Vanguard—Child of Princeton

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Let me get right to the point: *Were there no Princeton, there would be no Vanguard.* For it was only a wonderful series of happy accidents—beginning with my admission to this best old place of all as a member of the great Class of 1951—that led to the creation of Vanguard. Today we manage some $720 billion of investor assets, one of the two largest mutual fund complexes in the world. Like all numbers, that number, in and of itself, is not particularly important. What *is* important is that we created a unique corporate structure, a more efficient and economical way to serve investors, and a new way of managing investments that together have begun to reshape the way the financial community thinks about investing.

Of course Vanguard is a story of entrepreneurship, too. But an odd kind of entrepreneurship, involving, (1) the conversion of an existing enterprise to a higher use. (2) A business that demands virtually no capital assets. (3) An innovative corporate structure that was unlikely to be—and even 50 years later has yet to be—copied. (4) An original idea, the index mutual fund, which, simply put is the "killer app"—an investment strategy that cannot be empirically improved upon. And if that's not enough to make Vanguard atypical, I would add: (5) A firm specifically designed to provide neither equity nor entrepreneurial reward for its creators. (More about that later!) If those five peculiarities undermine my credentials to speak authoritatively on entrepreneurship, so be it. But I'll try, anyway.

Where It All Began

The story begins with the first of the almost infinite number of breaks I've been given during my long life. It came at Blair Academy , where, thanks to a scholarship and a job, I received a splendid college preparatory education. That priceless advantage, in turn, presented me with another break. With the help of another full scholarship and a job waiting on tables in Commons, I entered Princeton University in the late summer of 1947. (It was easier to get admitted then!)

Despite my academic success at Blair, I found the early going at Princeton tough. The low point came in the autumn of 1948, when I struggled with the first edition of Paul Samuelson's *Economics: An Introductory Analysis.* It was not a happy introduction to my major field of study, and I earned a well-deserved 4+ (D+ today) as my mid-term grade. With my other grades scarcely more worthy, my scholarship—and hence my Princeton career, for I had not a *sou* of outside financial support—was in dire jeopardy. But I ended the term with a nice upsurge . . . to a hardly distinguished 3 (today, C) average.

Academic distinction continued to elude me, but a year later fate smiled down on me once again. Determined to write my senior thesis on a subject that no previous thesis had ever tackled, Adam Smith, Karl Marx, and John Maynard Keynes were hardly on my list. But what topic *should* I choose? Perusing *Fortune* magazine in the reading room of the then-brand-new Firestone library in December 1949, I paused on page 116 to read an article about a business which I had never even imagined. And when "Big Money in Boston" described the mutual fund industry as "tiny but contentious," this callow and insecure—but determined—young kid decided that mutual funds should be the topic of his thesis. I entitled it, "The Economic Role of the Investment Company." Thus, the first **Entrepreneurial Lesson** that I'll present today: **#1. Get lucky.**

A Design for a Business?

I can't tell you that my thesis laid out the design for what Vanguard would become. But there's no question that many of the values I identified then would, 50 years later, prove to lie at the very core of our remarkable growth. "The principal function of mutual funds is the management of their investment portfolios. Everything else is incidental . . . Future industry growth can be maximized by a reduction of sales loads and management fees," and, with a final rhetorical flourish, funds should operate "in the most efficient, honest, and economical way possible." Sophomoric idealism? A design for the enterprise that would emerge a quarter-century later? I'll leave it to you to decide. But whatever was truly in my mind all those years ago, the thesis clearly put forth the proposition that mutual fund shareholders ought to be given a fair shake.

In any event, the countless hours I spent researching and analyzing the industry in my carrel at Firestone was rewarded with a 1+, and led to a *magna cum laude* diploma—a delightful, if totally unexpected, finale for my academic career at Princeton. And it came with a fine sequel: A half-century later, Dr. Samuelson, by then a Nobel Laureate in Economics, would write the foreword to my first book! (Another turnabout: In 1999, exactly 50 years after *Fortune* introduced me to the industry, that very magazine named me one of the four Investment Giants of the 20th century.) **Entrepreneurial Lesson #2. Turn disaster into triumph.**

Fate smiled on me yet again when a great Princetonian named Walter L. Morgan, Class of 1920 and the founder of Wellington Fund, read my thesis. In his own words: "Largely as a result of his thesis, we have added Mr. Bogle to our Wellington organization." While I agonized over the risks of going into that "tiny but contentious" business, my thesis research had persuaded me that the industry's future would be bright. So I cast my lot with this great man, my good friend until his death at age 100 in 1998, and never looked back. He had given me the opportunity of a lifetime. Bless his soul! **Entrepreneurial Lesson #3. Get a mentor.**

