

Mutual Funds in 1987: A \$700 Billion Trust

**Keynote speech by
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It is a distinct privilege for me to have the opportunity to deliver the keynote address at your 25th Annual Meeting. Certainly your theme—"The Challenge of Change"—is a profound one, and I will address it from the standpoint of the \$700 billion trust that mutual funds now represent.

To me, as an observer of mutual funds since the beginning of my college days in 1947—forty years of excitement and elation, interspersed with but a few moments of discouragement and disappointment—I come armed only with the perspective borne of that experience, to present some ideas about mutual funds in these halcyon days of rapid growth, heady markets, and truly incredible success. Perhaps few in this industry are as concerned as I am, however, about some of the new directions in which this business is moving today, and I hope you will forgive me if the views I will express are controversial. Having been asked to speak on "The Challenge of Change," I have little recourse but to speak with a blunt candor that reflects a deep concern about the very nature of some of the changes now taking place in the mutual fund field.

Let me begin by turning the calendar back ten years, to a morning in March 1977, when I last had the honor of addressing this group. I had come to discuss what was Vanguard's then shocking pair of decisions to change our marketing strategy and structure:

1. To convert our Funds to no-load status by eliminating all sales charges, thus abandoning the dealer distribution system within which we had worked in partnership for nearly 50 years.
2. To "internalize" our new distribution system, having our Funds directly assume the responsibility for—and the cost of—all marketing activities, reducing our advisory fees more than commensurately, and thus reducing the total expenses borne by the Funds.

The first decision was radical; the second, unique. Without precedent to guide us, we were entering a Brave New World. Doing so might seem obvious in retrospect, but it surely was frightening then. But beneath the fear was an underlying confidence far beyond what the facts would have justified. We assumed that the redemptions we might face from disgruntled dealers would not reach avalanche proportions. We also hypothesized that we could not lose much sales volume, for investor purchases of our shares were running at the puny monthly rate of \$5 million. As it turned out, ten years later, in January 1987, investor purchases were \$1.163 *billion*, a 200-fold increase. So, our no-load decision, it seems fair to say, has worked out well.

We expected to complete the internalization of our distribution activities, as I said to you at that time, "effective (hopefully) May 1, 1977." We were wrong. In fact, we had to face what I am told remains the longest Investment Company Act hearing in history, and our internalization was not finally

approved by the Securities and Exchange Commission until February 1981. To conduct business under a cloud of uncertainty for nearly four long years was a challenge, but we never lost confidence that the Commission would eventually support our Application. And finally, of course, it did.

Referring to our two vital decisions, I concluded my decade-ago remarks by saying: “as we move into the 1980s, time will surely tell whether our risky judgment was right or wrong and . . . whether we were correct when we ignored that familiar advice from Lord Keynes: “Worldly wisdom teaches that it is better for reputations to fail conventionally, than to succeed unconventionally.” I believe that outcome of “The Vanguard Experiment: says that, at least in this one case, the worldly wisdom was wrong. But you who know this industry so well can make that judgment.

Hits and Errors

Given that my talk on “Marketing Mutual Funds in the 1980’s” is now a decade old, it might be fun to discuss for just a few moments two predictions I made then that were right and two that were wrong, as well as two developments that I missed that have come to pass.

First, the hits. I modestly give myself an “A+” on pricing structure, boldly having predicted that the 1980s would obscure the then pure dichotomy between load funds and no-load funds. I suggested that while traditional no-load funds—with distribution efforts limited to a reasonable amount of advertising and a modest institutional sales program—would continue to grow, we would see the development of “quasi-no-load funds” with active retail sales forces, “following SEC approval of an ‘asset charge’ for distribution.” Such charges—now officially known as “12b-1” charges—have become part of the very fabric of our industry, though in dimensions and for purposes that I surely never imagined.

(Because Vanguard’s distribution application with the SEC involved our Funds—*not* our adviser—assuming distribution costs, I have been called “the father of 12b-1.” We do not, nor will we, have a 12b-1 plan, but the designation seems to stick. I can empathize with the misgivings that Dr. Frankenstein must have had about his monster.)

