Has Your Fund Manager Betrayed Your Trust?
Consider the "Stewardship Quotient"

Keynote Speech by
John C. Bogle, Founder and Former CEO, The Vanguard Group
Before
The American Institute of Certified Public Accountants
Personal Financial Planning Conference
Las Vegas, NV
January 5, 2004

Ever since the first of the mutual fund scandals came to light shortly after Labor Day 2003, the circle of fund organizations involved has continued to grow. To date, more than a dozen firms have been implicated in some form of late trading (*illegal* manager behavior) or international "time-zone" trading (*unethical* manager behavior), with many of the charges brought by New York Attorney General Eliot Spitzer, Massachusetts Secretary William Galvin, and the Securities and Exchange Commission already settled, resulting in substantial and well-deserved financial penalties imposed on the managers.

Make no mistake about it. Most of the firms involved in the scandals are major industry participants. Their aggregate fund assets of nearly $1.2 trillion represent nearly 20% of the industry's $7.2 trillion total. As the scandals have unfolded, investor reaction turned from incredulity to revulsion, and then to self-defense, with rising share liquidations at the firms that were affected. Even the firms that have so far received only subpoenas for information seem cautious about declaring their innocence, for it turns out that virtually all 401(k) transactions take place long after each day's 4 p.m. cut-off time for executing orders. What is more, one of the two prime clearing-houses for these transactions has been forced out of business. And there may be more enforcement actions to come.

The public judgment that these firms have betrayed the trust of their clients coincides with my own. And I see no reason why the reaction of those clients should not be harsh. What's really the point of keeping your money with a firm that has betrayed your trust? Even the new CEO of one of the largest firms involved seems to agree. " . . . There were individuals here," he said, "who had a lapse of judgment and who put their interests first ahead of shareholders . . . I believe that was the wrong judgment. *When an investment professional violates a fiduciary trust, you don't get a second chance*. And I don't think there's a statute of limitations." Amen!

If you, as investment advisers, share my views, where should you turn to replace those funds that have failed to measure up to the trust that you and your clients have placed in them? In my view, you should select funds from those organizations that have strived to strike a proper balance between the interests of fund shareholders and the interests of fund managers—those who, if you will, have placed a heavier weight on stewardship than on salesmanship, those who have done their best to put service to shareholders above service to themselves.

Look, I'm not naïve about this subject. *Every profession has elements of a business*. No organization in which expenses exceed revenues will long exist. But when I look at some of our nation's proudest professions—medicine, law, accounting, journalism, architecture, and, of course, trusteeship—I fear that the traditional balance has been gradually shifting away from that of trusted profession and toward that of commercial enterprise. Writing in *The New York Times Magazine* two Sundays ago, Roger Lowenstein bemoaned the loss of the "Calvinist rectitude" that had its roots in "the very Old World notions of integrity, ethics, and unyielding loyalty to the customer." "America's professions," he wrote, "have become crassly commercial . . . with accounting firms sponsoring golf tournaments" (and, he might have added, mutual fund managers not only doing the same thing, but also buying naming rights to stadiums). "The battle for independence," he concluded, "is never won." And so it is in the field of investment management.

A Challenge to Judgment

I have no particular wisdom to offer other professions about returning to their roots. But I do have some ideas on that score about the trusteeship of other people's money. What I'd like to do this afternoon is to challenge you to evaluate the firms who manage the funds that you offer to your clients in terms of the extent to which they appropriately balance the conflicts between business and profession. The scandals have given us all the opportunity to address that balance in a new light, for, when you think about it, the scandals have arisen when fund managers have clearly put their own interest in asset-gathering, business-building, and the maximization of fee revenues ahead of the interest of their fund shareholders in financial integrity, fair treatment, honest disclosure, and optimal investment returns.

But the bane of the scandals, truth told, is a blessing in disguise. For they awaken us not only to the shoddy illegal and unethical practices of various extreme forms of "market timing," but to the damage done by the equally pernicious but far more subtle forms of mutual fund market timing—in which all too many fund investors engage, and which the fund industry has aided and abetted. I'm speaking of the creation of style-box funds and sector funds, bought today to be sold on some date near or far, rather than truly diversified equity funds bought to be held, well, forever.

We have come a long, long way from the mutual fund industry that I joined in 1951. Then, the field was composed primarily of funds whose returns would more or less track the stock market itself; funds with low costs and low portfolio turnover; funds designed for long-term investors; and fund managers that measured up to this standard: *We sell what we make*. What a difference a half-century makes! Today, most of the funds that our industry offers to investors are relatively undiversified funds with high costs and high portfolio turnover; funds designed for market traders and short-term speculators; and fund managers that hew to a new standard: *We make what will sell*.

