The Wayback Machine - https://web.archive.org/web/20170630092122/http://johncbogle.com/wordpress/2006/0…

HOW MUTUAL FUNDS LOST THEIR WAY

JCB - Mar 15, 2006
The Wall Street Journal – June 20, 2000

In the past 50 years, mutual funds have gone from a $2.5 billion also-ran in the financial-services industry to a $7 trillion titan. Funds now enjoy an unchallenged position of leadership, accounting for 70% of the $2 trillion that U.S. families added to their savings over the past five years.

But while mutual funds may be the best game in town, they aren't playing nearly as good a game as they should. The returns of fund shareholders in stock, bond and money markets have fallen far short of what is available in those segments. A diminishing focus on stewardship, shrinking investment horizons and soaring costs are responsible. The mutual fund industry has lost its way.

I've been studying mutual funds since 1949, when I began researching my senior thesis at Princeton University. The change in industry direction has been dramatic. Back then, the mutual-fund industry was more a management business than a marketing business; today the reverse is true. We have moved from treating funds as investment trusts designed to serve their owner-beneficiaries to treating funds as consumer products, designed to attract the largest possible assets. This new approach has ill-served the interests of fund shareholders.

A dramatic decline in investment horizons has also changed the industry. In 1950-65, funds were long-term investments; fund managers were long-term investors; and fund shareholders held their shares for more than a decade. Costs weren't excessive and mutual-fund performance measured up to the reasonable expectations of investors.

None of this is true today. Funds, once investments for a lifetime, now come and go at a remarkable rate. Some vanish when they fail to achieve their investment objectives, liquidated or merged into other funds. Others, created to reflect the investment fashions of the moment, disappear when the fad passes. The go-go funds of the late 1960s and the government-plus funds of the late 1980s are but two examples. Many of today's Internet funds and technology funds will probably meet the same fate.

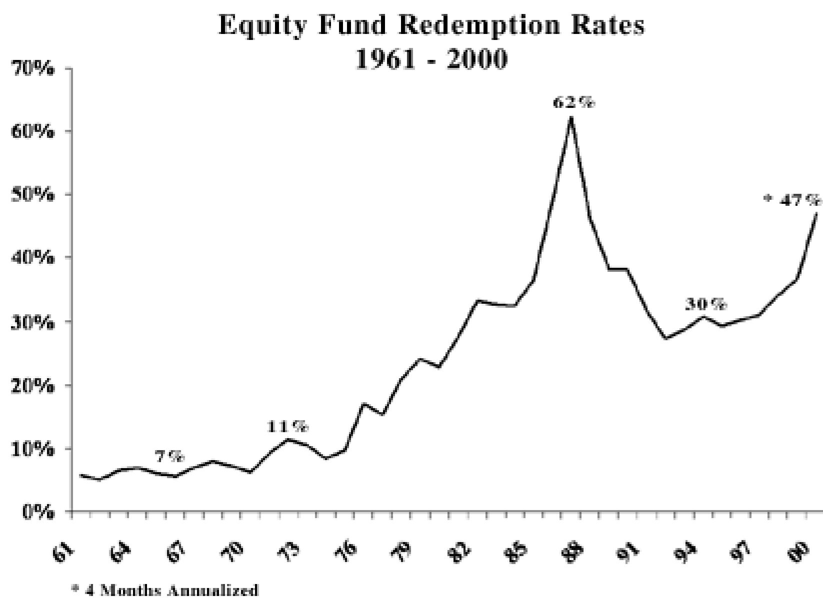
During the 1990s, 55% of equity funds failed, almost four times the 14% failure rate of the 1960s. Should the recent failure rate hold, 2,500 of today's 4,500 equity funds won't be around in 2010. Their owners will be victims of inferior performance and will be subject either to paying unnecessary taxes when they liquidate their shares or forced transfer to a new fund.

Fund managers, once long-term investors, have become short-term players — speculators, if you believe that holding stocks for an average of 406 days has little to do with investing. Fund portfolio turnover, averaging about 17% annually during my first 15 years in this industry, rose to 90% last year.