I also was close to the mark on product design—perhaps “A-“—anticipating both substantial innovation and an expansion of fund offerings to include fixed income funds, not only corporate bond funds, but also municipal bond funds offering a variety of maturities. Alas, Vanguard did not realize much competitive advantage from the three-tiered municipal bond fund we pioneered (Short, Intermediate, and Long Term Portfolios, rather than a single “managed” portfolio), and I failed to conceive of the “single state” municipals. Bond funds accounted for an incredible 75% of industry net cash flow last year. Left was but a 25% share for the traditional equity-oriented funds, which had comprised 85% of industry sales volume in 1975. Talk about the challenge of change! The Investment Company Institute did not even carry a separate breakdown of bond fund statistics until 1975, and municipal bond funds did not come into existence until 1976, when enabling Federal legislation was enacted.

If those were solid “hits,” surely there were gross “errors.” I could not have been more wrong when I predicted that “in the 1980s, (funds) will have to have lower operating expenses.” An “F” would be too generous a grade for that prognostication. The expense ratios of the 20 largest mutual fund complexes have risen from an average of 0.57 percent in 1977 to an estimated 0.80 percent in 1986. That 40 percent increase *may* not appear material, but it in fact represents a huge increase, for two reasons:

1. First, because so many low loads, redemption fees, and exchange fees have been added during the decade, the average complex had *total* expenses (stated advisory fees and other direct expenses,

plus “non-income statement” costs) equal to something like 1.10 percent of assets last year. Thus, the unit cost increase is really almost 100 percent.

2. Second, the assets of the average major complex were \$2 billion in 1977, but \$18 billion in 1986. Thus the total *dollar* expenses borne by the shareholders of the typical complex have risen from \$12,000,000 to \$200,000,000, an increase of about 1,500 percent. (In fairness, the average number of shareholder accounts has risen by 400 percent during the same period.)

If, a decade ago, I had merely predicted a “price war” in this industry, I would have given myself a higher grade, for surely we are witnessing one of the great price wars in the economic history of the United States. My higher grade, however, would have been a sham, because today’s great mutual fund price war is not a conventional price war. Indeed, it is not a war to lower prices, but to raise them. With the pervasive imposition of 12b-1 fees, deferred sales charges, direct fees for exchanges, redemption fees, and a surprising number of advisory fee increases, costs of existing funds are heading skyward. And new funds often begin with fees at a still higher plateau—2 percent is no longer an extraordinary expense ratio. My credentials as a prophet are clearly deteriorating!

They are not improved by my second significant error, the prediction that “institutional markets—pension, endowment, corporate, foundation—should become *extremely important* to our industry’s future growth.” Perhaps a “D” will reflect the actuality—that, according to Investment Company Institute data, the portion of our Industry’s assets represented by these institutional accounts eased only slightly upward during the past decade, from 12 percent to 14 percent. Put another way, mutual funds currently represent something like 2 percent of the assets of all corporate pension plans, by far the dominant institutional market. So, my supposition that mutual funds could penetrate these markets in an important fashion was just plain wrong.

Nonetheless, it is at least possible that the proverbial “jury is still out” on this issue. I believe that the recent trend from the traditional defined benefit pension plans toward defined contribution plans, and the related growth of 401(k) employee savings plans, will open vast new markets for mutual funds. It continues to seem to me that there is no investment vehicle providing benefits comparable to those offered by mutual funds: “simplicity, efficiency, liquidity, and flexibility: (the words I used a decade ago). Indeed, “flexible pricing” has made it the norm for funds of *all* types—not merely no-load funds—to offer their shares in this giant market without sales commissions. So, no matter how low my grade so far, I expect to see it raised in the years ahead.

Exponential Growth, and Operational Challenges

Turning, then, from my hits and errors to my misses, the major one was the failure to even conceive of the exponential growth in this industry. Consider these incredible changes since I spoke to you a decade ago:

- Total assets were then \$51 billion; today assets are \$720 billion.
- There were then 444 funds; today there are nearly 2,000.
- Investors purchases of regular funds in 1976 totaled \$4 billion; last year the total was \$165 billion.
- There was a net cash *outflow* of \$3 billion from all mutual funds in 1976; last year there was a cash *inflow* of \$175 billion.

Certainly, no one could have foreseen this incredible growth, nor the fact that mutual funds in the decade then ahead would be, by almost any measure, the fastest growing industry in America.

