"A Question So Important that It Should Be Hard to Think about Anything Else"

Remarks by

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I'm honored (and humbled) to be on the same program as two of Philadelphia's finest money managers, John Neff and Ted Aronson. Not only are they both professional *investors*, a somewhat exceptional title in this age of the professional *speculator*, but they are also men of extraordinary career accomplishment and high personal integrity. With their long experience, they are far more able than I to comment on the financial markets. I will focus on the evolution of the investment profession and on what lies ahead.[1]

"It is my basic thesis—for the future as for the past—that an intelligent and well-trained financial analyst can do a useful job as portfolio adviser for many different kinds of people, and thus amply justify his existence. Also I claim he can do this by adhering to relatively simple principles of sound investment; e.g., a proper balance between bonds and stocks; proper diversification; selection of a representative list; discouragement of speculative operations not suited for the client's financial position or temperament—and for this he does not need to be a wizard in picking winners from the stock list or in foretelling market movements."

While it may surprise those of you who happen to be familiar with my career, the words I've just spoken are not my own. They are the words of the legendary Benjamin Graham, as they appeared in *The Financial Analysts Journal* of May-June 1963, celebrating the 25th anniversary of your Institute. To say that I passionately subscribe to these simple principles of balance,

[1] Note: The opinions expressed in these remarks do not necessarily represent the views of Vanguard's present management.

diversification, and focus on the long term—to say nothing of being skeptical of stock-picking and market-forecasting wizards—would be an understatement. (Indeed, it's pretty much what I wrote in my Princeton senior thesis in 1951.) What's more, an entire chapter of my latest book[2] is devoted to showing that, given the radical change in our investment environment during the past three decades, Ben Graham would have gone even further, and endorsed the stock market index fund as the core strategy for the vast majority of investors. (Warren Buffett, who worked closely with Ben Graham, not only personally assured me of Graham's endorsement, but put it in writing in his endorsement of my new *Little Book.*)

The fact is that, even when I entered the mutual fund industry 56 long years ago—hired by fund pioneer Walter Morgan, whose Wellington Fund was, and remains today, the paradigm of these sound principles—this industry invested pretty much in the way Graham prescribed. The portfolios of the major equity funds consisted largely of a diversified list of blue-chip stocks; and managers invested for the long-term, eschewed speculative operations, managed their funds at costs that were (by today's standards) tiny, and delivered market-like returns to their investors. (As the record clearly shows, those fund managers were hardly "wizards in picking winners.")

What a difference a half-century makes! How different? Let me count the ways, comparing the industry I entered in 1951—56 years ago, almost back to your founding in 1947—with the industry I see today.[3]

1. **Enormous Growth**. Then, mutual fund assets totaled $2 billion; today, assets total more than $11 trillion, an astonishing 17 percent rate of annual growth.

2. **Investment Focus**. Then, almost 80 percent of stock funds (60 of 75) were broadly diversified among investment-grade stocks, pretty much tracking the movements of the stock market itself and lagging its returns only by the amount of their then-modest

[2] *The Little Book of Common Sense Investing—The Only Way to Guarantee Your Fair Share of Stock Market Returns* (John Wiley & Sons, 2006)
[3] In the interest of time I'm confining these remarks largely to equity funds, which now represent about 70 percent of mutual fund assets.

operating costs. Today, such “large cap blend funds”[4] account for only 11 percent of all stock funds. These 500 “market beta” funds are now overwhelmed by 3,100 U.S. equity funds diversified in other styles; 400 funds narrowly-diversified in various market sectors; and 700 funds investing in international equities—some broadly diversified, some investing in specific countries. The challenge in picking funds, dare I say, has become roughly like the challenge in picking individual stocks. I don’t consider that progress.

