“Gentlemen . . . To Save Our Business from Ruin, We Must Reduce Expenses”

Remarks by John C. Bogle
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On Receiving
The Special Achievement Award
of the National Association of Personal Financial Advisors
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It is a signal honor to be named as the first mutual fund executive to receive this award for distinguished service to the financial services industry, all the more so since the award places me in the company of author-journalist Jane Bryant Quinn, U.S. Representative Edward Markey, and SEC Division Director Kathryn McGrath, who have also stood for serving the mutual fund shareholder in the most honest, efficient, and economical way possible. It all comes down to giving the fund investor a fair shake.

I do not believe that the mutual fund industry is giving the investor a fair shake today.

- Marketing and promotion have taken precedence over management and trusteeship, a shift dramatized by the fact that the industry’s star *manager* of the 1980s and early 1990s has become the industry’s star *marketer* during the waning years of the millennium.
- The traditional mutual fund watchword—“For the long term investor”—is belied by fund portfolio turnover that now approaches 100% per year, and turnover of investors’ holdings of fund shares that has risen to 30% per year. Given this activity by both fund managers and fund shareholders, a more accurate watchword would be, “For the short-term speculator.”
- Fund costs march ever upward. It takes no more than hornbook arithmetic to realize that investors as a group inevitably earn market returns, *less the costs incurred in earning those returns*. The croupiers who run the mutual fund tables take off an ever-larger share of the market returns. And there are lots of croupiers: fund marketers and distributors, fund managers and administrators, lawyers and accountants, and brokers who handle the funds’ transactions—to say nothing of the

federal, state, and local governments who collect taxes, not only on fund income but on excessive distributions of realized gains born of all of that rapid portfolio turnover.

Revolutionary Words

A change in the entire *modus operandi* of this industry is imperative. Yet it seems nowhere in sight. So I urge you at NAPFA to bring this much-needed change by pressing the mutual fund firms to which you entrust your clients' assets to cut their costs. The litany of costs that I have just enumerated has added up to a serious diminution of fund returns during the long bull market. At least a quarter of the market's annual returns—more than 4 percentage points per year—have gone to the croupiers. When market returns fall back to more normal levels—*as they will*—the diminution will be cataclysmic.

> Gentlemen*, you must recognize (1) that companies having the smallest expense will have the ultimate advantage; (2) that companies having this advantage are the most desirous of correcting present abuses, and (3) that companies which cannot long survive the present condition of affairs are determined to nullify every effort for reform. To save our business from ruin we must at once undertake a vigorous reform. To do this, the first step must be to *reduce expenses*.

That is the message I bring to you today. Those words may sound rather idealistic and fiery—even revolutionary—so I quickly confess that they are neither new, nor mine. They are the words—right down to the italics—of my great-grandfather Philander B. Armstrong, who conceived the idea of mutual insurance in the property field, and formed the Phoenix Mutual Fire Insurance Company in 1875. A decade later, he spoke those words to his fellow leaders of the insurance industry in St. Louis, Missouri. The fact that my own career in the mutual fund industry, and my own convictions as well, so closely resemble his must stand as a monument to the fact that even the apple's apple's apple's apple doesn't fall very far from the tree.

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*Today, the quotation would properly read, "ladies and gentlemen."

Costs Matter—Enormously

The fact is that costs still matter. They matter in insurance and in mutual funds, and in *all* financial service industries. And they matter most where they are at once very large, compounded over time, and easily measurable relative to the value of the services provided. The confluence of those three factors is vividly etched in the investment record of the mutual fund industry.

During the past 15 years, for example, the return of the average equity mutual fund lagged the return of the total stock market by 2.75% per year (before taxes). Industry costs—fund operating expenses, marketing expenses, and advisory fees; sales charges and portfolio turnover costs—amounted to about 2½% per year. Assuming a continuation of that cost level and a normalized market return of, say, 10% per year, a $10,000 initial investment, simply invested in the stock market and compounded over a time period of 40 years—many of today's investors will own fund shares over a far longer period—would grow to $452,600. Invested in an equity fund, however, it would grow to but $180,400.