Related to this “miss” was the cursory treatment I gave to technology. While I noted that the revolution in computerized shareholder accounting systems had been essential to our provision of new products and services, and discussed the need for data processing systems to provide both more complete information to shareholders and better information on which to base our marketing decisions, I nonetheless failed to foresee the giant and sophisticated computer systems that would be necessary simply to keep up with the pace of our incredible growth in shareholder accounts—from 9 million when I spoke to you then to 44 million today. And the word “telephone” did not even appear in my talk. In retrospect, of course, communications technology was quietly to become every bit as important to our growth as processing technology.

There is little industry data on the growth of mutual fund operations and services, so let me take the liberty of citing Vanguard’s experience. For perspective, these changes came during a ten year period when our shareholder accounts grew by about four and one-half times, from 350,000 to 1,550,000 (about the same pace as the industry). During the 1977-1986 decade:

- The number of our Fund share purchase transactions grew from 60,000 to 2,400,000, a 40-fold increase.
- The number of our regular redemptions grew from 36,000 to 850,000, or 24 times.
- We did not even begin to count our telephone calls until 1979; since then, calls have risen from 160,000 to 3,300,000, 20 times over.

Think of the challenge of this change in just ten years! It would have been impossible to handle these kinds of volumes, especially given their astonishing rates of increase, without the computer and communications systems we in the industry and our partners have developed. Indeed, it is remarkable that, with so many fund organizations growing so fast, we appear to have survived this “volume crunch” without a major industry casualty. Under far less provocative conditions during the “paper crunch” of the late 1960s, many major fund groups (including ours) came perilously close to the edge of the abyss, and at least one toppled over it and had to suspend doing business.

Fund Accounting Rises to the Challenge

Another vital change in industry operations, of course, came in fund accounting services, and this was the second “miss,” simply overlooked in my earlier talk. A decade ago, these services were relatively routine, and the ability to provide precise daily asset valuations taken almost for granted. The number of securities held by most funds was small, and the preponderance was represented by common stocks which traded daily on the New York Stock Exchange. Absent industry data, let me illustrate with Vanguard’s experience: our then Twelve Funds held some 1,250 securities. About 1,050 were stocks, priced over Quotron each day; we relied largely on broker price quotations for the remaining 200 issues, mostly bonds.

Today, dare I say, things are different. The 65 funds we now administer own the astonishing total of 16,000 securities positions—more than a twelve-fold increase. And the diversity is equally striking—11,000 U.S. equities, 1,400 foreign equities, 700 corporate bonds, 1,200 municipal bonds, 1,400 U.S. Treasuries and Agencies, and 500 money market instruments! The quotations, of course, come in each

day from multiple sources, and in sum are turned into 65 precisely calculated closing net asset values by 5:30 p.m. each business day, the Lord willing.

Further, obtaining closing price quotations and recording interest and dividends each day are by no means the whole story of mutual fund accounting in 1987. The complexities are vast and far-reaching, including not only closing prices, but bid/ask spreads, currency adjustments, pricing bonds from an interest rate matrix, amortizing some premiums and all discounts, accounting for GNMA prepayments, and a whole host of other nuances. It is an incredibly complex task demanding extraordinary precision. It is indeed, the apotheosis of “the challenge of change.”

I have dwelt on these operational and accounting issues today in part because I failed to do so a decade ago, but in equal part to take the opportunity to salute you here today who provide the investment company services that are essential to our very existence. Too often your work is taken for granted by we who all are too accustomed to the “big picture,” as seen, of course, from the “ivory tower.” So, on behalf of the chief executives of the companies in this industry, I thank you and I salute you.

“Products” for Investors, Savers, and Speculators

Although my ramble from the past to the present clearly illustrates why prophets are indeed without honor, I would nonetheless now like to look ahead with you, and prophesy a bit more. While my long-term optimism about this wonderful business could *never* be squelched, my short term view is one of deep concern. It can be expressed simply: both through the funds we have developed and the way we have promoted them, we have in too many cases raised investor expectations beyond our ability to meet them. And, since the sharply higher prices at which we are offering our services directly reduce the performance we provide, we are on a collision course that is all too likely to shake to its roots the investor confidence that we have won (with a few detours along the way) during this industry’s first sixty-three years.

