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Bringing Mutuality to Mutual Funds

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In Whose Interest?

Forty years ago, Manuel F. Cohen, then chairman of the United States Securities and Exchange Commission (SEC), delivered a landmark address on the challenges facing the mutual fund industry. That speech, delivered at the 1968 Federal Bar Conference on Mutual Funds, was entitled simply *The 'Mutual' Fund*[1], with emphasis on the quotation marks around the word mutual. Chairman Cohen's main concern was that the designation 'mutual' was inappropriate in view of the changes the industry underwent in the 1960s that altered, for the worse, the industry's character and mission.

The fact is that even after 40 eventful years, the industry has not just failed to respond to the challenging issues raised by Chairman Cohen, but has moved in the opposite direction. Today, 'mutual' remains an inappropriate adjective to describe this business. The operation of almost all mutual funds is as far from the concept of mutuality as one can possibly imagine. Chairman Cohen illustrates this point in his 1968 speech:

"… the basic idea of a mutual fund is deceptively simple … [but its] salient characteristics raise a serious question whether the word 'mutual' is an appropriate description."[2]

While policyholders of mutual insurance companies and depositors in mutual savings banks were antiquatedly sharing in the profit of their institutions, mutual funds, Chairman Cohen stated, were different. He noted that fund shareholders paid fees to their external managers, who were often corporations in business to earn profits for their own shareholders, with a completely different and often opposed set of interests.

Chairman Cohen observed that the resulting fee structure had provided a real opportunity for the exercise of the ingenuity for which fund managers had established an enviable reputation.

"… after all, that is where the money is, and despite the common use of the word mutual, the principal reason these funds are created and sold is to make money for the people who sell them and those who manage them."[3]

Is there something improper or wrong, or even unethical about having funds operated with this purpose? Perhaps not. If this structure is not illegal, there seems to be something about the way in which the industry has evolved that flies in the face of the provisions within the Investment Company Act of 1940 that requires investment companies to be "organized, operated, and managed"[4] in the interests of their shareholders, "rather than in the interest of their managers and distributors."[5] Interestingly, the phrase 'mutual funds' does not appear in the statute.

An Exception to the Conventional Structure

There is a single exception to the conventional external management structure. The creation of Vanguard, in 1974, marked my attempt to create a family of mutual funds that was truly mutual, mitigating to the maximum possible extent the obvious conflict of interest that exists between funds and their advisors. Under the Vanguard at-cost operating structure, the profits that accrue to external managers are returned directly to the fund shareholders. The 150 funds in the group actually own the manager, The Vanguard Group, Inc., roughly in proportion to their share of the Group's aggregate assets, and share in the total expenses incurred by the funds in their operations by approximately the same proportion. Vanguard's responsibilities include providing all of the fund's administrative and marketing services and the largest portion of their investment management services.[6]

The directors of the funds and their management company are identical. Eight of the nine directors are otherwise unaffiliated with the company. No director is permitted to be affiliated with any of the funds' external advisors, whose fees are vigorously negotiated and whose performance is monitored by Vanguard staff. Since the Vanguard funds essentially operate and manage themselves at cost, the fund shareowners garner the extraordinary economies of scale that characterize investment management. It is fair to describe Vanguard as the only truly *mutual*, mutual fund complex. This shareholder-first structure has produced enormous growth in the assets of the Vanguard funds and enormous savings for investors. For example, in 2007, Vanguard's composite expense ratio of 21 basis points (i.e., 0.21 percent) was 76 basis points below the 97-basis-point composite weighted average expense ratio of its largest competitors. Within two years, cumulative fee savings for Vanguard fund owners will exceed U$100 billion. One might describe that total as real money.

Whence 'Mutual'?

If the word mutual did not appear in the Investment Company Act of 1940, when did it emerge? I've gone through old Investment Companies manuals published by Arthur Wiesenberger & Company back to its beginnings and not until the 1949 edition, a quarter-century after the industry began, do I find the first mention of mutual funds. But while the origin of the term remains a mystery, the paradoxical fact is that it first appeared only a short time before the industry began to abandon its early, mutual values. History confirms that from the inception of the first United States mutual fund in 1924 until the late 1940s, the predominant focus of mutual fund management was on portfolio selection and investment advice, rather than on distribution and marketing. In fact, the managers who founded Massachusetts Investors Trust, State Street Research and Management Company, and Incorporated Investors, the original Big Three of the fund industry, put themselves forth as the "twentieth-century embodiment of the old Boston trustee".[7]

During the industry's early years, sales of fund shares were typically the responsibility of separate underwriting firms financed by distribution revenues from sales loads and predominately unaffiliated with fund managers. For example, the primary concern of the State Street Research and Management Company partners was not to be distracted by the sales effort.