Happily, there are still funds and fund managers that have tried to hold the fort against the industry's new paradigm in which marketing has superceded management. When and if you decide that you and your clients have had enough of the sharp practices and misbehavior that have characterized the scandalized firms and decide to move assets to another fund or organization, it is these firms that I believe you should consider. Truth told, even if the funds you've been working with are not—or not *yet*—participants in the scandals, you might consider using the standards I'll shortly present to re-appraise how you think about *all* of the mutual funds that you favor with your trust.

The Stewardship Quotient

You know as well as I do—maybe better!—that past performance is a highly unreliable guide to the returns funds earn in the future. So I recommend that funds be considered (or, for that matter, ignored) by the extent to which they place the interest of their shareholders ahead of the interest of their managers—the very principle suggested by the Investment Company Act of 1940. When the Act says that mutual funds must be "organized, operated, and managed" in the interests of shareowners rather than in the interests of "investment advisers and underwriters" (i.e., distributors), it places the stewardship of investor assets over the salesmanship of the, well, "products" of the managers. Through what I call the *Stewardship Quotient* (SQ), we can measure twelve elements that help to reflect the degree to which the funds balance these two distinct, and often competing, interests. **Exhibit 1.**

Before I describe these twelve elements, a disclaimer. *I offer the highly subjective viewpoint that was the driving force in my creation, 30 years ago this coming September, of a firm that would hold stewardship as its highest principle.* Even though my career has, alas, reflected those values of stewardship imperfectly, you may regard my listing of these elements as self-serving, especially since the model of a fund group with a mutual, shareholder-owned structure has yet to be emulated, or even *copied*. Perhaps it is. But please know that I gain no pecuniary benefit by fostering these standards, only the profound conviction that they are the right ones for fund investors, the right ones for you, and, in the long run, the right ones for the fund industry.

Exhibit One will help you follow my reasoning. Entitled "The Stewardship Quotient," it lists twelve of what I consider to be the major differentiators that determine the degree to which a fund organization's priorities lie in serving the interest of its fund owners, versus the interest of its own officers, employees, and stockholders. Please be my guest in thinking about how you'd rate a given fund manager on each of these twelve criteria, from three points (best) to zero (worst). Then calculate the manager's SQ by adding up its scores, dividing the sum by 18 (the median score) and multiplying the result by 100. For example, a firm with two points in each category (24 in total) would have an SQ of 133.

Now, let me cut to the chase, examine the twelve standards, and tell you the ratings that I would favor.

1. **Fund Costs – Management Fees and Operating Expense Ratios.** Nowhere is the conflict between fund managers and fund shareholders more sharply and obviously manifested than in the level of management fees and operating expense ratios—from 2.21% for the high-cost quartile of equity funds to 0.65% for the low-cost quartile—a 1.56% differential that accounts for nearly 70% of the 2.38% enhancement in annual returns earned by the low-cost quartile over the past ten-years. (This pattern is *not* period-dependent; during the 1983-1993 decade, the return enhancement was an almost-identical 2.27%.)

Exhibit 1.

Manager Name ________________________

The Stewardship Quotient*

SQ Scores

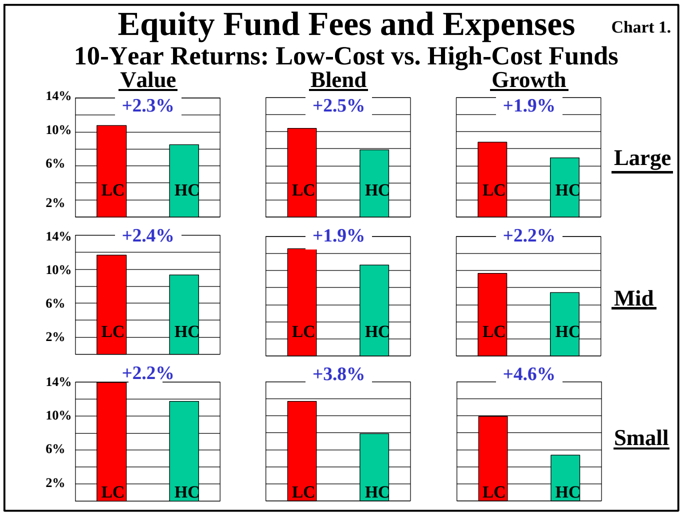
	3	2	1	0	Score
1. Management Fees and Operating Expense Ratios	Very Low	Below Average	Roughly Average	Above Average	______
2. Equity Portfolio Turnover	Under 30%	30%-60%	60%-100%	Over 100%	_____
3. Equity Diversification	Owns total market	Large cap-blend	Other style box	Sector Fund	_____
4. Marketing Orientation	Sells what it makes	Gives in, but rarely	Gives in sometimes	Makes what will sell	_____
5. Advertising	None	Limited	Extensive	Performance	_____
6. Pays for Shelf Space	No	Broker-Dealer Low pay	Broker Dealer High pay	Supermarkets	_____
7. Sales Commissions	Strictly no-load	No-load with small 12b-1 fee	Low-load	Substantial sales loads +12b-1 fees	____
8. Shareholder Stability (Redemption Rate)	Under 20%	21-35%	36%-60%	Over 60%	_____
9. Limitations on Fund Size	Clear size limits	Frequent fund closings	Rare fund closings	No limits on size	_____
10. Experience, Stability of Portfolio Managers	More than 15 years	10-14 years	7-10 years	Less than 7 years	_____
11. Insider Ownership of Fund Shares	Large, in many funds	Moderate, in many funds	Moderate, in few funds	Small or none	_____
12. Organization of Manager	Mutual	Privately owned	Publicly owned	Conglomerate subsidiary	_____

