Globalisation of Mutual Funds: Perspective, Prospects, and Trust

Keynote Speech by
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Despite some considerable hurdles, the globalization of the mutual fund industry is continuing and perhaps even accelerating. It is part—although, so far, only a very small part—of the near-explosion of the globalization of the entire investment management business.

However, it is hardly a takeover of the rest of the world's investment managers by the powerhouse firms in the United States. To the contrary, some of the very largest acquisitions turn that idea upside down: The takeover of Bankers Trust by Deutsche Bank (a combined $380 billion of assets managed); of Wells Fargo Nikko by Barclays Global Investors ($600 billion); of Kemper/Scudder by Zurich ($280 billion); and of Brinson by Swiss Bank Corp. ($380 billion). Total assets managed by these four merged firms alone approach $2 trillion. For better or worse, we are truly living in the age of the giant global manager.

Traditional independent U.S. mutual fund complexes are also making waves across the Atlantic pond, although the Pacific pond remains, well, peaceful. Aggressive fund marketers, including Fidelity, Merrill Lynch, Mellon/Dreyfus, and Morgan Stanley Dean Witter are at various stages of global development, albeit in some cases rather tentatively. While my design for Vanguard called for our firm to be at once both leading fund *innovator* and lagging fund *marketer*, Vanguard too has entered the fray, with incipient fund operations in Australia and Europe. Not too many years ago, I was described as "the most provincial man, in the most provincial company, in the most provincial industry, in the most provincial country, in the world." But times change, and I have fully supported our global foray.

I warn skeptics that Vanguard may well become a formidable opponent in international waters. Perhaps I need not remind you that just 200 years ago, at the Battle of the Nile, aboard his flagship HMS Vanguard, Admiral Nelson destroyed a formidable French fleet, putting an end to Napoleon's quest to conquer Egypt and India. Just two weeks ago, writing in *The New York Times Magazine,* Patrick O'Brian described the Nile as the greatest naval battle of the past 1000 years, so watch out! (I shall touch on our decidedly unusual strategy later in my remarks.)

The globalization that permeates the world of commerce and finance today has clearly impacted the mutual fund industry, and will continue to do so. But U.S. fund managers come to the contest with a unique perspective. First, our stock market, presently valued at $14 trillion, has by far the largest market capitalization in the world, 50% of the total and almost five times our nearest rival (Japan, with a 10%-plus share). What is more, our financial markets are surely the envy of most of the world in terms of transaction costs, liquidity, financial transparency, and both a culture and a legal system that favor shareholder interests. And during the past decade, of course, the U.S. stock market has generated the world's highest equity returns.

Perhaps unsurprisingly in the light of our great bull market, the U.S. mutual fund industry is also the giant of the globe. At $5½ trillion, it has no serious rival. Germany and France account for some $700 billion combined, with Japan at $360 billion and the United Kingdom at $285 billion. All told, the mutual funds of nations other than the United States total just $2½ trillion, less than one-half of the U.S. total.

The Development of Globalization

So it is easy to see why foreign financial institutions wish to take a stake in the U.S. fund industry, but far less clear why U.S. funds seek to find new acres of diamonds around the world when the diamond mine in the U.S. is a veritable Golconda. So, by way of perspective, let's briefly examine the history of globalization in the U.S. funds industry.

It really began in the late 1970s and early 1980s, when U.S. managers ventured into foreign markets on behalf of the U.S. clients they had always served. Assets in international and global portfolios, accounting for less than 1% of fund assets at the outset, swiftly grew to 6% in the 1980s, swelling to 12% in the 1990s. Managers learned to deal with the complexities of foreign markets, their variety, and their volatility. Managers were also required to develop new investment research and trading approaches, and to deal with different accounting standards and custodial systems. Today, one of every five U.S. funds invests in the international realm, with aggregate assets of some $400 billion. In addition, our domestic funds own another $100 billion of foreign stocks in their own portfolios.

