Time for Growth—Strengthening Trust and Confidence in Financial Services

"Investing is an Act of Faith"

Remarks by John C. Bogle, Founder, The Vanguard Group
at SIBOS Atlanta
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"Investing is an act of faith." So reads the very first sentence in my 1999 book, *Common Sense on Mutual Funds: New Imperatives for the Intelligent Investor*. "When we purchase Corporate America's stocks and bonds," I pointed out, "we are professing our faith that the long-term success of the U.S. economy and the nation's financial markets will continue . . . faith that our corporate stewards will generate high returns on our investments . . . and faith that our professional (money) managers will be vigilant stewards of the assets we entrust to them." These are *not* merely principles that apply in the United States. They are universal principles that apply all over the globe.

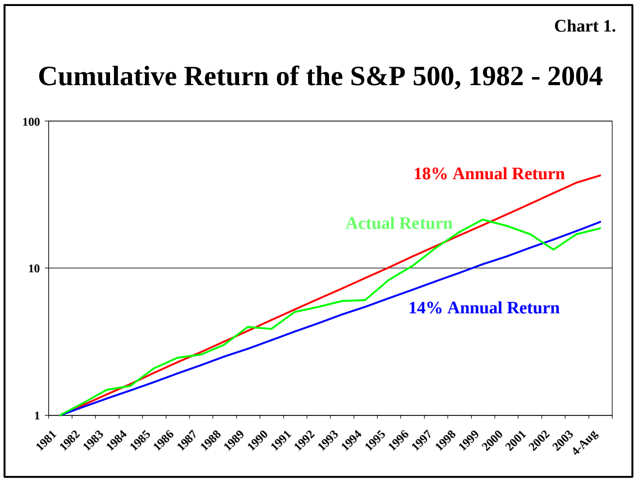
Perhaps it goes without saying that in recent years these three articles of faith—faith in the stock market, faith in the corporate executives who run our publicly-held enterprises, and faith in the trustees who manage our money—have been tested. *And found wanting*. If there is a single over-riding task that lies before us—especially each one of us in this room today—it is restoring the faith of our citizens in investing.

No one here is ignorant of the scandals we have witnessed in corporate America. It was not just "a few bad apples" such as Enron, Tyco, and WorldCom. The very *barrel* of our corporate system has been riddled with financial engineering, restated earnings, and inexplicably excessive executive compensation. Similarly, in mutual fund America, it is not only the bad apples, including some of the industry's oldest and largest firms—Putnam, Alliance, Massachusetts Financial Services—that have been implicated in the market timing scandals. The fund barrel itself is permeated by the profound conflict between the interest of fund *managers* and the interest of fund *owners.* Result: excessive costs that consume an astonishingly high portion of fund long-term returns.

If we are to restore the trust and regain the confidence of investors, we need governance reform both in corporations and in mutual funds. And in the markets of the future, we also need reform to insure that investors get their *fair share* of whatever returns the stock markets—all over the globe—are generous enough to provide.

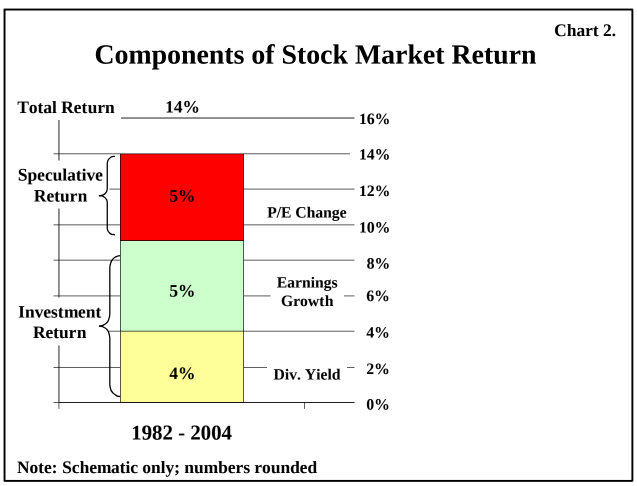
Stock Returns in the Past

The great market bubble at the turn of the century inflated stock returns to unsustainable levels—an astonishing 18% annual return on U.S. stocks from 1982 when the bull market began through the high as spring of 2000 began **(Chart 1)** was ultimately reduced by the subsequent (and inevitable) 50% crash to an average of 14% per year through October 2004. But we'd best not expect future returns at that level, well above the 10% long-term average.



