Mutual Funds: Parallaxes and Taxes

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Often, a small change in vantage point can engender a large change in perception. So it is with the parallax, exemplified by the angle created by the 2 1/4 inch distance between our eyes, which enables us to visualize objects in three dimensions. Today, mutual funds are too often viewed on a two-dimensional basis—*return* and *risk*—so I'd like to look at a third dimension: *cost*. Included in costs are both fund operating expenses and portfolio transaction costs, *and* taxes paid by fund shareholders. "Parallaxes and Taxes" is my theme, not only because of its vaguely rhythmic quality, but because far too many mutual fund portfolio managers and fund shareholders ignore the third dimension: cost. Cost is part of what I call "The Eternal Triangle of Investing." In particular, fund investors ignore the impact of the cost of taxes on their returns. With an estimated $600 billion of capital gains on the books in mutual fund portfolios today, it is high time that the subject of taxes receives the exposure it deserves.

In these boom times for equities, however, taxes are hardly a significant focus. Rather, the first word to come to mind when speaking of mutual funds today is "success." With the *possible* exception of technology, the mutual fund industry is at this moment probably the fastest-growing industry in the world. The public looks and sees the American dream coming true. Millions of investors getting, if not rich, surely richer. Compound annual returns on equity funds averaging an astonishing 26% in 1995-1997. Industry assets growing from $2.2 trillion to $4.3 trillion, with the equity fund segment rising from $900 billion to $2.3 trillion during the same period, a 46% annualized rate of growth. Cash flow into equity funds, flowing in at a healthy $4 billion monthly rate in late 1994, now cascading in at a $19 billion rate.

An Industry in Flux

And, in this worldwide age of the entrepreneur, the profits earned by the companies that manage mutual funds—from long-time industry participants to newly enchanted opportunists—have soared skyward at rates that make the returns to fund shareholders and the growth in fund assets pale by comparison. Some of the profits are simply reflected in the impact of rising assets, multiplied by rising industry-wide fee rates (in fairness, fees on some larger funds have tapered down slightly as assets have risen), but with operational costs rising at a far more modest pace. And huge fortunes have been created for those who have sold their management companies to eager buyers, often, as it happens, U.S. banks or global financial colossuses seeking entry into this newly crowned king of the financial hill—the mutual fund industry.

New funds are being created with the regularity of a drumbeat. Ten years ago, there were 700 equity funds. Today there are 3,000 equity funds, and new funds are currently being created at the rate of 500 per year. The development of a "franchise" name—shades of Procter & Gamble, Gillette, Coca-Cola, and Microsoft—is the *summum bonum* of the mutual fund industry. Small managers are joining with large ones, and large managers, eager to defend their fortresses or to expand them, are spending at a furious rate

on marketing and advertising campaigns. Such is the perception of the mutual fund industry after the bull's 15-year rampage in the stock market: an industry awash in wealth and success.

And what's the matter with that? In the abstract, nothing. That's the American Way. But with both eyes open, a more realistic image emerges. First, the stock market itself. To my ever-conservative eye, the market is valued today as if the extraordinary profit growth of Corporate America today will continue forever. Earnings of the companies in the Standard & Poor's 500 Stock Index have been growing at an astonishing 19% annual rate for five years now, compared to a previous long run (1926-1991) rate of 5.9%. We may be in a new era—put another way, we may have a new, higher mean to which to regress—but can a new earnings growth rate more than *three times* the old one really be sustained into infinity?

Today's bullish thesis was best summed up for me in an article in *WIRED*, a marvelously slick magazine for the, well, wired generation. Its thesis is entitled, of all things: "The Long Boom," with the subtitle "We're Facing Twenty-Five Years of Prosperity, Freedom, and a Better Environment for the Whole World. You Got a Problem with That?" No, "I got no problem with that." Who among us could possibly have a problem with (quoting from *WIRED*) "watching the beginnings of a global boom on a scale never experienced before. We've entered a period of sustained growth that could eventually double the world's economy every dozen years and bring increasing prosperity for—quite literally—billions of people on the planet . . . that will do much to solve seemingly intractable problems like poverty and ease tensions throughout the world, all without blowing the lid off the environment."