The hyperactive trading atmosphere of the day is partly responsible. But the shift in control from investment committee to portfolio manager has also played a major role. For better or worse, the industry's dominant force has changed from consensus to impulse. What's more, portfolio managers turn over at a rapid rate. The average manager lasts just six years, and then a new broom sweeps the portfolio clean. It seems there are few stars in the mutual-fund firmament, just many comets.

Since most fund trading takes place with other funds, the returns of fund investors as a group can't possibly be enhanced by all of this turnover. Its heavy costs create benefits that go largely to those who execute the transactions. The biggest beneficiary is the federal government, which has reaped billions of dollars from taxes on long-term capital gains — not to mention higher income taxes on substantial short-term gains. The premature realization of gains accounted for a major portion of the $30 billion of federal taxes paid by fund investors in 1999.

This contagious short-term virus has now spread to fund shareholders. Share redemptions, which ran at about 8% of fund assets during the 1960s and 15% during the 1970s, leaped to 30% during the 1990s, and are running at an astonishing 47% rate in 2000 (as shown in the nearby chart). This dramatic increase suggests that fund shares — once held by long-term investors for an average of 12.5 years — are today held for an average of just over two years. This is a sad fate for an investment that was originally designed to be the perfect medium for the long-term investor.



Redemption rates, meanwhile, are about twice as high as those published by the industry. Its data exclude redemption proceeds that are reinvested in funds of the same fund family. These exchange redemptions are about equal in amount to the regular redemptions that find their way into other funds, or individual stocks, or the bank, or to purchase a home or car.

All of these measures of mutual-fund investment activity — funds that come and go, portfolio holdings that come and go, portfolio managers who come and go, and fund shareholders who come and go — frustrate the achievement of long-term investment objectives. Equally counterproductive is the heavy burden of mutual-fund fees and expenses. When I studied the industry 50 years ago, expenses amounted to 0.77% of the assets of the average equity fund. This expense ratio has risen ever since. In 1999, it reached 1.61%, an increase of over 100%.

Given the staggering rise in fund assets, the surprising fact about the expense ratio is that it failed to decline. There are huge economies of scale in mutual-fund operations, but they aren't adequately shared with fund shareholders. The Investment Company Institute reports that even the lowest cost decile of funds has raised prices by 27% since 1980.

It is true, as the Investment Company Institute reports, that the annual cost of purchasing equity funds (including expenses and sales charges) is "only" 1.32% when weighted by fund assets. But according to its data, mutual-fund shareholders now pay estimated annual fees, expenses, and sales charges of $75 billion. Adding in estimated portfolio turnover costs of about $45 billion, mutual funds are generating returns of some $120 billion annually to their managers, marketers, and brokers — dollars that are diverted from the returns of fund shareholders.

These costs, along with heavy taxes, are responsible for the inadequate returns funds have provided their investors, returns that have fallen far behind those of the great bull market. During the past 15 years, equity funds — at least those that survived the period — provided a net return (after costs and taxes) of just 11.7%. By way of comparison, an index fund that owned the entire U.S. stock market — represented by the Wilshire 5000 index — would have earned a return, also adjusted for costs and taxes, of 16.1%. This advantage of 4.4% a year is larger than it seems. Compounded over the period, the average equity fund rose 426%, compared to 839% for the index fund. The fund shareholder received barely one-half of what might have been expected.

Investment horizons that are too short and costs that are too high are the principal problems facing the mutual-fund industry. The root cause of these failings is the industry's failure to focus on the primacy of the fund shareholder. It's called stewardship. The Investment Company Act of 1940 warns against organizing, operating, and managing funds in the interest of investment advisers rather than the interest of shareholders, but that warning isn't adequately heeded today. It is high time that fund managers and independent directors, as well as public officials and the media, give these issues the attention they deserve.

While my voice has been a lonely one, I am not without some important support. Henry Kaufman's insightful new book, "On Money and Markets," notes: "Basic fiduciary duty too often has been forgotten in the high-voltage, high-

velocity financial environment that has emerged in recent decades . . . the notion of financial trusteeship is frequently lost in the shuffle."

I hope that the mutual fund industry will find it, and will once again find its way.

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