Investment Management: Business…or Profession

And What Role Does the Law Play?

Remarks by
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In his introduction to my new book (*Common Sense on Mutual Funds: New Imperatives for the Intelligent Investor*), Peter Bernstein focuses on the fact that "conflict of interest between seller and buyer is inherent in our economic system," and describes the complexity of building a business "whose primary objective is to make money for customers by minimizing that conflict of interest—but at the same time be so successful that it would be able to grow and sustain itself." He speaks generously of how Vanguard has been able to accomplish that task, even as he recounts my growing concern that the mutual fund industry has failed to do so.

It is this industry's failure to find the proper balance between the conflicting interests of investing as a business and investing as a profession of which I shall speak this evening. While I am not an attorney, I shall take the liberty of touching on the role that the law might play in resolving this issue. Let me begin with the premise that a mutual fund, which is formed as a public corporation (business trust), and for which the directors (trustees) are charged with the responsibility for management, must be managed in the interests of its shareholders (beneficiaries). I believe it was Justice Oliver Wendell Holmes of the United States Supreme Court who said that trustees must "act with an eye single toward the interest of their beneficiaries." I do not believe that most fund directors have met that standard.

Let's Look At The Record

I will begin, however, not with what would inevitably be a fruitless attempt to describe the *actions* of mutual fund directors and managers toward their investors, but with a pragmatic analysis of the *consequences* of those actions as they are reflected in the returns managers have earned for fund shareholders in the financial markets: During the past decade, equity mutual funds have earned an annual total return of 15.7%. On an *absolute* basis, that return is robust to a fault.

But when examined on a *relative* basis, that return seems remarkably skinny. For the annual return on the total U.S. stock market during that decade was 18.3%. (The annual return of the Standard & Poor's 500 Stock Index was even higher—19.3%.) An outsider to the world of investing would almost have to suspend disbelief to imagine that the largely experienced, abundantly educated, highly-compensated managers of the mutual fund industry, who, after all are now paid something more than $55 *billion* per year for their efforts, could not even match the market—indeed, could provide only 87% of the market's annual return. And in a decade of record high returns, which inevitably *minimizes* the role of costs, at that. (A 2% cost, for example, consumes one-fifth of a 10% return but only—if that is the correct word—one-tenth of a 20% return.)

And it is indeed cost that is the villain of the piece. For the remarkably high costs that mutual funds incur are responsible for the severe shortfall in the rewards achieved by fund shareholders relative to the stock market. When we account for the fund shortfall of 2.6 percentage points per year, we find that the average equity fund expense ratio of 1.2% accounts for almost half of the shortfall. Further, these fund managers are decidedly short-term investors (it might be more accurate to describe them as *speculators*), turning over their portfolios at an annual rate of some 80% annually. A conservative calculation might put these costs at, say, 0.8% annually, bringing costs to 2.0%. Thus, on the face of it, the costs incurred by these managers accounted for almost 80% of the shortfall. The remaining 20%, more or less, was the consequence of the fund managers' deciding to maintain about 8% of their fund owners' assets in low-yielding cash reserves, incorrectly expecting stocks to fall, or for other reasons. Net result: Fund managers had stock-picking skills no greater nor worse than the man on the street, but fell far behind the market largely by reason of the costs they incur. As lucrative as the game was for highly-paid fund managers and for the market makers, for fund investors it was not worth a tinker's dam.

The Record Deteriorates

Sad to say, the results I have just portrayed substantially *overstate* the results actually achieved by mutual fund managers. First, because fund portfolios are *riskier* than the market. Specifically, (measured by the standard of deviation of monthly returns during the decade), funds are about 6% riskier. Their risk-adjusted return (measured by the Sharpe Ratio) therefore, was not really 87% of the market's annual return, but only 78%, a 9 percentage point reduction.

Second, by relying only on the records of the 525 equity funds which were in operation during the entire 1988-98 decade, the data ignore those funds that failed to survive the period. Such funds, dare I say, are rarely those that have "shot the lights out" in performance. To the contrary. So-called "survivor bias" typically results in an overstatement of 1% or more in fund industry returns. Using a 1% figure, survivor bias *alone* would reduce the fund return from 87% to 80% of the market return, a 7 point reduction.

