

**“The Case of the Dog that Didn’t Bark”**  
**Remarks to**  
**Mutual Fund Directors Education Council**  
**By John C. Bogle, Founder, The Vanguard Group**  
**Washington, DC**  
**January 11, 2001**

Good evening. By way of full disclosure, let me say a few words about Vanguard. We are a large mutual fund complex (assets of some \$560 billion), managed under a unique corporate and governance structure that shapes the perspective I’ll present. Our management company is owned by the mutual funds themselves. We operate on an “at cost” basis, and this year our expense ratio will average a bit more than 0.25%. We provide investment advisory services for almost \$400 billion of our assets. The remaining assets are supervised by external advisors under contracts negotiated at arms-length, with a weighted average fee rate of about 0.09%. You are unlikely to see any of this information in the studies prepared for fund directors by consultants. We are omitted, I am told, because we are “different”—as indeed we are. One can argue that difference is “good,” and I suppose one can also argue it is “bad.” But it is *unarguable* that our structure is cheap in terms of the services we provide our funds.

I appreciate Dean Ruder’s gracious invitation to be with you, and to discuss my views on the role and responsibilities of fund directors. I have given several talks on this subject, and I understand that you have in your folders a copy of my last year’s speech to the Practicing Law Institute. That speech offers Ten Commandments to fund directors, along with a Golden Rule: *Put fund shareholders first*. It is as simple as that.

I do not believe that there is sufficient awareness of that Golden Rule today, in part because independent directors have not fully measured up to their responsibility—codified in the 1940 Act—to place the interests of mutual fund shareholders ahead of the interests of mutual fund managers and distributors. I *know* that is a hard responsibility to fulfill, but I hope my reflections will help you fulfill it.

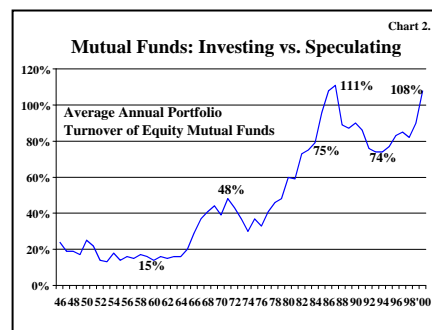
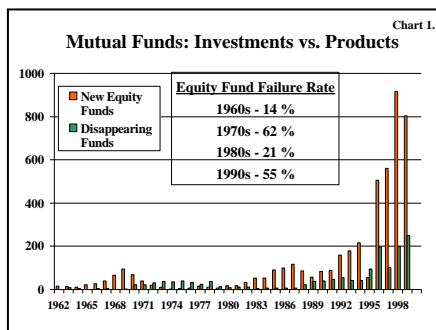
Something fundamental has gone wrong with the mutual fund industry, and fund directors must assume their share of the responsibility. In an article I’ve written for the coming

issue of *Bloomberg Personal* magazine, I describe the problem, using the famous Sherlock Holmes story about the slaying of a racehorse named *Silver Blaze*. Holmes noted “the curious incident of the dog in the nighttime,” curious because the dog *didn’t* bark. As a result of this insight, the canny detective realized that the culprit was the dog’s master.

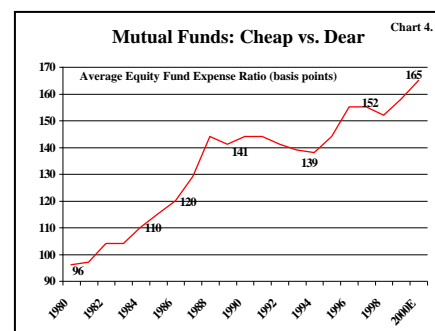
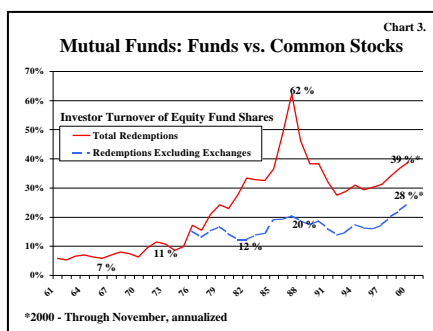
In the mutual fund industry, a majority of the fund directors are normally independent of the fund manager, and therefore nominally control the funds. But real control lies with the master of the funds—the fund manager. And history has shown that no matter what the master’s actions, the watchdog—a word almost universally used to describe the role of the independent director—simply doesn’t bark.