Total Points ________

SQ* ________

*** Stewardship quotient for manager = (Total score ÷ 18) x 100**

The relationship between expense ratios and returns is consistent not only over time, but over styles as well. In seven of the nine Morningstar "style boxes," the gap is remarkably consistent. The range of annual returns of the highest-and lowest-cost quartiles run between 1.9% and 2.5%, rising to 3.8% and 4.6% respectively only in the small-cap blend and small-cap growth areas, which have relatively few funds. **Chart 1**. Such a gap, of course, is intuitively obvious: If all of these expert professional fund managers, competing with one another, are, and indeed probably *must* be, average *before* the deduction of costs, then it is costs that will differentiate them.



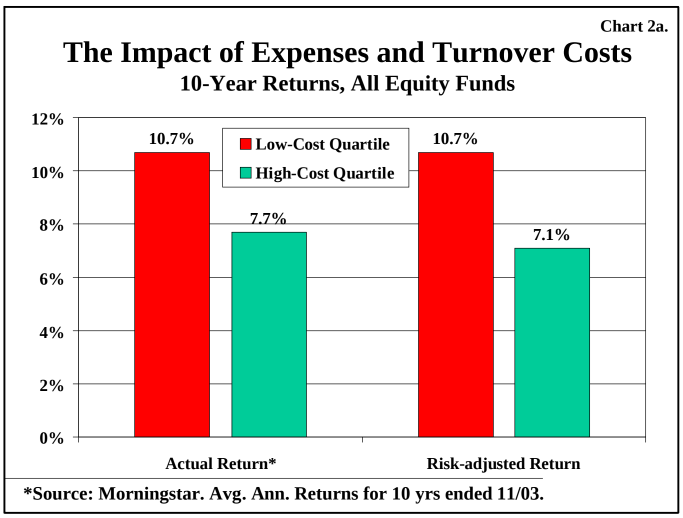
One major aspect of stewardship, then, is the setting of management fees, reconciling the clear conflict between managers (who seek to maximize their fees) and shareholders (who benefit by minimizing them). Lower fee rates, therefore, reflect a higher stewardship score. Since lower expense ratios clearly lead to higher returns, it is only common sense for fund advisers to do their fund shopping in the low-cost quartile[1]. For when you select a mutual fund for a client, you get what you *don't* pay for. *You get what you don't pay for*. So give three "stewardship" points to the tiny handful of firms with *very* low costs, and none to those above the (high) industry norm.

2. **Portfolio Turnover.** A similar inverse relationship exists between a fund's portfolio turnover and its returns: *Higher turnover correlates with lower returns*. For example, the lowest-turnover quartile of equity funds (average turnover of 15% per year) earned fully 2.3 percentage points of extra annual return vs. the highest-turnover quartile (an amazing *average* turnover of 176% per year). **Chart 2**. This relationship too was remarkably strong, ranging from about 1% to 2.3% in eight of the nine style boxes, but reaching 3.9% in the small-cap growth group. These return gaps appear to reflect largely the *costs* of turnover. For taxable investors, however, turnover also increases the tax burden, and on an after-tax basis the advantage for the low-turnover quartile rises from 2.2 percentage points to fully 3.1 percentage points. Let's award three stewardship points for lower turnover (say, below 30%), and none at above 100%.[2]