The investment returns of U.S.-managed international *funds* have paled next to the returns of funds investing in U.S. equities, but the investment returns earned by their *shareholders* have been far worse, as fund managers, as ever, have promoted various international market segments at what inevitably proved to be exactly the wrong times—Japan in the late 1980s, global short-term income funds in the early 1990s, emerging market funds right up until their peak at the end of 1993. Similarly, after their wonderful recent performance, European funds are now being promoted, probably an ominous sign for the future relative returns of these stocks. Despite these setbacks for *shareholders*, the building of an international fund asset base was a great advantage to U.S. fund *managers*, as they gained experience and expertise in investing beyond their own provincial boundaries.

As these barriers fell, managers grew more comfortable with the idea of developing money management "products" to sell to the rest of the world. The global offering of institutional advisory services has long since become rife, but the global offering of mutual funds, while only in the incipient stages, seems poised to take off. Witness the fact that we are all here in Bermuda this morning, just to share ideas, discuss problems, and seek opportunities in the global marketplace.

Six Forces Driving the U.S. Fund Industry

Why? What are the factors drawing U.S. fund mangers into the global fray? Let me list, for starters, these six:

1. The sheer demographic opportunities offered abroad are huge. The major industrialized nations have substantially older population profiles than the U.S. and even higher ratios of retirees to workers. For each dependent in the U.S. there are four workers, compared to only two and one-half abroad, with the ratios destined to shrink at an even faster rate abroad than in the U.S. Much public and private investing must be done if the world's citizens are to fund their retirement needs.

2. The massive move to defined contribution assets that we've seen in the U.S.—now fully one-half of the $4.3 trillion of total U.S. private pension assets—is virtually non-existent in the much smaller private pension asset base abroad. Mutual funds, rather than the traditional separate accounts, have become pre-eminent in the defined contribution arena, and our industry's skills in this field—our information, communications, and transaction technologies—have been honed to a razor's edge. The U.S. industry is ready to make its edge count as defined contribution assets burgeon abroad.

3. Funds sold outside the U.S. generate revenues to managers that can easily run 50% or more above those in U.S. funds. Why be satisfied with revenues of, say, 1½% of assets when 2½% is there for the taking? Sales charges, too, are higher abroad, and the higher brokerage commissions that fund portfolios generate offshore, in one way or another, may also find their way back to the managers.

4. Foreign fund markets seem largely untapped. Consider that mutual funds account for fully 23% of the liquid savings *assets* of U.S. families, but only 2½% of the savings of Japanese families. Again, fund assets of $20,000 per capita here compare with about $4,000 abroad. Opportunity, or so it seems, is knocking at the industry's door.

5. The U.S. fund market, on the other hand, looks in many ways saturated. Twenty-five years ago, before money market and bond funds had begun to make their mark, stock funds accounted for but 6/10 of 1% of U.S. savings *flows* of $180 billion. Last year, flows into stock, bond, and money market funds together accounted for an astonishing 99% of our $460 billion of national savings.

6. Further, competition is getting tougher in the U.S. Index funds—which require neither an advisor nor an advisory fee—and lower-cost stock and bond funds are building a dominant market share. In the past twelve months alone, just three U.S. fund groups—each known for offering funds at prices substantially below the industry's spectacularly high general levels—have accounted for nearly 40% of net cash flows into stock and bond funds. The remaining 50 major firms ($10 billion or more in assets) carved out an average market share of just over 1% each, with 12 of these firms—one of every four—actually in net redemption. Surely, fund managers must reason, it will be more profitable to bring in new assets at huge fees abroad than to reduce the generous fees that they presently extract from their U.S. shareholders in order to compete in the States.

Opportunities and Risks Abound

Together, these factors suggest that the opportunities for U.S. managers to build their profits by expanding their fund empires around the globe may hold considerable promise. But a global strategy also holds considerable risk. The global financial markets, for all of their underlying promise, are rife with contradictions and hazards. One need only think back to the perils of the summer of 1998, when markets lurched wildly, perhaps coming within a hair's-breadth of chaos. The precipitating forces lay largely in the emerging markets and Russia, with their economies deteriorating and their currencies plummeting. Investors the world over learned that global investing was hardly a one-way street.

