Giving the Bond Fund Investor a Fair Shake

Remarks by
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As I look at the names of those you have previously honored for lifetime achievement in the advancement of the analysis of fixed-income portfolios—from Sidney Homer and Henry Kaufman to Fisher Black and William Gross—I am, to put it mildly, profoundly humbled. I am truly an amateur in a list of those consummate professionals, and fully aware that I would not be standing before you had I not been surrounded, during my entire near half-century career in the mutual fund industry, by a cadre of the finest fixed-income professionals in the field. It is on their behalf that I accept your honor tonight.

Nonetheless, I've been an interested student of bonds and the bond market, and a vigorous participant in the bond fund segment of the mutual fund business, ever since my great mentor, Wellington founder Walter L. Morgan, brought me into this business in 1951. When I joined Wellington Management Company, one of my first jobs was analyzing the interest coverage of corporate bonds for Wellington Fund. Then, as now, this fund stands as one of the premier balanced mutual funds, forever it seems, holding an approximate 65/35 stock/bond portfolio, in which credit quality was uppermost in our minds. But it was only in the waning years of the "go-go" era in the stock market during the late 1960s that I became fascinated with the idea of a bond mutual fund. While bond funds had been an industry staple during the 1940s and 1950s, they began to vanish like the cigar-store indian. By 1968, only four fund sponsors were offering bond funds. When, during those heady days for stocks, I saw a cover of *Institutional Investor* depicting bonds as dinosaurs, I—ever the contrarian—was certain that it was time to start the first new bond fund to see the light of day in a quarter century.

Alas, my partners at Wellington Management Company—they were the investment experts—informed me that bonds were yesterday; stocks were tomorrow. So we compromised, forming a bond-based income fund known as Wellesley Income Fund in 1970. It was not until the stock market began to crumble in 1973 that I finally prevailed; we formed the Westminster Investment-Grade and High-Yield Bond Funds that year. But that departure from the equity road followed by the industry, alas, created just one more rift with my partners at Wellington Management. Early in 1974, I was fired.

But the phoenix quickly emerged from the ashes. Later in that very year, luck and determination combined to enable me to create Vanguard. Our *mutual* mutual fund organization, in which the funds would be managed by their own officers and staff—not by an external management company—was a new and unique structure. We would operate on an "at cost" basis, contract with outside professional firms to perform advisory services, and negotiate advisory fees at arm's length. To this day, Wellington Management has continued to provide bond management for Wellesley (now Vanguard Wellesley) Income Fund and the Westminster (now Vanguard) Long-Term and High-Yield Bond Funds, albeit at sharply reduced fee rates. Vanguard sets the investment objectives and broad policies, and Wellington implements the investment program. It has been a winning team, as all three funds have turned in commendable performance records over the years, the result of sound goals, solid strategies, skilled professional management, and low cost. Today, the two bond funds are the largest funds in their fields.

Then, in 1976, came Vanguard's first opportunity to change, not merely the structure of fixed-income management in mutual funds, but its very nature. In June, Congress passed a law making it possible for mutual funds to flow-through to their shareholders the tax-exempt character of municipal bond interest. The new law quickly spawned the creation of the first municipal bond funds, and within a year a score had come into existence. All were garden-variety municipal bond funds, with their managers implicitly focusing on long-term bonds while implying that maturities would be adjusted opportunistically in anticipation of changes in interest rates. I simply couldn't buy that strategy. Ever the contrarian, I was deeply skeptical that *any* manager could consistently forecast interest rates with accuracy, and thus significantly outpace the famously-efficient bond market over the long run.

The Three-Tier Municipal Bond Fund

It quickly occurred to me that, with our mutual structure, combining low operating expenses with the rock-bottom fees that we were in a position to negotiate, we could offer a municipal bond fund that could deliver to our investors the highest *net* yields in the field. Winning the performance derby, not by genius but by combining a less active approach to bond management with exceptionally low cost, quickly led to an idea so simple and obvious as to defy description. The proverbial light-bulb that turned on was the concept of creating, not a single "managed" municipal bond fund, but three separate funds: A long-term fund; a short-term fund (essentially the first tax-exempt money market fund); and—you guessed it!—an intermediate-term fund. Each would own high-grade tax-exempt bonds, rigorously maintain a defined maturity range, employ professional managers, and minimize portfolio turnover. And the shareholders would be rewarded with top performance.