Third, fund sales charges, almost universally ignored in calculations of fund returns, take an additional bite. Some 70% of the 525 surviving funds carry initial sales charges, which averaged about 7% at the start of the period. Amortized over the decade, these charges would have reduced the average annual returns for such funds by about 0.7%, bringing them—*again, for this reason alone*—down from 87% to 82% of the market return, another 5 point reduction, bringing the total to 21 percentage points.

The net result of this 21 percentage point aggregate reduction would take fund industry average annual returns from 87% to only 66% of the stock market's return. But let's be generous and call it 70%, representing an annual gain of 12.8% in an 18.3% stock market. The cumulative impact of this annual gap is staggering. At the end of the decade, an investment of $10,000 in the U.S. stock market would have grown to $53,700, compared to $33,300 for the average mutual fund (using the above methodology). The capital appreciation provided by the market, then, was $43,700, almost *double* the $23,300 of appreciation garnered by the investor in an average fund. Put another way, the buyer received 53% of the benefits provided by equities and the seller received fully 47%. It should go without saying that it was the buyer, not the seller, who put up 100% of the capital, and the buyer, not the seller, who took 100% of the risk. I find it impossible to imagine that this apportionment of the rewards of investing represents a fair balance between the conflicting interests of the buyers and sellers of financial services.

What Does The Law Say?

Where might the law fit in redressing this extreme imbalance? Well, I suppose that a law professor would say, let's look to the statute. In this case, the Investment Company Act of 1940. The Act says that investment companies (mutual funds) are, "affected with a national public interest . . . that they are media for the investment in the national economy of a substantial part of the national savings, [prophetically adding] and may have a vital effect on the flow of such savings into the capital markets." The Act then goes on to say that this national public interest "and the interest of investors are adversely affected . . . when investment companies are organized, operated, or managed . . . in the interest of . . . investment advisers or underwriters," rather than in the interests of mutual fund shareholders.

Alas, this properly lofty declaration of policy under the Act has not proven susceptible to enforcement. The 1940 Act has done little of substance to reconcile the imbalance of interests between buyers and sellers of mutual funds. Indeed, that imbalance is greater today than at any time since the Act became law nearly six decades ago. And cost, as I have noted, is the villain of the piece, largely accounting for the fact that the annual returns of equity mutual funds have represented, at best, 70% of the market's annual return during this great bull market decade.

Raising The Odds: From 70% to 99%

There is, of course, a straightforward way for investors to enhance that relationship. *Approaching 100% of the market's return is not only simple; it can be virtually guaranteed.* Merely owning an all-market index mutual fund—which requires no investment manager (and therefore need pay no advisory fee), operates with expenses of less than 0.20% per year (one-eighth of the cost of the average equity fund), and engages in virtually no portfolio turnover—will produce 98% to 99% of the market's rate of return. Further, for taxable investors, such an index fund has produced an *after-tax* annual return of about 92% of pre-tax *market* return, while the average equity fund has produced just 83% of pre-tax *fund* return, itself representing only 70% of the return of the market itself. Like expense ratios and portfolio turnover, taxes, as it turns out, are just one more cost that separates the returns earned by investors in the equity funds from the returns earned by the market.

And yet equity fund costs keep rising. The average expense ratio has risen from 1.20% in 1985 to 1.60% in 1998, which will almost certainly cause the shortfall of fund managers to be even greater in the next decade than in the past decade. It seems clear that fund directors have simply abdicated the responsibility that the language of the Act of 1940 seems on its face to demand: that investment companies be operated in the interest of shareholders rather than in the interest of investment advisers.