The Long Boom Thesis, essentially, is that nothing in the world can go wrong, that all is well, and all will be well for as far ahead as the eye can see. And in a world in which anything can happen, this thesis can't be rejected out of hand. But mark this old hand as one who is deeply, profoundly skeptical. I believe that there are heavy odds against Nirvana, and that it will be extraordinarily difficult to sustain today's environment of corporate earnings growth. If so, today's high multiples (22 times earnings vs. a long-term norm of 14) and tiny yields (an all-time low of 1.7% vs. a norm of 4 1/2%) are simply too extreme. (For what it's worth—and there are those who would say "nothing"— dividend yield has accounted for 40% of the long-term return on equities.)

Booming Markets, but Lagging Alphas

In any event, the mutual fund industry is riding on the crest of an historic bull market, but one that looks to be increasingly driven by speculative forces rather than investment fundamentals—earnings, dividends, and book values. Well, not really riding the crest, but following in the wake. During this near-three-year period in which the Standard & Poor's 500 Index has risen at a 32% rate, domestic equity mutual funds have provided a 26% return. (International equity funds have returned just 11%.) Sure, the Standard & Poor's Index has led the market, but it *does* account for 70% of the capitalization of the U.S. stock market. And the return for the total market (Wilshire 5000 Equity Index) has been no slouch, rising at a 30% rate. In all then, the awesome riches being heaped on mutual fund managers, in part because of their abundantly promoted professional stock-picking skills, have come hand-in-hand with the creation of wealth for mutual fund shareholders that, on any *relative* basis, has obviously been negative.

How can it be that professionally managed mutual funds have failed to match unmanaged market averages? Simply put, it *can* be because it *must* be. Because mutual fund managers as a group *are* the market, and simply must, over the long run, underperform appropriately weighted market indexes by the amount of their costs. And their costs are large—and growing. Fund expense ratios have been rising for decades, and equity fund annual expenses now average more than 1.5% of assets. Fund portfolio turnover rates have also soared, presently running near 90% per year, with a consequent escalation in transaction

costs, perhaps (though they are difficult to measure with precision) adding another 0.4% to the "fiscal drag" against an equity market in which frictional costs, in the abstract, do not exist. ("The market" has no advisory fees and no turnover.) That's a total expected annual shortfall of 1.9% for fund returns.

This shortfall—engendered importantly by costs—doesn't look like much when subtracted from a market providing a 30% annualized return—and, in fairness, probably wouldn't look like much if returns were, God forbid, "only" 20%. But, over time, it consumes fully one-fifth of a 10% return—to say nothing of confiscating four-tenths of a 5% return. Think for a moment about "Alpha"—a vital measure of a fund's return relative to the stock market, adjusted to reflect the relative risk assumed by the fund. The statistics are quite clear (*Morningstar Mutual Funds* is the best recognized source), and they show that the average mutual fund has provided an Alpha—a risk-adjusted return relative to the market—of -1.9% per year during the past decade. This number exactly equals the industry's estimated annual costs of 1.9%. It is no accident that these figures are normally quite similar.

But alas (from the industry's standpoint), the news is about to get worse. To tell you why, let me move further along the parallax, and view the tax aspect of cost—a vital element in my own three-dimensional view of an industry that is too often looked at in only the two dimensions of risk and return.

Taxes: The Industry's Black Sheep

The tax issue is the black sheep of the mutual fund industry—like the cousin who can't get her life together or the uncle who drinks too much—best kept out of sight and out of mind. If the industry feels that way, however, the shareholder cannot afford to. For it is the shareholder who pays the taxes on a mutual fund's income dividends and capital gains distributions generated by the fund's constant staccato of portfolio sales, and—at least in these halcyon bull market days—the realization of enormous taxable capital gains. The dichotomy is that a portfolio manager's performance is measured and applauded on the basis of *pre-tax* return—never mind that the Internal Revenue Service confiscates a healthy share of it. But the fact is that most portfolio managers simply don't spend much time agonizing over the tax consequences of their decisions.