For me (and here's where my parochialism comes in), I simply don't believe it is necessary for U.S. investors to invest abroad. After all, our financial markets are the envy of the world, our currency

the *lingua franca*, as it were, of most nations, and our climate for capital investment regarded as virtually ideal, to say nothing of the fact that our major corporations derive roughly one-fourth of their revenues and profits from outside the U.S. To be sure, non-U.S. stocks experience different market fluctuations at different times, and could help investors achieve a small reduction in what we call "standard deviation" in monthly portfolio returns. But diversifying abroad to reach this goal in an attempt to reach some imaginary "efficient frontier," and one based on past returns at that, hardly seems necessary for most investors.

Yet it seems obvious that investors in other nations must view the world through a global lens. In most other countries, it seems to me, citizens should place some of their capital investments outside their own national boundaries. (Whether they should hedge these holdings against the risk of their own currency is another matter.) Based on present market weights, one-half of a fully-diversified portfolio of global equities would be composed of U.S. stocks. But whether non-U.S. investors prefer a higher or lower proportion of U.S. stocks, few risk-averse portfolios will hold none. And here too lies an opportunity for U.S. fund managers to offer their wares.

That said, with the U.S. sitting "on top of the world" both figuratively and perhaps even literally, *nothing in investing is certain*. The U.S. markets seem to me to be priced for the best of all possible worlds. If that is too rosy a scenario to expect, our share prices may be riding for a painful fall. It is worth noting that only a decade ago, it was Japan that was sitting on top of the world, accounting for a dominant 43% share of the world's equity market capitalization, half again the then-U.S. share of 28%. Never forget that reversals of fortune are the rule, not the exception, in the financial markets. We just don't know where the risks lie. Put another way: "Do what you will, capital is at hazard."

Despite these risks, global *business* opportunities abound. Yet mutual funds, at least as their operations are conducted in the U.S., are not merely businesses. They have—*or should have*—the elements of a *profession.* Those who govern funds must operate under a standard of fiduciary duty. The dual nature of mutual funds—business . . . or profession?—is quite complex and conflict-ridden enough with regard to U.S. operations, but globalization raises the complexities to even higher levels, as I'll discuss at my conclusion.

Vanguard's Approach: Business as Usual. That Is, Unique

But first, perhaps a word about Vanguard's approach to globalization might help set the stage for that conclusion. Our approach is unique. It is destined to be ever thus for this *mutual* mutual fund complex, owned by its fund investors, operated on an at-cost basis, and carrying the lowest operating and distribution charges of any financial institution in the world. Our strategy, both in Europe and in Australia, is to offer solely directly-marketed no-load *market index* funds, at rock bottom expense ratios, initially largely to institutional investors, but gradually to individual investors as well.

Our long-term goal is to become a new force in world markets, a force that seeks out fiduciaries who are responsible for corporate retirement plans, and individuals who have come to realize, straightforwardly put, that, yes, *cost matters*. Put another way, we believe that the market for financial services will be increasingly commanded by *buyers*, not *sellers*, and that simply by giving investors a fair shake we will build a substantial asset base of loyal, durable, long-term investors.

Of course, in entering global markets, Vanguard operates under a powerful constraint. Given that it is our fund shareholders who own the management firm, the funds' investment abroad must be gradual, limited, carefully husbanded, and hold the promise of reasonable profitability down the road, so

as to fully recoup our initial stake. While that requirement might suggest that we should charge high prices for our global funds, such a practice would fly in the face of our deep-seated belief that the costs of investing are the critical determinant of the long-term returns earned by fund investors. How could we in good conscience maintain at once a low-cost line of funds in the U.S. and a high-cost line abroad?