As they wrote to investors in 1933,

"… it is our intention to turn over the active selling and the commissions to dealers … thereby leaving us free to devote … our entire time and effort to research and the study of the problems of investment."[8]

The same spirit was echoed by Judge Robert F. Healy, the SEC Commissioner primarily responsible for the legislation leading to the Investment Company Act of 1940. Here is how he opened the testimony at the hearings for the Act in 1939:

"… the solution [to the industry's] shocking record of malfeasance … was a group of expert trust managers who do not make their profits … distributing trust securities, styled principally for their sales appeal, but from wise, careful management of the funds entrusted to them."[9]

"… [the Commissioners] were anxious to protect the fund investor from the distorting impact of sales. Products[10] *designed for their appeal to the market did not, and do not, necessarily make the best investments."*[11]

Legendary industry pioneer Paul Cabot, one of State Street's founders and a major force in the drafting of the 1940 Act, agreed with the SEC on this point. Earlier, in 1928, he had described the abuses in the investment-trust movement of the day as:

"… dishonesty, inattention, inability, and greed. Even if a fund is honestly and ably run, it may be inadvisable to own it simply because there is nothing in it for you. All the profits go to the promoters and managers."[12]

While the derivation of the term mutual remains obscure, the prudent idealism behind the spirit of the industry when the 1940 Act was drafted arguably justified the use of the term. Yet the term mutual fund only came into being as the industry began to turn away from its original spirit of mutuality. From its early mission of stewardship of investor assets to its modern-day mission of salesmanship, a mission, as Chairman Cohen seemed to be suggesting, that would make the use of the term mutual something of a joke.

The Straw That Broke the Camel's Back

As with any major transformation, many factors were responsible for the sea of change that gradually subverted the fund industry's mission. For decades, the industry was operated by a group of small firms that were privately-owned by professional managers who provided advisory services and focused on earning a return on the capital that investors had entrusted to them. The industry then morphed into a group of very large firms that were mostly publicly-owned and controlled by corporate executives whose mission was asset gathering and whose focus was on earning a return on the capital of the owners of the management company. The straw that broke the camel's back of the traditional industry came when the owners of privately-held management companies gained the right to sell their ownership positions to outsiders, then to the public and finally to large financial conglomerates.

Paul Cabot did not approve of that change. For him, the private ownership of fund managers was essential and represented a moral imperative for him. He sharply criticized firms that would sell out to insurance companies and other financial institutions. In 1971, he recalled the negotiations over the Investment Company Act of 1940:

"… both the SEC and our industry committee agreed that the management contract between the fund and the management group was something that belonged … to the fund … and, therefore, the management group had no right to hypothecate it, to sell it, to transfer it, or to make money on the disposition of this contract … the fiduciary does not have the right to sell his job to somebody else at a profit."[13]

Ironically, 11 years later in 1982, Paul Cabot's successors, the partners of State Street Research and Management Company, sold the firm to (paradoxically, then-mutual) Metropolitan Life Insurance Company for at that time an astonishing profit of U$100 million. The Board's reasoning was as follows:

"… the affiliation of State Street with an organization having the financial and marketing resources of Metropolitan Life will result in the development of new products and services which the fund may determine would be beneficial to its [fund] shareholders."[14]

Such new products and services would be beneficial not to the Fund's shareholders, but to the management company, which became a subsidiary of the insurance company. In fact, the merger hurt the fund shareholders. "Performance lagged, and the manager's position in the industry declined from tops to average."[15] By 2002, Metropolitan Life abandoned the fund business, selling State Street Management and Research Company to Blackrock Financial for an estimated U$375 million. One of Blackrock's first moves was to merge the industry's third-oldest fund into another Blackrock fund, putting State Street Management out of its misery. I still refer to this event as a death in the family.

The Floodgates Open

The sale and resale of State Street Management exemplified the potential for trafficking in fund advisory contacts that greatly concerned the SEC during the drafting of the 1940 Act. While the SEC and the industry agreed that the management contract was an asset of the fund, the 1940 Act failed to explicitly articulate this sound principle. It would only be a matter of time until a sale of a contract would take place. That sale opened the floodgates to public ownership of fund management companies. The date was April 7, 1958, when the United States Court of Appeals for the Ninth Circuit ruled that the 1956 sale of shares in Insurance Securities, Incorporated (ISI), at a price equal to nearly 15 times its book value, did not constitute gross misconduct or gross abuse of trust under Section 36 of the 1940 Act. The SEC had gone to court to oppose the sale on the grounds that the excess price represented a payment for succession to the advisor's fiduciary office.

The Court agreed with the SEC that "a person occupying a fiduciary relationship with another will not be permitted to exploit such relationship for personal gain."[16] It weighed more heavily the fact that the value of the contract did not represent an asset of the trust fund, rather it reflected the business reality that the manager received a profit for rendering services in return for stipulated fees that the fund had contracted to pay. Regardless of whether this decision by the Ninth Circuit[17] was considered either good or bad, the US Supreme Court refused to hear an appeal. That narrow legal decision, now almost a half-century ago, played a definitive role in setting the industry on a new course. A course where manager entrepreneurship in the pursuit of personal profit would supersede manager stewardship in the interest of prudent investment returns for fund shareholders.