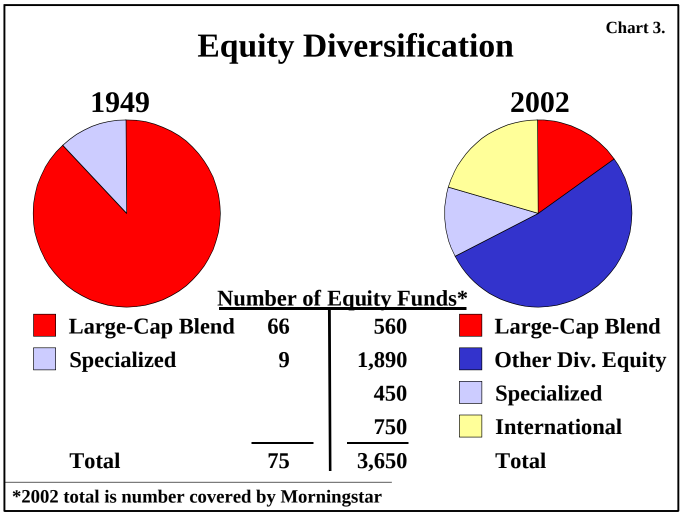
[1] It's also a good idea to look at the *dollar* amount of fees as well as the fee rate. 1% for a $100 million dollar fund may be reasonable; even ¼ of 1% for a $30 *billion* fund—$75 million per year—may be excessive.

[2] Like management fees, there may be special considerations regarding turnover. Quantitative funds, for example, often have turnover in excess of 100%, but they typically are effective at minimizing transaction costs.

Interestingly, if we look at funds on a *total* cost basis (including expense ratios *and* turnover costs, which I've estimated at a conservative 1% of the turnover rate i.e., a cost of 0.5% for a fund with a portfolio turnover of 50%), we find a combined cost/benefit ratio that is even *stronger* than its two individual parts. The combined expense/turnover cost ratio for the lowest-cost quartile is 0.97%, and for the highest-cost quartile 3.43%, a cost-advantage of fully 2.46% per year. This gap is manifested in an even larger three percentage-point advantage in annual performance—10.7% vs. 7.7%. **Chart 2A**. Since the high-cost funds (annual standard deviation of 23.7%) have assumed about 30% *more* risk than the low-cost funds (standard deviation of 18.1%), the gap in risk-adjusted returns is even larger: Low-cost quartile 10.7%, high-cost quartile 7.1%, a huge 3.6 percentage-point *annual* edge in risk-adjusted returns for the low-cost funds. Whether we like its decision or not, the jury is in, and has rendered its verdict: *Costs matter*. Funds that are managed with a view toward low operating and turnover costs for their investors reflect a significantly higher concern for the stewardship of investor assets than their peers.



3. Equity Diversification. Even as stewardship has something to do with organizing, operating, and managing mutual funds that have low costs and low turnover, it also has something to do with offering mutual funds that are very broadly diversified and designed to be held for the long-term. At one extreme lies the all-stock market index fund, owning essentially all of the publicly-traded equities in the U.S. and holding them forever. At the other extreme, we have the specialty funds, investing in narrow market sectors such as telecommunications and technology, ultimately created for trading purposes. And in the middle lie the funds following various style specialties—mid-cap value, small-cap growth etc., representing a bet that, at least from time to time, these styles will outpace the market as a whole, and can be owned as part of a portfolio and/or traded on an opportunistic basis. In its early era of stewardship, the fund industry was dominated by broad, market-oriented funds. **Chart 3**. But in its recent era of salesmanship, such funds have found themselves in the minority, surrounded by an army of more specialized funds with narrow policies.

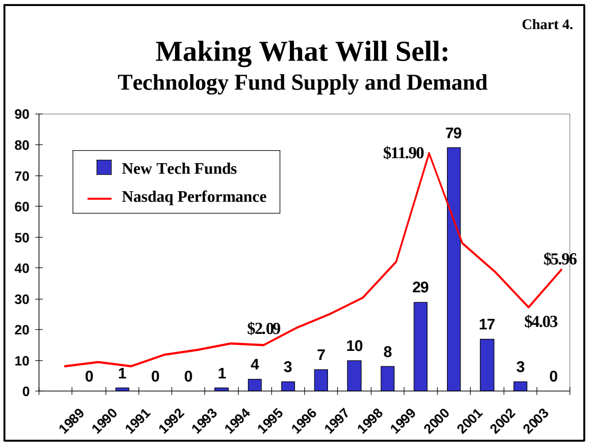


I admit to a strong bias toward highly-diversified funds, especially low-cost index funds. Why? Because they deliver no more nor less than what they promise—as close to 100% of the stock market's annual rate of return as is achievable. Because of costs, beating the market is by definition a loser's game for investors as a group, so earning the market return itself is a virtual guarantee that an investor will, over the long-term, accumulate more assets than his neighbors. I'd award three stewardship points for highly-diversified funds (including all-market index funds) and none for sector funds.

4. Marketing Orientation. What is more, the record is clear that the gap between the returns earned under the highly-diversified, low-cost, broad market concept, relative to the more concentrated funds-as-individual-stocks concept, is far larger than the cost differential. Why? Because the cost differential reflects only the *economic* component of the investment management service. But there is also large *emotional* component to the returns earned by investors. Since buying and holding the entire market is apt to entail far less trading and far less emotion, such investors actually earn the market return.