Ever since the industry began in 1924, it has essentially ignored the tax issue, and in the "good old days" funds were sold as much on the basis of "looking for more income" as on the basis of total return. (In the 1940s and early 1950s, stock yields averaged 8%, bond yields 2 1/2%.) Indeed, the industry often sloughed over the difference between income dividends and capital gains distributions, adding them together to arrive at a "total distribution yield," a practice not legally permitted since 1950. In recent years, as tax-deferred IRA accounts and 401(k) corporate retirement plans have come to the fore, tax considerations have gotten even less attention. In fact, investors in tax-deferred accounts are now the driving force in industry growth, accounting for nearly 40% of the assets of equity funds as a group. Investors in these accounts need burden neither their minds nor their checkbooks with tax issues.

But the owners of the other 60% of fund assets do not have the luxury of ignoring tax considerations. Each year, they must pay taxes on the fund distributions they receive. Yet mutual funds do not provide adequate disclosure about the tax implications of their investment strategies, portfolio turnover expectations, and gain realization policies. Look under the "Dividends, Capital Gains, and Taxes" heading in a typical fund prospectus, and you'll find something like: "The fund distributes annually substantially all of its net income after expenses and any capital gains realized from the sale of securities. Dividends and short-term gains are taxable to you as ordinary income; distributions of long-term capital gains are taxable to you as long-term capital gains." That is proper disclosure as far as it goes. *But it doesn't go nearly far enough.*

Portfolio managers, fund sponsors, and distributors *know* that funds don't pay much, if any, attention to tax concerns. This important fact should be stated in the prospectus: "The fund is managed without regard to tax considerations, and, given its expected rate of portfolio turnover, is likely to realize and distribute a high portion of its capital return in the form of capital gains which are taxable annually, a substantial portion of which are likely to be realized in the form of short-term gains subject to full income tax rates." (Some funds might modify the last phrase.) There would seem to be only two reasons that the disclosure of that known fact doesn't find its way into the prospectus: one, inadvertence; two, some sense that it would encourage investors to focus on the negative impact of excessive taxes on their total returns. I believe the sentence quoted should be included as a prominent part—if not the opening sentence—of the disclosure of fund tax considerations in the prospectus.

Today I estimate, very roughly, that mutual funds are carrying capital appreciation of a cool $600 *billion* (25% of equity fund net assets), representing a potential nearby liability to taxable shareholders of some $80 billion. Perhaps $150 billion of this appreciation will be realized and distributed to investors in 1997 alone, carrying a liability of $10 billion to taxable shareholders. I can only hope they are ready to pay it.

What is more, external circumstances could exacerbate the situation. Just as rising markets, which bring in new money, *dilute* per share distributions, a declining market, which could cause net liquidations, *increases* per share distributions. (Fund accounting practices give rise to strange outcomes!) In a down market, when share prices tumble, it is possible, if not likely, that new fund investors with unrealized losses would nonetheless receive substantial taxable capital gains distributions. "Forewarned is forearmed."

With all this background, let's look at tax impact in a longer-term context. On the income distribution side, perversely enough, the tax impact is, in a sense, beneficial. Equity mutual funds are today earning gross income—before expenses—at the rate of about 2.1%. (Their equity holdings yield about 1.7%; their 7% average reserve position 6%.) But fund expenses average 1.5%, meaning that equity fund investors receive a puny 0.6% yield on which to pay taxes. Expenses, in fact, are consuming 71% of fund income. In the paradoxical world of mutual funds, then, the higher the expense ratio, the more "tax efficient" the income component of total return. "Alice in Wonderland" writ large!