Starkly put, the fund investors would accumulate 38% of the capital provided by the equity market, and the suppliers of fund services would confiscate the remaining 62%. In other words, the investor puts up 100% of the initial capital, assumes 100% of the risk, and receives 38% of the return. The croupiers, having put up none of the capital and having assumed none of the risk, consume 62% of the return. To give the fund shareholder a fair shake, quoting Great Grandpa Armstrong, "the first step must be to reduce expenses."

Industry Expenses Soar

Yet industry expenses are not only not being reduced, they are soaring. Since 1980 the annual expense ratio of the average equity fund has risen by more than 40%—from 1.10% to 1.57% of fund assets. It has been documented, well, everywhere. But, the industry takes the position that the cost of fund *ownership* is declining. Or that's what the industry's Investment Company Institute *says*. What it *means* is that, according to its rather tortured and convoluted methodology, the cost of *purchasing* equity funds has, in fact, declined, from 2.25% annually in 1980 to 1.49% in 1997. The industry reaches this conclusion by including sales charges *plus* expense ratios, and then *weighting the results by the sales volume of each fund each year*. High

cost funds that don't sell don't count. Virtually ignored in the ICI methodology, the managers of funds that investors shun nonetheless prosper, even as their shareholders suffer.

To the extent that the industry's overly-generous appraisal of the data, along with its somewhat specious series of definitions, can be regarded as valid, what the data really show is that, quoting from the independent *Morningstar Mutual Funds* analysis, "the drop has been driven by investors, not by shareholder-friendly mutual fund companies," and that a few fund families "deserve credit for keeping their expenses down, but one shouldn't credit the entire industry for the virtues of a few—and for the diligence of investors in seeking them out."

Given the dynamic combination of (a) the increasing importance of no-load funds (sold without commissions); (b) the rapid growth of low-cost market index funds; and (c) the remarkable rise in market share of the industry's sole *mutual* mutual fund complex—the unique structure adopted by a firm that operates its funds on an "at cost" basis (you'll recognize that firm as Vanguard)—the industry's claim that the cost of purchasing, as distinct from owning, fund shares has declined may well even be valid, as far as it goes. However, it doesn't go nearly far enough. It ignores the fact that the heavy cost of portfolio transactions is a *major* "cost of fund ownership" which probably—the industry is tight-lipped on this subject—adds up to a full percentage point to fund costs, raising the total annual cost to as much as 2½%—the very number I used earlier in my example of a $10,000 investment compounded over 40 years.

Is There Price Competition?

There are perhaps 700 mutual fund managers. At least 50 of them have the scale and resources to compete on every front in the mutual fund industry wars. In most corners of the capitalistic marketplace, the result would be fierce price competition to *reduce* prices. But, as the record shows, there is plenty of competition to increase prices. Competition to reduce prices is conspicuous by its absence. To say the very least, the industry disagrees with that conclusion. The official position of the ICI: "Let there be no doubt in anyone's mind—mutual funds compete vigorously, based on price." It is an absurd—I would argue, irresponsible—position.

If there is vigorous price competition, how can the industry explain the fact—buried deep (and without comment) in the Investment Company Institute analysis of the costs of fund "ownership"—that the *lowest cost* 10% of funds have raised their direct expenses from 0.71% to

0.90% per year? A 27% cost increase. (*Including* Vanguard, whose equity fund costs—using the ICI methodology—are down from 0.67% to 0.27% since 1980, a reduction of 60%!) If there is price competition, how can the industry possibly explain how the industry's *sole* very low cost provider has, since last July, accounted for an eye-popping 80% of the cash flow into direct-marketed (no-load) stock and bond funds . . . without significant competitive response. (That's right: Vanguard cash flow, $40 billion; other direct marketers $9 billion.) In what other industry could a relative upstart capture a market share of 80% and not have a single competitor imitate its strategy? How one can equate this picture with the allegation that mutual funds compete vigorously based on price is beyond my comprehension.

