The Road Less Traveled

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I. The Prophesy

Almost 43 years ago, in July 1974, one of the most memorable events of my long career took place. I was in Los Angeles at the headquarters of the American Funds, meeting some of the friends that I had gotten to know during my long service as a governor of the Investment Company Institute, and chairman during 1968-1970.

During the day, the late Jon Lovelace, head of the firm, came into the conference room where we were gathered and asked me to meet with him privately. He had some important industry issues that he wanted to discuss. Jon, son of Jonathan Bell Lovelace, founder of the American Funds in 1931, had a high reputation for business integrity, independence of thought, and wisdom, and I was eager to meet with him.

Following my visit to his firm, however, I had scheduled a dinner meeting before flying back to Philadelphia on the 7:30 a.m. flight the next morning. "That's fine," Jon said, "I'll meet you at the LAX breakfast room counter at 6 a.m."

When I arrived, Jon was already seated at the counter. After exchanging a few pleasantries, he got right to the point. "I understand that you're planning to create a new mutual fund complex that will actually be *mutual*, owned by the fund shareholders." I responded that, yes, I hope to create a firm with mutual structure. But I was in the midst of a nasty battle to rebuild my shattered career, and its outcome was unpredictable.

Substantial portions of this essay were the basis for a speech delivered to the Morningstar Investment Conference in Chicago, Illinois on April 27, 2017. The opinions expressed in the essay do not necessarily represent the views of Vanguard's present management.

To put it mildly, Jon did not like my idea. I still remember his exact words, "If you create a mutual structure, you will destroy this industry." Viewed in the light of what would follow decades later, if Jon Lovelace only had added (which he surely implied), "you will destroy this industry *as we now know it*," his reputation for wisdom and foresight would have been even further enhanced.

II. The Upstart and the Revolution

This compelling anecdote begins my story of how an upstart firm, founded at the bottom of a vicious bear market in 1974 (down 50%), overcame the high odds against its survival, let alone its success. The firm had an unprecedented mutual structure. It was compelled to use an external investment adviser with a previous record of failure. It was limited in its ambit to fund administration, and barred from engaging either in portfolio management or share distribution. It would soon stake its future on an unprecedented strategy—a stock portfolio that would require no investment adviser. And, as if those liabilities were not enough of a burden, the firm had a brand-new name.

As you now must know, that *name* was Vanguard; that unprecedented *structure* was mutual; and that *strategy* began with the creation of the world's first index mutual fund. Whether you applaud this novel approach to mutual fund structure and strategy—or maybe even wish that it had failed—that structure and that strategy have changed the nature of the mutual fund industry "as we then knew it."

Call it creative destruction. Call it disruptive innovation. Call it luck. (Good luck for Vanguard; not such good luck for our peers.) But more than anything else, call it good karma. For surely fate would have eventually awakened the investment world to this fundamental truth: before intermediation costs are deducted, the returns earned by equity investors as a group precisely equal the returns of the stock market itself. After those costs, therefore, investors earn lower-than-market returns. *Fact*: The only way to maximize the share of the financial market returns earned by the 100 million families whom the fund industry serves is by minimizing the costs borne by fund shareholders.

I'll soon celebrate my 66th anniversary in this wonderful business, beginning when I joined Wellington Fund in July 1951. I decided to mark the occasion of my (I think) unprecedented record of service in the fund industry by offering a brief history of how I came to found Vanguard and First Index Investment Trust (now Vanguard 500 Index Fund). The world of investing knows too little of this history and of the revolution that, decades later, would follow.

Few, if any, industry leaders contemplated this outcome. They were bound by "presentism." In a recent issue of *The New Yorker*, essayist Adam Gopnik tells us that, "of all our prejudices, the strongest is presentism . . . the assumption that what is happening now is going to keep on happening, without anything happening to stop it." Surely that assumption was held by mutual fund industry leaders (except Jon Lovelace!), who paid no attention to this new fund complex with its new name and a new structure, at once both ridiculous and logical. These leaders tacitly assumed that the existing fund framework would keep on happening. That was a big mistake.