The Index Fund Solution

The index fund solution, of course, is not acceptable to investment advisers. Almost without exception, they shun index funds like the plague, offering them only as "loss leaders" when business circumstances require them to do so (i.e., when large 401-k thrift plans or powerful institutional investors demand them). The index solution, finally, is not acceptable simply because it redresses the imbalance between fund buyer and fund seller in a way that leaves the buyer omnipotent and the seller impotent: nearly 99% of the stock market's annual return goes to the buyer, only 1% to the seller. Yet it must be clear that it is only a matter of time until investors turn seriously toward index funds and away from most active managers. Finally, it is the index fund that establishes and clarifies the heretofore missing link between investment cost and investment return. If the fund directors can't—or won't—act to eliminate

the misfeasance that excessive fund costs constitute for the shareholders whom they represent, the fund shareholders themselves will finally vote with their feet.

The responsiveness of fund directors to other means of linking adviser returns to investor returns is conspicuous by its absence. As fund assets have soared, fees rates have actually risen; advisory fees have soared at an even higher rate; and adviser profits have gone through the roof. Asset increases are most typically generated by funds with good *past* performance, even as those soaring assets help to force *future* performance to revert to, or below, industry norms—hardly a model of achievement. High fees for performance excellence—i.e., incentive fees based on the relationship between the fund's performance and the market's—always as scarce as hen's teeth in this industry—are rarer than ever. Just 106 out of 5,190 stock funds elect to pay their managers for premium performance, and have those managers accept a commensurate penalty for performance shortfall, a system that seems logical to a fault in providing a fair balance between buyer and seller.

Beyond Equity Funds

Finally, however, no matter how dismal the grim realities of the past, the hope (or expectation) of future performance excellence by individual funds clouds the issue of equity fund fees and performance. But there are huge areas of mutual fund investing where the issue of cost vs. value comes into clear focus—areas where no amount of hope or expectation can *possibly* lead a fund to market-beating returns. It is impossible, for example, for a money market fund to provide a higher return than the going rate for safe, liquid short-term investments. Yet we can document the use of money market shareholder resources that are so egregious as to constitute a sheer waste of corporate assets.

The case is universally clear that the net yield of a money market fund is the result of deducting whatever advisory fees and other costs the fund incurs from the going rate for short term money market investments. Currently, for example, both high-cost managers and low-cost managers are earning gross yields of 5.5%. But the high-cost quartile of funds deducts costs of 1.3% (yes . . . fully 1.3% per year), and provides a net yield of 4.2% to investors. Funds in the low-cost quartile deduct 0.4% and provide investors with a return of 5.1%, a 22% yield premium over their high cost rivals. How can directors of those 80 high-cost funds possibly justify that gap? Yes, it *is* as simple as that.

Dollars and Sense

Now consider not just the *expense ratio*, but the *dollars* that are involved, using this specific contrast between the fees paid to two investment managers in this field. One $47 billion money market fund pays its manager $170 million per year for investment advisory services (not counting the $55 million the manager is paid for shareholder services and the $42 million paid for fund distribution services). Yet another money market fund, with just slightly fewer billions to manage, is paid less than $5 million per year. Both funds own high-quality A-1/P-1 and U.S. Treasury paper, both employ large, experienced professional staffs, and both currently earn 5.5% yields, before expenses. But one Fund operates with its own staff, on an at-cost basis, and pays its shareholders 5.2%; the other hires an external manager for a percentage fee, and pays *its* shareholders 4.9%. Even assuming that the external manager's costs are double the internal manager's, its profit could well exceed $160 million—a 90%-plus pre-tax margin. Why didn't some—or most, or even all—of that sum go into the coffers of investors, the owners of the fund that the directors have a fiduciary obligation to protect? Were the directors of the high-cost fund serving the interests of the manager . . . or the shareholders? You can decide.

Like money market funds, bond funds tend to provide returns consistent with the maturity and quality characteristics of their portfolios. Yet the fee differences are astonishing. One $9 billion GNMA fund pays its manager $42 million a year for investment management services (for selecting among credit-safe, U.S. Treasury-backed GNMA securities, at that), while another (larger) $10 billion fund pays its manager $1.2 million annually for doing the same thing. What could possibly account for that huge $40 million-plus diversion of fund returns from investor to manager? We know that it is not performance; the low-cost GNMA fund, perhaps unsurprisingly, has turned in a consistently better record for its fund shareholders. As in the money market case, how can such fee differentials persist when consistently uniform pre-expense returns are generated by commodity-like portfolios of comparable quality? Who, in short, is minding the store? The answer, finally, is the fund directors *should be* minding the store, but they are not doing their job.