But when fund managers act as salesmen of specialized funds, investors almost universally act at the *wrong* time. They favor the fads that are in the momentary limelight, in the expectation that investors will take the bait. Partly because of their own greed, investors do exactly that, jumping in *after* a particular style peaks, and just *before* it goes, well, out of style. As a wise man said, "the issue is not people with *investment* problems, it is investments with *people* problems."

Fund managers cannot possibly be unaware that the best time to *sell* an exciting new fund concept is usually the worst time to *buy* it, a trend so clearly illustrated by the industry's forming more and more technology funds as their prices soared. Early in the 1990s, for example, it was rare to see more than a single new tech fund created in a single year. But in 1998-2001, 133 new tech funds were created. After the fall, of course, the number plummeted, with only three tech funds created in 2002, and none in 2003. **Chart 4**.



The manager's range of choice between solid, diversified funds that largely reflect the stock market as a whole and narrow, specialized funds whose popularity blows back and forth in the market winds is a powerful reflection of its emphasis on stewardship vs. salesmanship. The fact is that the highest stewardship is reflected by managers with the strongest discipline against pandering to the public taste for the hottest new investment ideas, especially those managers who limit their offerings to what they do well—maybe a single fund or even a half-dozen. Managers who jumped on the "new economy" bandwagon a few years ago and lured in, collectively, hundreds of billions of investor dollars that went up in smoke when the bubble burst, were firms that *made what would sell*. No stewardship points for them; three points for firms that simply *sold what they made*.

5. Advertising. When it comes to advertising, the stewardship-salesmanship orientation is patently obvious. Who *pays* for it? The existing shareholders of the fund. Who *benefits* from it? The managers who gain revenues by enticing new shareholders to invest in the fund. (It is often argued that the manager is spending "its own money" to promote the fund, but of course it is the fees paid by shareholders that are the source of this money, which could otherwise be waived and returned to the fund.) There is simply no evidence whatsoever that advertising benefits fund investors by bringing in new assets adequate to create economies of scale that offset the amount spent.

But there is considerable evidence that building fund assets above a certain size impinges on its manager's ability to create superior performance. In generating costs to investors, advertising expenditures reflect a serious question about stewardship; spending these dollars to promote fund growth suggests that salesmanship is in the driver's seat. For whatever reason, most fund firms find it necessary to spend shareholder dollars to promote new and existing funds. So I'd award the three point maximum to firms that don't advertise, two points to those that do so only on a limited basis, and one point to those whose advertisements are rife. (Keep your eyes open!)

But zero points to funds that advertise their performance. Why? Because, almost universally, we advertise only our most successful funds, and we do so only *after* they have generated high returns. When they fail or when the stock market has tumbled, we lapse into complete silence. Ads that follow that pattern strike me as inherently misleading. When, at the stock market's peak in March 2000, 44 funds advertised in MONEY magazine, preening about returns that averaged an astonishing 85.6% during the preceding year alone, could fund advertisers really have been thinking stewardship? Today, 3¾ years later, it sure looks a lot more like salesmanship. **Chart 5.** Of those 44 funds, nine no longer exist. The average return of the funds that survived came to *minus* 39.5%, a mere 125 percentage points short of the gains they had so recently touted.

Chart 5.

Performance Advertising

Perception

Average annual return touted by 44 funds advertising in March 2000 issue of Money magazine:

85.6%

Reality

Average cumulative return earned by those same funds from March 2000 through November 2003*:

-39.5%

***Does not include the performance of nine funds which no longer exist.**

6. Shelf Space. When funds pay for "shelf-space" to build distribution, fund advertising finds a baneful counterpart. A decade ago, when the first of today's mutual fund supermarkets came into existence, it was a transforming moment for the industry. No longer would investors pay their own commissions or transaction costs when they shopped there. Rather, the managers whose funds were effectively listed for sale would pay for what came to be known as "shelf space," a marketing concept if ever there were one. Few observers expressed concern that the apparent ability to make what appeared to be "free" transactions would lead to a rise in market timing or to a high-turnover mentality by investors; or that *all* of the fund's shareholders were effectively paying for the shelf space even though *few* of them were actually utilizing the service.

It wasn't long, of course, before the national wire houses that did *not* view themselves as supermarkets demanded similar treatment. As the going rate for bringing in assets rose—from 0.20% to 0.25%, to 0.30%, to what now seems to be 0.40%, firms that never considered their funds to be "products" of "supermarkets" soon found that sharing their management fees with brokers was a requisite to receiving the broker's support. Somewhere along the way, an important line was crossed, and stewardship was on the wrong side of it. So for me, three points for funds that will have no part of paying for shelf space, one or two points for funds that are paying for broker-dealer space, and zero for funds that are spending their shareholders resources (directly or indirectly) on supermarkets.