The industry thought that a truly mutual structure was not even worth acknowledging. Even 43 years later, it has yet to be copied. And our peers snickered at the index investment strategy that the mutual structure facilitated, even demanded. One leader said, "The great mass of investors aren't going to be satisfied with average returns. The name of the game is to be the best." Another asked, "Who wants to be operated on by an average surgeon?" And a popular poster on Wall Street declared, "Help Stamp Out Index Funds! Index Funds are Un-American." The indexing idea was so absurd that it took until 1988—13 years later—before the first (and pretty much the last) of the industry's "Old Guard" reluctantly joined the embryonic index fund movement.

III. The Opportunity to Speak

Now is the time that I've chosen to speak out on the fund industry today. But this is *not* a victory lap. I've been around too long to take victory laps before the game is over. Nor is it a valedictory. I've got much more to accomplish in my life and in my career. It begins with the saga of the improbable creation of Vanguard, the firm I founded almost by accident, and the even less probable creation of the index fund.

I'll then describe how Vanguard became a colossus, the most dominant firm in the history of the mutual fund industry—$4 trillion in assets, 23% market share of assets, an incredible $304 billion in 2016 cash flows (an unprecedented 171% of industry cash flows), and of course in costs. Asset-weighted, an expense ratio of just 12 basis points—the industry's lowest-cost provider. As Psalm 118 tells us: *The stone that the builders rejected has become the chief cornerstone*.

Next I'll discuss two business strategies that today's active fund managers might adopt to respond to the new environment, now dominated by index funds. Then I'll offer an alternative and starkly contrasting strategy designed to serve fund investors. Finally, I'd like to give you a few personal reflections about my long career in this industry.

Strange as it may seem, during my career began with my 1951 Princeton senior thesis on "The Economic Role of the Investment Company," calling out values that have been reaffirmed all through my career.

- Mutual funds' "prime responsibility must always be to their shareholders."
- Funds must operate in "the most efficient, economical, and honest way possible."
- Funds "can make no claim to the superiority over the market [indexes]."
- Funds should represent "the great number of inarticulate and ineffective individual clients" in corporate governance.

Foresight? I doubt it. Callow? Sure. The new paradigm I created for mutual funds may well have found their genesis 66 years ago in the callow idealism of a prototypical college student.

Truth told, I hoped to present the story of Vanguard and its implications for the mutual fund industry at the coming General Membership Meeting of the Investment Company Institute. My credentials: former chairman of the ICI board; a leader who brought three of ICI's future chairmen into the fund industry (and helped to groom a fourth); founder and long-time CEO of the ICI's largest member and largest dues payer; a voice that ought to be heard, discussing the new and disruptive trends that those fund executives gathering in Washington D.C. deserved to hear from the pioneer of the revolution that is changing the fund industry *as we knew it,* not so many years ago.

My request was inspired by Louise Cooper, a journalist for *The Times* of London, who interviewed me last autumn. When she learned that I had not been invited to speak to the ICI for nearly three decades, she was shocked, and urged me to request a speaking slot at this year's GMM. It was not to be. I was politely informed by Institute President Paul Stevens that the GMM is designed to pull the industry together around a common theme, not to pit one competitor against another. (Leave aside that the industry's common theme of active investment management doesn't seem to be working very well, and that competitors regularly speak at the ICI gathering.)

To me, Paul's decision seemed to be classic presentism, short-sighted and provincial. But I didn't bother arguing with him. The things that I had to say were, I thought, worth hearing by those who care, and who care deeply, about the future of this industry—the industry that I have loved for two-thirds of a century. Rejected by ICI, I asked Morningstar for an opportunity to speak at their annual Investment Conference. They immediately opened a slot for me. Thank you, gracious Morningstar leaders! And since my overriding theme today is providing a better, fairer investment experience for mutual fund investors, any audience that includes so many investment advisers to fund investors is far better-suited to hear my story than the audience at the ICI meeting. (I hope that doesn't sound like sour grapes!) My central message: a call for a better deal for fund shareholders, for Vanguard's clients and for the clients of the nation's registered investment advisers.

IV. The Background

Six months prior to my meeting with Jon Lovelace at the airport in 1974, I had been both the CEO of Wellington Management Company and Wellington Fund, the industry's dominant balanced fund. But I had been fired from my position at Wellington Management Company, adviser to Wellington Fund and its associated funds, mostly as a result of a disastrous merger with a manager of highly aggressive growth funds. Yet I remained CEO of the Wellington *funds*.

