"Putting Investors First"

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I love the theme of the CFA Institute campaign for May 2015: "Putting Investors First." But I believe that such a campaign should be, well, eternal. For it is in those three little words—*putting investors first*—that we find the fundamental justification for our profession of investment management, our investment strategies, our securities analysis, and our financial planning.

And yes, "putting investors first" is at last gaining momentum in the evolution of our nation's financial system. That phrase is simply another way of stating the core principle of my own campaign to establish a federal standard of fiduciary duty, the duty of everyone who touches "other people's money" (OPM) to place the interests of our clients above our own interests.

The idea of fiduciary duty is simple enough, and, I think unarguable. (How many members of our profession would want to operate under the mantra: *"We put our clients' interests second, but it's close.*"?) But the implementation of this simple idea has proven fraught with challenges. Ferocious opposition exists. Even worse, to the extent that reluctant acceptance exists, it pays little more than lip service to the fiduciary principle. The reality of the U.S. investment system is that it has rarely been dominated by this principle. But today, it has become a matter of enlightened self-interest to fully honor this lofty standard.

The opinions expressed in this speech do not necessarily represent the views of Vanguard's present management.

Challenges in Finance

Let me now turn to three current challenges in finance. First, the underlying reality of our current market system. Almost all industry leaders, academics, and regulators agree that the fundamental purpose of our financial markets is to raise capital for companies that create jobs, build organizations, and manufacture products or provide services, with growing efficiency and with lower costs to consumers.

Capital formation, as this process is known, is largely represented by the raising of equity capital for new and existing companies. In recent years, total public stock issuance (IPOs, etc.) has averaged some $250 *billion* annually. On the other hand, during the same period, the annual volume of stock trading has averaged $35 *trillion*. Thus, capital formation has represented just 7/10ths of 1% of the activities of our financial system, trading activity 99.3%. And much of that trading, to state what must be obvious, has *nothing* to do with long-term investment. In fact, much of that frenzied activity is merely short-term speculation. Our challenge is to return long-term investing to its starring role in the financial movie, not merely as a co-star or in a cameo role, nor as a mere extra.

Second, consider the recent proposal by the Department of Labor to apply an explicit standard of fiduciary duty to those providing investment advice to individuals in retirement plans, notably IRAs and 401(k) thrift plans. These plans are now being relied upon as retirement plans by the vast majority of Americans, without ever having implemented the appropriate and necessary structural changes to transform these savings plans into retirement plans.

The proposed DOL rule would subject stock brokers to a standard of fiduciary duty when advising on the retirement plan investments of their clients (with a generous "carve-out" for exceptions), as distinct from the existing—and lower—standard of "suitability." But the proposal of this simple "putting investors first" standard is being opposed with a vengeance that I've rarely witnessed. Opponents of the fiduciary standard say: "too much regulation" . . . "will damage the small investor" . . . "will ruin the business." The challenge we face is to support the principle that our investor/clients have the right to demand that their interests take precedence over our own businesses. CFA Institute has already taken the lead in this stand. It is up to CFA professionals to follow.

Third, consider the structural anomaly of America's largest financial institution—the mutual fund industry, now overseeing $18 trillion of OPM. The mutual fund industry is dominated by firms that are publicly-owned or are owned by financial conglomerates. Of the 50 largest fund providers, 40 are in this category—30 owned by banks and other financial conglomerates, 10 directly held by public shareholders.

Result: despite the Biblical warning that “no man can serve two masters,” *most fund managers are fiduciaries to two separate sets of stockholders*. The conflicts of interest between them are obvious and substantial. Alas, I fear, it is the managers who operate the funds who put themselves first, not the fund investor. The challenge: to eliminate this obvious conflict of interest. “Just say no.” It won’t be easy, but one day it *will* happen.

This domination by public owners is relatively new. When I first joined Wellington Management Company in 1951—could it really be 64 years ago?—fund managers, with only one or two exceptions, were the principals of the fund’s manager. They were largely investment professionals, owned their firms, were focused on management, and considered themselves as fiduciaries. (As you might imagine, I knew many of them.) Today, the industry is largely driven by conglomerates—run by business-driven marketers focused on creating higher returns on the capital that their firms have invested in the management company—increasing assets under management, making what will sell and creating new sources of revenue, all with the goal of building their own profits. (This is a profitable business; 50% pre-tax profit margins are not uncommon.) *That’s capitalism!* But it has ill-served mutual fund investors.

How Did It Happen?

