Mutual Funds and Life Insurance: Contrasts and Parallels

Remarks by John C. Bogle, Chairman and Founder
The Vanguard Group of Investment Companies
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Thank you for your kind invitation.

I come from a business which operates on the principle of full disclosure. So, as a wandering stranger from the mutual fund industry in the midst of life insurance industry tycoons, I must start in with a disclosure about my heritage. My great grandfather, Philander B. Armstrong (1847-1927), spent his entire career in the insurance industry, founding several insurance companies, including the Phoenix Mutual and "The Armstrong." But he moved from advocate to reformer to antagonist during his years in the business. He was, as it happens, a believer that low costs were essential for policyholders, and he became something of a missionary. I have a copy of a speech he delivered to insurance executives in St. Louis in 1886 in which he said: "To save our business from ruin, we must undertake a vigorous reform and the first step must be to *reduce expenses*." (Italics in original). He capped his crusade in 1917 by publishing a book cataloging what he saw as the industry's sins. It was titled, *A License to Steal*.

Well, I didn't know all this history until long after I found myself following a remarkably parallel course in my own career in the mutual fund industry. I founded Vanguard—a mutual-type company—in 1974; my mission has been to make this a better industry for its shareholders; I too believe that my industry charges too much; and I've also written a book (*Bogle on Mutual Funds*—Grampa Armstrong and I seem to favor our family names!) that sharply criticizes many mutual fund industry practices. I quickly add that I have not come here to lecture you on your shortfalls, if any, but to draw some historical contrasts between our respective industries, and some parallel challenges both industries face today.

In this era of unprecedented enthusiasm for common stocks, mutual funds have become the dominant financial institution in the United States. Fund assets now total exceed those of bank savings accounts, life insurance reserves, and private pension reserves. The soaring success of the mutual fund industry—despite its faults—can truly be described as a phenomenon of historic proportion. I say that, not only as a student of the history of financial institutions, but one who has spent nearly a half-century in this industry. I think I have seen enough during this span to qualify as a thoughtful observer, though hardly either a disinterested or dispassionate one.

Let's go back for a moment to 1949 when I was a junior at Princeton University. I was reading an article in *Fortune* magazine ("Big Money in Boston") describing mutual funds as a "tiny but contentious industry with great potential." I decided on the spot to write my senior thesis on this then obscure field. And that I did, completing "The Economic Role of the Investment Company" in 1951. I liked what I saw, and decided to try to make a career of it. Walter L. Morgan—founder of Wellington Fund in 1928, and still alive and well today at age 99—liked my thesis and gave me a job. It was the first break of my business career.

Wellington was then a tiny company and mutual funds a tiny industry, dwarfed by America's other financial institutions. When I began with Wellington Fund (then our only fund) its assets were $150 million; mutual fund industry assets were $2.5 billion; life insurance assets were $55 billion. But, as they say, "a lot can happen in 50 years." Today, assets in the Vanguard Group mutual fund organization (of which Wellington Fund is a part) have increased 2000-fold to $300 billion; assets in the mutual fund industry have increased 1600-fold to $4.1 trillion; life insurance assets have increased 45-fold to $2.4 trillion. That's what happens over time when differential compound growth rates of, respectively, 18%, 17%, and 8%, come into play. "The magic of compounding" writ large!

I suppose what we have seen over the past half century—but especially in the past 15 years—what Austrian economist and Harvard Professor Joseph Schumpeter described in 1911 as "creative destruction"—the process by which one industry strikes at the heart of another by bringing to bear a novel approach to solving the needs of the public—in this case, its perceived financial needs. Few would disagree that there has been a sea change—"revolution" is not too strong a word—in the savings and investing patterns of America's families.

Four Stars That Have Shined On Mutual Funds

The principal basis for the revolution is not hard to find. Stocks have become the investment of choice by investors; bonds are playing second fiddle. Equities are the principal (but by no means entire) focus of the mutual fund industry, and equity market returns of +17% per year over the past 15 years were by far the highest for any major class of financial assets—importantly, in this raging bull market, with very little *perceived* risk. By contrast, bonds have been the principal focus of the life insurance industry. While bond market returns of +12% annually were extraordinary during this period—greatly improved over earlier periods, albeit with considerable inflation risk and volatility risk—they have provided only about two-thirds of the returns on equities. However, when these returns are compounded over fifteen years—stocks +900% vs. bonds +400%—we are talking, roughly speaking, about the difference between day and night. It would be little short of astonishing if this spread in financial market returns had not accounted for a large part of the striking differential in the growth rates of the two financial industries. Turning a famous quote on end, you in the life insurance industry could easily say, "the fault, dear Brutus, is not in ourselves, but in our stars."