Within a decade, many of the major firms in the fund industry joined the public ownership bandwagon, including Dreyfus, Franklin, Putnam, as well as Wellington. Over the next decade, T. Rowe Price and Keystone (now Evergreen) also went public. In the era that followed, financial conglomerates acquired big firms such as Massachusetts Financial Services, Putnam, American Century, Alliance, AIM, and many others. The original trickle of public ownership of fund management companies eventually became an ocean. Today, the tide of public ownership of fund management companies has subsided and private ownership is at an all time low. Among the 50 largest mutual fund management complexes, only nine have maintained their original private structure including Fidelity, American Funds, Dodge & Cox, Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF), and Vanguard. Of the 41 remaining firms on the list, nine are publicly-held and 32 are owned by banks, giant brokerage firms, and US and international conglomerates. As the data will shortly demonstrate in this article, the seemingly irresistible trend towards public and largely conglomerate ownership has ill-served mutual fund shareholders.

Vanguard Goes the Other Way

Only a single firm swam against this epic tide and operated under a novel and unprecedented structure. The story of its creation is a story worth telling.[18] In 1960, my employer, Wellington Management Company, was among the firms to ride that early wave of industry Initial Public Offerings (IPOs).

In 1965, when I assumed leadership of the firm, I realized we had to deal with the challenges involved in serving two demanding masters whose interests were often in direct conflict. Obviously, we had a fiduciary duty both to our fund shareholders and to our management company shareholders. When a privately-held management company becomes publicly-held, this conflict is greatly exacerbated.

I soon went public with my concerns. Speaking at the annual meeting of my Wellington partners in 1971, I revealed an ancient prejudice of mine:

"… all things considered, it is undesirable for professional enterprises to have public shareholders. Indeed it is possible to envision circumstances in which the pressure for earnings growth engendered by public ownership is antithetical to the responsible operation of a professional organization. Although the field of money management has elements of both a business and a profession, any conflicts between the two must, finally, be reconciled in favor of the client."

It is a matter of fiduciary principle, as no man can serve two masters.

I explored some ideas about how a reconciliation might be achieved including, a mutualization, whereby the funds acquire the management company. Within three years, I found myself in a position where I would not only talk the talk about mutualization, but would walk the walk. A series of dire events in the stock market was enough to destroy the happy partnership formed by an unfortunate merger I implemented in 1966 and I was axed as the Chief Executive Office of Wellington Management Company on January 23, 1974. I remained Chairman of the mutual funds, with their largely separate and independent Board of Directors. After a seven month struggle, I persuaded the Board to establish the funds' own administrative staff under the direction of its operating officers and I would continue as Chairman and President.

The Board allowed Wellington Management Company to retain its name, so I had to create a name for the new firm. I proposed the name, Vanguard, and the directors approved it. We began operations on May 1, 1975. Over the next two years, we moved beyond our narrow administrative mandate to engage in fund portfolio management and share distribution services as well. The first fund we formed was the world's first index mutual fund, modeled on the Standard & Poor's 500 Stock Index. When its IPO was completed in August 1976, we had raised a mere U$11 million. Despite that meager start, Vanguard 500 Index Fund, with its several series, is now the largest mutual fund in the world.

Only a few months later, in February 1977, the Board accepted my recommendation that the funds terminate their distribution agreements with Wellington Management, eliminate all sales charges and abandon the broker-dealer network that had distributed Wellington shares for nearly half a century. Almost overnight, the firm moved from a seller-driven, load-fund channel to a buyer-driven, no-load channel that is maintained today. Only 21 months after Vanguard began operations, the fledgling organization had been transformed into a fully-functioning fund complex responsible for administration, distribution and investment management. What we referred to as the Vanguard Experiment in fund governance was about to begin in earnest.

How it All Worked Out

Some 34 years have elapsed since Vanguard began operating under its unique mutual structure, and 50 years since the Ninth Circuit decision opened the floodgates to public ownership of fund managers and the age of conglomeration that has overwhelmed the industry. Paradoxically, the philosophies underlying these two events are diametrically opposite. Mutual ownership views mutual funds as trust accounts, managed under the direction of prudent fiduciaries. Outside ownership, on the other hand, demands that investment funds be viewed as products that are manufactured and distributed with the objective of maximizing profits for the manager. It's time to look at the record and compare the results of firms that follow these opposing philosophies.

I am fond of saying that in more than three decades, Vanguard has proven to be both a commercial success and an artistic success. A commercial success, because the firm's structure has proven to be a superb business model. Fund assets under management have grown from U$1.4 billion at its 1974 founding to U$1.2 trillion today, now likely the largest firm in the fund industry. Of course, the stock market boomed during most of that period and the fund industry flourished. Nonetheless, Vanguard's market share of industry assets has soared from a mere 1.8 percent in 1980 to 10.6 percent today, without a single year of decline. If that share had remained at 1.8 percent, assets of the Vanguard funds would be U$220 billion today. Almost all U$1 trillion of our growth—80 percent of it—has come from increased market share.