As to the mutual fund “product” (a word I have come to despise), we are venturing, if history is any lesson, into dangerous ground. The mutual fund built its success at first on its appeal as an *investment*, from our industry’s start in 1924 through the mid-1970s. The next wave of success, essentially over the past decade, has been based on its appeal to *savings*, first with money market funds as interest rates soared, later with bond funds as interest rates came down to more “normal” levels. But now, I fear, we are extending our ambit to *speculation*, sometimes implicitly (as in the tacit promotion of market timing programs *via* the exchange privilege), and sometimes explicitly (as in the development of highly-volatile equity funds and market sector funds).

Speculation is clearly evident in the “market timing” that now exists in our industry, and there is little doubt that many of the “new breed” of investors in mutual funds believe it to be a panacea. A plethora of “newsletters” provide timing signals to our shareholders, and we do little to moderate their trading activity. The exchange privilege, originally designed to make possible sensible long-range financial planning without excessive sales commissions, has become overwhelmingly a means to speculate on stock prices, euphemistically described as “taking advantage of changing market conditions,” and sometimes available 24 hours a day. (Dinosaur-like, I find myself wondering just who it *is* that feels the compulsion to go from stocks to cash at 3 a.m.!) Clearly, many of today’s shareholders demand this flexibility; they know all too well the value of cost-free transactions. And we can pray that they will blame only themselves if their strategy fails. But if portfolio transaction costs are palmed off by these investors on the remaining fund shareholders, a fund has an obligation to suspend its exchange privilege. This, it is fair to say, will not make our marketing departments happy. While we cannot protect the investor from his own fallibility or his own greed, we should either not promote this opiate, or,

if we do, take the responsibility of making the investor aware of the hazards involved and administer it with discipline.

But perhaps the best example of our industry's outreach to speculators rather than investors and savers lies in the offering of highly aggressive, often narrowly focused equity funds. This is not the first era of such tactics in mutual fund marketing. During the stock market boom of the mid-1940s, a remarkable 60 percent of industry net cash flow from investors was directed into "specialty funds," largely those investing in a single industry. Indeed there were then 75 such funds, compared with but 55 diversified equity and balanced funds. They were among the giants of this industry, but few of you here today will remember such names as Group Securities, New York Stocks, and Managed Funds, for their existence was evanescent.

In the final analysis, such specialty funds, I fear, are subject to the ultimate criticism: *they will not work*. The investor churns violently back and forth from one fund to another, often turning over his assets what appears to be at a 500 percent annual rate (an astonishing 25 times the normal 20 percent rate for the industry today). Gradually, he is all too likely to erode his capital to the point where he is no longer part of a desirable, as it were, "target market." Meanwhile, the fund itself is incurring heavy trading costs and charging heady advisory fees, to the point where an electronics fund, for example, cannot conceivably match the return of electronics stocks as a group. (At least an "industry index fund" could do that.) If I am correct in this analysis, today's specialty stock funds, having come and gone once in the 1940s, will come and go again in the 1980s.

When the speculator sours on mutual funds—an eventuality that will accelerate when we get the next sharp market correction—what then do we have to offer the investor and the saver? The obvious and, I think, correct response is "back to basics"—back to broadly-diversified, economically-managed funds with sensible objectives. Indeed, I expect that the pendulum will swing even further away from today's speculation. If the investor wants (and needs) broad diversification among equities, and if the saver wants (and needs) broad diversification among bonds, perhaps unmanaged stock index funds and bond index funds will become important factors in this industry in the decade ahead.

There is not much evidence to support this view. Our stock index fund—Vanguard Index Trust—during its first decade has been, as they say, an artistic but not a commercial success. We have consistently matched the Standard & Poor's 500 Stock Index within on-half of one percent per year, during a period when the Index itself has been a solid performer—usually outpacing about two-thirds of pension equity accounts. Nonetheless, our modest (by today's standards) \$600 million no-load index fund still finds itself without a counterpart. In an industry where mimicry is a way of life, I am almost embarrassed that our competitors have failed to ape our pioneering product. So, undaunted and perversely, we have formed "Vanguard Quantitative Portfolios," which will seek to harness the incredible power of the computer to manage a diversified equity portfolio, all the while remaining in lock-step with the Index, but trying to eke out a 2 percent to 3 percent annual performance advantage. This approach toward "relative predictability," you will note, is essentially diametrically opposite to our industry's direction today. (We dare to be different!)