3. **Investor Behavior.** But fund investors no longer just *pick* funds and *hold* them. They *trade* them. In 1951, the average fund investor held his or her shares for about 16 years; today that holding period averages about four years. To make matters worse, fund investors don’t trade very well. Because they usually chase good performance, and then leap out after bad performance, the asset-weighted returns—those actually earned by *fund investors*—have trailed the time-weighted returns reported by *the funds themselves* by an astonishing amount—more than 6 percentage points per year over the past decade. (Cumulative 10-year return reported by the funds: 133 percent; return earned by their investors, 27 percent.) Astonishing! And depressing.

4. **Investment Process.** In 1951, funds were typically managed by investment committees. Today I can’t identify a single fund run by a committee. In this age of the portfolio manager, some 1,800 equity funds are managed by a single individual, with the remaining 2,900 run by a “management team,” or a whole series of “portfolio counselors.” This evolution—really a *revolution*—has led to costly discontinuities. A “star system” among mutual fund managers has evolved—with all the attendant hoopla—although most of these stars, alas, have turned out to be comets. The average portfolio manager now lasts for but five years.

5. **Investment Strategy.** In 1951, mutual funds focused *on the wisdom of long-term investing*, holding the average stock in the portfolio for about six years. Today, the

[4] The Morningstar categories are based on nine boxes, with three market-cap categories (large, medium and small) set on one axis and three styles (growth, value, and blend) on the other.

holding period for the average *fund* is just over one year (1.1 years, to be exact). More charitably, on a dollar-weighted basis, the average holding period is about 1.4 years. Either way, today mutual funds are largely focused on *the folly of short-term speculation*.

6. **Industry Mission**. Over the past half-century-plus, the mission of the fund business has turned from *managing* assets to *gathering* assets, from stewardship to salesmanship. We have become far less of a management industry and far more of a marketing industry, engaging in a furious orgy of "product proliferation." Our apparent motto: "If we can sell it, we will make it." During the 1950s, the number of equity funds grew nicely, by about 35 percent. But during the 1980s, the number of equity funds soared by 110 percent, with another 125 percent increase during the 1990s (most of which, alas, were technology, internet, and telecommunications funds, and aggressive growth funds focused on these areas). Since every action leads to a reaction, of course, the 13 percent fund failure rate during the 1950s has also soared. The failure rate is now on track to reach nearly 60 percent this decade. "As ye sow, so shall ye reap."

7. **Costs.** Ah, costs! Costs have soared. On an *unweighted* basis, the expense ratio of the average fund has doubled, from 0.77 percent in 1951 to 1.54 percent last year. (All right, to be fair, when *weighted* by fund assets, the expense ratio has risen from 0.60 percent to 0.87 percent, a lower, but still staggering, increase of nearly 50 percent. Whichever figure you like, this rise in costs is a major negative. Despite the quantum growth in industry assets since 1951, managers have arrogated to themselves the extraordinary economies of scale available in the field of money management, rather than sharing these economies with fund owners. Money managers—especially the giant financial conglomerates that now own 40 of the 50 largest fund organizations—are all too eager to focus on the return on *their own capital* rather than focus on the *capital they are investing for fund shareholders*. One more big negative for this industry.

This combination of asset growth, truncated investment focus, counterproductive investor behavior, hair-trigger investment process, short-term investment strategy, product proliferation (inevitably followed by "de-proliferation"), and soaring costs have together constituted a serious disservice to investors. Perhaps I shouldn't speak so bluntly, but I'm inspired by this sentence from last week's *The New York Review of Books*, part of its review (a little late!) of my previous book, *The Battle for the Soul of Capitalism*: "After a heart transplant eleven years ago, Bogle retired to a life of full-time hell-raising." Well, no. *No*. Paraphrasing Harry Truman: "I'm not giving 'em hell. I'm just telling 'em the truth, and they think its hell."

The soaring costs of mutual funds is just one part—actually a relatively *small* part—of the costs that investors incur in our nation's system of financial intermediation. The direct costs of the mutual fund system (largely management fees and operating and marketing expenses) are currently running at an annual rate of almost $100 billion, but funds are also generating some $10 billion of fees to financial advisers, and enormous transaction fees to our brokerage firms and investment bankers, and lawyers, and all those other facilitators.