If the fund manager is the culprit, what is the crime? For me, it is the change in the central ethic of the mutual fund industry from the *profession of investing*—the stewardship of shareholder assets—to the *business of marketing*—gathering assets, and creating whatever “products” it takes to do so. Five problems have resulted from this change:

1. **Soaring Turnover Among Mutual Funds.** Fifty years ago, most mutual funds held to prudent long-term investment objectives. Today, less than half of all equity funds, by my count, meet that standard. Increasingly created to capitalize on hot stock styles and hot money managers, mutual funds now come and go at an unparalleled rate. Started opportunistically, they fail frequently, their goals largely unfulfilled. During the 1960s, 14% of all funds failed to survive the decade. During the 1990’s, 55% of funds—more than one half!—failed to survive. And I’d bet that more than half of today’s 4800 equity funds won’t be around a decade hence. This diminution of our traditional long-term focus has ill-served fund investors. **(Chart 1)**



2. **Soaring Fund Portfolio Turnover.** Portfolio turnover has leaped from 17% annually during the 1950s to 108% in 2000. With this change from long-term investing (a six-year holding period for the average stock) to short-term speculation (an 11-month holding period) has come higher transaction costs and far higher tax costs to fund investors. Part of the increase reflects a shift from conservative, even staid, investment committees to individual portfolio managers, who themselves last for an average of but five years. There is no evidence whatsoever that this change has been good for shareholders. **(Chart 2)**
  
3. **Soaring Turnover of Fund Shares.** With the erosion of the industry's focus on funds with long-term staying power, fund shareholders are turning over their own shares at an unprecedented rate. In the 1950s, share redemptions averaged 6% of assets, an effective 16-year holding period. By 2000, the rate had leaped to nearly 40%, a 2½ year holding period. All of this shuffling around in the chase for performance has resulted in an incalculable—but significant—diminution of shareholder returns. **(Chart 3)**
  
4. **Soaring Fund Expense Ratios.** In 1950, fund expenses averaged just 0.77% of tiny assets of \$2½ billion. By 2000, with equity fund assets having grown to a gargantuan \$4 trillion, the expense ratio had more than doubled, to 1.65%. Naturally, the rates are lower when weighted by fund assets, but even then the increase (from 0.62% to 1.03%) was 70%. In the face of a 160,000%(!) increase in fund assets, that expense ratio increase presents clear evidence that it is not fund *shareholders* have enjoyed the staggering economies of scale available in the money management field. No, it is the fund *managers* who have been the beneficiaries. **(Chart 4)**
  
5. **Inferior Relative Performance.** The bottom line: fund investors have not received their fair share of the stock market's bountiful rewards. That shortfall is easily measured. Over the past 30 years the average *surviving* equity fund provided an annual return of



11.2%, equal to 87% of the stock market's 12.8% annual return, a 1.6 percentage point annual lag accounted for largely by fund costs—significantly lower 30 years ago than today. Compounded, the fund return of 2,500% was but 64% of the market return of 4,000%. For the fund investor, who put up 100% of the capital and took 100% of the risk, I do not believe that 64% of the market's largesse is a fair share. What is more, the average return of these surviving funds surely substantially overstates the reality. More than one-half of 1970's equity funds (194 of 355) no longer exist, and the records of those doubtless laggard funds is lost in history. The 1970 fund investor, it turns out, had just one chance in 15 of picking a fund that beat the market. (Chart 5)

These five trends—the overriding interest of managers in asset gathering and sales promotion, in investment failures and speculation, and certainly in maximizing fee income and arrogating to themselves most of the economies of scale—surely suggest that the interests of fund managers are being placed ahead of the interests of fund shareholders, *precisely* what the 1940 Act was expressly aimed at preventing. Taken together, soaring investment activity and soaring costs have had a powerful negative impact on the returns earned by fund shareholders. Unless reversed, these trends will continue to harm mutual fund investors in the years ahead. Indeed, in the coming era of likely lower equity returns, the damage will be even more pronounced.

If crimes they are, the culprit is clearly the fund manager. For whether privately-held, publicly owned, or a subsidiary of a global financial conglomerate, it is the manager who is the master. So the watchdogs do not bark. And yet aren't independent directors essential participants in the creation of new funds and the dissolution of those that don't work? Aren't independent directors aware of soaring portfolio turnover and the shuffling of managers? Are independent directors even *informed* that shareholder turnover is soaring, and that industry data inexplicably under-report fund turnover rates by 50%? Don't independent directors approve the

Chart 5.