Such a split—retained as head of the mutual funds, fired as head of the funds' adviser—was unprecedented in our industry's history. The idea of splitting the two jobs—the fund role, traditionally titular in nature; the management company job, holding the implicit power to control the funds—seemed sort of, well, weird. But to me, the concept of putting the fund directors—and thus the shareholders to whom they are responsible—in the driver's seat was a far more rational structure for mutual fund governance than the traditional convoluted structure. We called it "the Vanguard Experiment" in mutual fund governance.

By eliminating the profits to an outside firm, Vanguard would quickly become the low-cost provider in an industry where costs are (almost) everything, and where—except for the highly cost-competitive index fund segment—our peers have little interest in competing on costs. (It's bad for management company profits!) The mutual "at cost" structure would put the fund clients first. *A declaration of independence of the funds from their investment adviser.*

This solution appealed to my logic, my contrarian streak, my determination, and my idealism. But in addition to those (I think) noble motives, I had a less noble motive: I wanted to survive. I wanted to continue my then 23-year career in this wonderful industry. Creating such an independent structure may well have been my only chance to do so, and I appealed to the board of directors of the Wellington funds depart from their normal presentism mindset and take this drastic step. It would not be easy. The structure that I proposed quickly led to a bitter fight—the fired CEO vs. those who had fired him. The outcome was in doubt until the battle ended, six months after it began. The new firm had perhaps one chance out of ten to survive. But finally, Vanguard was born.

In 1975, we made our first strategic move—to create an index fund. While all of our peers had the *opportunity* to create the first index fund, only Vanguard, with our unique mutual structure, had not only the *opportunity,* but the *motive*. The seed of the idea of the index fund was planted in my 1951 senior thesis (remember, funds "can make no claim to superiority over the market [indexes]"). The foundation of our philosophy was my first-hand experience in trying but failing to select winning managers. And a timely and fortuitous inspiration from Nobel Laureate Paul Samuelson then precipitated the creation of the first index mutual fund.

Dr. Samuelson's essay, "Challenge to Judgment," was published in the first edition of the *Journal of Portfolio Management* in the fall of 1974. It struck me like a bolt of lightning. By happy coincidence, I read his essay just as the stock market hit bottom and moments after Vanguard was founded. His credibility was a vital factor in my ability to persuade Vanguard's board to approve of the creation of the world's first index mutual fund. Once considered unthinkable, indexing has triumphed, and active managers will have to either join the index revolution and/or expand their range of investment options by developing new active investment strategies. Or do nothing. Whatever the case, active fund management is not going to vanish from the earth. But to think that change stops here would seem like rank presentism.

Recent data from Standard & Poor's reaffirms the tough job facing active managers. For the first time, S&P SPIVA ("Index Versus Active") produced comparative data for the past 15 years on a broad matrix of funds. S&P calculated the percentage of funds in each category that were outperformed by their relevant market index. On average, the indexes outperformed an astonishing 90% of all actively-managed mutual funds:

	Percentage of Funds Outperformed by Indexes		
Fund Category	**Growth**	**Core**	**Value**
Large-Cap	**95%**	**97%**	**79%**
Mid-Cap	**97**	**99**	**90**
Small-Cap	**99**	**95**	**81**

Over the 15-year period, the passive indexes outperformed the average actively-managed funds by 1.5% annually, a cumulative enhancement of almost 25% for capital accumulation, simply by the use of passive market indexes.

V. The Optimal *Business* Strategy for Active Managers

So what strategic business options are open to active fund managers? As a group, these managers have lost big chunks of their market share year after year, albeit—given the strong bull market of the recent era—often with assets under management that continued to grow.

I'm hardly without experience in actively managed mutual funds. I did sporadic work in the Wellington research department, served for many years on its Investment Committee, and experienced first-hand the frustration of our fruitless efforts to identify portfolio managers who could turn so-so results into superior performance. In 1966, as Wellington's new, young CEO, I merged Wellington Management Company with a small equity fund manager that jumped on the Go-Go bandwagon of the late 1960s, only to fail miserably in the subsequent bear market. A great—but expensive—lesson.

In 1978, after Wellington's catastrophic decade-long fall from grace under these aggressive managers, I personally reset Wellington Fund's strategy, and presented the fund's manager with a 50-stock sample portfolio. Since then, Wellington has been a remarkably consistent performance leader over its balanced fund peers, largely because of its consistent one-to-two-percentage-point expense ratio advantage and its low portfolio turnover. Vanguard Wellington Fund has regained its rank as one of the nation's two largest balanced funds. I also selected the managers for the new active funds that we would form. Vanguard's success in active management continues to this day. With a strong tailwind of low costs, in 2016 Vanguard ranked #1 in cash flow among actively-managed stock and bond mutual funds.