In the Business, then Out

By 1965, Mr. Morgan had made it clear that I would be his successor. At that time, the Company was lagging its peers, and he told me to "do whatever it takes" to solve our problems. Young and headstrong (I was then but 36 years of age), I put together a merger with a high flying group of four "whiz kids" who had achieved an extraordinary record of investment performance over the preceding six years. (Such an approach—believing that *past* fund performance has the power to predict *future* performance—is, of course, antithetical to everything I believe today. It was a great lesson!) Together, we five whiz kids whizzed high for a few years. And then we whizzed low. The speculative fever in the stock market during the "Go-Go Era" of the mid-1960s "went-went." Just like the recent "new economy" bubble, it burst, and was followed by a 50% market decline in 1973-1974. The once happy band of partners had a falling out, and in January 1974 I was deposed as the head of what I had considered *my* company. **Entrepreneurial Lesson #4. Get fired.**

But without both the 1951 hiring, which providentially brought me *into* this industry, and the 1974 firing, which abruptly took me *out* of it, there would be no Vanguard today. Removed from my position at Wellington Management Company, I decided to pursue an unprecedented course of action. The *company* directors who fired me composed only a minority of the board of Wellington Fund itself, so I went to the *fund* board with a novel proposal: Have the Fund, and its then-ten associated funds (today there are 100), declare their independence from their manager, and retain me as their chairman and CEO.

It wasn't *exactly* the Colonies telling King George III to get lost, as it were, in 1776. But *fund independence*—the right of a fund to operate with its own leadership, in the interest of its own shareholders, free of domination by the fund's outside manager—was at the heart of my proposal. *Mirabile dictu*! After a contentious debate lasting seven months, we won the battle to administer the funds on a truly mutual basis, under which they would be operated, at cost, by their own wholly-owned subsidiary. **Entrepreneurial Lesson #5. Dare to be bold!**

With only weeks to go before our incorporation, we still had no name for the new firm. Fate, of course, smiled again. In the late summer of 1974, a dealer in antique prints came by my office with some small engravings from the Napoleonic War era, illustrating the military battles of the Duke of Wellington, for whom Mr. Morgan had named his first mutual fund 46 years earlier. When I bought them, he offered me some companion prints of the British naval battles of the same era. Ever enticed by the sea and its timeless mystery, I bought them, too. Delighted, the dealer gave me the book from which they had been removed. Even as I had browsed through *Fortune* in Firestone Library 25 years earlier, I again browsed through the text.

With my usual luck, I happened to turn to the saga of the historic Battle of the Nile, where Lord Nelson sank the French fleet and ended Napoleon's dreams of world conquest. There was Nelson's triumphant dispatch from his flagship, "Vanguard, off the mouth of the Nile." Together, the Wellington tie-in, the proud naval tradition embodied in HMS Vanguard, and the leading-edge implication of the name *vanguard* were more than I could resist. So on September 24, 1974, nearly 30 years ago, *The Vanguard Group* was born. Consider this syllogism: *No Princeton, no thesis; no thesis, no Morgan; no Morgan, no Wellington; no Wellington, no merger; no merger, no firing; no firing, no Vanguard.* Without Princeton the patriarch, Vanguard the child would never have been born. **Entrepreneurial Lesson #6. Getting lucky multiple times beats getting lucky once.**

A Narrow Mandate

Given the fiery crucible of contention out of which Vanguard was born, the Fund directors decided to allow Vanguard—owned, under its new mutual structure, by the funds themselves—only the narrowest of mandates. Our sole task was to handle the Fund's *administration.* Our crew, numbering only 28 members when we began the long voyage, was responsible only for the Fund's operating, legal, and financial affairs. But administration comprises but one of the three sides—and arguably the least important side—of the triangle that represents mutual fund activities.

The other two, more critical, sides of the triangle—*investment management* and *share distribution*—were to remain with my rivals at Wellington Management. Yet it didn't take a genius to realize that our destiny would be determined by what kind of funds we created, by whether the funds could attain superior investment returns, and by how—and how effectively—the funds' shares were marketed. When we were prohibited from presiding over these activities, I knew that a rough road lay ahead. **Entrepreneurial Lesson #7. Never get discouraged.**

The fact that investment management was outside of Vanguard's mandate led us, within months, to an unprecedented action that today seems obvious—the fruition of an idea I had toyed with for years. Based on evidence that I had gathered in my Princeton thesis, I had written that mutual funds should "make no claim to superiority over the market averages." Was this thought the precursor of my later interest in simply *matching* the market with an index fund? Honestly, I don't know. But when I wrote those words way back in 1951, that moment may well have been when the seed was planted that germinated into my recommendation to the fund Board of Directors in September 1975: that Vanguard organize and operate the first market index mutual fund in history.

