

FUTURE INVESTMENT POLICY FOR WELLINGTON FUND

A Discussion Memorandum

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## Background

Wellington Fund will soon celebrate the 50th anniversary of its founding by Walter L. Morgan on December 27, 1928. For the first thirty years--until Windsor Fund began in October, 1958--it was the only Fund in what is now the 13-Fund Vanguard Group of Investment Companies. While it remains the largest Vanguard Fund, capital flow trends of recent years virtually assure that it will be replaced by Windsor as our "flagship" within a year or two.

Wellington Fund's asset erosion has been extreme and consistent. From a year-end high of \$2,048,000,000 in 1965, assets have declined to \$704,000,000 currently. The principal cause of this decline is capital outflow from the Fund, as these trends took hold:

- (1) An unremitting decline in investor purchases of Wellington shares, from \$159,000,000 in 1965, to a projected \$1,300,000 in 1978. This 99% decline is equivalent to a compound rate of decline of 33% per year.
- (2) Continuing share liquidations vastly in excess of sales volume, and averaging about \$100,000,000 per year over the past decade. While these dollar volumes are huge, they in fact represent a relatively stable and favorable rate of liquidation (averaging 9.3% for the decade) compared both with other Vanguard Funds and with the mutual fund industry in total. In fact, the only year in which Wellington experienced an unfavorable liquidation rate (16%) was 1972, the year following our failure to pay a year-end capital distribution.
- (3) Net capital outflow since 1966 has totalled \$1,070,000,000.

The performance problems faced by Wellington Fund since 1965 (and most notably in 1967-8, 1971-3, and 1977) have been a contributing, but not a controlling factor, in the Fund's capital outflow picture. All balanced funds--dealer-distributed, captive sales force, and "no-load" alike--have experienced an ongoing and significant gap between sales volume and liquidations. Basically, what has happened is that in the 1960's and early 1970's, balanced funds lost "market share" to the more aggressive common stock and growth funds. After the failure of many

of these funds to deliver on their performance promise, however, the marketing pendulum swept all the way over to the much more conservative income funds (including corporate and municipal bond funds), totally by-passing the balanced funds in the process. This tabulation illustrates the point:

	<u>Market Share of Industry Sales</u>		
	<u>Balanced</u>	<u>Stock</u>	<u>Income</u>
1955(e)	40%	55%	5%
1960	20	72	8
1965	17	73	10
1970	5	85	10
1975	3	71	26
1977	1	32	67

There is little evidence—or even hope—that these trends will change in such a manner as to restore the traditional balanced fund to market share levels of fifteen or twenty years ago. Thus, if Wellington is to remain in a viable position to keep its existing shareholders and to attract new investors, the question of a change in its investment policy must be considered. It should be emphasized that such a change in policy should not be construed as a change in its fundamental investment objectives: (A) conservation of capital, (B) reasonable income return, and (C) profits without undue risk. Rather, the questions are: would Wellington Fund's shareholders be better served by readjusting the relative emphasis on each of these three objectives? And, if so, what would the nature of that adjustment be?

#### Shareholder Objectives

To help answer these two questions, we can rely with a high degree of confidence on two recent surveys of Wellington Fund shareholders. One was a personal interview survey conducted by Parker-Allen Company in 1974; the other, a mail survey of shareholders conducted by the Vanguard staff following our "no-load" decision in early 1977. These surveys were mutually confirmatory as to the objectives, requirements, and demographics of the Fund's 100,000 shareholders.

The Parker-Allen study reported that--

- 42% of shareholders considered themselves as "somewhat conservative" and 52% "very conservative".
- 38% sought "returns" of 4%-6.5%; 33% of 6.5%-8.0%, and 25% of 8%+.
- 21% of liquidating shareholders cited "low dividends" as the reason for redeeming (31% cited poor performance).
- Over 50% of liquidators placed their money in a higher-income, more stable investment.
- In evaluating the Fund's three objectives, 49% felt reasonable income was most important, 26% felt capital growth to be most important, and conservation of capital was sought by 16%.
- 66% of the shareholders were over age 65, further indicating a current income, conservation of capital approach.