The story of that unfortunate evolution in fund ownership is little known. It was the result of a tiny transaction that would transform an entire industry, years before it became the giant of American finance. The transaction: owners of Insurance Securities, Inc. (ISI), the managers of Insurance Securities Trust Fund—a highly successful fund of its day, now long gone—sold their management company to other investors for $4.2 million, 14 times its book value of $300,000. *Tiny!* Despite vigorous opposition by the SEC, the Ninth Circuit Court of Appeals ruled in 1958 that the sale violated no law.

When the U.S. Supreme Court declined to review the verdict, the floodgates were opened to IPOs, mergers, and acquisitions of fund management companies. By the mid-1960s, a score of fund management companies had gone public, including, yes, Wellington and Dreyfus and Franklin and Putnam, followed by MFS, American Century, Oppenheimer, and others. “Trafficking” in management contracts, the SEC’s greatest fear, became commonplace, and many fund managers were acquired by huge banks and insurance companies.

It wasn’t supposed to be that way. Discussing the negotiations with the SEC that led to the Investment Company Act of 1940, fund industry leader Paul Cabot, president of State Street Investment Trust, believed that the private ownership of fund managers was essential. Indeed, it represented a moral imperative for him, and he sharply criticized firms that had sold out to insurance companies and other financial institutions. In 1971, he recalled the negotiations over the 1940 Act: "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 sell 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."* The spirit of the '40 Act seemed to reflect that principle. Alas, the letter of the act failed to be specific on that point. (Ironically, in 1982, the private owners of State Street Management—including Mr. Cabot—sold their company to Metropolitan Life Insurance Company for a profit of $100 million.)

Personal Experience

I know from first-hand experience about the challenges of dealing with these two masters. One was the management company, a firm fighting for its place in a highly competitive marketplace; the other, the mutual fund, a pooled investment trust seeking to earn solid returns (consistent with its stated objectives) without assuming undue risks.

When fund managers were under the ownership of investment professionals, and when the industry was small and, in the grand scheme of things, inconsequential, this conflict seemed of little importance. But during the 1964-1974 era, highly risky "Go-Go" funds came to dominate the mutual fund industry and manager profits soared. The conflict between fiduciary duties owed to the management company stockholders and the fund shareholders quickly surfaced.

In 1965—a mere half-century ago—legendary Wellington founder Walter L. Morgan discussed with me the dire situation that our firm was then facing. Our flagship fund, the conservative and balanced Wellington Fund, was looking staid and out-of-step with the "new era." Mr. Morgan, deeply concerned, told me—a kid, really, age 35—to take charge of his firm and "do whatever it takes to fix Wellington's problems." (To this day, I remember those words.)

Loaded with unwarranted self-confidence—arrogance?—and ignoring the industry's challenges that I'd recounted in 1951 in my Princeton senior thesis on the fund industry, I rose to the challenge! Before a year had passed, I'd put in motion a merger that would, well, "fix" Wellington Management Company. Our new, much smaller partner from Boston ran one of those Go-Go funds (Ivest Fund, now lost in the dustbin of history), and we were once again competitive in the marketplace. What's more, this merger brought us into the pension fund management business, which I thought would be a natural extension of the talents of our new management team's mutual fund activities.

So, I honored my fiduciary duty to the owners of Wellington Management Company—Mr. Morgan and its public shareholders. The firm had "gone public" in 1960, joining the parade of fund managers who poured through the gates opened by the ISI case. But I also believed that I had honored my separate and distinct fiduciary duty to the shareholders of Wellington Fund, for I expected that our new managers would apply their investment talents to enhancing the fund's faltering returns . . .

Wrong! Wrong! Wrong! Looking back, the merger was an abject failure—perhaps the worst merger ever, although AOL/Time Warner sets a high standard indeed. Though the "new era" finally ended, in this case, as 1973 began. Then, Wellington Fund had reached the most aggressive allocation to equities in its near-half-century history (82%, often of marginal investment quality). Its returns tumbled, and its reputation plummeted. Every one of our equity and balanced funds—including several new ones—failed its shareholders. And Wellington Management's stock would trade at $6 per share, down 90% from its 1968 high of near $60. And, having given up too much stock to our new partners in the merger (who were largely responsible for our dismal performance) *they* fired me. My promising career had ended.

Lessons Learned

Why am I telling you these tales of challenges in finance, corporate law, fiduciary duty, and a small but significant slice of my personal saga? Because random events, seemingly unimportant when they occur, often come to be consequential, changing the nature of the investment profession.