7. Sales Loads. It is no secret that the fund industry, like the financial services industry in general, is in many respects a marketing business. Indeed, we would be but a fraction of our giant size today had there *not* been securities brokers and salesmen to carry our message to investors who otherwise might have learned about mutual funds not only far later, but with far less information. Although its costs obviously detract from the returns investors earn, that information service is essential and it has value. But I'm not at all sure that we are getting the *right* information to investors. We focus on past performance, knowing that, if it is not negatively correlated with future returns, the linkage is anything but causal. To earn their keep, advisers should focus their clients on factors such as sound asset allocation, broad diversification, low cost, and simplicity.

But when investors have already paid sales commissions to own the funds involved in the scandals—especially if they have done so recently—they should consider reinvesting in funds that don't carry commissions. They've already bought the ticket for their investment voyage, and they shouldn't have to buy it again. So they should seek out funds that meet the standards of stewardship that have been, to some degree at least, ignored in the funds they held. Even if they are subject to penalty sales charges when they redeem, it's probably better to move out rather than continuing to pay 12b-1 fees for years more.

In broad generalization, no-load funds are less engaged in salesmanship than load funds. After all, the purpose of the load is to compensate a salesman. So I'd think about awarding three stewardship points to *pure* no-load firms, and drop it to two points if a small 12b-1 fee is charged. While there are a number of good fund managers with reasonable sales charges and 12b-1 fees, the fact is that these costs are a significant drag on returns. So consider awarding no stewardship points for these funds; if you think other factors so dictate, award one point.

8. Shareholder Stability. During my first two decades in this business, market timing was anathema. Shareholder redemptions averaged about 8% of assets, suggesting a holding period of 12-plus years for the average investor. But the redemption rate then began to steadily rise, reaching an average of 41%(!) in 2002, a holding period of just 2.4 years for the average fund investor. Amazing!

Part, but only part, of the increase was accounted for by illegal late-trading and by the international time-zone trading that I described at the outset. (The average redemption rate for international funds is more than 100% per year!) But the largest part is accounted for by the fact that we've created an industry of funds with relatively narrow styles and funds focusing on concentrated sectors; funds, if you will, bought by investors, not to be held for an investment lifetime, but to be sold at some point along the way. That the investors who engage in such foolishness are playing a loser's game (unless, of course, they're given free rides through late trading and time zone trading!) is only the tip of the iceberg. The problem is that substantial trading volumes generate costly portfolio turnover for the fund itself, a disservice to all those investors who trusted the fund managers to be their faithful stewards.

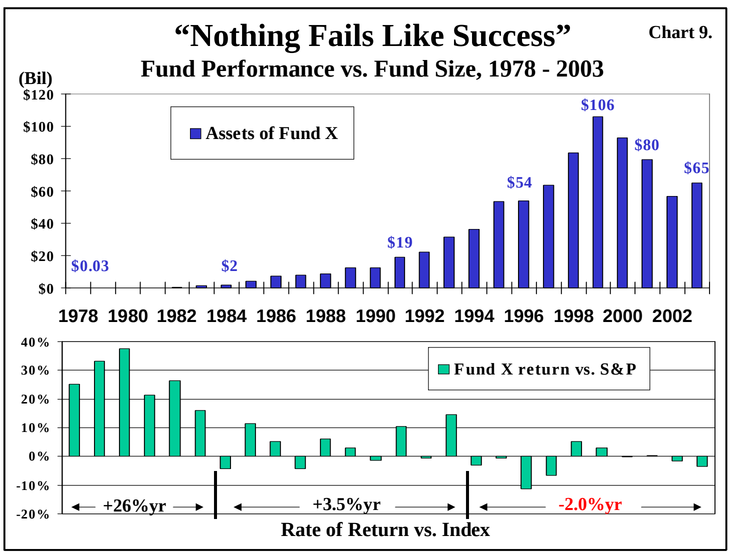
The proof of the pudding is in the eating. If funds are heavily focused on stewardship, they ought to have redemption rates, in today's foolish high-fund-turnover environment, of no more than about 20%. (About 1800 funds, or one-fifth of the total, meet this test.) While that seems like a high number to me, let's award them three full stewardship points, with two points with rates somewhat below the current 42% norm—say 20% to 35%—and a stingy one point if the redemption rate stays below 60%. But zero points when rates exceed that level, along with a warning that when redemptions exceed 100% of fund assets (there are, unbelievably, 1,133 mutual funds in that category!) there must be heavy market timing going on.[3] (If you want to *subtract* a stewardship point for firms that countenance—or even encourage—high levels of trading activity, or *add* a point for those that have voluntarily imposed a redemption fee on short-term trades, please be my guest.)