When the board reminded me that investment management was not within Vanguard's mandate, I argued that the index fund wasn't "managed"; it would simply own all 500 stocks in the Standard & Poor's 500 Index. Disingenuous or not, this argument narrowly carried the day. When we organized the fund in late 1975, we had made our entry into the *second* side—the investment side—of the fund triangle. First Index Investment Trust (now named Vanguard 500 Index Fund), derided for years as "Bogle's Folly," wasn't even copied until 1984, after nearly a decade had passed. *What a great idea!* But our original index fund is now the world's largest mutual fund. **Entrepreneurial Lesson #8. Emerson was right. Build a better mousetrap and the world *will* beat a path to your door.**

Eliminating a Sales Force

How could we take over the third and final side of the triangle—share distribution? Once again, we devised a novel solution to a seemingly insurmountable challenge: We would abandon the network of brokers that had distributed Wellington shares for the previous half-century, and simply eliminate the *need* for distribution. We would rely, not on sellers to *sell* fund shares, but on buyers to *buy* them. After another divisive board battle, we took that unprecedented step in February 1977, converting overnight from the industry's traditional broker-dealer *supply-push* selling system to a sales-charge-free, no-load, *demand-pull* marketing system. In just 18 months from the day our skeleton enterprise began operations with its narrow mandate, we had become the full-fledged mutual fund firm we are today. **Entrepreneurial Lesson #9. Never give up. Never. Never. Never. Never. Never.**

There was really only one further step in the evolution of Vanguard's central concept. Within six months of our no-load decision we created a series of municipal bond funds with an unprecedented structure. Even as I had come to believe that precious few stock managers could outguess the stock market, so I had come to believe that precious few bond managers could outguess the bond market by accurately forecasting the direction and level of interest rates. Yet our peers, offering "managed" tax-exempt bond funds were implicitly promising they could do exactly that—a promise that could not be fulfilled. So why not depart from the crowd and form not a *single* tax-exempt bond fund, but a *three-tier* bond fund offering a *long-term* portfolio; a *short-term* portfolio; and—you guessed it—an *intermediate-term* portfolio? It's difficult, in truth, to imagine a more banally simple idea. *But it had never been done before*. It changed, almost overnight, the way investors thought about bond fund investing, and the industry quickly adopted the concept.

Strategy Follows Structure

All of the changed I've just cataloged may seem convoluted and even arcane, so let's think for a moment about what we had done in the design of Vanguard's structure and the determination of Vanguard's strategy. We had created a unique mutual *structure* in which costs could be reduced to the bare-bones minimum, and a *strategy* that emphasized mutual funds in which the linkage between our costs and our investors' returns would be obvious, indeed almost causal. *Strategy follows structure*. The one great—and largely unrecognized—idea of investing is this: *Costs matter.*

Why do costs matter? Consider the analogy of the stock market as a casino, in which the investor-gamblers swap stocks with one another, a casino in which, inevitably, all investors as a group share the stock market's returns, no more, no less. *But only until the rakes of the croupiers descend.* Then, what was inevitably a *zero-sum* game—a fruitless search by investors to beat the market *before* costs—becomes a negative-sum game *after* the costs of investing are deducted. Beating the market, by definition, is then a loser's game. *Gross market return, minus intermediation costs, equals net investor return*—clearly, a highly complex arithmetic formula. **Entrepreneurial Lesson #10. Be a mathematical genius. (Only kidding!)**

Since playing the mutual fund game carries heavy costs and entails lots of croupiers, each wielding a wide rake, the losers lose lots. Sales commissions when most funds are purchased. Fund management fees and operating costs. Marketing costs, including all those expensive advertisements you see. Transaction costs paid to stock brokers and market-makers when fund managers buy and sell the stocks in fund portfolios over and over again. The excessive tax costs to which funds unnecessarily subject their shareholders as the result of their incessant, often mindless, turnover. Taken together, these costs, roughly 3½% to 4% of fund assets each year, compounded year after year, have given taxable mutual fund investors but about one-half of the market's return during the past decade and—I'm glad you're sitting down!—only a little more than one-third in the past quarter century. The average fund investor, who put up 100% of the capital and assumed 100% of the risk, garnered something like 33% of the market's after-tax return. Yes, *costs matter*. **Entrepreneurial Lesson #11. Never underestimate the power of the obvious.**