The Vanguard 1977 study, while composed in a different way, generally confirms the earlier Parker-Allen study. Based on questionnaires returned by a sample of larger investors (500+ shares) in the Fund, it produced the following results--

- 73% have an investment philosophy they consider "conservative"; 26% are "moderate"; only 1% are "aggressive".
- 56% stated that "current income" best describes their investment objective; 33% stated "growth and income"; only 11% stated "long-term growth".
- 64% of shareholders over age 65; 24% age 55-64; remaining 12% age 35-54.
- 70% of shareholders are retired, and 60% have under \$20,000 of annual income (27% under \$10,000).

Together, the surveys indicate what a far less comprehensive analysis of our shareholder correspondence indicates: that a greater emphasis on current income (which would in fact today come hand-in-hand with somewhat greater capital conservation) would meet the needs of our shareholders. If this higher income could be realized without an important sacrifice in total return (income + capital

growth) and with an ongoing growth in our dividend income, it is virtually inconceivable that it would not have an important and favorable impact on the Fund's present list of shareholders.

### A Portfolio Approach to Higher Income

If, as it appears, higher income is the key goal to be sought by Wellington Fund, the principal questions are these: how much higher? And at what, if any, sacrifice to the Fund's capital conservatism and profits objectives? To provide a framework for discussing these issues, the Vanguard staff has analyzed three common stock portfolios--

- the present Wellington Fund portfolio (August 31, 1978)
- a hypothetical portfolio, equally weighted among 50 of the 300 largest stocks in the S&P 500, selected on the basis of higher yields, reasonable earnings growth rates, and generally assured prospects for future dividend growth.
- a "combined portfolio", blending the present and hypothetical portfolios in a manner that utilizes the Fund's present high-income stock holdings, but replaces other holdings with more income oriented issues in order to achieve more income while minimizing portfolio turnover.

These portfolios are attached as Exhibits A, B, and C.

We measured each of the three stock portfolios on six measurement standards:

- (1) Current income yield.
- (2) Projected earnings growth rate (using Value Line projections for the 1978-1982 period).
- (3) Total projected rate of return (yield plus earnings growth).
- (4) Price Earnings Ratio.
- (5) An index of current "value" (using the John Neff rule-of-thumb of dividing P/E ratio into projected total return).
- (6) Projected dividend increase from 1978 to 1982 (again using the Value Line data).

This table provides, in summary form, the results of the analysis shown in the portfolio Exhibits:

	<u>Present Portfolio</u>	<u>Hypothetical Portfolio</u>	<u>Combined Portfolio</u>
1. Divided Yield	5.0%	6.9%	6.6%
2. Earning Growth Rate	<u>11.0</u>	<u>8.7</u>	<u>9.5</u>
3. Total Return	<u>16.0%</u>	<u>15.6%</u>	<u>16.1%</u>
4. Price-Earnings Ratio	8.8X	7.2X	7.1X
5. "Value" (3 → 4)	2.05	2.25	2.42
6. Five Year Divided Growth	57%	53%	52%

The combined portfolio (Exhibit C) is of course in part hypothetical in nature. It is presented, not to suggest investment selections that should be made by the Fund's investment adviser, but rather to establish broad parameters that might be considered in establishing appropriate objectives for current income and income growth for Wellington Fund, giving due consideration to total return and "value" as defined above. While we have further assumed a 65% common position for the Fund, this is merely a working "target". Also to be considered are the possibilities of enhancing the Fund's income through a more aggressive strategy for fixed income securities, and the possible use of convertible securities for both income and growth purposes.