So, yes, I know the reality: *Investing is a hard business*. I repeat: *Investing is a hard business.* So what does an active manager do? Here are some suggestions from respected commentators about business strategies that might help today's active managers to survive.

First, Laurence B. Siegel, CFA Director of Research. Success will come to active managers when they "present convincing evidence, both historically and in the process they intend to use in the future, that they have a *good chance* of beating the relevant benchmarks after costs."

Second, John Rekenthaler, Morningstar guru, *eminence gris,* and in my book the industry's most astute observer of mutual fund trends. He endorses three approaches: (1) Make funds "available for a limited time, until they reach a certain size, at which point they will be closed." (2) Adopt "niche" strategies that are "capable of very large surprises . . . a fund that holds 25 stocks." (3) "Ask more of your investors. . . . Educated investors make for better investors . . . with happier investor experiences."

Third, McKinsey & Company. In the "New Era in Asset Management," firms "will need value propositions that are more closely aligned with the evolving needs of clients; new technology-enabled investment and distribution capabilities, new vectors of growth and productivity . . . strategic agility . . . retool their organizations, change internal mindsets, and take a 'bifocal' approach to resource allocation."

Well, sorry, guys. Citations one and two are reasonable to consider. But I can't imagine generalizing those ideas to encompass active managers as a group, who, because of their costs, would be unable to match whatever returns the total stock market delivers. It will be a far tougher job if stock returns over the coming decade are well below that grand 50-fold gain in value enjoyed during the 1982-2017 era—as I expect they will be. As to the third citation, did any of you readers understand that consultant-speak gobbledygook any better than I did?

Allow me to disagree with their conclusions. I believe that two different business strategies will emerge for active fund managers. The two strategies will follow from two divergent corporate structures: (1) Closely-held firms (controlled by their founders or inside executives, including some firms with minority holdings by public shareholders), and (2) fund managers owned by financial conglomerates and banks.

For the closely held firms, the optimal strategy will be "Don't do something. Just stand there." Today's large fund complexes, many of which pursue sound, if not index-beating strategies, seem likely to do nothing, at least in the foreseeable future. These large firms also have the resources to pursue other lines of business beyond investment management, although I don't see how that strategy could create value for their mutual fund shareholders.

They may try to offer new active funds; they may (with great reluctance) put a toe into the traditional index-fund water. But there's little point in cutting their management fees, for minimal cuts won't help. (What's the point of cutting your fees, say, in half from 100 to 50 basis points when index funds cost as little as 4 basis points?) Severe fee cuts would decimate profits—resulting in sharp compensation cuts for insiders that would be hard to tolerate, and for firms with minority public shareholders, a slap in the face for investors who have become used to powerful profit growth. (I continue to have grave reservations about public ownership of fund managers.)

Boring as that "do-nothing" strategy might seem, it is far more likely to preserve the profits of managers than slashing fees, or more aggressive marketing, or jumping (likely fruitlessly) on the bandwagon of low-cost traditional indexing. But some of these firms may wish to launch ETFs to capitalize on the popularity of passive indexing by active investors. That might help to maintain their profitability—albeit at far lower profit margins than traditional active funds. Opportunistic marketers might develop a niche strategy, inducing narrowly focused ETFs (think lithium ion battery producers, or Israeli tech firms) and hope that they attracts assets.

Another strategy might be to translate a quantitative, rules-based active strategy into a proprietary index and sell an ETF that tracks it. This sort of strategy is often referred to as "Smart Beta," really an actively managed wolf in an index fund sheep's clothing. Mark me down as dubious as to their long-term staying power. *Offering narrow, even speculative ETFs could well be the optimal short-term marketing strategy for attracting cash inflows and generating trading commissions. But it is unlikely to be the optimal long-term investing strategy.*

For the fund managers owned and controlled by financial conglomerates (including banks), I believe a totally different strategy will emerge. Using the terminology of The Boston Consulting Group, maintain your fund business as the "cash cow" that it is today—delivering high margins and generous profits, albeit likely at a declining rate. Don't invest more capital. Don't cut management fees. Nominal cuts won't help, and severe cuts would eliminate those cash flows. While fund cash outflows are highly likely to continue, a sharply rising stock market, however unlikely, would help offset the outflows, slowing the declines in assets under management, fee revenues, and profits. With this cash-cow strategy, these conglomerates will have a perfectly good business rationale, but I'm guessing that many of their mutual fund subsidiaries will ultimately be sold at bargain prices or merged with other similarly-situated firms.