Given those elementary mathematics of the market, the insight that led into a low-cost structure and an index-oriented, structured-portfolio strategy is not only obvious, but startlingly obvious. It can't have been a mystery to the other firms in our industry. All of our rivals had the same *opportunity* as Vanguard to create such a structure, but, just like the prime suspect in a murder mystery, we alone had the *motive* to act. Because of our mutual *structure*, the finger of guilt, as it were, pointed directly at Vanguard. We sought low costs to maximize the returns for our *fund* shareholders; our rivals, eager, to maximize the returns for their *management company* shareholders, sought the highest returns that traffic would bear. **Entrepreneurial Lesson #12. Competition is easier if your competitors won't—and can't—compete on costs.**

Opposition from a Formidable Source

While we had struggled long and hard to establish Vanguard on a firm foundation, however, our enterprise was still built on sand. For we were operating only under a *temporary* SEC order that allowed us to operate under our unique mutual fund structure. Astonishing as it may seem today, in 1980, nearly three years after giving us that temporary approval, the SEC reversed its ruling, leaving us in a no-man's-land that I never contemplated. Aghast, for I knew we were doing what was right for our shareholders, we mounted a vigorous appeal. Finally, in 1981, after a struggle that had lasted *four long years*, the SEC did an about-face, approving our plan with these powerful words:

> The Vanguard plan actually furthers the objectives [of the Investment Company Act of 1940] by ensuring that the Funds' directors . . . are better able to evaluate the quality of services rendered to the funds. The plan fosters improved disclosure to shareholders . . . promotes savings from economies of scale. . . clearly enhances the Funds' independence . . . provides them with conflict-free control over distribution. . . and promotes a healthy and viable fund complex within which each fund can better prosper.

Wow! The Commission's endorsement—virtually a commercial message on our behalf—made the struggle worthwhile. At last, our foundation was a rock, firmly in place. **Entrepreneurial Lesson #13. "I'm from the government and I'm here to help you." Sometimes.**

Assets Double Every Three Years

The years in which our structure was hanging by a Damoclean thread were a challenge. But when the SEC finally gave us the green light in 1981, the stock market had begun to recover, and our assets had doubled, from $1.4 billion to $3 billion. By 1983, they'd doubled again to $6 billion; by 1985, again to $12 billion; by 1986, again to $24 billion; by 1990, *again,* to $48 billion. Assets doubled yet *again* to nearly $100 billion in 1993, then again to $200 billion in 1996, and *again* to $400 billion in 1998. No one thought that remarkable record could continue. *It didn't.* Nonetheless, despite the tough stock market since the bubble burst in 2000-2002, our assets now total $720 billion.

Our simple group of index funds, structured bond funds, and money market funds—each providing a near causal relationship between low costs and high returns—constitute the powerful engine that has driven that amazing growth. The assets of these funds now total $520 billion, fully 75% of our asset base. What is more, we have also applied the principles on which they are based—an emphasis on rock-bottom operating costs, minimal portfolio turnover, no sales charges, diversified, investment-quality portfolios, and clearly-defined objectives and strategies—to substantially all of the remainder of our assets, largely actively-managed equity funds. In the marketplace of intelligent long-term investors—individual and institutional alike—whom we have chosen to serve, our strategies are mutually reinforcing. **Enterpreneurial Lesson #14. An internally-consistent strategy is one of the keys to business success.**

Now, I recognize that creating a new company out of the framework of an existing company may not quite qualify as entrepreneurship. But I hope you'll consider as entrepreneurial the initiatives I've discussed today: (1) The creation of a new form of governance in the mutual fund industry, a *mutual* structure in which the interests of fund investors take precedence over the interests of fund managers and distributors. (2) Forming the world's first index fund, a passive portfolio designed simply to provide the returns provided by the stock market, a challenge that precious few portfolio managers have bettered over time. (3) A new paradigm for bond fund management. (4) Abandoning a proven distribution system in favor of a new and untried one. (5) The sheer energy required to get it all done, in the face of a divided board of directors and the initial opposition of a Federal regulatory agency. We marched to our own, different, drummer, and it worked. **Entrepreneurial Lesson #15. Take the road less traveled by. It can make all the difference.**

The Fruits of Success . . . or Success for Its Own Sake?