The combined portfolio, while it offers higher current income than at present, is remarkably similar to the present portfolio in total projected return, in "value", and in income growth. However, it inevitably differs from the present portfolio in certain aspects of its industry mix, as illustrated here:

	<u>Present</u>	<u>Combined</u>
Utilities	8.8	22.7%
Finance	11.5	14.6
Basic Industries	46.7	39.4
(Oil)	(19.4)	(16.6)
Consumer Products	23.0	17.3
Applied Science	<u>10.0</u>	<u>6.0%</u>
	100.0	100.0%

This precise industry mix is not essential to meeting the Funds' proposed income objective, although some increase in the present utility component would probably be required.

Substantial portfolio turnover would be required if the proposed strategy were adopted. Specifically, the development of the combined portfolio--keeping substantially all of Wellington's present holdings meeting the established requirements for the new portfolio--would involve some \$238 million of the Fund's stock holdings, or about 49% of the equity portfolio. Again, we did this statistical exercise simply to put a dimension on what might be involved. While sales, and the subsequent purchases, of securities in these amounts are large, to say the least, it is possible that the attendant turnover costs could be minimized by allowing reasonable time to carry out the program, by putting out both sales and purchases in negotiated "packages", and perhaps by engaging in "swapping" of one equity position for another. In any event, while this 49% turnover rate would be large, the nature of the proposed income-oriented investment policy would likely result in very low turnover in subsequent years.\*

Such a sales program would also involve the realization of substantial capital gains. Specifically (again, merely to establish magnitudes), gains of \$45 million would be realized. These would have to be offset against capital losses realized by Wellington in prior years in the amount of \$215 million, most of which cannot be carried forward beyond November 30, 1982. In such circumstances such realized gains cannot be distributed, nor do we believe it would any longer be possible to make the capital surplus distribution that has been customary each year since 1967 (except for 1971). The implications of this change in policy should also be fully evaluated.

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\* The total transaction cost of the initial turnover might run about 1%, if adequate time were allowed to take advantage of trading opportunities. This would mean a reduction of 0.3% in the Fund's capital performance.

### A Long-Term Look at Income vs. Growth

To be sure, much of the portfolio data reviewed above is based on future projections. And projections, no matter how carefully put together and how well-intentioned, are no more than that. Thus, we decided to undertake a long-range analysis of the total performance of income stocks vs. growth stocks to determine whether there was any sustainable historical differential between these two types of equities. In effect, we wanted to answer the question as to whether there was any historical evidence that would suggest one strategy or the other as the preferred route for Wellington in terms of total return. There is surprisingly little data available on this subject, in part because such data is difficult to assemble and evaluate (e.g. a stock like duPont was probably classified as a growth stock in 1965, when it sold at 260 representing a P/E of 30X and a yield of 2.3%. Today, however, priced at 126, with a P/E of 9.9X and a yield of 5.0%, it might well be classified as an income stock).

A more fruitful approach, it seemed to us, would be the analysis of growth stock portfolios relative to income stock portfolios over an extended period of years. The mutual fund industry offers a number of excellent candidates for such an examination, and we chose the following funds for it.

- Growth Stock Portfolios: Chemical, Massachusetts Investors Growth, National Investors and T. Rowe Price Growth
- Income Stock Portfolios: Broad Street, National Stock series, Puritan and Washington Mutual Investors.

To have the maximum possible time horizon for this exercise, we examined the average performance of the funds in each group over a period of nearly 40 years--1940 to 1978 inclusive\* (See Table 1). Over this entire span, the annual rate of total return (income + capital) was 11.3% for the <sup>income</sup> ~~growth~~ funds and 10.5% for the <sup>growth</sup> ~~income~~ funds. Thus, the income funds enjoyed a rate of return that was 0.8% higher.