1.

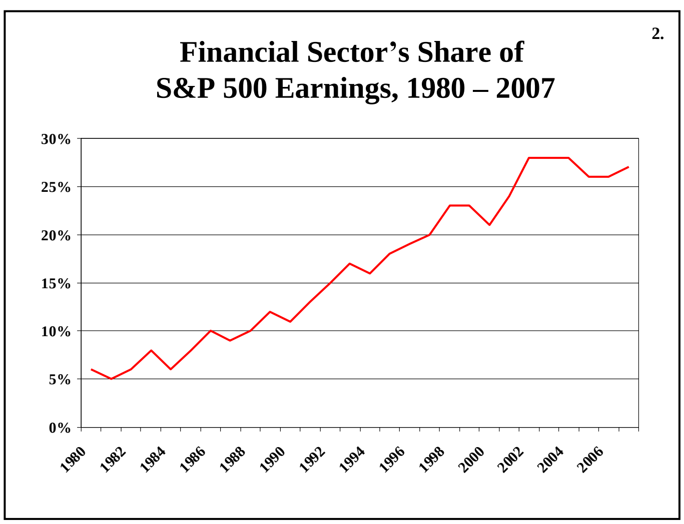
Estimated Costs of Securities Intermediation, 2007
(billions)

Investment Banking and Brokerage	**$308**
Mutual Fund Operating Expenses	**100**
Hedge Funds	**45**
Variable Annuities	**30**
Pension Fund Advisory Fees	**15**
Legal / Accounting Fees	**15**
Financial Advisors	**10**
Bank Trust Departments	**5**
Total	**$528 billion**

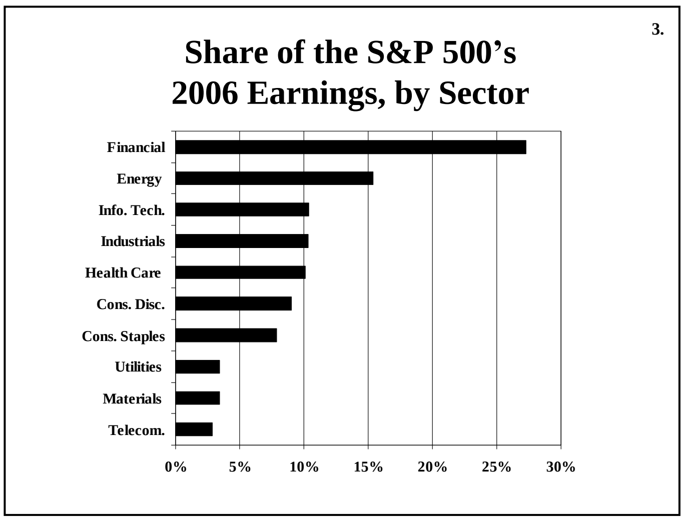
All of these fund expenses, plus fees paid to hedge fund and pension fund managers, plus advisory fees and trading costs and investment banking fees and all the other costs will total about $528 billion this year. **(Chart 1)** But don't forget that these costs recur year after year. If the present level holds for the next decade (I'm guessing that it will grow), total intermediation costs would come to a cool $5 trillion. (Just think about these cumulative costs in the context of the $16 trillion value of the U.S. stock market and the $14 trillion value of the bond market.)

Does this explosion create an opportunity for money managers? You better believe it does! Does it create a problem for investors? You better recognize that, too. For as long as our financial system delivers to our investors in the aggregate whatever returns our stock and bond markets are generous enough to deliver, but only *after* the costs of financial intermediation are deducted (i.e., forever), these enormous costs will seriously undermine the odds in favor of success for our citizens who are accumulating savings for retirement. Alas, the investor feeds at the bottom of the costly food chain of investing.