As we consider today's index fund tsunami, it's critical to understand its two distinct components, a distinction largely ignored by the industry and the media. One component is the ETF—the exchange traded fund—enabling investors to trade a seemingly infinite variety of index funds using almost 2000 different indexes, often tailor-made by their sponsors. As the original ETF advertisements said, "now you can trade the S&P 500 Index all day long, in real time." (I'm compelled to point out that broad market ETFs are fine, as long as you don't trade them.) ETFs are also a key ingredient in the growth of robo-advisors, which are bringing down the costs of advice for investors.

The other component is the TIF, the acronym that I'm struggling to establish (so far without much success) for the traditional index fund, essentially a low-cost, broad market index fund designed to be bought and then held forever. That first S&P 500 Index fund that I created way back in 1975 was (and is) a TIF.

When the late Nathan Most, creator of the ETF, offered Vanguard the opportunity to join forces with him by making our TIF available in ETF form, I declined his offer without hesitation. I stood on the principle that trading mutual funds is ultimately a loser's game, and that our 500 Index Fund was designed for long-term investors. I have nary a regret about my decision.

Yet without its own acronym, our data collectors have largely turned "a blind eye" (as Lord Nelson did at Copenhagen) to TIFs. As 2017 begins, TIF assets—$2.5 trillion—are identical to the ETF total. In fact, TIFs have grown at a slightly faster rate than their tradeable cousins since 2011. (Both TIFs and ETFs have grown at about 18% annually.) I expect both kinds of index funds to continue to grow, eventually at a much slower rate, and for very different reasons. But I concede that challenged active managers are most likely to go the ETF route.

Good news for active managers. Presentism leads us to assume that today's powerful dominance of index funds will continue indefinitely. But as Herb Stein, Chairman of President Nixon's Council of Economic Advisers, pointed out, "If something cannot go on forever, it will stop." But will index fund dominance fade? Or will it grow? Will it end? When? Only time will tell.

Let me be clear: I believe that the "stay the course" strategy is the optimal business strategy for today's largest active fund managers. I also believe that the cash-cow approach is the optimal business strategy for the fund managers owned by financial conglomerates—just one more of their "product lines," rather than a passionate commitment to our industry.

VI. The Optimal *Fiduciary* Strategy for Mutual Funds

But wait a minute. What if the optimal *business* strategy for fund managers ill-serves the mutual fund shareholders who have entrusted their assets to the funds? We cannot ignore a very different strategy—really a counter strategy—one that serves the interests of fund shareholders. Let's call it the *fiduciary* strategy—a strategy that puts fund owners first. Look, I understand that all enterprises face conflicts of one kind or another, and balancing business values with fiduciary values is no easy task. (Even at the only firm in which the fund shareholders own the management company, conflicts exist.) But it is my deeply-held opinion that the flawed structure of this industry has created deep fissures that will, ultimately have to be closed.

Far too little introspection on this distinction between business values and fiduciary values has permeated the minds of industry leaders, including the ICI. Managing mutual funds typically remains an insanely profitable business, with pre-tax profit margins often exceeding 50%. How could it be otherwise? During 1982-2016, we've been blessed with the strongest stock market in history. The S&P 500 enjoyed a 50-fold-cumulative gain (an average return of 12.1%). Few if any mutual funds (except, of course, broad market index funds) earned this return for their shareholders, but no one seemed to notice. Few shareholders were unhappy when they received, say, a 30-fold or 40-fold gain. Yes, absolute returns are far more visible then relative returns, and investors thanked their lucky stars—and their "smart managers"—for their stunning absolute returns.

That great 34-year bull market drove our industry's growth and raised investor expectations of the returns that stocks are likely to achieve in the coming era. But the markets weren't alone in helping our business grow. While we are good at cursing interference by regulators, we have been blessed by a Federal government that has enabled the formation of tax-exempt municipal bond funds and tax-favored retirement plans—IRAs, pension plans, and thrift plans. Together, these tax-favored structures account for some $7.9 trillion of the present $17 trillion asset base of the mutual fund industry. So our industry has benefitted from two remarkable happenings, manna from heaven that we can take no credit for.