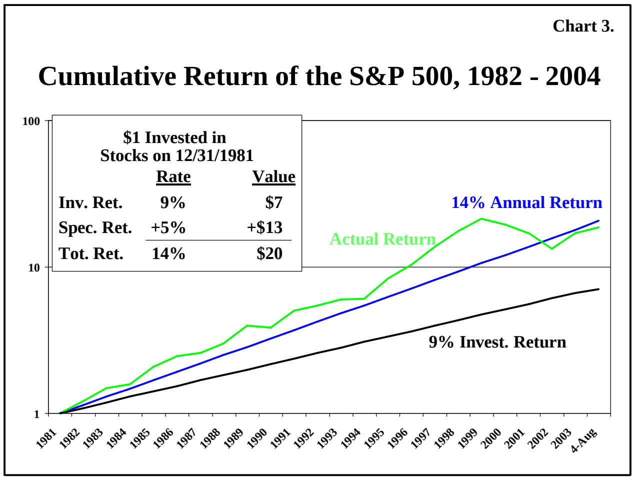
For stock market returns are not actuarial tables. But when we know the *sources* of stock market returns—*and we do*—it is possible to set rational expectations for the future. It's not complicated. As Lord Keynes pointed out way back in the 1930s, the sources of stock returns are: (1) *investment* return (he called it *enterprise*), the sum of the initial dividend yield and subsequent annual earnings growth; and (2) *speculative* return, the change in the public's valuation of stocks, measured by how much investors are willing to pay for each dollar of corporate earnings (the price/earnings ratio).

The market's 14% annual return during the 1982-2004 period, **(Chart 2)**, was a result of: (1) an *investment* return of 9%; including an average dividend yield of 4% and earnings growth of 5%; (2) an increase in the price-earnings ratio from 8 times to 22 times—an impressive 175% increase, spread over 22 years, for a speculative return of some 5% per year. Total return, then, 14%.[1] (While I use U.S. data, it should go without saying that these two sources of return drive all of the world's markets.)



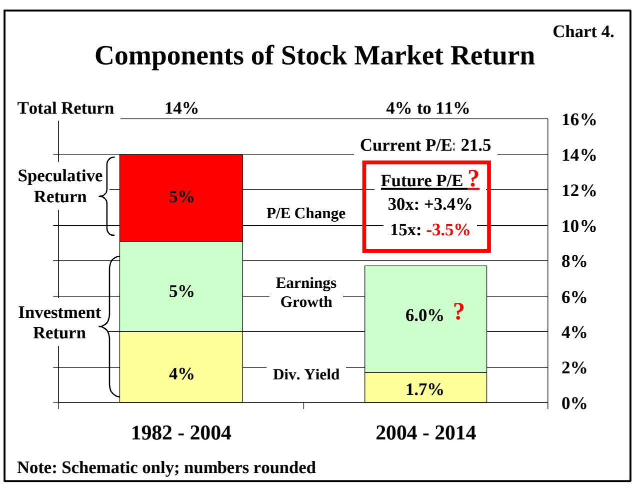
[1] Note: For purposes of simplicity, I have used rounded percentages throughout.

Compounding greatly leveraged the role of that speculative return. While $1 invested in stocks grew to $20 over that long period, it would have grown to but $7 solely on the basis of investment return. **(Chart 3)** Speculative return accounted for the remaining $13 in value, playing nearly *double* the role of its investment partner.



Stock Returns in the Years Ahead

The conditions that set the stage for that bull market no longer prevail. The dividend yield today is 1.7%, a full 2.3 percentage points shy of the 4% yield in 1982 **(Chart 4)**. Even if we are lucky enough to achieve 6% earnings growth, the annual investment return over the coming decade would come to just 7.7%. And today's relatively expensive price/earnings ratio of 22 times is a far cry from the cheap level of 8 times when the bull market began.



We can't be sure of the future P/E level, reflecting as it does, the hope, greed, and fear of investors. But we *do* know if the P/E ratio, ten years hence, were to rise to 30 times, the annual speculative return would be *plus* 3.4%, suggesting a total return on stocks of 11% per year during the coming decade. On the other hand, were the P/E to tumble to the 15 times the long-term norm, the resulting *minus* 3 ½% return would slash the total return on stocks to just over 4%.

That's a broad range, so let's fine-tune it by finding out what *you* expect. When I polled your group in an opinion survey, I asked two simple questions. First, "at what rate do you expect corporate earnings to grow during the next ten years: 4% or less annually, 5%, 6% or 7% or more?" Almost no one expected 7%, and few expected 6%. The overwhelming majority answered "5%." With today's dividend yield of 1.7%, then, this group expects an *investment* return of 6.7%.

Second, I asked, "what P/E ratio do you expect to prevail in 2014: less than 15 times, 15 to 20, 20 to 25, 25 to 30, or more than 30 times?" *No one* expected a P/E of more than 25 times and only few expected a 20-plus figure. A clear consensus averaging about 18 times emerged. Result: a speculative return of –1.8% over the decade. Combined with your expected investment return of 6.7%, then, you expect a return on stocks of about 5%.

Whether reality will be better, or worse, than the forecast based on your reasonable expectations, only time will tell. But I agree with you that subdued returns on U.S. stocks lie in prospect. (My own guess is in the 6%-8% annual range.) If so, there are strong implications for the way that mutual funds are operated and managed.

Costs Matter

This brings me to the critical role of costs. It's fine to say, as I read in the 1Q04 edition of SWIFT *Dialogue* that "efficiency is not the key reason for a client to appoint a fund manager, it is performance." That's true, but it doesn't advance the argument, for performance, as the record makes crystal clear, is intimately related to cost efficiency.