The bull market, on the other hand, has been our shining star—for better or worse. But there have been at least two other stars that have shone on the mutual fund industry. One is the Federal tax code. In 1976, it was amended to enable municipal bond funds to exist; in 1980, it was amended to enable individual investors to open tax-deferred IRAs; and in 1984, it was interpreted as enabling the establishment of tax-deferred 401(k) thrift plans. These three salutary tax changes helped cause wide shifts in individual savings preferences and brought new focus on saving for retirement. And mutual funds had at the ready the investment programs to meet the needs of an increasingly different and ever-more-knowledgeable public. Together, municipal bond funds and investor-directed savings programs account for nearly one-half of the mutual fund assets today.

And we can't ignore another star that shines on us. The computer revolution. It provided us with communications technology, transaction technology, and record-keeping technology without which the mutual fund, as we know it today, simply could not exist. Imagine mutual funds without 800 numbers. Without daily asset valuations for retirement plan investments. Without the ability to handle huge daily cash flows. Without seemingly instantaneous liquidity (for our investors, as well as our portfolios). Without exchanges among funds. While technology, by encouraging the use of mutual fund shares by short-term traders, has played hob with the traditional principles of mutual fund investing for the long

term—creating serious potential problems as yet not fully recognized—it would be hard to argue that technology has not been a star in our industry's transformation and growth.

All three stars—magnificent equity markets, beneficial tax changes, and remarkable advances in information technology—set the stage for our industry's rise to fame and fortune. But there is a fourth star that has shone on us, and that star—creative innovation—we can claim as our own. During the past 15 years, the number of mutual funds has increased from 700 to 7,000. The industry has greatly broadened from its historical dependence on equities to include bonds (which, I emphasize, have performed well in absolute terms) and short-term investments (causing the cream of the savings market to desert banks in favor of money market funds). And equity funds now include not only those with the industry's traditional focus on U.S. blue chip stocks, but also funds emphasizing small cap stocks, international stocks, and stocks in particular industries.

Compared to perhaps a dozen funds in 1982, a major fund family now encompasses an average of 150 individual funds. Significantly, no-load funds—purchased directly, without sales commissions, by investors—now compose fully one-half of industry assets (including money market funds). "A fund for every investor, and for every purpose under Heaven" could serve as an accurate slogan for the modern mutual fund industry.

Beneath The Stars, Some Dark Spots

But, beneath these four stars that have shone on us, there are, from my perspective, some troubling dark spots. First, there is a developing tendency for funds to be treated as if they were individual stocks—actively traded in apparently commission-free marketplaces (where, in fact, fund investors end up paying large costs). Since the early 1980s, the average holding period for a mutual fund share has dropped from more than ten years to less than three years. The development of this "casino capitalism," it seems to me, is an absurd way to handle what I have believed—for nearly a half-century—to be the greatest long-term investment medium ever known.

Further, the marketing of mutual funds has become highly aggressive, too much so for an old-timer in an industry which I conceive of primarily as a trustee for other people's money, and not as a modern-day collection of Procter and Gambles, Budweisers, or Coca-Colas, hawking "consumer products" for their "franchise brands." In this business, investing is becoming marketing. *The message is becoming the medium*. And we appeal far too much (for me at least) to the desire to accumulate substantial wealth with ease, the apparent certainty of doing so through equity funds, and the ease of picking super-funds based on their past performance. To compound the problem, we simply fail to adequately address two critical issues: (a) the risks and (b) the costs of investing in mutual funds.

Marketing and distribution, of course, are highly expensive functions. So, "money is no object" seems to have become our industry's tacit watchword. But it is the fund shareholder whose money is no object, and the fund manager who reaps the benefits of the money spent on marketing, earning rising fees as the assets roll in. At the outset of the growth curve, some beneficial economies of scale may accrue to a fund's shareholders. Then, shareholders neither gain nor lose, and the benefits of growth accrue to the manager, who enjoys rising fees. Finally, as the fund grows to an extremely large size, fees continue to soar but asset growth constrains portfolio diversification and liquidity, negatively impacting the shareholders. They have paid to foster the fund's growth, and they have been disadvantaged in return.

In part because of soaring marketing expenses, fund expense ratios have risen sharply. Fifteen years ago, the expense ratio of the average equity mutual fund was 0.75% of assets. Despite the enormous

growth in assets since then (from $50 billion to $2.1 trillion for equity funds alone), today's expense ratio is 1.55%, more than double. Huge economies of scale exist in this business, but the fund manager, not the fund shareholder, has been the beneficiary. Adding in the transaction costs incurred by ever-higher fund portfolio turnover policies (from 35% per year to 90% a year since 1980) and the drag of cash reserves, it appears that the future returns of mutual funds may lag market returns by as much as 2.0% per year, compared to the 1.5% negative gap that existed shortly after Vanguard began.