Alpha Takes Another Hit . . . From Taxes

The impact of taxes on the capital component is another story altogether. The tax blessing, as it were, in the income component of return is overwhelmed by the tax bane on the far larger capital component. To take a simple example: during the past fifteen years, the average equity fund enjoyed an average annual return of 14%—2% from income and 12% from capital. But the net asset value of the average fund increased by just 7% per year, leaving 5 percentage points accounted for by realized capital gains. The recent maximum tax rates have been 40% on short-term gains and 28% on long-term gains. If we assume that the average marginal tax rates on fund shareholders were 33% and 25% respectively—and that 80% of the gains were realized on a long-term basis—the tax rate would have averaged 27%, and the capital return reduced by 1.4 percentage points, sharply reducing realized (and publicly reported) returns, while leaving risk unchanged.

The fact is that taxes have a hugely negative impact on relative returns. Playing off the title of an outstanding article by Robert H. Jeffrey and Robert D. Arnott in *The Journal of Portfolio Management*, "Is Your Alpha Big Enough To Cover Its Taxes?", I'd say: "No, your Alpha is being eaten alive by taxes." That situation is made somewhat more dire by the fact that, as the past record I cited earlier showed, equity

funds, largely because of their investment costs, already have had a *negative* Alpha of -1.9%. On an after tax basis, it just fell to something like -3.3%.

It's important to recognize that what's happening here is largely the product of the inordinately high portfolio turnover rates of mutual funds. Twenty years ago, portfolio turnover averaged 30%; today it averages nearly 100%. While individual stocks may be held for decades (and by some managers—Warren Buffett comes quickly to mind—rather successfully) or even generations, mutual funds are rushing to buy and sell their stocks based on transitory changes in price, without concern for tax consequences. The fact is that this behavior sharply reduces the returns generated for their taxable owners. Further, some fund managers are so hair-triggered that many of the gains are short-term in nature (less than one year) and are taxed at ordinary income rates. Nearly 30% of fund gains fell into this category last year, and, with the end of the limitations on "short-short" gains under the new Tax Reform Act, this figure could well increase.

It is highly unlikely that fund turnover will slow so greatly as to mitigate the gain realization issue. First, the fact is that reducing a fund's turnover from 150% to 100% simply doesn't matter. Substantially all gains are realized fairly quickly. Authoritative studies suggest that turnover rates would have to be reduced to 20% or less to make a material improvement in the tax burden—but that *any* turnover whatsoever has a negative impact.

What happens when the basic strategy of a fund calls for limited turnover? Something very good for fund investors. The tax bill falls, and the after-tax return rises accordingly. It *is* as simple as that. For as taxes are deferred, returns rise significantly with each additional year that an investor elects to hold fund shares. And through tax elimination--for example, if an investor's heirs receive the shares with a stepped-up cost basis at the time of the investor's death—after-tax return leaps upward.

Nonetheless, even if, as a policy matter, good intentions exist to reduce turnover, it obviously soars—and substantial gains are realized—when a new portfolio manager is brought in to manage a fund. This is an event that happens with increasing frequency in this era of *manager* turnover—most notably evident in the transient "superstar" managers who are lured away by huge stipends, entrepreneurial instincts, or the fact that the large asset size of the funds they are leaving has impeded their ability to deliver outstanding returns.

To say that these are especially critical issues for wealthy investors considering investing in mutual funds in the accumulation and distribution of their estates would be a powerful understatement of the issue. As one commentator[1] has observed, "Taxable investing is a loser's game. Those who lose the least—to taxes and fees—stand to win the most when the game's all over." In the fund arena then, just as costs matter, so taxes matter.

A Good Solution: The Index Fund

At this point, you are probably thinking either (a) that you should just forget about mutual funds, or (b) that there must be a better way to achieve the valuable diversification that mutual funds clearly provide. Well, there *is* a better way through which you can avoid suffering the negative consequences of both high costs *and* excessive taxes, and come as close as the law of the financial markets allows to achieving a positive Alpha. For there are a relative handful of funds that operate at a minimal cost and with a minimal tax burden. Most are market index funds, usually owning all of the stocks in a given arena (i.e., the Standard & Poor's 500 Stock Index, composed of large cap stocks that represent 70% of the value of the

[1] James P. Garland, *The Journal of Investing*, Spring 1997.

total market) or in a few cases the entire stock market (the Wilshire 5000 Equity Index). And they are working well, especially the latter, since significant changes to its composition simply do not take place.