If presentism leads this industry to believe that such mammoth returns will recur from this point forward, or that the federal government has some further gifts to bestow on our industry, we are fooling ourselves. Indeed, I believe that it is more likely that the administration will act to take away some of these gifts (which tend to favor high-income investors) by limiting the tax deferrals available to corporate thrift plans and individual retirement plans.

VII. The Economies of Scale

The remarkable growth of mutual fund assets has served the owners of fund management companies bountifully, but it has bypassed the owners of mutual fund shares. All of the economies of scale in investing—and more—have benefitted fund managers. *None of these economies were shared by fund investors.*

Can that allegation really be true? Let's look at the record. During 1951, the year that I joined the industry, fund assets were $3 billion, the asset-weighted expense ratio was 63 basis points; and total expenses were $20 million ($187 million in today's dollars). As the industry grew, dominated by equity funds in those early years, the asset-weighted average expense ratio actually *declined*, to 55 basis points. But then the rise began. By 1980, equity fund expense ratios had risen 120% to 121 basis points, double the 1951 level.

In 1980, equity fund assets were $44 billion. By 2016 these assets had soared to more than $8 trillion. Expense ratios of actively-managed funds had declined to 84 basis points, still 53% above the 1960 level. With the growth of lower-cost bond funds, the industry-wide asset-weighted expense ratio for long-term funds is now at 68 basis points, almost 25% above the 1960 level. With total fund assets averaging $17 trillion in 2016, fund advisory fees and operating expenses come to a total of $110 billion per year—5,600 *times* the 1951 level of $20 million in an industry whose assets grew by 5,400 fold. Economies of scale for fund investors—zero.

The industry's huge revenue growth has been a bonanza for the owners of fund managers. Just look at the returns on the stocks of publicly held fund managers. Over the past two decades alone, the shareholders of the three largest publicly-owned fund managers have enjoyed annual returns averaging 13%, almost double the annual return of 7.7% on the S&P 500 Index, a return earned by remarkably few mutual funds. Cumulative returns: fund managers +1167%, S&P +339%. More than triple. Wow!

But the owners of mutual funds—those whose hope and trust have built this giant industry—are paying their active equity managers at a rate that has increased by 53% since 1960. Given those enormous increases in our industry's asset base, one can only wonder how this dichotomy could have taken place.

My views on this subject are obviously strong. But informed opinion is catching up. In his 2014 text *Asset Management*, for example, Columbia Professor Andrew Ang opens his chapter on mutual funds with this pungent summary.

> "Mutual fund managers are talented, but on average none of that skill enriches asset owners. The average mutual fund underperforms the market after fees, investors chase funds with high past returns only to end up with low future returns, and larger mutual funds do worse than smaller funds. While the Investment Company Act of 1940 gives significant protection to ordinary investors, *most mutual funds are run for the benefit of mutual fund firms rather than investors*." [Emphasis added.]

Simply put, Dr. Ang, now managing director of fund manager BlackRock, is telling us that the master of the mutual fund is the external firm that controls it. But why shouldn't the master be the shareholders who *own* the fund? (That is the standard way that all other U.S. corporations operate.) As the King James Version of the Bible tells us, *"no man can serve two masters, for he will hate the one and love the other, or hold to the one and despise the other."* While that love/hate pairing is too strong even for me, the point is a valid warning to the mutual fund industry. Hence the question: When the business strategy for the owners of the firm conflicts with the fiduciary strategy for the owners of the funds, whose interests comes first? To me, the answer is obvious. If this industry is to realize its promise to investors, the fund owners must be the master.

VIII. Can a Fiduciary Serve Two Masters?

In 1985, I gave a speech to a gathering of state financial regulators. It was entitled, "Where Are the Independent Directors?" My concluding words were, "I hope they'll be back soon." Today, 32 years later, there is little evidence that the directors have returned. One can only wonder why so many fund boards of directors have seemed to have ignored that "shareholder first" principle, and failed to garner for benefit of the fund shareholders at least a portion of those staggering economies of scale.

It doesn't matter whether the fund director is served by a privately-held manager or a giant financial conglomerate. Nor whether he or she is an "unaffiliated" director who meets the legal criteria for independence, or an "affiliated" director, associated with the management company. *Both types of fund directors have an identical fiduciary duty to serve fund shareholders*. Of course the affiliated director has a fiduciary duty; *both* to the fund shareholder *and* to the management company shareholder, two related enterprises with at least one critical factor that is in direct conflict—the level of management fees. I think we all know which master has received the love.