Let me close by considering the classic definition of the entrepreneur, "one who undertakes an enterprise," and ask *why* does a person undertake an enterprise? In his *Theory of Economic Development*, economist Joseph A. Schumpeter dismissed material and monetary gain as the prime motivation of the entrepreneur, concluding that these motives are far more powerful:

- "The joy of creating, of getting things done, of simply exercising one's energy and ingenuity, and
- "The will to conquer, the impulse to fight . . . to succeed for the sake, not of the fruits of success, but of success itself."

When Schumpeter identified entrepreneurship as a vital moving force in human economic progress, he ascribed it as a combination of those motives. Note that he downplayed *the fruits of success* as a primary motivator. Entrepreneurship, he tells us, is really about success itself, accomplishment, creativity, joy, energy, and the will to fight for one's ideas. *And so it is!*

Long before Schumpeter, a man often described as "America's first entrepreneur" also eschewed personal gain. Like many entrepreneurs, Benjamin Franklin was also an inventor, creating, among other devices, the lightning rod and the Franklin stove. He made no attempt to patent the lightning rod for his own profit, and declined an offer by the governor of the Commonwealth for a patent on his Franklin stove, the "Pennsylvania fireplace" he designed to improve the efficiency of home heating and benefit the public at large. Franklin believed that, "knowledge was not the personal property of its discoverer, but the common property of all. As we enjoy great advantages from the inventions of others," he wrote, "we should be glad of an opportunity to serve others by any invention of ours, and this we should do freely and generously."

And there is yet another aspect of entrepreneurship that we should not ignore. While *ideas* are a dime a dozen, even the best of them require *implementation* to bring them to fruition. So let's all be humble enough to suppress our entrepreneurial egos and realize that the care and handling of those human beings who join us in the mission to turn an idea into a reality require is an essential prerequisite of success. Helen Keller said it beautifully. "*I long to accomplish a great and noble task, but it is my chief duty to accomplish humble tasks as though they were great and noble. The world is moved along, not only by the mighty shoves of its heroes, but also by the aggregate of the tiny pushes of each honest worker*." **Entrepreneurial Lesson #16 (after John Donne) "No man is an island, entire of itself."**

Taking the Plunge, and Cashing In

The theme of this conference is "The Building Blocks of Entrepreneurship—From Taking the Plunge to Cashing In," and I've done my best to give you 17 lessons (one of which is still to come) that I hope will serve as building blocks that you can use as a frame of reference for your own entrepreneurship. I've tried to honor the first half of the subtitle by describing not only *the* plunge, but the *many* plunges, I've taken during my long career, at first with failure (that early merger that cost me my job), and later with what I guess passes for success—the mutual structure, the index fund, the three-tier bond fund; the gamble on a new marketing system.

Alas, I have nothing to say about the second half of the subtitle, "cashing in." The concept of a mutual structure that is the rock foundation of Vanguard simply doesn't entail cashing in for the founder, or for any one else. To do so would belie the very core of our existence—that our mutual fund shareholders are the actual owners of our firm, and their annual cost savings—estimated at something like $6 billion *per year*—in effect, extra cash flow on their fund investments.

Yet I'm a long way from sackcloth and ashes, for four major reasons: (1) I've been very well paid in salary and bonus incentives; (2) I prefer to save money rather than spend it; (3) I've been dollar-averaging—in part, in our tax-deferred savings plan—for 53 long years, and I can assure you that it works; and (4) I've been wise enough to follow my own prudent investment advice: lots of stocks in youth and middle age, lots of bonds in my later years, nearly all in our low-cost Vanguard funds with index or index-like strategies. That works too!

Far more important than the rewards of the pocketbook—more things, more material possessions, more useless extravagance—are the rewards of the soul and spirit that come from trying to serve others rather than oneself. Whatever my entrepreneurial achievements may have been, I believe they have helped those honest-to-God, down-to-earth human beings who have invested with Vanguard in order to avoid the many, often deep, potholes on the long road to investment success, and thus capture their fair share of the returns with which our financial markets have rewarded us, and to enjoy a more comfortable retirement than most of their neighbors, just as Dr. Samuelson wrote in his foreword to my first book. I revel in that outcome. So I conclude with . . . **Entrepreneurial Lesson #17. Our greatest rewards come when we foster economic progress, and help to build a better world.**

So that's my story. Sometimes I wonder what my life would have been like had Princeton, 57 long years ago, not opened its heavenly gate and let me in.

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