Costs Matter

Does that gap matter? You bet it does. For in the long run, expenses make the difference between matching the market's return and falling far short. Call it the performance gap. Consider this extreme example: In a "normal" market environment, stocks have earned annual returns averaging +10%. But a 2.0% expense charge would consume one-fifth of that return. Compounded over time, the difference is enormous: a 10% return takes $10,000 to $1,170,000 over 50 years; an 8% return—the market return net of 2% expenses—takes it to $470,000. *There is a difference!* The investor has surrendered $700,000—about two-thirds of his potential accumulation—to the costly financial system. *And the system didn't even put up any of the initial capital.*

Thus fund expenses will *have to* come down—but probably only when today's carefree perception that costs don't matter (or at least don't matter very much) becomes tomorrow's economic reality that costs matter—enormously. Costs may, finally, be the difference between victory and defeat in wealth accumulation. (I should note that 50 years is hardly an "extreme" test period. People now begin a lifetime of working and investing—say, in a corporate thrift plan or an IRA—at age 25, and are still living off the fruits of their accumulation at age 75.)

The industry's unwillingness to recognize the relationship between operating costs and returns to investors—and its commensurate willingness to raise prices—opens the door to competitors—within the industry and without. In a conventional situation (and with stock prices soaring to all-time highs, today's situation is hardly conventional), the rising price structure of the industry should mean opportunities for rivals to come in and compete. In theory, here is where the life insurance industry comes in, as you have done with the development of your enormous variable annuity business (and perhaps ultimately, will do with variable life insurance). Variable annuity separate accounts are now a $400 billion business, in which the life insurance industry, I understand, provides about 45% of the distribution volume, but contracts out most of the investment management to the mutual fund industry, which has rapidly created separate account clones modeled on existing mutual funds (a requirement of the law that has always struck me as ludicrous). That is fair enough competition—and indeed the business that has developed has helped fund firms to prosper: a new business channel, as it were, and surely a product worth offering to supplement traditional fixed annuities.

But if variable annuities are the ointment, cost is the fly. For from my odd perspective—but I think also the perspective of other careful observers—the relatively high cost of variable annuities frequently completely eliminates the advantage of tax-deferred investing, and indeed sometimes results in a net disadvantage. This fact was brought starkly home to me when I recently saw an advertisement for a variable annuity by a large life insurance company. It described how "tax deferred compounding builds wealth faster." The ad depicted the results of an investment of $50,000 over 20 years earning an 8% average annual return (ostensibly the market return). A bold chart pointed out that at the end of the period the investment would have been worth $233,000 on a fully tax-deferred basis, a windfall gain of $87,000 over the value of $146,000 in a currently taxable program.

But then it offered a footnote: "the illustration does not reflect deductions for mortality and expenses for administrative charges or for specific portfolio management fees." To say the very least, that is quite an important omission. Since these fees might normally run in the area of 2.2%, the 8% market return would be reduced to 5.8%. Therefore the *true* final value of the fully tax-deferred investment would not be $233,000, but $154,000. The $87,000 surplus has been slashed by 91%, to $8,000. And after taxes payable on withdrawal from the annuity, the surplus has become a $24,000 deficit.

Given this example, is tax-deferral *really* "building wealth faster?" I think not. The power of extra costs and the power of tax deferral has destroyed. The "value proposition" presented in the ad has been turned on its head.

Competition, Cost, and Structure

So, the life insurance industry, like the mutual fund industry, had best keep cost carefully in mind. Because every day—again, in my biased view—there are more financially savvy, intelligent, self-motivated investors who realize that *costs matter*. Worse, from your standpoint, I fear, that there are lots of low-cost vultures out there that are eager to capture their business. Savings bank life insurance, for all its limited success so far, is one of them, and banks—with recently apparent Federal government support—seem eager to join the fray. TIAA-CREF (Teachers Insurance and Annuity Association-College Retirement Equities Fund) is another. Confession being good for the soul, I must say that Vanguard is another. What is more, low cost is not only our good fortune and that of our shareholders. It is our mission.

The premise on which we began the firm in 1974 was that we could succeed in serving investors faithfully and well by offering investment services on an "at-cost basis"—paying minimal advisory fees and operating expenses, and charging no sales commissions. (We went "no-load" in 1977.) And once we embarked on our strategy, at least four good things lay in prospect: (1) Shareholders would earn more money (primarily because our firm would not earn profits); (2) The focus would be on risk-averse investing, because our professional managers, with the cost advantage we afford them, would look good on the performance charts without taking extra risks with client investments; (3) We would form a minimal-cost market index fund immediately (and, yes, in 1975, the first one) because that should be a can't-lose-the-race-in-the-long-run proposition for investors; and (4) Marketing extravagance and the attendant hype would be minimized. (Why would we spend our shareholders' money on advertising when it enriches neither our clients nor our firm?) And indeed, we have been able to deliver on all four of those promises.