Further, our index-only strategy focuses on an investment arena that, while now becoming not only well-established in the U.S., but widely-dominant (40% of equity fund cash flow during the past 12 months), is conspicuous only by its near-absence from the mutual fund scene abroad. Yet for an index fund to provide 95% or more of the return of the market index it emulates, it *must* maintain low costs. In the long run, index funds provide premium *performance* at a discount *price*—in the U.S. and in international markets alike. Index funds therefore hold a powerful edge over active managers who, finally, are offering discount *performance* at a premium *price*. Around the globe, region by region—Europe, the Pacific, the Emerging Markets—so the record of the past clearly confirms. Let me be clear: indexing works in *all* segments of the financial markets.

Given the large capital investments in global markets being made by our rivals, their vast resources, and their reliance on the tried and true strategies that have made them so immensely profitable in the U.S., our index-limited, cost-limited, resource-limited strategy may appear foolhardy. But who knows? Even as the element of surprise and a novel battle plan won the day for Nelson against a superior force at the Nile 200 years ago in the naval battle of the millennium, so those same elements may work for this latter-day Vanguard.

This 180 degree difference between the mutual fund industry's approach to globalization and Vanguard's approach brings me full circle to the crucial point on which I have twice touched earlier in these remarks: The impact of globalization on the conduct of mutual fund affairs as a business vs. as a profession; as an opportunity to enrich the profits of advisors vs. enriching the profits of fund shareholders; and finally as a question of marketing and commerce vs. management and fiduciary duty.

Marketing and Commerce vs. Trusteeship and Fiduciary Duty

It almost goes without saying that huge investments will be required to build a global presence and the accompanying "brand image." Taking on the banks in Germany and France, the independent brokers in Japan, and the entire financial establishment in the United Kingdom will be neither easy nor cheap for U.S. fund firms dreaming of global empires. But it is not just the escalation of marketing and distribution costs, but legal fees, accounting costs, systems and program expenses, dollars spent on transfer agencies and custodians. These costs, ultimately, are paid by fund shareholders either directly or through the "management fees" (very loosely speaking) charged by their advisers. And the question of who, finally, regulates a global fund industry remains to be seen. These are critical issues which I hope will receive some thought during the course of this conference.

The point is that with each megamerger of investment managers, and with each multi-million dollar investment in the introduction of foreign funds, the U.S. mutual fund industry becomes *less* a trusteeship, and *more* a business whose purpose is to provide a high return on the capital of the management company (or to justify the ever higher prices paid to acquire management companies by financial service conglomerates). Not one red cent of the purchase price, I might note, has ever been paid to the fund shareholders whose high fees in fact justify the high purchase price. An interesting legal issue! The stakes in this contest are huge, for these global financial firms are duty-bound *to their own shareholders* to seek to earn their cost of capital and more. Yet the higher the profits of the managers grow, the more the profits of the fund investors *must* shrink.

Essentially, the concept of economic value calls for earning a return on equity that exceeds the cost of capital. That cost, in turn, is measured by the return of the stock market, which, so the theory goes, represents a viable alternative for the investor's dollars. Earning the cost of capital is fundamental to the conduct of the affairs of the emerging global financial powerhouses. Yet their high fees and charges preclude the shareholders of the funds they manage from doing so. As the managers seek to meet their own profitability goals, the impact on the fee structure of the funds they offer is hardly likely to be benign. Yet mutual fund fees and expenses represent the direct and, finally, immovable obstacle to having mutual funds in the aggregate *ever* earn their own cost of capital. That trade-off is direct and dollar for dollar. The conflict of interest could hardly be more clear.

Amid all of today's change and growth in the mutual fund industry—including the globalization that doubtless lies before us—I would simply remind this audience of the nature of the fiduciary responsibilities of fund managers and trustees. These words from Justice Benjamin Cardozo remind us all of the proper handling of conflicts of interest:

> Many forms of conduct permissible in a workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior . . . a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity . . . Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.

I entreat you all—particularly those of you who are members of the international bar—to convey the thoughts in my remarks today, and that very citation, to the managers and trustees of the fund organizations you serve. For the conduct of the mutual fund industry, too, must be higher than that trodden by the crowd.

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

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