same period, assets of the Vanguard funds (including Wellington Fund) soared to $2.4 trillion—almost twenty-fold more than MFS—Vanguard’s market share recently reached 18 percent, by far the highest in industry history.

“Puritan Boston and Quaker Philadelphia”

What accounts for this epic reversal in industry leadership? It comes down, I think, largely to the difference between “Puritan Boston and Quaker Philadelphia.” (As it happens, that is the title of a 1979 book by E. Digby Baltzell.) In 1969, MIT abandoned its highly successful original business model—similar in some respects to Vanguard’s later mutual structure—with its primary focus on prudent trusteeship and low costs. MIT became the nucleus of MFS, a new, profit-seeking firm created by its trustees who awarded themselves its ownership and control. Seven years later, in 1976, those new owners sold MFS (raking in healthy personal profits) to a publicly-owned Canadian insurance company. MIT's once rock-bottom expense ratio (fund expenses as a percentage of assets under management) leaped skyward, soaring from a low of 0.17 percent in 1961 to 1.33 percent for the MFS funds in 2012, an astounding increase of 700 percent. MFS remains dependent on selling its fund shares—still carrying those onerous sales loads—through its broker-dealer network. The firm has yet to offer investors an index fund.

In each case, Vanguard did precisely the opposite. With a bow to the legendary Quaker thrift and simplicity, Vanguard's new mutual structure eliminated public ownership and incorporated rock-bottom costs. The firm's 2013 expense ratio of 0.15 percent (about one-sixth of one percent) is but a tiny fraction of the soaring expenses that MFS assesses its fund shareholders, and far below the industry norm of about 1 percent. Driven by investor demand, no-load funds have now become the standard in the industry. And Vanguard's early experiment in index funds (holding the stocks and bonds of various market sectors, the S&P 500, for example, and simply delivering their returns to investors) has come to dominate our asset base—$1.6 trillion of our $2.4 trillion total. Together, those contrarian decisions have been the prime force in Vanguard's rise to industry leadership.

The Wisdom of Adam Smith - 1776

What we are seeing in Vanguard is the rise of the American investor/consumer—the mutual fund shareholder who demands that his interests should take priority over the interests of the owners of the fund management companies. Though the concept of serving clients before self has yet to flourish in Financial America, it is hardly a new idea. I began today's lesson in Philadelphia's history with the revolution that began in 1776. I close by coming full circle with a central principle that first saw the light of day in 1776. It was then, in *The Wealth of Nations*, that Adam Smith summed up the issue without equivocation:

> . . . 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 . . . *the interest of the consumer* . . . *must be the ultimate end and object of all industry and commerce.*

This principle is as applicable to *all* businesses, yours and mine alike. To survive and prosper, we all must serve the interests of our clients and customers. In Vanguard's case, it comes down to the central principle of fiduciary duty—the responsibility of those entrusted with other people's money—to place the interests of investors first and foremost. And it all began with the incredible good luck of stumbling upon that 1949 magazine story, echoed in the Princeton thesis it inspired, then to my career at Wellington, and finally to the creation of Vanguard nearly 40 years ago. As I wrote in my 1951 thesis, "the principal role of the investment company should be to serve its shareholders." In the years ahead, that simple standard must become the watchword of the entire mutual fund industry.

Wrapping Up

I'm so pleased that those "Acres of Diamonds" that I found in Philadelphia all those years ago have helped Vanguard to earn the clear leadership in mutual funds that Philadelphia has demonstrated in other areas of finance over the past two-plus-centuries. Of course, our leadership is paradoxical. We lead in managing money for fund investors, but we have yet to find a single follower of our mutual structure among other fund managers. But one day, I hope sooner rather than later, our rivals will have to follow, painful as that transition will be for them. The "Consumer is King" philosophy resonates all over the world. (Just think of what e-commerce has done—and will continue to do—to the face of "business as usual." Not that I'm particularly smitten with the gradual diminishment of person-to-person, face-to-face interactions.)

While I never set out to restore the long history of leadership that Philadelphia finance had earned in other ways in earlier centuries, I fortuitously chose a career in the mutual fund industry. Of course I'm pleased with the way it worked out, even as I recognize that our own work and mission has been but a pale shadow of the lives of our giants of yore. I believe our leadership in the nation's huge and powerful mutual fund industry, being well-principled, will endure. But we'd best keep Vanguard's mission consistent with our founding investment principles and ethical and human values, lest some latter-day challenger removes the ever-uneasy crown of leadership from our head. It has been known to happen before.