Back in the 1950's, who would have imagined that turnover of stocks (25%) would have reached such extraordinary heights (180% in 2014)? Who would have imagined that the "tiny but contentious" mutual fund industry (*Fortune* magazine's words in 1949, words that inspired my senior thesis on mutual funds) would come to dominate American finance? Who would have imagined that the respected trust departments of the Philadelphia banks during the 1950s—whose leaders were the consummate fiduciaries—would vanish, or that every major bank here would be acquired by a giant national bank conglomerate?

While we're about it, who would have imagined that a little-noticed legal case involving a small mutual fund management company would precipitate a new structure that would reshape an industry. Or that a 1966 fund merger, the catastrophic failure of one man's career, would, in a matter of months, lead to the creation of Vanguard, or that during the 40-plus years that followed, this uniquely structured, fund-shareholder-owned firm would become the unquestioned leader of the mutual fund industry—now managing over $3 trillion of OPM. Or that the embodiment of its principal investment strategy—the index fund—would, simply by buying and holding the stocks of the largest companies in America, begin to change the very nature of finance?

And on a far larger scale, who could have imagined the enormous consequences of the creation of IRAs (1974) and corporate thrift plans (1978)? The federal government's loss of trillions of dollars in federal tax revenues by making these tax-deferred plans available to investors? The gradual displacement of defined benefit (DB) retirement plans by defined contribution (DC) plans? (Assets of DB plans now total $6 trillion; DC Plans and IRAs, $12 trillion or twice as large.) In the aggregate, the assets of these two distinct retirement systems alone come to $18 trillion—six *times*, for example, the assets of the Social Security Trust Fund.

And who could have imagined that the ownership of stocks by institutional investors would rise from 10% in 1950 to 70% in 2015? Well, Peter Drucker did. See his 1976 book *The Unseen Revolution*, describing the 1950 genesis of General Motors' precedent-setting pension plan, designed to invest in "The American Economy." But he would have been appalled—appalled— to see how rarely these institutional owners would exercise their immense voting power.

Even a decade ago, who could have imagined that the intersection of technology and indexing would lead to the creation of a whole new way of providing investment guidance to individual investors. Asset allocation—not stock-picking or fund picking—is now well on its way toward becoming the principal function of the registered investment adviser (RIA). Or that low costs (low fees, and low-cost index funds) would become the desideratum of the rapidly emerging new system?

Will "Robo" advice work? Why not? The record is crystal clear that while the *average* RIA should be expected to match the *gross* return generated in our financial markets, and to lag the *net* return (after costs), even that expectation has proven to be optimistic. As professor Burton Malkiel wrote in a recent *Wall Street Journal* op-ed piece, a strict fiduciary standard—echoed in the theme of CFA Institute, "Putting Investors First"—"is likely to result in massive changes in traditional ways of doing business."

The lesson: *Don't take anything that you see today as enduring. Don't take it for granted.* Change and challenge will remain eternal. Technology will continue to change what we all do in ways that are just amazing. High-frequency trading and rock-bottom transaction costs are more likely to accelerate than diminish. The high costs of giant actively managed mutual funds will begin to decline significantly. Trading in stocks will gradually slow, replaced by the newest form of speculation—the exchange-traded fund (ETF). Are you aware that today's dollar trading volume in the 100 largest ETFs is now almost as high as trading the 100 largest common stocks themselves ($16 trillion annualized, vs. $18 trillion). Or that turnover in those ETFs is 1428%, eight *times* higher than in those stocks (179%)? I repeat the message: *Take nothing for granted. Nothing!*

Where Do We Go From Here?

Yet despite those massive changes, the eternal realities remain; realities that face the trustees of endowment funds, foundations, and philanthropies, as well as the wonderful investment professionals that are at the heart of our financial system. Focus on long-term investment, not short-term speculation. Focus on the costs of investment services—not only expense *ratios*, but expense *dollars*—the dollar amount of advisory fees that mutual funds pay to their managers—and never forget the hidden costs of portfolio turnover and the heavy burden of taxes. Focus on appropriate asset allocations relative to each client's investment goals. Focus on portfolio risk, for the day will come—indeed, I believe it is here now—when avoiding excessive risk is every bit as important as seeking high rewards.

And whether you are an investment professional or a portfolio manager; an investment adviser to a large pool of capital or to the retirement plan of a beginning investor; a client or a trustee of a pension fund, endowment fund, or a philanthropy, mind your investment behavior! By which I mean, take the long view. Hold hope, greed, and fear—the three classic enemies of investment success—at bay. It is ever thus.