Whether considering the returns earned by stock funds, bond funds, or money market funds, fund investors as a group are not receiving adequate returns on the capital that they have invested. Overpoweringly, the reason lies in the substantial deduction from market returns engendered by the fees paid to fund managers, by the other fund operating expenses, by sales charges, and by hefty portfolio turnover costs that these managers incur. The law has placed on fund directors the responsibility to serve the interests of fund investors rather than fund managers, and cost is the crux of the issue. Yet, short of strict fee regulation, obvious solutions do not come easily to mind.

The SEC Roundtable

Two weeks ago, the Securities and Exchange Commission held a two-day Roundtable on the Role of Independent Investment Company Directors. (I might note that I believe that “non-independent” directors, usually owners and officers of a fund’s external investment manager, have the same responsibilities as independent directors under the law, however untenable a position in which that may place them.) As I reviewed the list of 56 participants, the extensive agenda, and the press reports, I didn’t sense that the meeting raised the pivotal issues I have discussed in these remarks. Whatever the case, the Roundtable provided little guidance as to future actions. However, it was reported that Chairman Levitt, while wanting to go further than a mere listing of “best practices,” was reluctant either to develop new SEC rules or to seek legislative changes.

I applaud the Chairman for raising the central issue of the role of fund directors, and I’m inclined to agree that it is unrealistic to expect rules of director conduct to bring us out of the quagmire fostered by the industry’s peculiar, indeed unique, system of governance. But it is that system that has had the effect of depriving fund shareholders of the returns they probably expected, likely could have enjoyed, and certainly deserved: Their fair share of market returns.

Balancing Conflicting Interests: A Beginning

How can we develop a fair balance of the interests of investor-buyers and manager-sellers? Since cost is the issue, and present cost disclosure wholly-inadequate, a good place to begin would be a study, led by the SEC’s Chief Economist, of industry revenues, expenses, and profits. Then we could, just as at Watergate, “follow the money.” Fund investors spent some $55 billion(!) on mutual fund services last year. Let’s ask each fund manager to report, for the fund complex, and for each individual fund within the complex: (a) its advisory fees, service fees, distribution charges, sales commissions, other fund expenses, and total revenues; (b) its total expenses, separating out those for investment management and research from those for advertising, sales, and marketing, administration and investor services, etc.; and (c) its profits, before and after taxes. Then we’ll know *exactly* where the money went,

and how productive it proved in serving fund shareholders. It will give us information never before available, and will be a fine beginning.

Next, the SEC ought to require that each fund provide a regular annual disclosure of the same information, for the fund itself and for all of the funds served by the adviser. Then shareholders will know exactly how, and to what avail, their money is being spent. At that point, given this age when information technology reigns supreme, the press, analysts, and the academic journals can analyze this information to their hearts' content, and create a level of disclosure that will enable fund shareholders to decide for themselves whether their interests are being served by the fund directors they have elected to serve them. The sunlight of full disclosure is, finally, probably the best disinfectant for the ailments that have so clearly stood in the way of the ability of funds as a group to capture the optimal share—it ought to approach, though it can never exceed, 100%—of the returns of whatever financial market is considered: money market, bond, or stock.

New Imperatives

The sooner this information is made available, the better. The subtitle of my new book is "New *Imperatives* for the Intelligent Investor." The "imperative" comes because I am convinced that the costs borne by funds are far too heavy, and time is indeed money for fund investors. Once the process I have recommended takes hold, I'm sure other avenues will also develop that will serve to turn this industry away from its business instincts that are so counterproductive for fund shareholders and toward the professional instincts that have been so conspicuous by their absence in this booming era for the financial markets.

I may well have been wrong in my recollection of Justice Holmes as the source of the "eye single" phrase I cited at the start of my remarks, but I am certain of the writer of the words with which I conclude these remarks, Justice Benjamin Cardozo:

> 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. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions . . . Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.

The mutual fund industry's conduct, 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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