And by the superficial measures of the marketplace, the strategy seems to have worked. We are now first in the industry in long-term growth rate, first in current cash inflow, and second in net assets. At the moment, at least, my main concern is that we are getting so large that we have to work harder every day to avoid the bureaucratic tendencies that all too easily result from huge size, and be ever more careful to avoid the liquidity risk and over-diversification tendencies that arise when investing extraordinarily substantial investment assets. Fortunately, our initial decision, all those years ago, to run money in a conservative, quality-oriented, structured-policy way has been a great boon to us in dealing with the challenges of size. I suppose our biggest handicap, if such it be, is being viewed as "the enemy" in the mutual fund industry, where our goals and structure remain unique to this day.

But, it is our structure that engenders our mission. We can fairly, if loosely, be described as a "mutual" mutual fund complex. Our management organization is owned by the fund shareholders, and run on an at-cost basis solely on their behalf—not, as is the case elsewhere in our industry, by a privately or

publicly-held profit-seeking corporation. And that is the driving force of virtually every competitive advantage that we may enjoy.

In this context, I must candidly confess that it is not clear to me why the major life insurance companies (and, for that matter, the rapidly-vanishing savings banks) have apparently not been able to capitalize on their mutual structure to demonstrate the same kind of "sustainable competitive advantage" that we seem to enjoy (at least according to Harvard Business School strategic guru Michael E. Porter). After all, the mutual structure was developed by leaders of your industry—Grampa Armstrong among them—long before the U.S. mutual fund industry was born in 1924.

I admit there is a key difference: a mutual fund balance sheet is composed entirely of equity capital, bereft of debt, and the capital required to enter this business--if you are patient--is close to zero. On the other hand, life insurance companies and savings banks have, in effect, an enormous book of policy (or savings) liabilities with a fixed call on assets, and require at least some significant capital. But the basic similarity is profound: all three structures—mutual life insurance companies and their policyholders, mutual savings banks and their depositors, "mutual" mutual funds and their shareholders—were designed to put the client in the driver's seat. A structure in which the client is treated not as a mere customer, but as an owner, has a wonderful mission and even ethical virtues. And that structure must lead to a strategy that is founded on delivering services at the lowest reasonable cost. And I maintain a profound conviction that low cost is the key to long-run success in the financial services field.

It is curious to me, in my ignorance, that the insurance industry seems to be moving away from the mutual structure, a change apparently fostered by capital needs as well as an increasingly hostile tax environment. There are 25% fewer mutual companies today than a decade ago. Mutual companies are developing new hybrid forms, creating special operating units that can issue stock. Paradoxically, even the mutual funds formed by mutual life companies are not truly mutual. (Now there's an awkward sentence!) What I mean is that, for whatever reason, none of the insurance-sponsored mutual fund families has chosen to adopt a structure like Vanguard or TIAA-CREF.

Whether insurance company or mutual fund, whether mutual in structure or stockholder-owned, however, all providers of financial services face the "distribution dilemma." In the mutual fund industry, I can state with confidence that the dilemma is the direct, frontal conflict between "low cost" (which impacts the long-term returns earned by investors in the financial markets) and "distribution power" (which is, today at least, virtually mandatory—and expensive—in the asset gathering process). In the long run, I believe the balance will shift toward favoring the client rather than the distribution system.

Why? Because investors are beginning to recognize that the allocation of assets between equities and bonds—not the selection of particular mutual funds—is what will control their long-term returns, and that active managers claim much but, as a group, deliver nothing. And the reason is simple: costs make the difference. Those who ignore this plain fact, faced by low-cost service providers, run the risk of falling victim to Schumpeter's principle of creative destruction.

I do not suggest that chartered life underwriters, financial consultants, and other personal financial advisers are not necessary. In the process of establishing and implementing a sound investment program, and in estate and tax planning in this complex world, they are often essential. They deserve to be paid, and paid well, for the value they add. But, in the competitive market for financial services today, we must *all* be working, however painful, to rein in excessive marketing and distribution costs, and run our investment management, financial planning, and general operations with an eye toward much greater cost efficiency. As Grampa Armstrong said in his speech to insurance leaders in St. Louis 130 years ago: *"Gentlemen, cut your costs."*

In the information revolution that is upon us, many of the expensive, once-tedious tasks of financial planning in the face of multiple variables—including market returns, inflation, and taxes—is now far less complex and costly. Websites on computers all across the land can do the unimaginable. Professional help is still required—but against the background of an investing public that, quite literally, becomes better informed with each passing day. Our challenge then, is the same as the challenge facing every industry on the face of the globe: providing better services at lower costs, or preparing to be creatively—if gradually—destroyed. It is a challenge that faces each one of us.

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