The fact—and it is hardly a secret—is that the returns of equity mutual funds tend to lag the stock market's returns by the amount of their costs. Those costs are not trivial. With equity fund expense ratios averaging 1.6%, portfolio turnover costs of perhaps 1% per year (given the industry's present astonishing turnover rate of 110% per year), and sales charges on fund purchases (amortized over a decade) adding, say, 0.5% annually, all-in fund costs come to about 3% per year.

Such costs appear to be the primary, if not the sole, reason for the 3% lag between the stock market annual return of 14% from 1982 to 2004, and the 11% return of the average U.S. equity fund. But if the market delivers a return of 6% a year during the coming decade—a percentage point above your projections and a percentage point short of mine—a 3% cost would confiscate 50%(!) of the annual total. **(Chart 5)** Worse, compounded over the full decade, the equity fund investor—who, mind you, put up 100% of the capital and assumed 100% of the risk—would enjoy just 43% of the stock market's return.

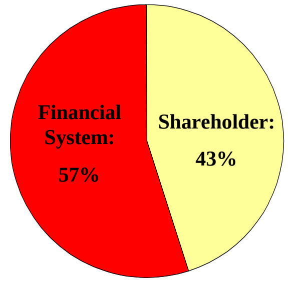
So long as *gross return in the markets, minus the intermediation costs of our financial system, equals the net return that flows through to investors* (in fact, it is a tautology), it must be obvious that if we are to ensure mutual fund investors with a reasonable share of the market's future returns, we must take a substantial chunk of costs out of the mutual fund system.

Chart 5.

Division of Market Returns Over Ten Years:
Impact of 3% Annual Costs in a 6% Market

Initial Investment of $10,000

	Final Value	Growth
Earning 3%:	$13,400	$3,400
Earning 6%:	$17,900	$7,900
Shortfall:		$4,500



Listen to Ben Graham

The costs of fund management are high, in part because we trade stocks with such alacrity, and at such high costs, with *one another*. After transaction costs, this is obviously a loser's game. Here's how Benjamin Graham, Warren Buffett's great mentor, described what institutions do on Wall Street: "The stock market is technologically remarkably well organized. But in fact, it is a huge laundry in which institutions take in huge blocks of each others washing, to the tune of 30 *million* shares a day, without rhyme or reason." (That was in 1976. Imagine what Ben Graham would have thought about today's laundry, where we wash three *billion* shares a day!)

So, inspired by Heidi Miller's challenging remarks at your opening plenary session yesterday, let's face the facts, by asking two existential questions:

- Existential Question #1: If the giant mutual fund industry is tautologically destined to match the returns of the stock market before costs, and then lag by the amount of its costs, how can we claim superior investment management as our core competency?
- Existential Question #2: If there is no conceivable way for the industry to add value through providing market-superior returns, isn't reducing the costs of our services the only—the *only*—way to improve the returns that our clients receive?

So, especially if we face a lower return environment, fund management fees and marketing expenses and operational costs, under both competitive and regulatory pressure, *must* decline. That incredible 110% portfolio turnover in the great laundry that is Wall Street must also decline, and with it total fund transaction costs. And, yes, index funds—funds that buy and hold, and sell only to meet cash outflows—closely matching the return of the stock market and operating at extremely low cost, must and will continue to grow.

The Role of Information Technology and Securities Processing

For those of you involved in information technology and securities processing, let's bend our efforts to shave costs to the lowest reasonable level. We must create ever more efficient systems for transaction flow, for communications, for data security, and for risk management, to say nothing of new information systems that will enable real-time monitoring of capital flows, *fund* trading costs, *shareholder* trading frequency, and compliance.

That quantum improvements in cost structure are well within our reach I have no doubt. "Where there is a will, there is a way," and you seasoned professional experts will help us find it. But please don't forget this Existential Question #3: *Who will benefit from these efficiencies*? The investment managers and distributors of funds, with reduced cost structures and enhanced profits? Or the front-line fund investors, with fee and expense reductions that reflect the lower costs we develop in providing these services?

The outcome is not clear, for the typical fund manager owes a fiduciary duty to *two* sets of owners—serving, if you will, two masters—a duty to the management company itself (or to its parent and *its* public stockholders); and a duty to the mutual fund itself and its own, much larger, set of public owners. It is a conflict that is hardly easy to resolve.

Suffice it for me to say that it is high time we focus on the interests of the fund shareholders. The present era of more subdued stock market returns demands it; today's post-scandal environment demands it as well. Even as the reestablishment of trust in the stewardship of money management is an ethical prerequisite, it is also a business necessity. Those firms that best serve investors—with the highest quality funds, at the lowest reasonable cost, offering the optimal combination of investor services—will ultimately win the minds, hearts, and trust and confidence of investors. It is those firms that will re-earn the privilege of managing Other People's Money.

NOTE: At the conclusion of the question and answer period, each panelist was asked to state a single wish for the future: Mine:

> In 1951, in my Princeton University thesis, I wrote: "the role of the mutual fund is to serve both individual and institutional investors . . . to serve them in the most efficient, economical, and honest way possible." Fifty-three years have now gone by, and my wish is that we set the meeting of that standard as our highest priority.