\* Since three of the eight funds we examined did not begin operations until the late 1940's, the averages for the early years include a smaller number of funds. We do not believe this procedure materially reduces the validity of the data



Of course, there were periods in which the growth funds showed more advantageous performance. Looked at on a decade-by-decade basis (see Table 2), growth stocks had the best of the game in the 1950's (19.7% vs. 16.5%). However, the two sets of portfolios gave about the same performance in the 1940's (9% plus or minus) and in the 1960's (10½% plus or minus). Of course in the 1970's the income stocks have so far done much better (7.7% vs. 2.4%). The important point is that there seems to be no systematic long-term bias as between the two types of portfolios.

We also looked at the various cycles in which one class of stocks demonstrated better results than the other. Specifically (again see Table 2), we found the following swings of the pendulum:

- The "income cycles," in which the income funds surpassed the growth funds by the indicated amounts of annual return:
  - . 1939-1944: + 11.3%
  - . 1960-1964: + 3.7%
  - . 1967-1970: + 12.8%
  - . 1972-1977: + 12.6%
  
- The "growth cycles", in which the growth funds surpassed the income funds by these annual returns:
  - . 1944-1951: + 10.5%
  - . 1951-1956: + 0.3%
  - . 1956-1960: + 5.9%
  - . 1964-1967 + 7.4%
  - . 1970-1972 + 12.2%
  - . 1977-1978 + 6.6%

In substance, this cycle analysis shows that the income funds had the better returns in four cycles aggregating 17 years; the growth funds had the better returns in five cycles also aggregating 17 years; and the results were about the same in the tenth cycle (1951-1956).

Most, but not all, of the cycles were in the 4 to 5 year range. This evidence raises the question as to whether the 1978 relative resurgence of the growth stocks does not have some years to go. The question, of course, has no obvious answer. Further, to avoid making changes deemed in the immediate interest of Wellington Fund shareholder on the basis of "timing" various cycles would seem a hazardous sort of approach. In short if we want to adopt a long-run investment strategy emphasizing income for Wellington Fund and its shareholders, it would seem best to begin the work of adjusting the portfolio to such a strategy without delay.

#### Implications of An Income Strategy

What tangible results would be involved in an income strategy for Wellington Fund? First, we can examine the change in dividend income. Let us assume, for the purposes of argument, that we were to accept in toto the idea that Wellington Fund's income stocks could provide a current yield of about 6.6%\*, with expected dividend growth of 52% over the next four years, and without material sacrifice to the Fund's total (income-plus-growth) return. What kind of current and future income might we be able to generate? The following table presents the figures, assuming a balance of 65% stock and 35% bonds:

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\* For comparison, the current yield on the equities in Wellesley Income Fund's portfolio is 6.9%.

Gross Yields

<u>Year</u>	<u>Stocks</u>	<u>Bonds</u>	<u>Total Portfolio</u>	<u>Expenses</u>	<u>Net Yield</u>	<u>Dividend Per Share</u>
1	6.6%	9.2%	7.5%	0.5%	7.0%	\$ .67
2	7.5	9.2	8.1	0.5	7.6	.73
3	8.3	9.2	8.6	0.5	8.1	.78
4	9.2	9.2	9.2	0.5	8.7	.84
5	10.0	9.2	9.7	0.5	9.2	<u>.89</u>
Total 5 year Income						\$3.91

By way of comparison, the Fund's present strategy is now generating income at an annual rate of \$.55 per share. Using a slightly higher five-year indicated dividend growth (57%), this five year income stream would be \$3.23 per Fund share, compared to \$3.91 per Fund share in the above table. In other words, the proposed income strategy could generate \$.68 of additional income over a five year period, helping importantly to replace the \$.25 per share surplus distribution paid annually over most of the past twelve years.

The income growth projections used for both the present Fund portfolio and the combined portfolio are based on Value Line estimates, and perhaps are on the aggressive side. A 55% dividend increase over a five-year period represents a compound rate of increase of 11% per year. While this rate is well above the long-term rate of increase in the S&P 500 dividend (6% per year, using a 1939-1944 base), it is only slightly ahead of the 9% rate of increase for 1974-1978. On a "real" (inflation-adjusted) basis, in all likelihood, the projected data is quite consistent with past long-run trends.