How did Vanguard earn that commercial success? By the artistic success the firm had achieved, which I define as providing superior investment returns to shareholders. The data indicates that the performance of the Vanguard funds has indeed been superior, while the returns produced by the financial conglomerates that dominate this industry have been inferior. Let's look at the record. While there are many ways to measure fund performance, I'll use one of the more sensible methodologies, relying largely on the Morningstar system, in which the risk-adjusted returns of each fund are compared with the risk-adjusted returns of its direct peers over a full decade. Under this system, 10 percent of funds receive five stars (the top rating) and 10 percent one star (the bottom rating); 22.5 percent receive four stars and 22.5 percent receive two stars; the middle 35 percent receive the average grade of three stars.[19]

That deceptively simple methodology results in the calculation, for each fund complex, of the percentage of its funds ranked with four and five stars and subtracting from that total the percentage of funds ranked with one and two stars. The result is a segmentation between the funds that provided distinctly superior returns and those that provided distinctly inferior returns, with an industry-wide norm of zero percent. While I've never seen this methodology used before, I believe that minimizing the funds in the one and two star categories provides an equally important benefit for fund shareholders.

We measured the returns achieved by 50 of the largest fund complexes, defined as the firms managing at least 40 individual funds excluding money market funds. Only one fund complex had assets of less than U$25 billion. This remarkably representative list covers more than 8,800 funds with some U$7 trillion in fund assets, and 80 percent of the industry's long-term asset base. A summary of the results that show the scores of the top six firms, the bottom six firms and six fairly well-known firms that achieved roughly average performance records for their funds, is presented in Table 1. The top-ranking fund complex, in terms of providing superior returns to its investors, was Vanguard. With 59 percent of the Vanguard funds in the top group and less than five percent in the bottom group, the firm's performance rating is +54.[20]

Joining Vanguard among the top three are Dimensional Fund Advisors (DFA) and TIAA-CREF, both at +50. Coincidentally, all three firms are focused largely on index-like strategies. At number four is T. Rowe Price (+44), followed by Janus (+38) and American Funds (+26). I believe that most objective observers would agree that over the past decade, at least five of these six firms have been conspicuous in delivering superior returns, a judgment that would confirm the validity of the methodology. Again coincidentally, this six-firm list is dominated by four management companies (Vanguard, DFA, TIAA-CREF and American) that are neither publicly-owned, nor controlled by a conglomerate.

On the other hand, each of the bottom six firms is a unit of a large brokerage firm or a financial conglomerate. Their ratings range from -40 for Goldman Sachs to -58 for Putnam, the lowest-ranking firm with only four percent of its funds in the top category and 62 percent in the bottom category. Strikingly, every single one of the 17 lowest-ranking firms on the 50-firm list is conglomerate-held, while only one of the firms among the top ten can be similarly characterized.[21] In the middle group, all producing average scores for their funds, is one publicly-held firm (Franklin, +9), one owned by a large investment banker (Morgan Stanley, +2), one privately-held (Fidelity -3) and three owned by conglomerates (all below par, with one rated at -4 and two at -14).

Considering the high-performing, average-performing and low-performing groups together, it becomes clear that the only firm with a truly mutual structure, and the other three firms with privately-held structures, dominate the top group. These firms have provided consistently superior returns for their fund shareholders, in sharp contrast with the inferior scores that clearly characterize the funds managed by financial conglomerates.

Table 1: Major Mutual Fund Managers: Fund Performance

		Manager	% of Funds Ranked Highest (4 or 5 Stars)	Lowest (1 or 2 Stars)	Highest Minus Lowest
Highest Returns	1	Vanguard	59%	5%	54%
	2	DFA	57	7	50
	3	TIAA-CREF	54	4	50
	4	T Rowe Price	53	9	44
	5	Janus	54	16	38
	6	American Funds	46	20	26
Average Returns	7	Franklin Templeton	31	22	9
	8	Morgan Stanley	32	30	2
	9	Fidelity	31	34	-3
	10	Barclays Global	27	31	-4
	11	AIM Investments	20	34	-14
	12	Columbia Funds	23	38	-14
Lowest Returns	13	Goldman Sachs	15	55	-40
	14	Dreyfus	12	53	-40
	15	MainStay Funds	20	60	-40
	16	John Hancock	17	60	-43
	17	ING Investments	9	64	-55
	18	Putnam	4	62	-58

Source: Morningstar (December, 2007) (long-term funds only)

Performance Evaluations from a Higher Authority

While any performance methodology is inevitably imperfect, I believe that the methodology chosen here is not only reasonable, but a significant enhancement over most other methodologies. Let's not rely on statistics alone to evaluate fund performance, but find out how the fund shareholders themselves regard the funds they own. Thanks to a survey done in 2007 by Cogent Research LLC, we now have measures of how fund shareholders feel about the mutual fund firms that manage their money. In short, shareholders are arguably the highest authority for the appraisal fund performance.