It would be difficult to be very proud of such a elemental conception. Yet it took years before this simple basic notion was established as the industry norm, as it has now become, for tax-exempt and taxable bond funds alike. The strategy may have been obvious, but the obvious has been in many respects my stock in trade. One writer, determined to explain Vanguard's leadership in fund innovation, pointed to my "uncanny ability to recognize the obvious," a wonderful paradox, since the obvious is, by definition, something *anyone* can recognize. In that sense, the three-tier, high-quality, low-cost fixed-income strategy we developed in 1977 had the same genesis as our 1975 pioneering of the index stock fund: The simple insight that it is the *costs* of investing that determine the gap between the returns the stock and bond markets *provide* and the returns investors as a group *receive*. Conclusion: To the victors—the shareholders of the lowest cost funds—belong the spoils.

Even if everyone in the fund business *did* recognize this obvious fact, however, Vanguard alone, with its internal management structure, had the *opportunity* to become the low-cost provider, along with the *motivation* to act: our primary objective was to serve the fund shareholder. We also had the *will* and the *determination* to shake the mutual fund industry to its very foundations. It is this missionary zeal—most notably evident in our fixed income management strategy and our market indexing strategy—along with the talents of the professionals who manage our active funds and administer our passive funds, our internal structure, and our thriftiness that are, slowly but surely, reshaping the way Americans invest.

So it was during 1970-1977 that we put in place the essential elements of the fixed income strategy that we follow to this day. But in the years that followed, we made critical additional decisions to insure our success. A few of the major ones:

- February 1977 – We eliminated all sales charges and broker distribution, going no-load and solidifying our claim as the low-cost provider.

- August 1977 – We hired Citibank as investment adviser of our three new municipal bond portfolios, our first use of an adviser other than Wellington.

- June 1980 – We founded the first no-load GNMA fund, today by far the largest in its field.

Perhaps our most important decision was made in September 1981, when we formed the Vanguard Fixed Income Group and internalized the management of our municipal bond and money market funds. This was Vanguard's first foray into the field of active investment management, as we terminated Citibank as our municipal bond fund manager and Wellington as our money market fund manager, again slashing fund expenses. One of the great bonuses of this move was bringing Ian MacKinnon aboard to run our fledgling effort, and he has done so with distinction to this day. We'd come a long way in a fairly short time, but were soon to take yet another major initiative.

The Bond Index Fund Comes Into Being

As you might imagine, that initiative was the creation, in 1986, of the first *bond* index fund for individual investors, Vanguard Bond Index Fund (now "Vanguard Total Bond Market Index Fund") combined our fixed-income strategies with our confidence in the merits of indexing. The idea of creating a total bond market fund, investing in U.S. Treasuries, GNMAs, and investment-grade corporates and operating at minimal cost, was, like just about everything else we've done, obvious. The Fund was in the conceptual stage when FORBES magazine, in an article detailing the inability of the managers of high-cost bond funds to match the returns of the bond market, plaintively queried, "Vanguard, where are you when we need you?" That was all the inspiration I needed to accelerate our timetable, and the bond index fund began operations before the year ended. It does just what its sister stock index funds are designed to do: Outpace the results of high-cost active managers who ply their trade in the same investment fields. Among all 1200 taxable bond funds, it is now the third largest.

The success—both artistic and commercial—of our total bond market index fund gave me the courage to take yet another obvious initiative in 1994. We created the first (and still the only) bond index fund with a series of varying maturities. (Once again, highly imaginative! . . . short-term, intermediate-term, and long-term.) Of all the funds we've started, I think these were the most controversial, with little enthusiasm from the investment side of the house, and even less from the individual investor and institutional investor sides. The objections were not idle: "How could these funds *possibly* compete with our toughest competitor, another three-maturity bond fund with a proven record, comparably high quality, and costs virtually as low?" That competitor, of course, was Vanguard, already offering *managed* short, intermediate, and long-term U.S. Treasury and corporate bond funds. But I had no doubt that we needed to preempt the bond index fund market that was sure to develop, and so we did. Our three defined-maturity bond index funds, too, have obliged by giving a splendid account of themselves, essentially tracking their index targets before taking into account their minimal expenses. They have grown at a modest but steady pace, and they are proving themselves. I have no doubt that the best is yet to be.

Looking at the Vanguard fixed income funds as a group, they are clearly setting the industry standard in both the taxable and tax-exempt areas. With $82 billion of assets, we now manage the largest aggregation of bond funds in the industry. Another $68 billion of Vanguard money market funds—among the five largest asset aggregations in *that* field—brings our total fixed-income fund assets to $150 billion. This quiet success comes surprisingly close to matching the much-more-widely-publicized success that has carried our equity index fund assets to $190 billion. Taken together, this $340 billion aggregation of assets—nearly 70% of Vanguard's $500 billion total—is a wonderful testament to the majesty of simplicity in an empire of parsimony.