You may not be aware that public ownership of mutual fund managers did not come along until almost three decades after the industry began. Way back in 1958, the SEC fought the sale of Insurance Securities, Incorporated, a California fund manager to an outside buyer. The Commission argued that the sale represented a breach of fiduciary duty by ISI, and would ultimately lead to trafficking in management contracts. The Commission lost its case in the U.S. Court of Appeals for the Ninth Circuit, and the U.S. Supreme Court determined to let the decision stand. The floodgates to public ownership were swung wide open, and the character of this industry changed. Today 30 of the 50 largest fund managers are held by banks and financial conglomerates, 10 more with significant public ownership—in all, 40 of the 50 largest fund managers.

The SEC's concern was prescient. For decades, trafficking in management company ownership has characterized much of the fund industry. Management companies are bought and sold in the marketplace. Fund directors seemingly sign up with the new management company (which bought the firm from the previous management company), but rarely extract any material benefit for the fund shareholders whom they are duty bound to represent.

In the 2003 Berkshire Hathaway Annual Report, Warren Buffett used far tougher words than mine:

> Year after year, at literally thousands of funds, directors had routinely rehired the incumbent management company, however pathetic its performance had been. Just as routinely, the directors had mindlessly approved fees that in many cases far exceeded those that could have been negotiated. Then, when a management company was sold—invariably at a huge price relative to tangible assets—the directors experienced a "counter-revelation" and immediately signed on with the new manager and accepted its fee schedule. In effect, the directors decided that whoever would pay the most for the old

management company was the party that should manage the shareholders' money in the future . . . sadly, "boardroom atmosphere" almost invariably sedates their fiduciary genes."

My own concern about this issue goes back even further than Mr. Buffett's. In 1971, as CEO of Wellington Management Company, then a publicly-held manager, I addressed our executives with these words: *"It is possible to envision circumstances in which the pressure for earnings growth engendered by public ownership is antithetical to the responsible operation of a professional organization."* That proposition has been proven over and over again. The necessary resolution of this issue would be to roll back conglomerate ownership, came to grips with the public shareholder issue, and at last make it clear that the interests of mutual fund investors must come first. It will not be an easy battle.

IX. What Would a Fiduciary Strategy Mean?

So yes, the fiduciary duty of fund directors and fund managers must take precedence over the business strategy of fund managers. The Investment Company Act of 1940 clearly demands this fiduciary strategy. Section 1 declares that is in "the national public interest and the interest of investors," in the words of the SEC, that "funds should be managed and operated in the best interests of their shareholders, rather than in the interests of advisers, underwriters, or others." This industry has largely ignored that fundamental principle.

When that legislative policy is finally honored, a fiduciary strategy for fund owners will emerge. Fund directors will surely demand sharp reductions in management fee rates, perhaps implemented gradually. Discipline in the fund line-up, with funds that are focused on long-term objectives and policies rather than funds formed to capitalize on the fashions of the day. Adding index funds to their offerings. Far fewer dollars spent on marketing. And maybe even the adoption of a truly mutual shareholder structure, with elected fund directors in full control of the mutual funds "managed and operated in the best interests of their shareholders." And a return to the industry trademark principle from which we've strayed, a traditional policy that "we sell what we make," abandoning our present policy of "we make what will sell." That particular form of presentism can no longer keep on happening.

In a surprising parallel to that type of "sell-what-we-make/make-what-will-sell" dichotomy, a recent *New York Times* review of a new book about "the" business school, the author cites a similar stark contrast in the values of America's future business leaders:

> “When students enter business school, they believe that the purpose of a corporation is to produce goods and services for the benefit of society. When they graduate, they believe that it is to maximize shareholder value.”

Adam Smith would have concurred with that opening proposition: the purpose of the corporation is to produce goods and services that benefit society. In 1776, in *The Wealth of Nations*, he articulated the point clearly:

> “Consumption is the sole end and purpose of all production; and the interest of the producer ought to be attended to only so far as it may be necessary for promoting that of the consumer. The maxim is so perfectly self-evident that it would be absurd to attempt to prove it.”