Consider this simple example. Assume there are just two large mutual funds, Fund A charging 2% per year and Fund B charging 0.20%. In the first year, investors are unaware of the role costs play, and Fund A has sales of $100 million and Fund B zero. In the next year, investors wake up. Fund A has no sales and Fund B $100 million. Miraculously, under the ICI methodology, the cost of fund *acquisition* (not *ownership*) has dropped by 90%—from 2% to 0.20%. How would Fund A's manager respond? If the manager cut the fee to 1%, his profits would be squeezed, yet a cost-conscious marketplace would ignore it. At 0.50%, his profits would be gone, and the impact on the market would be no more than minimal. And at 0.20%, the manager would probably be bankrupt. So the manager of Fund A doesn't reduce his 2% expense ratio. *Price competition is defined, not by the behavior of consumers, but by the actions of producers*.

What would real price competition look like? The answer is as simple as it is obvious. Since Vanguard's success has been based on long-term investing at low-cost, competitors would have to: (i) cut their management fees and the portfolio turnover of their managed stock and bond funds; and (ii) plunge enthusiastically into the index fund fray; a "kicking and screaming" entry won't do the job. These changes would make money for their *investors*. But they would slash profits for their *management* companies (and their shareholders), for it costs managers money to give shareholders the fair shake they deserve. The simple economic truth is this: As long as today's awesome level of profitability is priority number one for the managers, fund shareholders will pay the price, and industry expense ratios will continue to edge ever upward.

Fund Costs and Financial Planning Advisers

Sharply reduced costs in this fund industry will obviously serve fund shareholders, but it should not go without saying that it will also serve personal financial advisers. You charge, as you must, fees for the services you provide your clients, and you deserve a wide choice of suitable, fairly-priced funds from which to choose the mutual funds you offer. That simple fact, indeed, lies behind my conviction, reached more than a decade ago, that Vanguard, with its low-costs, should be the natural ally of financial planners and registered investment advisers, with their need to keep the *total* level of client costs at reasonable levels. Working in unison, personal financial advisers can press the funds to reduce their costs with a power far greater than my idealistic vision. If your association, representing individual investors, could somehow join with retirement plan trustees, representing institutional investors, and demand a fair shake for fund investors, you could make a real difference in enhancing the future returns earned by your clients.

In this context, I was struck by your Code of Ethics. It uses wonderful words that, as it happens, rarely if ever appear in mutual fund literature: "fiduciary responsibility to clients. . . practicing fairness and suitability. . . integrity and honesty." These are the *right* words to describe the values of firms and individuals entrusted with the stewardship of the assets of investors. If you can influence this industry not only to promulgate the same standards, but to reduce costs, perhaps my words today will mark the beginning of constructive change in the mutual fund industry that will advance the interests of tens of millions of its shareholder-owners.

Four Generations—Two Authors—One Idea

It will take a long time. I know that, if only because of the experience of Great Grandpa Armstrong, an insider taking on the property insurance industry in the 1880's and 1890's. According to his biography, "his methods were original and diametrically opposed to almost every recognized underwriter in the country." Perhaps frustrated by the failure of his ideas to catch hold in the fire insurance industry, by the turn of the century he had turned his critical gaze to the life insurance industry. He wrote a classic, if rather intemperate, book entitled, "A License to Steal," subtitled "Life Insurance, The Swindle of Swindles. How Our Laws Rob Our Own People of Billions," published in 1917. His concluding words were these:

> "Why talk about correcting the present evil? The patient has a cancer. The virus is in the blood. He is not only sick unto death, but he is dangerous to the community. Call in the undertaker."

When Great Grandpa Armstrong wrote those words, he was the same age as the apple of his apple's apple when my own new book, "Common Sense on Mutual Funds: New Imperatives for the Intelligent Investor," was published two months ago. While my book about mutual funds is rather more temperate than his about life insurance, it makes the same point: ". . . the industry has embraced practices that seriously diminish its shareholders' chances of successful long-term investing . . . Mutual funds should provide the greatest sum of investor returns with the least management expense, (but) the natural order has been turned on its head. The result not only defies nature, it offends common sense . . . Common sense demands that funds be governed in the interests of those who own them."

With your help, we can accomplish that goal.