<b>The Odds of Success: Returns of Equity Funds</b>			
<b>1970 - 2000</b>			
	<u>Stock Market</u>	<u>Avg. Fund</u>	<u>Fund Share of Market</u>
Avg. Annual Ret.	12.8 %	11.2 %	87 %
Cumulative Ret.	4,029 %	2,564 %	64 %
<u>Number of Funds</u>			
Beginning of Period:	355		
End of Period:	<u>161</u>		
Non-survivors:	194		
Odds of Selecting a Winning Fund:	1 out of 15		

Chart 6.

<b>Director Compensation</b>		
<b>Management Company vs. Mutual Fund</b>		
<u>Fund Manager</u>	<u>Management Company</u>	<u>Mutual Fund</u>
Giant Bank <sup>1</sup>	\$ 44,000	\$ 642,000
Giant Brokerage Firm	55,000	400,000
Large Fund Manager	48,000	363,000
Giant Investment Banker	41,000	286,000 <sup>2</sup>
Insurance Holding Co.	46,000	240,000 <sup>3</sup>
Average	\$ 47,000	\$ 386,000

1-Parent of Fund Manager  
2-Plus annual pension of \$157,500 for 10 years.  
3-Plus annual pension of \$115,000.

management fee for every new fund and every fee increase for an existing fund? There is simply no way that fund directors—-independent and affiliated alike—can avoid accepting responsibility for the harmful trends that beset the industry.

Why do the watchdogs remain silent? One reason may well be that the independent directors of large mutual funds are so well paid that the line has blurred between a “disinterested” role (the word the Investment Company Act of 1940 uses to describe independent directors) and an “interested” role (the word used to describe directors who are paid employees of the fund’s investment manager). A 1996 study showed that the annual fee for an independent director of the ten highest-paying fund complexes averaged \$150,000, nearly *double* the \$77,000 directors’ fee paid by the ten highest-paying *Fortune 500* companies.

Fund director’s fees are even higher today. In a curious and disturbing paradox, it is hardly unusual for independent *fund* directors to be paid far higher fees than those paid to the independent directors of the very corporations that manage the funds. The highest-paid fund directors, in five mutual fund groups, in fact, receive fees averaging \$386,000 annually (in two cases, supplemented by \$100,000-plus annual pensions), compared to just \$47,000 for their management company counterparts, directors of the companies (often large financial conglomerates) whose business is the operation of the funds. **(Chart 6.)**

What could possibly explain this huge differential? Could these fund directors possibly be shouldering *eight times* the responsibility shouldered by their corporate counterparts? Consider the facts: A *corporate* director is responsible for approving the corporation’s policies and business objectives; selecting the chief executive officer; approving multi-million dollar expenditures on plant and equipment; determining an appropriate capital structure, dividend policy, and stock repurchase program; and, typically, approving a mission statement focused on the creation of long-term economic value for the corporation’s shareholders, measured by returns that are higher than the corporation’s cost of capital.

Chart 7.

<b>Money Market Fund Expenses For A Major Fund Complex</b>		
Total Assets: \$61 Billion		
\$ Million		
	Annual Fees	Est'd. Ann. Expenses
Investment Management:	\$ 254	\$ 10
Distribution:	64	64
Shareholder Services:	71	71
<b>Total:</b>	<b>\$ 389</b>	<b>\$ 145</b>

Mutual fund directors are responsible for *none* of these decisions. Rather, in the industry’s own parlance, they are “watchdogs” for each of the 100-300 funds usually managed by the large fund complexes, *approving* (and rarely, if ever, *disapproving*) each fund’s advisory and distribution contracts, custodian agreements, and pricing and valuation procedures; and *monitoring* investments and portfolio quality and liquidity—part of a seemingly imposing list of 40 duties set out by the industry, but duties that, in the real world, are largely perfunctory. None of these duties, moreover, relates to a fund’s mission and its obligation to create economic value by earning the cost of its capital.

Further, those approvals and that monitoring take place under the direction of the fund’s chairman—a chairman who is, almost without exception, also the chairman (or a high official) of the fund’s management company. The chairman controls the agenda; the staff reports are made by his subordinates; the responsibilities for management are theirs alone. It’s simply not reasonable to attribute the vastly higher fees paid to these independent fund directors to their having assumed vastly higher responsibilities than their management company counterparts. That leaves us with at least the possibility that such high fees are there to subtly encourage directors to act at the manager’s behest.