Let's begin with a baseline: the after-tax return of the Standard & Poor's 500 Stock Index. We'll deduct income tax from the dividends, and assume no capital gain realization, deferring all capital gains taxes. With a pre-tax return of 16.7% over the past 15 years, it produces an after-tax return of 15.1% as shown in the table below. The after-tax return amounts to 91% of its pre-tax return.

Next, let's look at the actual experience of the first index fund, which has been around since 1976. Its record bears out in practice what I've just been preaching: that costs and taxes matter, and that minimizing them through an index fund works. This fund, modeled on the Standard & Poor's 500 Index, presently conducts its operations at a cost of about 0.20% per year. Its turnover has averaged about 4% to 5% (its cousin, linked to the Wilshire 5000 Index of the total stock market, has averaged an even lower 2%). Its 15-year pre-tax return was 16.4%, and with after-tax return of 14.3%, a flow-through of 87%.

Now, we'll calculate the same figures for the average mutual fund: 15-year pre-tax return of 14.3%, after-tax return of 11.8%—a flow-through of but 83%. This table presents the data, and reflects the critical fact that the index itself ranks in the 84th percentile on a pre-tax basis, but rises to the 92nd percentile after taxes. For the index fund, the rank rises from the 81st percentile to the 86th percentile. The first figure is largely shaped by the high operating expenses of the typical fund; the latter by the heavy tax burden engendered in this typically high turnover industry.

S&P 500 Index and Mutual Funds

Rate of Return: 1981-1996

	Before Taxes	After Taxes
Index Return	+16.74%	+15.14%
Index Fund	+16.44%	+14.33%
Average Mutual Fund	+14.29	+11.80%
Index Advantage	+2.45%	+3.34%
Index Fund Advantage	+2.15	+2.53
Funds Outpaced by Index	84%	92%
Funds Outpaced by Index Fund	81	86

In summary, during the past fifteen years—admittedly a good period for giant cap stocks—the focus on low costs helped place the index fund well into the top quartile of mutual fund returns (81st percentile). The focus on tax minimization took it near the top, well, octile (86th percentile). Not too shabby, it seems to me for a passively managed fund that didn't even have the putative advantage of a skilled portfolio manager.

I should note that the index *fund* returns understate our expectations, because the fund had a somewhat higher expense ratio during the early part of the period than its recent level of 0.20%, and experienced two years (1985 and 1986) of fairly high gain realization, resulting from relatively high shareholder liquidations. The fund now has policies in place designed to minimize the recurrence of this situation. I believe that the best approximation of future relative pre-tax and after-tax returns should fall somewhere between the index itself and the index fund.

Yet while there is a high degree of certainty that the low cost advantage of indexing will persist, there is a somewhat lower level of certainty that the deferral of gain realization will persist. First, index

funds, by virtue of their low turnover, should build up their *unrealized* gains over time. Somewhere way down the road, those gains will inevitably be realized. Second, despite the intention of an index fund to avoid realization, it is susceptible to a run of shareholder redemptions that could force it to liquidate highly appreciated portfolio holdings. Nonetheless, given the value of tax deferral even for a limited period, it is difficult to visualize a circumstance under which the potential tax advantage offered by index funds, *relative to traditional actively managed funds*, will not persist.

A Better Solution: Tax-Managed Funds

In any event, in 1994 at least one fund group, concerned about these issues, developed a series of low-cost "tax-managed" funds. The most popular form is based on a growth stock index (emphasizing lower-yielding equities to minimize the tax burden on income) and, when capital gains are realized, realizing offsetting losses by the sale of portfolio holdings that have declined (even at the expense of precisely matching the index), replacing them later on. Importantly, in addition, the possibility of abrupt share redemptions is minimized by charging a penalty transaction fee—*payable to the fund and its remaining shareholders*—if shares are redeemed within five years of purchase. So far, this system seems to be working well. Redemptions are a tiny fraction of industry norms, and speculative "market-timing" short-term investors have been conspicuous by their absence.