Interestingly (and, again, based on the Value Line projections), the total projected return on the combined portfolio (16.1%), would compare quite favorably with the present portfolio (16.0%). While the combined portfolio would have a lower earnings growth rate (9.5% vs. 11.0%), it would more than make up for this deficiency with its higher income yield (6.6% vs. 5.1%). Further, with both

portfolios having comparable total returns, but the combined portfolio having a lower P/E ratio (7.1X vs. 8.8X), the combined portfolio would have a higher "value" component (dividing P/E into total return) of 2.42, vs 2.05 on the current portfolio.

What we have, then, is a shift of the Fund's total return marginally away from its capital component, toward its income component, without apparent sacrifice in total return, and with what would appear to be lower risk. (Obviously, a great deal of work remains to be done on the risk characteristics of both the present portfolio and the combined portfolio). In substance, the shift in emphasis increases the more predictable component of the Fund's return (income) and reduces the less predictable component (capital appreciation). Given the nature and objectives of the Wellington Fund shareholders set forth at the beginning of this paper, it is difficult to regard that shift as in any sense negative.

### Future Marketing Plans

Effectively serving the Wellington shareholders, of course, must be the principal—indeed the over-riding-- purpose of any shift in relative emphasis among the Fund's three fundamental investment objectives. However, we believe that these shareholders would gain important benefits if our proposed new strategy improved the Fund's present substantial cash outflow posture. We take it as a given that, for the reasons outlined at the outset, a significant enhancement in income would reduce liquidations generally, and would mitigate the negative impact of the elimination of the surplus distribution. We also note that higher income would automatically increase the amount of dividends reinvested by shareholders by about \$6,000,000 per year at 1979 levels, thus reducing net capital outflow (in 1978, outflow will be about \$50,000,000). But, it will take the development both of existing and new markets for Wellington Fund if we are to ultimately turn the Fund's negative cash flow into a positive one.

It must be obvious that the "odds" in favor of such a turnaround are not particularly encouraging--either for Wellington or for other balanced funds. Even if the traditional balanced approach is abandoned in favor of a more income-oriented approach—and moves in the direction proposed here for Wellington are also being taken by Investors Mutual and Scudder Balanced Fund (renamed Scudder Income Fund)—there will still be the marketing "pendulum" problem of investors seeking even more income (bond funds) at certain times and even more growth (stock funds) at others. Also, to be realistic, the "family of funds" approach now makes it easy for investors to create their own tailor-made program (e.g. Windsor/Westminister for the low tax bracket investor and Windsor/Warwick for the high bracket investor), creating a "balance" that may be both more attractive and more flexible than what Wellington can offer.

Nonetheless, a properly-marketed package offering Wellington as a conservative "current income/growth of income" program should enhance our opportunity for a higher level of investor purchases, in areas such as these:

- (1) Present individual shareholders, who should be favorably impressed with the higher income they would receive.
- (2) Personal holding companies, which, in our experience, are often both conservative and "income-sensitive".
- (3) Smaller pension and profit sharing plans, for which a "single security" approach can provide greater convenience and simplicity.
- (4) Smaller foundations, for the same reasons as set forth for the pension and profit sharing plans.

This is not, of course, a very imposing marketing program. And it will require both time to "season" as we in fact meet the income objective, and a demonstrably effective performance record for Wellington Fund. But it is a beginning.

Of equal importance, the proposed change in strategy will take the Fund in a direction that would be consistent with even further changes "down the road," if such changes become necessary. If in the long-run it is necessary to make Wellington into a strictly high income fund (like Wellesley Income Fund, for example), at least we will be part way there when and if the decision-point arrives. But surely that is the only intelligent direction to move from our present posture at the "center" of the aggressive/conservative pendulum. In the alternative, it is difficult to see any merit at all in moving in the opposite direction--making the fund less conservative, with greater equity-orientation, higher risk, and lower income.