The Cogent study[22] measured client loyalty, presenting investors with a scale representing the extent of their trust in their managers: ten points awarded for the highest rating (definitely recommend to other investors), one point for the lowest (definitely not recommend to other investors). Each firm was scored by subtracting the percentage of shareholders who rated the firms at five or below from the percentage who rated the firms at nine or ten. Only 11 of the 38 firms evaluated had positive loyalty scores. The average score was -12, a message about investor confidence in the fund industry that would seem to be less than a rousing tribute.

Simply put, fund shareholders seem to get it. In Table 2 we see a remarkable, if hardly exact, correlation when we juxtapose these loyalty scores for each firm with its performance scores. Vanguard's performance score (+54) and loyalty score (+44) were both the highest in the field. Putnam's scores, also similar (-58 and -54 respectively), were both the lowest in the field. When disparities between the two scores exist, they seem to arise because the performance ratings, presented in Table 1, reflect the returns reported by the mutual funds themselves. These reported returns can vastly overstate the returns that fund investors have actually earned. That's often the case in this business, for fund marketers have a seemingly irresistible impulse to promote shares of a fund only after the fund has achieved sterling performance, which results in an impulse to purchase the funds that also seems irresistible to fund investors. Following such superior performance, such funds seem to have an almost equally irresistible impulse to revert not only to the market mean, but even below it.

The most glaring gap between the performance rating (+38) and the loyalty rating (-30) appears for the Janus funds. Let's examine their records. During the ten years ending December 31, 2007, the five largest Janus funds produced an average annual return of 9.3 percent, a solid margin over the annual return of 5.9 percent for the S&P 500 Index. During the first three years of that period, the Janus returns soared far above the Index return and, as the market rose to new heights, some U$50 billion of investor capital flowed into the funds. In the bear market that followed, the funds collapsed. As a result, most Janus investors actually experienced dismal returns.

Table 2: Major Mutual Fund Managers: Fund Performance and Shareholder Loyalty

		Manager	% of Funds Ranked Highest Minus Lowest	Client Loyalty Score
Highest Returns	1	Vanguard	54%	44%
	2	DFA	50	n/a
	3	TIAA-CREF	50	n/a
	4	T Rowe Price	44	21
	5	Janus	38	-30
	6	American Funds	26	12
Average Returns	7	Franklin Templeton	9	1
	8	Morgan Stanley	2	-18
	9	Fidelity	-3	12
	10	Barclays Global	-4	n/a
	11	AIM Investments	-14	-48
	12	Columbia Funds	-14	-47
Lowest Returns	13	Goldman Sachs	-40	-32
	14	Dreyfus	-40	-45
	15	MainStay Funds	-40	n/a
	16	John Hancock	-43	-10
	17	ING Investments	-55	-11
	18	Putnam	-58	-54

Source: Morningstar, Cogent Research (December, 2007)

During the decade, these Janus funds reported time-weighted returns averaging 9.3 percent per year, a compound ten-year return of +157 percent. The Janus fund investors, on the other hand, earned dollar-weighted returns averaging 2.7 percent per year on the money invested, a compound return of only 38 percent. This means that the returns earned by Janus shareholders for the decade fell 119 percentage points behind the returns that the Janus funds reported. That truly astonishing gap surely accounts for the gross disparity between the funds' high scores in reported performance and their low loyalty scores, based on the actual investment experience of Janus shareholders.

Costs Rear Their (Usually Ugly) Head

The data clearly shows that truly mutual investing has not only reaped rewards for its clients, but has also earned their loyalty. Also apparent is that financial conglomerates have not only failed their investors, but have earned their state of disgrace. How do we account for these differences in return? Obviously, there is a certain amount of luck, skill and timing in performance ratings, even though much of the impact of those variations evens out over a period as long as a decade. Even more of the disparity is mitigated when the management firms run one hundred or more funds.

It turns out that there is one factor that plays a major role in the relative returns of peer funds. Fortunately, it is a factor that persists over time: the costs that funds incur in delivering returns to investors. Funds with similar objectives, managed by competent and experienced professionals and compared over an extended period of time, are likely to achieve similar returns, but only before the costs of investing are factored in. These costs come in many forms including the expense ratio (i.e., annual percentage of asset value consumed by management fees and operating expenses), sales loads that represent the cost to acquire fund shares, and transaction costs representing the expenses incurred in the execution of the investment decisions made by the fund's portfolio managers. Since transaction costs are not publicly available, the all-in expense ratios I'm using, including sales loads built into the B and C share classes, are the most satisfactory measure of the aggregate impact of fund costs.