More recently, others in the industry have begun to respond, and six new purportedly tax-managed funds have been formed during the past year. But none follow an index strategy, and none, so far as I know, have taken steps to limit redemptions. Overall, save their "leaning against the wind" to avoid excessive turnover, their investment objectives are conventional, as are their pricing structures. These limitations, in my view, will make if difficult to reduce either the tax bite or the bite that operating expense ratios take out of Alpha.

Properly structured, however, the tax-managed fund is, I believe, destined to become a strong force in the mutual fund field. And I believe that the reduction of taxes on long-term gains from 28% to 20% under the new Tax Reform Act will accelerate this trend by raising the "tax discount" on long-term capital gains by fully 1.7 times—from 12% to 20%. In addition, the Act has given a lesser relative advantage to gains on securities held for 12 to 18 months (28% tax), reducing to high turnover mutual funds the benefits of the new lower rate. In all, a low-cost tax-managed fund can take most of the sting out of a negative Alpha.

A New Idea, Sixty Years Old

With all of the high-priced creative and imaginative talent in this industry, I find myself wondering why someone, somewhere, hasn't dreamed up alternative, perhaps even better, ways to enhance after-tax mutual fund returns. Surely the opportunities abound. Let me describe my own idea. I start with a fund that simply buys a large sampling of high quality blue-chip growth stocks, and holds them unless fundamental circumstances change radically. Where, you ask, do we find the budding Warren Buffett to manage it? Honestly, I don't know. So, I shift gears. Why not a fund that buys, say the 50 largest stocks in the Standard & Poor's Growth Index universe? (That's nearly 30% of the capitalization of *the entire stock market*.) Simply hold them "forever" and don't rebalance as prices change. If there is a merger, keep the merged company; if a company is bought for cash, reinvest the proceeds, either in the next largest company or in the fund's other holdings (it probably won't matter which you do); if it fails and goes out of business, well, just realize that can happen.

Then, run the fund at an expense ratio of 20 basis points, just incurring bare-bones operating costs. Minimize exposure to shareholder redemptions with a stiff redemption fee and/or strong limitations on daily liquidity (i.e., open the fund for redemption only, say, on the last day of each quarter). These latter steps will, of course, make it difficult to attract quick-triggered opportunists. But—over time—make it commensurately easy to attract serious long-term investors (today, an endangered species). But the rewards to them should be far larger than the risks.

The potential reward to investors: Huge. In a stock market which averages a 10% pre-tax return, the average fund might, based on reasonable assumptions, provide a pre-tax return of 8.0% and an after-tax return of 6.5%, while a low-cost buy-and-hold fund with merely an average gross return might achieve a net return of 9.8% before taxes and 9.0% after taxes. (This is a conservative hypothesis, with an after-tax spread of 2.5% that is well below the shortfall of 3.3% that actually existed between active funds and the Standard & Poor's 500 Index during the past 15 years.) For the long-term investor, these numbers would be little short of dynamite. $100,000 invested at the outset would, after 25 years have grown to $862,000 after all taxes for the tax-managed fund, nearly double (!) the value of the $483,000 for the conventional actively managed fund. I guess it's fair to conclude: "Yes, costs and taxes matter."

The potential risk to investors: Small. Essentially, it's the risk that the 30% of the entire investment universe represented by the 50 largest growth stocks today would underperform the remaining 70% of the market by more than 3.0% per year *over the long-term.* (At that figure, the choice between the two funds would be indifferent.) The powerful forces of efficient financial markets would likely repel any such challenge, and such a defeat for our hypothetical fund could be accomplished, over the long term, only against all odds. The surprising, if simple, fact is that broad diversification makes it just as difficult to achieve significant *under*performance relative to the market as to achieve significant *over*performance. In short, the risk-return equation appears highly favorable, thanks simply to the minimization of the fiscal drag of operating and tax costs. (That's the three-dimensional view once again, as seen from this pair of eyes.)