Thus, if change in Wellington Fund is required--and we believe there can be little doubt that it is--the proposed direction of change would be fully consistent not only with the interests of present shareholders, but of future shareholders as well.

TABLE I

## GROWTH FUNDS VS. INCOME FUNDS

1940 - 1978

Year	<u>Annual Performance</u>		<u>Cumulative Performance</u>		<u>Relative Cumulative Performance</u>
	<u>Growth</u>	<u>Income</u>	<u>Growth</u>	<u>Income</u>	<u>Growth vs. Income</u>
1940	-9.6%	-9.0%	90	91	99.3
1941	-7.3	-7.0	83	84	99.0
1942	14.3	19.0	95	100	95.1
1943	23.6	33.0	118	133	88.4
1944	19.0	22.0	140	163	86.2
1945	426	39.5	200	227	88.1
1946	2.6	-8.0	206	209	98.3
1947	-2.3	-2.5	201	204	98.5
1948	-2.7	-0.3	196	203	961
1949	22.7	14.3	240	233	103.2
1950	30.0	25.7	312	293	106.7
1951	28.3	16.7	401	341	117.3
1952	4.5	12.3	419	383	109.2
1953	1.3	-2.3	424	375	112.9
1954	51.5	51.5	642	568	112.9
1955	23.0	20.5	790	685	115.3
1956	13.5	10.0	897	754	119.0
1957	-5.3	-12.0	849	663	128.0
1958	43.7	44.0	1,220	954	127.8
1959	18.7	11.9	1,449	1,067	135.7
1960	7.1	-1.4	1,551	1,053	147.3
1961	22.5	24.7	1,901	1,313	144.7
1962	-15.2	-6.9	1,612	1,224	131.6
1963	21.4	18.2	1,957	1,446	135.3
1964	11.9	17.1	2,189	1,693	129.3
1965	25.2	16.7	2,740	1,974	138.8
1966	-0.6	-7.4	2,724	1,828	149.0
1967	29.6	23.0	3,527	2,248	156.9
1968	6.1	20.6	3,743	2,712	138.0
1969	3.5	12.4	3,870	3,048	126.9
1970	-7.5	6.9	3,583	3,258	110.0
1971	26.0	13.6	4,515	3,702	122.0
1972	22.9	11.2	5,549	4,112	134.9
1973	-21.4	-7.8	4,367	3,792	115.2
1974	-31.3	-16.9	3,000	3,227	92.9
1975	28.7	38.0	3,858	4,450	86.7
1976	12.7	31.0	4,345	5,829	74.5
1977	-6.1	-3.0	4,079	5,660	72.1
1978	20.6	13.5	4,920	6,419	76.7

GROWTH FUNDS VS. INCOME FUNDS  
1940-1978

ANNUAL RATE OF RETURN

	<u>GROWTH FUNDS</u>	<u>INCOME FUNDS</u>	<u>GROWTH VS. INCOME</u>
<u>TOTAL PERIOD</u>			
1940-1978	10.5%	11.3%	-0.8%
<u>BY DECADE</u>			
1940's	9.2%	8.8%	+0.4%
1950's	19.7	16.5	+3.2
1960's	10.3	11.0	-0.7
1970's	2.4	7.7	-5.3
<u>BY CYCLE (yr. ends)</u>			
1939-1944	7.2%	18.5%	-11.3%
1944-1951	16.1	5.6	+10.5
1951-1956	17.4	17.1	+0.3
1956-1960	14.7	8.8	+5.9
1960-1964	9.0	12.7	-3.7
1964-1967	17.3	9.9	+7.4
1967-1970	0.4	13.2	-12.8
1970-1972	24.5	12.3	+12.2
1972-1977	-6.0	6.6	-12.6
1977-1978	20.0	13.4	+6.6