On Mutual Funds, Cheaper Is Better

By **John C. Bogle**

If there is anything that mutual fund investors have learned during the volatile past decade, it's that the past is not prologue. Between December 1999 and December 2009, U.S. stocks on the S&P 500 had an annualized total return of -0.9%. That's one of the four lowest for any decade in the past century and a far cry from the long-term average of 8.1%.

A mutual fund's past returns are no guarantee of its future. Even the most sophisticated rating systems are erratic at best in forecasting a fund's performance in the years ahead. But for decades, academic experts and analysts have proven that fund costs are a powerful predictor of relative performance. Returns come and go, as it were, but costs go on forever.

A recent study by the Morningstar fund evaluation service came to this very same conclusion. In an admirable report that was the opposite of self-serving, Morningstar found that using fund-expenses ratios as a factor in choosing mutual funds was even more helpful than relying on its own carefully constructed "star ratings." Specifically, focusing on funds with the lowest expense ratio was more helpful in fully 58% of the time periods studied.

"In every asset class (U.S. stock funds, international stock funds, balanced funds, taxable bonds, and municipal bonds) over every time period," Morningstar wrote, "the cheapest quintile produced higher net returns than the most expensive quintile." Among domestic equity funds, the returns of the lower-cost funds outpaced the returns of the higher-cost funds by about 1.3 percentage points annually. That proves to be a compelling edge. Over a 50-year investment lifetime, for example, a return at the 8.1% historical average for stocks would produce nearly 50% more capital than a return of 6.8%.

These calculations actually understate the success of low-cost funds. "Survivor bias"—only the more successful funds survive to make it into the database—permeates the equity-fund data. According to Morningstar, in the highest-cost quintile only 57% of equity funds survived over the past five years. Even in the lowest-cost quintile, only 81% survived. So much for relying on most mutual funds as long-term investments.

> A new study confirms what I've been saying for decades: Paying high fees to fund managers is the route to lower returns.

The idea that costs matter is not new. In a 1966 article in the Journal of Management, economist William F. Sharpe concluded, "all other things being equal, the smaller a fund's expense ratio, the better results obtained by its stock holders."

Morningstar's independent conclusion confirms my own hardly disinterested studies, made over decades. In the first edition of my 1999 book "Common Sense on Mutual Funds," for example, I showed that the annual return of the lowest-cost quartile for balanced funds averaged 14%, versus 12.1% for the highest quartile—a 1.9 percentage point annual margin. My advice to fund investors: "Do your fishing in the low-cost pond."

Despite the irrefutable evidence on the impact of fund costs, fund expenses continue their upward march. According to data Vanguard has collected from the Investment Company Institute (2009) and Wiesenberger (1960), the expense ratio of the average equity fund weighted by fund assets has risen to 0.86% in 2009 from 0.54% in 1960, an increase of 59%.

During this half-century, industry data show that equity fund assets have burgeoned to $5 trillion from $10 billion, a 500-fold increase. But fund costs rose at a far faster rate—to more than $42 billion from $50 million, a near 800-fold leap. Conclusion: The huge economies of scale available in managing other people's money have largely been arrogated by fund managers to their own benefit rather than to the benefit of fund shareholders.

Despite the modest decline in the expense ratio reported by the Investment Company Institute since 1990—to 0.86% from 1%—total fees paid by equity fund investors continued to soar, rising to $42.7 billion from $2.3 billion. That quantum increase refutes the notion, put forth by so many industry participants, that fund expenses are declining.

Further, while expenses as a percentage of equity-fund assets have eased downward over the past two decades, expenses as a percentage of dividend income soared. According to data we've collected at Vanguard's Bogle Financial Markets Research Center, fund expenses consumed 19.5% of equity-fund dividend income in 1990 (about the same as in 1960). As dividend yields fell, that ratio then doubled to 38.5% in 2009, after reaching an astonishing high of 51% in 2000.

Consider that confiscation of dividend income in the context of the fact that dividend yields have accounted for one-half of the long-term return on stocks—four percentage points of the 8% total. Fund expenses, then, are now consuming almost 40% of that major contributor to stock market returns. With that enormous erosion of income, the average equity fund, according to Morningstar, currently delivers a puny dividend yield of just 1% to its shareowners.

It is high time for costs to be recognized as a crucial factor in determining the future returns that funds earn. We need far better disclosure of these various measures and studies, and we need to recognize that, despite the periodic promulgations to the contrary by the Investment Company Institute—the trade association for fund managers—fund costs, against all logic, continue to rise, to the clear detriment of fund investors.

Mr. Bogle is founder and former chief executive of the Vanguard Group. His ninth book, "Don't Count On It!" will be published in October by Wiley.