X. A Personal Perspective

At the outset, I promised you a personal perspective on some of the thoughts that cross my mind during this 66th year in the fund industry. (Dare I say that few in this audience have even *lived* that long!)

First, this is an extremely happy time in my life and career. To live to see my dream come true of “The Triumph of Indexing”—the title of a small history that I penned and published in 1993—is, well, a nice thing. It’s something that wouldn’t have happened without the heart transplant that I received on February 21, 1996, 21 years ago. Of course I’m thankful for that miracle.

If my career means anything, I hope it means that caring counts. Caring about the millions of honest-to-God, down-to-earth human beings who have trusted Vanguard, and whom we’ve done our best to serve. Caring about the thousands of wonderful, loyal, crew members who are committed to our values, not only of serving our investors, but caring about them. As I often remind Vanguard’s crew, “ideas are a dime a dozen, but implementation is everything.” Caring about those wonderful Bogleheads, whose website is the leading financial forum on the internet.

Let me be clear: It was never my intention to build a colossus . . . only to earn for the families who entrust us with their life savings the best returns that they could realistically achieve, at the lowest cost and at the highest level of service. Truth told, very early in our history I worried more about the challenge of managing huge assets than about survival.

When Vanguard assets crossed the $4 trillion mark earlier this year, my first thought was the title of an early speech to our crew in which I warned about the perils of giant size. I asked, "Which Axiom?" would prevail: Will it be, "Nothing succeeds like success?" Or will it be, "Nothing fails like success?" So far in Vanguard's history, it is the first axiom that has prevailed.

My worry was, dare I say, premature. For the year was 1984, and our assets had then just crossed the $8 *billion* mark. While I never sought to build a colossus, I was too stupid to realize that if we merely gave investors their fair share of the returns we've enjoyed in the stock and bond markets, we'd *become* a colossus.

By creating the mutual structure and the index strategy, we've been the first mover, a huge advantage in fostering our growth. But I've also been the most prolific public advocate about these inseparable elements of our growth. In my 2005 book *The Battle for the Soul of Capitalism*, I cited St. Paul: "If the sound of the trumpet shall be uncertain, who shall prepare himself for the battle?" My trumpet about the mutual structure and the index strategy has been certain: eleven books, 575 speeches and lectures, 26 articles in academic journals, numerous op-eds, countless interviews, and (literally) daily letter from our shareholders—often deeply touching stories about their lives and their gratitude. I answer every one.

I'm not a presentism guy. I've always tried to anticipate what tomorrow may hold. Times change. Tastes change. Reputations change. As I so often warned our staff, "There's a giant in this room. While we can't see him, he's carrying a huge sledgehammer and he's about to slug us right in the nape of the neck." Today's known unknowns present ample risks. But the unknown unknowns, like that powerful but invisible giant, are always lurking out there, unseen.

Fifty-seven years after my first heart attack in 1960, my health is pretty good, and my voice remains strong—and as opinionated as ever. My scoliosis is severe. "The spirit is willing, but the flesh is weakening." But I'm still me. I hope that one of my Princeton classmates was right when he recently told me that, "you're still the kid—the same determined, idealistic, shy, friendly kid—that I knew back in 1951, 66 years ago." I consider that the ultimate accolade.

So that's it. To sum up my long career (so far!): My enthusiasm for life and for this industry, ever changing, remains; caring about our investors, making them the primary focus of our efforts; earning—and, I believe, deserving—their trust; helping to build a fiduciary society with a noble purpose; making a difference in an industry that I'm proud to have joined almost 66 years ago; and still striving to measure up to Paul Samuelson's 1993 appraisal of me as a man who "changed a basic industry in the optimal direction."

Whatever the case proves to be, whatever the future may hold, the mutual fund industry has changed, in part because I took the road less traveled—indeed, never traveled before—all those years ago. What better way to close these remarks than with these words by Robert Frost?

> **"I shall be telling this with a sigh**
> **Somewhere ages and ages hence:**
> **Two roads diverged in a wood, and I—**
> **I took the one less travelled by,**
> **And that has made all the difference."**

* * *

On the very day that I completed this final draft of this essay, I received a neatly handwritten note from a young and appreciative shareholder who had read my book *Common Sense on Mutual Funds.* He then invested in the Vanguard Total Stock Market Index Fund, and intends to hold it forever. In one more of the happy coincidences that have marked my long career; his closing words were, **"And that has made all the difference."**