The tremendous drain on investment returns represented by the costs of our investment system raises serious questions about the efficient functioning not only of that investment system, but of our entire society. Over the past two centuries, our nation has moved from being an agricultural economy, to a manufacturing economy, to a service economy, and now to what is predominantly a financial economy. But the financial economy, by definition, subtracts from the value created by our productive businesses. Think about it: while the owners of business enjoy the dividend yields and earnings growth that our capitalistic system creates, those who play in the financial markets capture those investment gains only *after* the costs of financial intermediation are deducted. Thus, while investing in American business is a *winner's* game, beating the stock market before those costs—for all of us as a group—is a *zero-sum* game. And after intermediation costs are deducted, beating the market becomes a *loser's game.*



The rise of the financial sector is one of the little-told tales of the recent era. Twenty–five years ago, financials accounted for only about 5 percent of the earnings of the 500 giant corporations that compose the Standard & Poor's 500 Stock Index. **(Chart 2)** Fifteen years ago, the financial sector share had risen to 10 percent. In recent years, financial sector profits have soared even higher, to an all-time peak of 27 percent. If we add the earnings of the financial affiliates of our giant manufacturers (think General Electric Capital, for example, or the auto financing arms of General Motors and Ford) to this total, financial earnings now likely exceed 33 percent of the earnings of the S&P 500. The finance sector is now by far our nation's largest generator of corporate profits, larger even than the *combined* profits of our huge energy and health care sectors, and almost three *times* as much as either manufacturing or information technology.[5] **(Chart 3)**



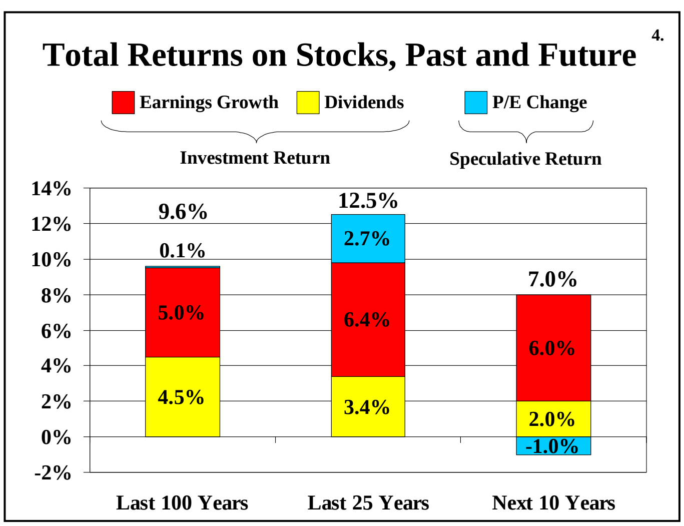
We're moving, or so it seems, toward becoming a country where we're no longer *making* anything. We're merely *trading* pieces of paper, swapping stocks and bonds back and forth with one another, and paying our financial croupiers a veritable fortune. We're also adding even more costs by creating ever more complex financial derivatives in which huge and unfathomable risks are being built into our financial system. "When enterprise becomes a mere bubble on a whirlpool of speculation," as the great British economist John Maynard Keynes warned us 70 years ago, the consequences may be dire. "When the capital development of a country becomes a by-product of the activities of a casino, the job of capitalism is likely to be ill-done."

[5] For the record, the 2006 operating earnings of the S&P 500 totaled $787 billion. The earnings of the major sectors (in billions) were: Financials $215; Energy $121; Health Care $79; Manufacturing and Technology each $81.

Once a profession in which business was subservient, the field of money management has largely become a business in which the profession is subservient. Harvard Business School Professor Rakesh Khurana was right when he defined the standard of conduct for a true professional with these words: "*I will create value for society, rather than extract it*." And yet money management, by definition, extracts value from the returns earned by our business enterprises. Warren Buffett's wise partner Charlie Munger lays it on the line:

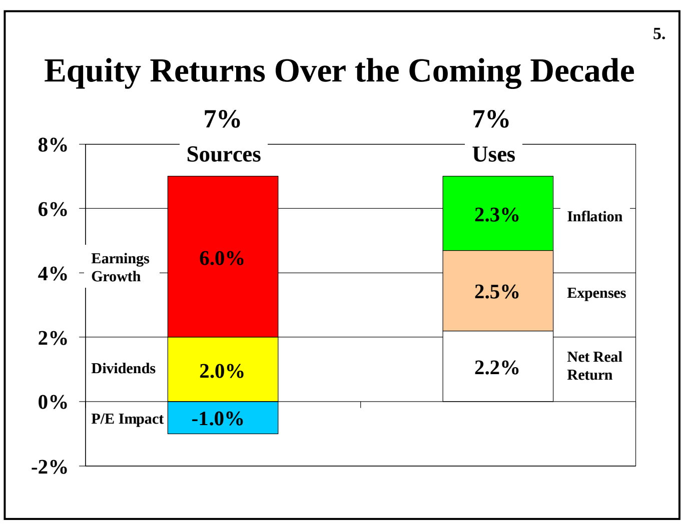
> "Most money-making activity contains profoundly antisocial effects . . . As high-cost modalities become ever more popular . . . the activity exacerbates the current harmful trend in which ever more of the nation's ethical young brainpower is attracted into lucrative money-management and its attendant modern frictions, as distinguished from work providing much more value to others."

Yet even as I write these remarks, I read that this brainpower is pouring into financial services at the most breath-taking rate in history. Today, the number CFAs (Chartered Financial Analysts) is at a record high of 78,000, and *Barron's* recently reported that "no fewer than 140,000 new applicants—also a record high—from every corner of the earth are queued up to take the exams that will confer on the lucky ones the coveted (CFA) imprimatur." In one sense this explosion is wonderful, suggesting that our professional designation is highly-valued. But it also raises serious concerns that the field will get more and more crowded, causing the costs of financial intermediation will to rise to even higher levels.



What's more, those rising *costs* are all too likely to occur in an era of falling *returns* on equities. Briefly put, the 100-year return of 9 ½ percent annually on stocks included a 4 ½ percent dividend yield. **(Chart 4)** Today's 1.8 percent yield represents a dead-weight loss of 2.7 percentage points in future investment returns. By the same token, the glorious 12 ½ percent return of the past 25 years included not only a 3.4 percent dividend yield, but an 1.7 percent annual speculative return, borne of a price-earnings return that rose from 9 times to 18 times—a double! The drop in yields, and the likelihood (in my view) that today's price-earnings ratio of 18 will not only *not* redouble, but is apt to decline by a few points in the coming decade, means that we are likely to experience a future return on stocks of about 7 percent.

Shamelessly, I persist in reducing that *nominal* annual return of 7 percent by the estimated 2.3 percent expected rate of inflation, slashing it to a *real* return of just 4.7 percent. **(Chart 5)** Annual mutual fund costs—sales loads, expense ratios, and hidden turnover costs—are now running at about 2.5 percent, reducing the humble real return of the average fund by more than half, to just 2.2 percent. *2.2 percent!* (That may be a best-case scenario. For I've ignored taxes, though most fund investors cannot; I've also ignored the likelihood that the annual return of the fund *investor*, based on past experience, will not come anywhere *near* 2.2 percent.) So, yes, investment costs are at the crux of the ability of our nation's families to earn the wealth to which they aspire.



Despite the importance of this issue, I know of not a single academic study that has attempted to calculate the value extracted by our financial system from the returns earned by investors, nor (as far as I know) has a single article on the subject ever appeared in the *Financial Analyst's Journal.* Perhaps the best way to honor the legendary Benjamin Graham—and the value he created by his incisive view of our investment system—would be for us to tackle this vital, if largely unrecognized issue of investment costs.

One week ago, Princeton's 2007 valedictorian, Glen Weyl, described his passion for intellectual inquiry in this way: "There are questions so important that it is, or should be, hard to think about anything else." *There are questions so important that it is, or should be, hard to think about anything else.* The functioning of our nation's system of financial intermediation is just such a question. Please not only think about it, but think about how to make it function far more effectively than it does today.