9. Limitations on Fund Size. Many, perhaps most, managers are in the business of gathering the maximum possible amount of assets, the better to increase their fee revenues. Yet it is no secret that, in the field of investment management, "nothing fails like success." Promoted aggressively, funds with apparently superior performance records draw large amounts of capital, and eventually get muscle-bound; their investable universe shrinks; the impact of their portfolio transactions on the prices at which

[3] Some idea of the fund's interest in serving long-term owners lies in the number of round-trip transactions allowed to a shareholder during a twelve-month period. Two round trips is on the low side (though it seems a lot to me!). If eight or more are allowed, no stewardship points.

the buy and sell rises; and soon their ability even to strive to recover the glory of their early days has vanished. A perfect example is a fund (call it Fund X) whose glory days in 1978-1983—annual return of 26% above the S&P 500—carried its assets from $30 *million* to $2 billion. **Exhibit 9**. It did fine in the *next* ten years, too (+3½ a year ahead), growing to $31 billion, on the way to $100 billion in 1999. But the *performance* momentum had long since come to an end. Fund X has fallen short of the Index return in seven of the past ten years, and its return has lagged the Index by 2% per year.

In cases like this, salesmanship is clearly in the driver's seat, and any notion of stewardship seems powerless to influence the speed and direction of the automobile. While some funds (for example, index funds and other funds with very low turnover) are relatively immune to the burdens of dinosaurism, most funds are not. So I'd award three stewardship points to firms that announce in advance any limitations on assets (and then live by them!), two points to those that frequently close funds to new investors so as to preserve their investment characteristics for existing shareholders; just one point to firms that have closed funds, even if infrequently and too late, or, even worse, have announced the closing *in advance*, a sure-fire way to *increase* cash flow; and a zero to funds that are allowed to grow without concern for the obvious consequences.



10. Experience and Stability of Portfolio Managers. A critically important part of measuring stewardship is what happens behind the scenes of fund management. Do the managers act like, well, *stewards*? It is not easy to measure trust and confidence and integrity, but information about the age, education, professional experience, and tenure of fund executives and portfolio managers is widely available. In general, I would cast my lot with the veterans who have worked through a market cycle or two, who can clearly articulate their philosophy and strategy, and who run portfolios that give living expression to those factors. Typically, it seems to me, such managers also focus on the long term, whether they emphasize what are (rather crudely) called value stocks or growth stocks.

Morningstar reports that the typical portfolio manager runs a fund for just *five* years, which seems a long way from stewardship to me. Consider a typical shareholder who owns five funds—and holds them, however unlikely that may be, over an investment lifetime. Employing 50 different portfolio managers over 50 years seems much more like a choice of "products" than the selection of a trustee. So I'd reserve three stewardship points for managers with something like 15 years of experience and tenure, with no points (except under special circumstances) for those with less than seven years on duty.

More than incidentally, while we've come to think about "portfolio managers" as our prime consideration, please don't ignore funds run by *teams* or *investment committees*. We now know that many seemingly well-qualified portfolio manager *stars* have turned out to be more like *comets*, burning out after a few years in the limelight. In a real sense, the wisdom of the collective seems more suggestive of stewardship (especially since the individual "stars" are often promoted with dazzling salesmanship), and I'd not hesitate to award three points to funds run by experienced investment committees.

11. Insider Ownership. Put me squarely in the camp of those who prefer fund directors, executives, and portfolio managers who "eat their own cooking" by investing importantly in the shares of the funds they manage. A few firms even take this philosophy to a (wonderful!) extreme, requiring their insiders to invest *all* of their liquid assets in their funds. Three stewardship points for them, and for others who approach that goal in spirit, if not quite in letter. After all, we can expect a steward to have special concern in the administration of his own investments. If there's little or no ownership by the fund insiders, zero points.

Unfortunately, there's little solid information on this vital issue, with no requirement that management company officials and portfolio managers disclose either their holdings of fund shares or their fund share transactions. (As the scandals have shown, some fund managers were even engaging in market timing in the shares of the very funds they were managing!) I hope the SEC will soon require this disclosure; in the meantime, investment advisers ought to ask for this information. If the answer is "none of your business," consider investing in funds in which the stewards are not only willing, but eager, to disclose their policies, their holdings, and their transactions alike.