Table 3 adds a column to Table 2 that shows the expense ratios of the equity funds in each group.[23] It shows that the three firms with the highest performance ratings are the same firms, in the same order, that have the lowest annual expense ratios. For the top-performing group, in total, the average ratio is 0.69 percent. Expense ratios for the middle group average 1.24 percent, although that group is also populated with fairly costly funds.[24] The bottom group of performers has the highest expense ratios, averaging 1.57 percent per year. This data shows that relative costs are a principal determinant of relative fund returns. Costs matter a great deal.

Price Competition?

Despite the powerful message in Table 3 about the importance of costs, price competition remains conspicuously absent in the mutual fund industry. Investors seem to be largely unaware of the direct and causal relationship between fund costs and fund returns. Table 3 shows that there are only three low-cost firms in the industry and that these three firms dominate the performance statistics. Yet together they constitute a mere 14 percent of industry assets. How can the remainder of the industry continue to maintain expense ratios that average 1.5 percent per year, five times as high?

According to Brian Cartwright, general counsel of the SEC:

"…[there are many] signs the mutual fund marketplace may not be performing in a way one would expect in a satisfactorily functioning competitive market …American investors may be being deprived of the long-term returns they deserve."[25]

Clearly, price ought to be the talisman that drives investor choice, forcing fund managers to reduce costs, but that is simply not happening. Yes, money flows are increasingly directed toward the lower-cost funds. Vanguard has not only initiated that trend, but has been its prime beneficiary. Other fund complexes are not following the lead.[26] In short, if price competition is not defined by the action of consumers, but by the actions of producers, then price competition is conspicuously absent in the mutual fund industry. Why don't fund managers compete on costs? To do so would be antithetical to their vested financial interest in maximizing the return on their own capital, which in turn is based on the level of fees and the growth in assets under management.

Table 3: Major Mutual Fund Managers: Fund Performance, Shareholder Loyalty and Costs

		Manager	Funds Ranked Highest Minus Lowest	Client Loyalty Score	Avg. Eq. Fund Exp. Ratio
Highest Returns	1	Vanguard	54%	44	0.23%
	2	DFA	50	n/a	0.33
	3	TIAA-CREF	50	n/a	0.37
	4	T Rowe Price	44	21	0.93
	5	Janus	38	-30	1.21
	6	American Funds	26	12	1.06
Average Returns	7	Franklin Templeton	9	1	1.48
	8	Morgan Stanley	2	-18	1.23
	9	Fidelity	-3	12	1.31
	10	Barclays Global	-4	n/a	0.41
	11	AIM Investments	-14	-48	1.59
	12	Columbia Funds	-14	-47	1.41
Lowest Returns	13	Goldman Sachs	-40	-32	1.59
	14	Dreyfus	-40	-45	1.65
	15	MainStay Funds	-40	n/a	1.49
	16	John Hancock	-43	-10	1.40
	17	ING Investments	-55	-11	1.72
	18	Putnam	-58	-54	1.56

Source: Morningstar, Cogent Research (December, 2007)

The Triumph of Conglomeration

The truly mutual model of the mutual fund has yet to be copied and domination of the industry by the conglomerate model remains. Early on, Chairman Cohen recognized the serious problems that would be created by this conglomeration. In a 1966 speech, he spoke of:

"… new and more complex relationships … [between] institutional managers and their beneficiaries, [and sought] a more adequate scheme of regulation that ultimately will protect beneficiaries from unwarranted action by their managers, and will realize the fullest benefits of their participation [in their funds]. [His concern about] public ownership of investment advisors … and the beginning of a trend toward their acquisition by industrial companies, [which makes it] increasingly difficult to define the responsibilities of institutional managers, [who may] be obligated to serve the business interests of the very companies in which they invest."

That is exactly what has happened.

The snowball effect that began with the onset of public ownership of management companies in 1958 took a while to gain speed. During the 1980s and 1990s, it gathered strong momentum. With this massive wave of conglomeration, the industry's mantra gradually changed from the stewardship that characterized its early tradition to the salesmanship of today. Asset-gathering became the name of the game and with it came the wave of product proliferation that carried the number of mutual funds from 560 in 1980 to some 12,000 today.

It's Time for a Change

Only two weeks after that 1966 speech by Chairman Cohen, the SEC sent Congress a massive report by its staff entitled Public Policy Implications of Investment Company Growth (PPI).[27] In that report, the SEC noted the burgeoning level of fund fees, then at an annual level of a mere U$134 million versus more than U$100 billion today. It also noted the effective control that advisors held over their funds and:

"… the absence of competitive pressures, the limitations of disclosure, the ineffectiveness of shareholder voting rights, and the obstacles to more effective action by the independent directors."[28]

The SEC also noted:

"… the advisor-underwriter permeation of investment company activities to an extent that makes rupture of existing relationships a difficult and complex step … [rendering] arm's length bargaining between the fund's board and the managers … a wholly unrealistic alternative."[29]

Yet the SEC was:

"… not prepared to recommend at this time the more drastic statutory requirement of compulsory internalization of management [i.e., mutualization]. [Rather, the SEC recommended the adoption of a] statutory standard of reasonableness … a basic standard that would make clear that those who derive benefits from their fiduciary relationships with investment companies cannot charge more for services than if they were dealing with them at arm's length.. [Under this standard, the measure would be] the costs of management services provided to internally-managed funds and to pension funds and other non-fund clients. [If the standard of reasonableness does not] resolve the problems in management compensation that exist … then more sweeping steps might deserve to be considered."[30]

With vigorous lobbying by the Investment Company Institute (the self-anointed representative of fund shareholders that is in fact the powerful voice of fund managers), the reasonableness standard was never enacted into law. Fund fees soared and conglomerates gradually acquired the overwhelming majority of large mutual fund managers. As a result, more sweeping steps will now have to be considered.

What's to be Done?

My idealism tells me to fight for compulsory internalization,[31] at long last making it possible to delete those quotation marks around the 'mutual' fund that reflected the prescient concerns expressed by Chairman Cohen in the speech he delivered 40 years ago. My pragmatism suggests otherwise. Powerful and well-financed lobbyists led by the Investment Company Institute, the fabulously profitable management companies and their conglomerate owners and the U.S. Chamber of Commerce, would take up arms against such a seemingly radical proposal. Their campaign would come with unbridled enthusiasm and energy, and virtually unlimited financial firepower. Given the dismal state of corporate governance among our nation's business corporations, the self-interested opposition would almost surely defeat the reform of our fund management corporations and fail to honor the public interest and the interest of investors, the very interests that the 1940 Act was designed to protect.

Hope is not completely lost. There is a way to honor the spirit and letter of the Act so that investment companies are organized, operated and managed in the interests of their shareholders rather than their managers and distributors. It would take a series of logical steps to achieve this goal; some already in the work; some proposed by an earlier SEC and now seemingly in jeopardy. Some new steps would take us even further toward that goal. One simple, if dramatic, organizational change that would create enormous momentum toward fund operational independence from their advisors is the following:

1. Require that 100 percent of fund Directors be unaffiliated with the management company. There is no point subjecting management company Officers to the profound conflicts of interest of serving as fund Directors as well. It's time to honor the principle that no man can serve two masters.

2. Require that the Chairman of the Board be independent of the management company. Such a separation of powers, ordained for our federal government in the Constitution, is not only a fundamental principle of governance, but simple common sense.

3. Require the retention by the funds of Legal Counsel independent of the Advisor and a Chief Compliance Officer. Both have already been mandated by the SEC, but we must require them to be responsible to the Fund Board, reporting to the independent Fund Chairman.

4. Require that Fund Boards retain Advisors and Experts necessary to carry out their duties, in order to provide truly objective and independent information to the Board. In its 2004 recommendations, the SEC recommended language authorizing such staff or consultants. It should be mandatory, but apply only to fund complexes of a certain size and scope.[32]

5. A specific regulation that authorizes funds to assume responsibility for their own operations including administration, accounting, financial controls, compliance, shareholder record-keeping and so on. Such a structure would cut the Gordian knot that has given fund managers de facto control over the funds they manage.[33]

6. Enact a federal standard of fiduciary duty for financial institutions, one that would apply to fund directors. The fact is that mutual fund managers and pension fund managers, public and private alike, face serious conflicts of interest in carrying out their duties. In today's relatively new agency society, in which financial institutions control more than 70 percent of stock ownership, there has been a serious failure of these agents to serve their principals - largely fund shareholders and pension beneficiaries.

Two Powerful Endorsements

This critical analysis of the mutual fund industry is not mine alone. Listen to Warren Buffett:

"…fund independent directors … have been absolutely pathetic. They follow a zombie-like process that makes a mockery of stewardship. Independent directors, over more than six decades, have failed miserably."

Then, hear this from another investor, one who has not only produced one of the most impressive investment records of the modern era, but who has an impeccable reputation for character and intellectual integrity, David F. Swensen, Chief Investment Officer of Yale University:

"…the fundamental market failure in the mutual-fund industry involves the interaction between sophisticated, profit-seeking providers of financial services and naïve, return-seeking consumers of investment products …Investors fare best with funds managed by not-for-profit organizations, because such firms focus exclusively on serving investor interests…"[34]

I regard these two powerful endorsements of the positions I hold as a call for action. It's time to make fund directors aware of their duty to serve the fund shareowners rather than the entrenched fund managers and to bring independent leadership to fund Boards. That is the purpose of the six changes I've delineated. I'm well aware that for some firms, these changes may finally lead to the full mutualization that, in the only case study that exists, has served shareholders so well. It's also time to return to court and seek to overturn the ghastly legacy of the Ninth Circuit's erroneous decision in 1958 that opened the floodgates first to public ownership and then to conglomerate ownership.[35] It's high time to return the industry to its professional roots, with fiduciary duty at the fore.