I freely concede that, given the way the fund industry has traditionally been structured and the way fund boards have traditionally operated, acting with independence is no mean task. Directors are typically invited on the board by the chairman, and the chairman and other officers of the manager control the board agenda. The prevailing perception is that the system works just fine, and “rocking the boat” is rarely a valued attribute. Most independent directors, I’m confident, do their best to be fair, but the pervasive nature of the board’s domination by the manager, when added to the director’s self-interest in receiving fees (which obviously grows stronger as fees rise), makes it easy for even the best of directors to justify a collegial acceptance of the status quo.

### **Avenues for Change**

How can we endow fund directors with true independence? These four changes would help:

1. An independent director should serve as board chairman.
2. No more than one management company director should serve on the board.
3. Independent directors should select their own successors, without management participation.
4. The board's legal counsel should be completely independent of the management company.

I'm delighted to note that the recent rules promulgated by the SEC deal with the last two issues. But even without SEC rules, a strong board could take appropriate action on the first two issues, opening the door to the Board's focusing solely on the interests of shareholders.

To use this independence to bring reasonableness to fund fee full levels, one more change would help. Mutual fund directors should review not only expense *ratios*, as is the custom, but expense *dollars*. The Board should demand that the manager provide an accounting for each dollar of fund assets that are spent—the *sources* (investment advisory fees, 12-b1 fees, etc.), and the *uses* (investment management, distribution, operation, manager's profits, taxes, etc.), of cash resources for each fund and for the entire complex. Studies prepared by fund consultants should also report the dollar amounts of fees paid by peer funds, as well as their expense ratios.

What might this examination of sources and uses show? Let me present just one extreme example, using a money market fund. Why a money market fund? Because here the conflict is clear: The manager seeks to charge high fees so as to maximize the return on *its* capital; the fund wants to pay low fees so as to maximize the return on *its* capital. And the amount of the fee represents virtually the sole differentiation in return. We'll follow the money in a \$61 billion group of money market funds managed by a large financial conglomerate. In 2000, the funds paid some \$254 million in management fees, \$64 million in distribution fees, and \$71 million in shareholder service fees and operating costs. Total: \$389 million, equal to 0.63% of assets. **(Chart 7.)**

The fees spent on distribution and shareholder services probably cover the cost of those services. What about the amount spent on investment management? Consider a good-sized money market fund, regularly rolling over short-term U.S. Treasury bills and high-grade commercial paper, with absolutely no hope of materially exceeding the returns available in the money market. It *might* take as many as a dozen people, performing tasks that are substantive but

not taxing. With office space, computers and other services, it *might* be possible to get the investment management costs for these money funds to \$5 million—with a generous dollop of indirect overhead, perhaps even to \$10 million.

Now let's do the subtraction: \$254 million in management fees, minus, say, \$10 million of cost. Result: a net profit of \$244 million to the manager. In the money market field, where it is virtually impossible for even the best manager to add even the smallest value, and where each million dollars paid to the manager reduces by one million dollars the return of the shareholder, such a huge diversion of returns would be obvious. *But only if the watchdogs are watching.* Despite the collegial atmosphere and self-interest involved, when the watchdogs finally get the numbers and follow the money they'll be compelled to take action that brings fund fees down to realistic levels. The same principle—the more to the manager, the less to the shareholder—applies to investment-grade bond funds, to bond and stock index funds, and in the long-run, as the data make clear, to most actively-managed stock funds. *Costs matter.* And directors ought to examine them thoroughly.

I've looked at the industry this evening in its broadest aggregates. It may well be that none of the funds you serve is subject to the sharp criticisms I've raised. But it's hard to imagine that few, if any, of you couldn't be better stewards of the assets shareholders have entrusted to your care if you operated under a more enlightened governance structure. When fund directors examine the apportionment of fund returns between managers and shareholders; when directors consider the baneful trends that have developed in investment activity and fund costs; when the bright spotlight of public attention is focused on directors' fees that seem grossly disproportionate to the responsibilities assumed and the time commitments involved; when board leadership devolves to independent directors served by independent counsel; and when the watchdog has no master but the investors that he or she is duty bound to serve; *then*, whenever trouble is afoot, we shall hear that barking dog, the strong watchdog that will lead the way in giving the fund investor a fair shake.