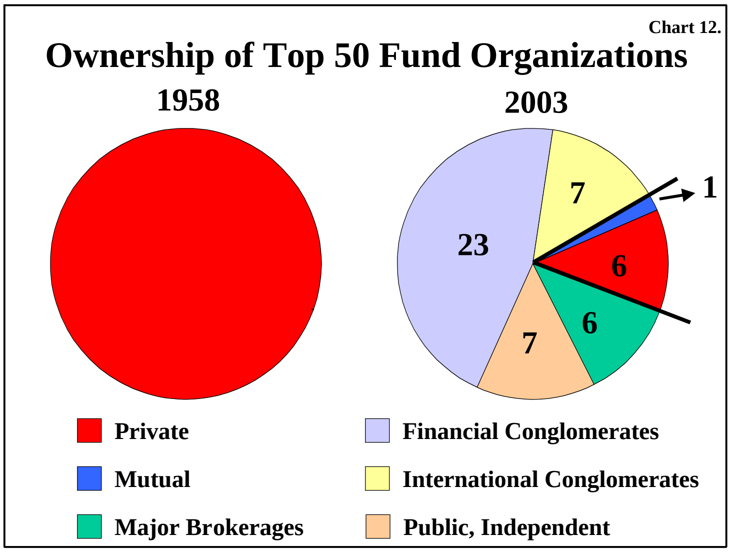
As to fund holdings by directors, there is also a serious, indeed inexplicable, information gap. Somehow the Investment Company Institute persuaded the SEC to exempt fund directors from disclosure of the precise number of shares they own, the standard for *all* other public corporations. Rather, fund directors need only disclose the *range* of their holdings: none; $10,000 or less; $10,000 to $50,000; $50,000 to $100,000; over $100,000, both for the fund and for all funds in the group. What earthly good it does for an investor to learn that a trustee has spread a modest $100,000 (or more?) among 100 or more funds in the group? That *may* be better than no disclosure at all. But barely! The sooner we revise the regulations to provide full and accurate disclosure, the better.

And last, but hardly least:

12. Organization of Managers. When I came into this industry all those years ago, virtually *all* fund management companies were small partnerships or corporations, closely held by their principals. They were but a step removed from the funds they managed, and looked at themselves as trustees, stewards of the assets entrusted to their care, members of the profession of investment management. By 1958, this sound structure was on the way out. Public offering of management company shares became possible, and numerous management company IPOs quickly followed. At that point, managers began to focus on the price of their stock and the interest of their *public* owners. Their earlier focus on the welfare of their fund shareholders had to compete with their focus on the welfare of *their own* owners, which would be fostered by building the fund group's asset base, increasing revenues, marketing aggressively, and making as much profit as they could.

But that was only the beginning. Gradually, both public and private management companies were purchased by giant financial conglomerates—banks and brokers and insurance companies, U.S. and international—whose principal interest was not the return on the capital of the *fund investors* they served, but on the return on *their own* capital. If a bank bought a fund manager for $1 billion, by golly, it would earn its, say, 12% cost of capital—$120 million per year—come hell or high water. As a result, *professional* interests—the stewardship of shareholder assets—were superceded by *business* interests—salesmanship, marketing, and revenues. Manager profits became the name of the game, and the industry's values changed accordingly.

Today, among the 50 largest fund managers, 36 are owned by giant financial conglomerates and seven are publicly-held, with six remaining private. **Chart 12**. The remaining firm (Vanguard) is mutually owned by the funds it manages (and therefore by their shareholders). You are free to agree or disagree with my awarding three stewardship points to firms that choose the mutual structure (so far, we're all alone!), two points to the firms that remain private, and one point for those that are publicly-held. And if you agree that the spirit of stewardship is vastly diminished when a fund manager is owned by a conglomerate far-removed from the fund's operations, a score of zero seems the right judgment for funds operating under that structure.



* * * * *

If you decide to move away from the fund groups that have betrayed your clients' trust, I strongly urge that you consider these twelve elements of the stewardship quotient in selecting the replacement funds. Of course I would not suggest that you accept the precise standards and point ratings I have listed. Make your own judgments; even add some elements of your own. But I hope that you will agree that your clients will be best served if your advice is focused on those firms that strike a balance between stewardship and salesmanship—a balance between professional standards and business pressures—that holds the interest of their fund shareholders at the highest possible level. These are, after all, *your* clients about whom we're speaking.

Come to think of it, the list I've given you may have even a broader use. Rather than thinking of it only as series of checkpoints for the selection of new funds for clients who wish to move away from the scandal-riddled firms, I believe that you would profit by thinking of the list as a series of checkpoints in selecting the firms that will be responsible for managing *all* of the mutual fund assets that you oversee for your clients. I believe that is the soundest way that you can earn, and retain, their trust.

You'll find, I think, few fund firms that have SQs higher than 150, and many that have SQs below 50. It is a *very* safe bet, in my hardly objective view, that during the decade that lies ahead the former group will deliver significantly higher returns to your clients. So write down your scores, and when 2014 rolls around we'll compare notes.

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