In short, it's time for a new order. It's time to go back to the future and honor the vision of trusteeship held by Paul Cabot, to the vision of SEC Commissioner Healy to protect investors from the distorting impact of fund sales, to the wise and prescient vision of SEC Chairman Manuel Cohen, who challenged us to build an industry that is worthy of deleting those quotation marks that he placed around the word 'mutual' and at last bringing true mutuality to the mutual fund industry.

Endnotes

1 "The 'Mutual' Fund", an address by Manuel F. Cohen before the 1968 Conference on Mutual Funds, Palm Springs, California, March 1, 1968.
2 Ibid.
3 Ibid.
4 Investment Company Act of 1940, 15 U.S.C. § 80a- 1(b)(2) (2000), available at http//www.sec.gov/about laws/ica40.pdf.
5 In re: The Vanguard Group, Inc., S.E.C. Investment Company Act Release No. 11,645, 22 SEC Docket 238 (Feb. 25, 1981).
6 The investment advice for approximately 70 percent of Vanguard's fund assets—largely index, bond, and money market funds—is provided internally on an at-cost basis by Vanguard itself. The remaining 30 percent of assets are in funds advised under contracts held by a score of external advisors.
7 Yogg (2006).
8 Ibid.
9 Ibid.
10 I believe that referring to mutual funds as "products"—even worse, as "products manufactured by their advisers"—demeans the fiduciary spirit of the 1940 Act. Decades ago I banned the use of the term at Vanguard and imposed a fine of $1.00 for each usage.
11 Yogg (2006).
12 Ibid.
13 Ibid.
14 Ibid.
15 Ibid.
16 Ibid.
17 A note in the Harvard Law Review of April 1959, Number 6, took issue with the Ninth Circuit's decision, agreeing with me that the decision was ill-decided. "If (the Act) is construed to incorporate the basic principle that a fiduciary owes individual loyalty to the beneficiary and must avoid any conflict of interest, then a seller should not be allowed to transfer his fiduciary office for personal gain . . ." page 180.
18 To prevent this extensive essay from being even longer, I have summarized the story of Vanguard's formation, including the tortuous path of negotiating and the compelling economics of my proposal for fund shareholders under which funds would acquire Wellington's *mutual fund* business. (Its counseling business would have been returned to the pre-merger partners.) An expanded version of the story can be found in my lecture "The Mutual Fund Industry, From Alpha to Omega," at Boston College Law School on Februrary 20, 2003, available at 222.johncbogle.com.
19 By weighting the analysis by number of funds rather than by assets, this procedure has one strength not in evidence in other methodologies, which almost invariably ignore the impact of sales loads. My methodology captures the returns of "B" and "C" shares, usually smaller in assets but in which sales loads are built into their expense ratios and thus deducted from their returns. This method gives a more realistic picture of the performance actually delivered to fund shareholders in all share classes.
20 Full disclosure: two much smaller firms have higher ratings; Dodge & Cox, with 4 funds, achieved a remarkable rating of +100; Royce and Associates, with 31 funds, had a score of +65.
21 The success of Neuberger Berman, ranking #8 with a score of +19, was largely achieved before its 2003 sale to Lehman Brothers.
22 The *Wall Street Journal* published the ratings for only eight of the firms in the survey. The other ratings were made available for this essay. Many of the firms in the performance survey were not included in the loyalty survey.
23 Since the largest variations in fund expense ratios come in equity funds, I have excluded the expense ratios of bond funds—which are generally lower—from this comparison. This practice also eliminates the distortion that would be created when firms manage different proportions of bond funds to stock funds.
24 The funds managed by Barclays, with a ratio averaging 0.41 percent, largely follow lower-cost index or index-like strategies.
25 Speech by Brian G. Cartwright, before the 2006 Securities Law Developments Conference, December 4, 2006.
26 I'm often told that Vanguard's demonstrably low costs—increasingly recognized in the marketplace—are responsible for setting an upper limit on prices among our competitors. But that level is still far too high for my taste.
27 U. S. Government Printing Office, December 3, 1966
28 Ibid.
29 Ibid.
30 Ibid.
31 But not for all fund complexes, only for complexes that exceed certain thresholds; for example, fund complexes that manage over $25 billion in assets *and* more than 30 mutual funds.
32 For example, complexes meeting the standards outlined in Endnote 31. In my darker moments, I'd consider applying this requirement only to fund complexes in which a majority of the directors are unable to actually name all of the funds on whose boards they serve.
33 It is a curious fact that the operational function was ignored in the 1940 Act, which refers solely to the other two functions of fund management, investment advice and share distribution (underwriting).
34 Swensen (2005).
35 Interestingly in light of my recommendations here, the note in the Harvard Law Review cited in Endnote 17 concludes with this caveat. "However, the sellers might be allowed to sell control for any consideration if the fund had an independent board of directors … with control of the proxy machinery and the power to select another adviser."

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