The Wayback Machine - https://web.archive.org/web/20160808040025/http://johncbogle.com:80/wordpress/200…

FAIR SHAKE OR SHAKEDOWN?

JCB - Mar 15, 2006
The Wall Street Journal – July 8, 2004

Recently described on these pages as "a strange law enacted in 1940," the Investment Company Act is the foundation of the modern mutual-fund industry. It requires that funds be "organized, operated, and managed" in the interests of fund shareholders, rather than in the interests of their managers and distributors.

What is "strange" about the law, however, is not that it effectively ratified the pre-1940 Act standard that clearly separated the fund corporation from the management corporation that it employs to provide it with the administrative, investment advisory and distribution services it requires to exist. Rather, what is strange is that the Act failed to establish a structure that would facilitate the realization of its noble purpose: Put the fund investor first.

Last month, a courageous Securities and Exchange Commission took the first major step in accomplishing that goal, adopting a rule that requires the chairman of a fund's board of directors to be unaffiliated with — essentially, independent of — the management company.

It will take time for fund investors to benefit from that requirement. But standing alone, it is not enough to redress the existing structure in which the manager controls the fund, dictating the contractual terms under which it provides all of the services the fund requires in order to exist. It will also take further restructuring in fund governance.

An ideal governance structure requires, first, a far heavier representation of independent directors, and the new SEC rule requires that at least 75% of a board be independent, another forward step. Second, since individual fund directors often simultaneously oversee as many as 100 to 300 separate mutual funds in a given group, fund directors need an independent staff to provide to the board unbiased information that includes analysis of the investment returns, risks, management fees, expense ratios and capital flows for each of the funds in the complex. (The new rule authorizes, but does not require, such a staff.)

Third, this structure must be buttressed by a statutory standard of fiduciary duty added to the 1940 Act requiring directors to assure that funds are, yes, "organized, operated, and managed" in the interests of their owners. Such a standard should also provide guidelines for aiding directors in carrying out their trusteeship responsibilities.

The fund industry and its lobbyists vigorously argue that mutual funds need no such independent oversight. "Trust us," say the managers, "we'll do what's right because our reputation is at stake." And, as the recent scandals have shown, reputation risk is hardly to be ignored. Investors have pulled more than $100 billion out of the funds whose managers have betrayed their shareholder's trust. But these scandals represent only the tip of the iceberg in which the interests of fund owners are subservient to those of fund managers.

In the mutual-fund industry, relying solely on market forces has proved to be a weak remedy for bad behavior. As asset-gathering replaced prudent management as the industry's prime focus, fund expenses rose and nearly 500 new, largely speculative, "new economy" funds were organized and offered at the recent bubble's peak. The fund failure rate soared, with some 1,900 equity funds disappearing in the last decade alone, lost in the dustbin of history, often merged with other, better performing funds, under the same management.

If one accepts the idea that mutual funds are just another consumer product, and that consumers once burned — their hard-earned retirement savings devastated — will be twice shy, the present industry structure, although it hardly meets the statutory goal, is fine. But if one believes that the stewardship responsibility for other people's money is a sacred trust, it is high time for structural reform in the fund industry. For by allowing funds to be organized, operated and managed in the interests of their management companies rather than their owners, the fund industry has defied the principles of the 1940 Act.

Few have taken the trouble to examine the heavy penalties that managers have extracted from the returns earned by fund investors. During the past decade, for example, while the stock market has returned an average of 11.1% per year, the average equity fund has delivered just 8.6% — a 2.5 percentage-point shortfall roughly equivalent to the drain of the heavy sales charges, management fees and operating expenses, and portfolio turnover costs it incurred. (The notorious tax inefficiency of funds would extract several additional percentage points.)

To make matters worse, the returns earned by the average equity fund investor fell far short of that already unacceptably low net return achieved by the average fund. A recent comparison of the shareholder (dollar-weighted) returns of the 100 largest equity funds with the average fund (time-weighted) returns would have reduced that 8.6% figure to just 6.2%. To understand the enormity of that shortfall, consider that an 11.1% return on $10,000, compounded over 10 years, grows by $18,650, while a 6.2% return grows by just $8,250 — an astonishing shortfall of 56% in accumulated capital.

A recent study sponsored by industry giant Fidelity Management — which has a huge economic stake in maintaining the status quo that produced that grotesque shortfall — purported to show that funds with affiliated chairmen produced better performance for their owners, and with lower costs. But the study was badly flawed. By simply redefining the categories, one discovers that the study actually showed that the 889 funds run by banks and brokers provided by far the worst returns. The 1,326 other funds with affiliated chairmen provided returns that were somewhat better, but virtually identical to the results produced by the 89 other funds with independent chairmen.

Moreover, at the top of the Fidelity list — by a wide margin — were the 75 funds that do not allow even a single representative of their investment adviser to serve on their boards. (Full disclosure: All of these funds are members of the Vanguard Group, which I organized and which is still operated and managed on an at-cost basis by a management company owned by the funds themselves.)

It's only a matter of time — although, human nature and inertia being what they are, doubtless a long time — before a second fund organization recognizes that such a structure is one obvious response to the 1940 Act's original principles. So the developing new standards that have now begun with a more independent board structure hardly end there.

Capitalism ought to be about capturing the benefits of equity investment for those who put up the capital and take the risks. The record makes it impossible for fund managers to assert that they have achieved that goal for our 91 million citizens who own mutual funds. It is high time to put their interests front and center, rather than allowing the self-interest of fund managers to prevail. It's all about giving the shareowner a fair shake.

0 COMMENTS

The opinions presented in www.johncbogle.com do not necessarily represent those of Vanguard's current management.
© Copyright 2006-2011 by John C. Bogle