There is, Ecclesiastes tells us, nothing new under the sun. And that ancient maxim is in a sense true of my "new" idea. I may be one of a tiny handful of mutual fund historians who retain the memory of a similar fund formed in 1938. Structured as a fixed trust, Founders Mutual Fund picked just 36 of the blue-chip stocks of the day, which it held, as it happens, until 1983, when the fund abandoned the strategy. And in fact, at the end of that 45-year period, *the fund held the same thirty-six stocks it had owned at the outset,* including IBM, Procter & Gamble, duPont, Union Pacific, and Eastman Kodak—not only durable (by definition), but successful, enterprises.

Prior to the change in its strategy (I couldn't locate any record of its first five years), the Fund earned an average annual return of 10.3% pre-tax, less than the return of 11.6% on the Standard & Poor's 500 Index, a gap predictably engendered in part by the Fund's operating costs of 0.5%. Interestingly, however, its return was virtually identical to the 10.6% return of Massachusetts Investors Trust, the largest (and lowest cost) equity fund throughout the entire era. While we could not precisely calculate after-tax returns, the record shows that Founders distributed only minimal gains during the period, while MIT distributed substantial gains. In short, it is quite likely that Founders Mutual won the after-tax race. A similar fund, Lexington Corporate Leaders Fund, formed in 1935 and invested in just 30 stocks, impressively outpaced the Standard & Poor's 500 Index (16.0% vs. 15.6%) over the past 22 years (the earliest comparison available using Morningstar's database). These comparisons prove one thing, and one thing only: that a fund selecting a fixed initial list of large blue-chip stocks *can* give a fully competitive account of itself on an after-expense, pre-tax basis, and by so doing, *can* generate a substantial margin of after-tax advantage relative to other funds.

The Parallax View

I, for one, hope that investors will finally become mature enough to realize the importance of a new approach that considers all three dimensions of mutual fund investing—risk, return, and cost. And I hope that I will not have to wait long for the fund that I have described to see the light of day: a fixed trust owning a diversified list of 50 U.S. blue-chip growth stocks. Indeed in this global day and age, it could well be accompanied by a sister fixed trust with a list of 75 of the largest growth stocks in the world. Both would be handsome-looking lists. But whatever stocks are chosen, the fixed trust must be operated at minimal cost, and structured to limit cash inflows and outflows.

I also hope that the mutual fund industry will wake up to the critical issue of taxes, review their investment policies, and consider whether our 15 million taxable shareholders are getting a fair shake. We do not have a monopoly on investor affection. If fund managers persist in ignoring the tax consequences of their decisions, a diversified list of individual stocks, held directly, with realization controlled by the investor, can represent a fine alternative to a mutual fund.

Well, the ideas I've discussed with you today, however obvious and painfully simple, are fully consistent with my parallax view of the mutual fund industry today. And the new fund I've discussed is not just another transitory fad to capitalize on the strategy of the moment, like so many funds in the past few years, but a durable concept that capitalizes on age-old basics. Not just a focus on what's most marketable to speculative investors in the short-term, but on what's most serviceable to intelligent investors in the long-term. Sure, the timing of introducing such a fund is risky: all timing is, and all funds are. Yes, the markets of the world, particularly in the United States, look over-extended today. But as I've often said; "Never think you know more than the market. No one does." Impulse is your foe in the great quest for long-term investment success.

But in that great quest, time is your friend. Properly implemented, "buy and hold" is a wonderful long-term strategy, and is the surest possible way for those interested in wealth management to optimize their returns. We in this industry ought to have the wit and the wisdom to fully acknowledge that today's mutual funds, with hefty costs and high turnover rates, are not nearly attractive enough to taxable investors, and to exercise our creative ingenuity to do something about it. We owe a fair shake to our traditional base of taxable shareholders, investors who badly need our services, but only if our funds are properly structured. It's about time we moved in that direction, relying above all on a simple truth: "stay the course." It is as useful an axiom in investing as in navigating a great ship, and indeed as in life itself.

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