Performance: Strategy and Low Costs

The key to this success is, of course, our bond fund performance. The Morning-stars abound. Among our 30 ranked bond funds, 22 Vanguard funds hold Four- or Five-Star ratings, none hold One-Star, and only two hold Two-Star ratings. (Both are long-term Treasury funds. When rates rise, doggone the slightly longer maturities their strategies entail!). FORBES magazine lists 41 "Best Buy" fixed income funds; fully 19 bear the Vanguard name. And the other rating services come to the same general conclusions.

The disciplined strategies I've described today—followed assiduously by our bond index funds and only slightly less so by our managed bond and money market funds—have been essential to that performance success. Our competitively low costs, too, carry a major share of the credit. The average annual expenses of our fixed-income funds as a group came to 0.22% of assets in 1998, compared to the 0.85% expense ratio of our peers, in effect enabling us to start the year with a 60-plus basis-point advantage. Key to our low expense ratios are the extraordinary economies of scale we realize and deliver to shareholders. Our contract with Wellington Management entails advisory fees that average just two (2!) basis points on the $23 billion of assets in our Long-Term Corporate, High-Yield, and GNMA funds. We slash even that rate by half in our Vanguard fixed-income group, running our $15 billion in bond index funds and our $113 billion pool of U.S. Treasury, corporate, and municipal bond and money market funds at a cost of a *single* basis point—not too shabby in a field in which many advisory fees alone (excluding *additional* distribution and administrative fees) may run from 50 to 100 basis points per year.

Speaking Out for the Bond Fund Shareholder

As part of my life's work in this industry, I've not been satisfied to create what I think are better ways of investing, ways that are more likely to deliver the returns that trusting investors have every right to expect, returns that approach 100% of whatever returns the grace of the markets provide. I've spread the word far and wide, in countless speeches, articles in financial journals, and press interviews—a process that has enhanced my not inconsiderable unpopularity with fund executives and industry associations. And perhaps uniquely among industry executives, I've focused heavy attention on bond funds. I've even had the temerity to write chapters on bond funds in both of my books, pounding out my message of common sense investment strategy and low cost.

I've also been shameless about challenging the role of bond funds carrying sales commissions. Some $400 billion of the $800 billion of bond fund assets are in funds in which investors have paid loads that average 3½% of the amount invested. What is more, such funds tend to have even *higher* expense ratios than no-load funds, the second half of a double whammy that is impossible for investors to recoup. Yet most performance comparisons totally ignore these punitive sales costs. Raising awareness of the devastating toll that excessive costs extract from bond and money market returns is, finally, making a difference. It's all part of my mission to give investors in fixed-income mutual funds and equity mutual funds alike a fair shake.

Performance and Professionalism

It must be obvious that Vanguard's investment strategies and our low cost structure are conditions *necessary* to explain our success. But a further condition—a condition sufficient—is needed to explain our tough climb to the pinnacle of the mutual fund fixed-income arena. Given the professional status of this audience, I have saved it for last. That condition sufficient is the professional management of Vanguard's bond funds. We have had the benefit of a group of intelligent, trained, experienced, talented, and credentialed fixed-income experts who have served us ably and with remarkable durability over the years. Ian MacKinnon, the leader of Vanguard's internal fixed-income team, is at the peak of his profession, strongly supported by Robert Auwaerter on the taxable bond side, by Christopher Ryon on the tax-exempt bond side, and by Kenneth Volpert, our bond indexer. They, in turn, are buttressed by an 80-person crew whose watchword is quality, whose standard is discipline, and whose *modus operandi* is diligence. Wellington's Earl McEvoy, one of the consummate bond managers, has helped run our High Yield Bond fund since 1984, and Wellington's Paul Kaplan, another professional of the highest order, has served our GNMA fund for more than a decade. (Our low portfolio *manager* turnover, combined with our low *portfolio* turnover, provides our funds with a powerful advantage.) These pros believe in the guiding principles I've outlined to you, practice them every day, and pass them along to new members of their crew. The system works.

In accepting your award, I ride on the coattails of these fixed-income professionals. It is fine to come up with simple investment ideas, to create a structure that provides low costs, and to build straightforward systems for the delivery of our funds. But without sound implementation, they could amount to nothing. So I compliment my trusted associates, these fine human beings who bring high honor to the profession of managing and analyzing fixed-income securities. I compliment you, too, for devoting your careers to the honing of your own high professional standards and skills. Tonight, I am in debt to my colleagues, even as I am in debt to you for honoring me.

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