Wrapping Up

Yes, I've been saying these things for four-plus decades at Vanguard and for almost a quarter-century before that at Wellington Management Company, under the tutelage of my great mentor Walter Morgan. Indeed, these ideas appear in that idealistic thesis on the fund industry I wrote at Princeton University during 1949-51. Dare I say that they have stood the test of time.

And, yes, they all lead to an important emphasis on considering a strategy of buying—*and holding*—broad-based, low-cost stock and bond index funds. (Pardon the commercial!) More than ever, index funds are being recognized as the only way to guarantee our clients their fair share of the returns generated in the stock and bond markets . . . whether those returns are positive or negative, whether they will prove to be above, below, or even far below, historical norms.

My quest may be a lonely one in the fund industry, *but I'm hardly alone in the larger world*. So don't just take my word for it. Heed Warren Buffett's "four Es:" The greatest *enemies* of the *equity* investor are *expenses* and *emotions*. And consider his formulation of Sir Isaac Newton's hypothetical Forth Law of Motion: *For investors as a whole, returns decrease as motion increases.*

Heed Benjamin Graham. When asked in 1975 to appraise our profession he said that, "most financial analysts and investment advisers are above average in intelligence, business honesty, and sincerity . . . but . . . they spend a large part of their time trying, valiantly and ineffectively, to do things they can't do well. . . . The average manager of institutional funds [cannot] obtain better results than the S&P Index over the years . . . The average institutional client should be content with the results of the [S&P 500] . . . [and] should require such results as a condition for paying standard fees to advisors." That's the day I dream of!

Heed Yale's brilliant endowment manager David Swensen in *Unconventional Success*, his book about personal investing:

> "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. The drive for profits by Wall Street and the mutual-fund industry overwhelms the concept of fiduciary responsibility. The powerful financial services industry exploits vulnerable individual investors. . . . *Ultimately, a passive index fund managed by a not-for-profit investment management organization represents the combination most likely to satisfy investor aspirations."*

The accumulated wisdom of Messrs. Buffett, Graham, and Swensen—three of the great minds of investing—hardly requires a genius to understand. But *acting* on that wisdom is never easy. Why? Because our investment system is based on *action*. ("Don't just stand there. Do something!) This is especially true today. The prospects for returns on financial assets in the coming years are unlikely to reach historical norms, and the temptation is to do whatever it takes to earn yesterday's return.

In stocks, reasonable expectations during the coming decade strongly suggest a return no more than 6% to 7% annually in nominal terms, *before* adjusting for inflation, investment fees and expenses, taxes on income and capital gains, and counterproductive investment behavior. Together, these costs could easily total 1% to 7% per year. Real, after-cost annual returns for stock investors, could range from 1% to 3% over the next ten years. (The arithmetic is an eye-opener!) Inflation is beyond our control, but investment expenses, taxes, and our behavior are, to a large extent, well within our ability to control.

The arithmetic for bonds is even worse. The benchmark 10-year U.S. Treasury note has a current yield of 2.2%, which is almost certain to result in a decade-long return of 2% to 3% per year. With a larger weighting of investment-grade corporates and a modest extension of maturities, a high-grade bond portfolio might allow a 3% *gross* yield. But after inflation, investment fees and expenses, taxes, and misbehavior (yes, it's a concern among bond investors too), *negative* real returns over the coming decade seem a certainty. Warning to trustees and managers of corporate and state and local pensions: the 7 ½% future return your pension funds are assuming is simply not going to be there—not with a 50/50 stock/bond portfolio unlikely to earn a *gross* annual return of much more than 4%, maybe a net return of 3% after investment costs and 1% or less after inflation.

Exceeding the market's return—net of investment costs—*may* be possible for a single fund or manager. *But it is impossible for all funds and managers as a group*. Seeking out higher-than-market returns and accepting higher-than-market risks is rarely advisable. Going further out on the long limb of risk is a dangerous choice. (Limbs have been known to break.) Even in today's environment of low expectations for future returns on financial assets, the most reliable strategy is to accept the markets' returns, get your clients' asset allocations right, hold investment costs to a minimum, and of course, keep your fingers crossed. That simple formula may not be the most brilliant investment strategy ever designed—especially to you who have done the challenging work of earning your CFA charters. *But the number of strategies that are worse is infinite.*

We cannot know the future, but we should expect surprises and challenges. No matter what happens, there is one simple strategy that will never steer us wrong: put our clients' interests first. At last, our investor/clients are poised to take their position at the forefront of our industry. To coin a phrase: *The arc of finance is bending towards fiduciary duty*. *"Putting investors first."*