And, we have also just formed the first publicly-available bond index fund—Vanguard Bond Market Fund. The unmanaged bond indexes, like the unmanaged stock indexes, have been formidable competitors for America's professional money managers, usually outpacing about two-thirds of pension bond accounts. This Fund too will provide substantial relative predictability to investors. Like our stock index fund, our bond index fund will employ no advisor, pay no advisory fee, and operate at an expense ratio in the 0.25 percent range. Such costs will thus consume only 3 percent of the fund's interest income, compared to 12 percent to 25 percent (it is true!) for most other "regular" bond funds. Perhaps it goes without saying that, if an index approach begins to permeate our industry (I do not expect much

agreement that it will), relative cost will become a major differentiator, and the “price war” will do what price wars are supposed to do: drive prices down.

Greshan’s Law and Mutual Fund Advertising

If the general direction of product development in this industry concerns me, the intensity of promotion concerns me even more. I refer principally to advertising that has run amok, advertising that is at once strident, blatant, hyperbolic. If these seem strong words, just open the Sunday *New York Times* Business Section, or read the most recent *MONEY* Magazine, or leaf through the last ten pages of any *Wall Street Journal*. But I urge you not to take it for granted; consider it as if you were a visitor from another planet, trying to decide where to invest the reward you just received for being the first interplanetary traveler.

What would you see? Mostly, claims of huge increases in value, achieved (though you are not told this) during one of the great bull markets of this century, often accentuated (nor are you told this) by highly-speculative investment policies. Here is a sampling of the claims advertised in *MONEY*, February 1987: +1,565 percent, +6,523.50 percent, +504 percent, + 156.32 percent, +348.7 percent, and, of course, \$10,000 growing to the magically-precise total of \$651,228. (If you believe that, I have a bridge I want to sell you!)* Inured as I have become to these outrageous claims, even I did a “double take” at a recent headline reading: “Follow These 5 Simple Rules and You Too Could Make \$667,000,000.” Well, it proved not to be a mutual fund ad, but who can predict tomorrow?

You would also see claims of income yields that are unbelievable—largely because they are untrue. Just a week ago I received a card in the mail offering me a “high return” of 11.90 percent from a portfolio offering “the safety of U.S. government securities.” Now, I know that Treasury bonds are presently yielding 7.t percent to 8 percent, and I wondered what could possibly be going on here. The answer, like too many answers in our advertisements, was right there, but in small print. The “current distribution rate” was based on annualizing the past three months’ distributions, which comprised 60 percent interest income and 40 percent short-term gains! Obviously, the fund’s yield has been hyped with premiums earned on the sale of covered call options on its bonds. But unless the fund is run by “a genius in investment management,” it will have its bonds called away when interest rates decline, and hold its bonds when rates rise. It is difficult to fathom how the net asset value can do other than decline over time, as capital is miraculously converted into income, but the advertisements do not tell you that.

The fact of the matter is that Gresham’s Law is at work in the mutual fund industry today. Bad advertising—advertising that panders even as it produces results—is driving out good advertising—advertising that talks sense, explains costs, describes risks. Too many in this industry are advertising past performance—total returns and yields—that they must know as a certainty cannot be sustained, and will not soon recur. A philosophy that “everyone else is doing it” seems all too pervasive even among the responsible organizations, and the meaning of the phrase “lowest common denominator” has seldom been more clearly demonstrated.

I believe that those kinds of zealous, simplistic advertising techniques have no place in this industry. By adopting the customary and time-tested techniques used to sell cosmetics, aspirin, and frozen foods, too many firms have come to view themselves as businessmen selling hot products, not as fiduciaries offering trust services. But our investment services are too important to the investor’s financial well-being, too market sensitive and too unpredictable, too complex and too easily misunderstood to be offered under the loose standards and banal simplicity of most consumer product

* I recently received a “Tell-a-gram” updating this number through December 31, 1986. It is \$679,958.

advertising. One industry participant recently said, “selling mutual funds is just like selling perfume; we’re selling hope.” I pray that that is a minority view.

A \$700 Billion Trust

At the 1936 General Membership Meeting of the Investment Company Institute, there was a huge banner reading “Mutual Funds: A \$600 Billion Industry.” My hope today, as I come full circle in these remarks, is that this year’s banner will read “Mutual Funds: A \$700 Billion Trust.” For we are much more than a mere “industry.” And we must hold ourselves to higher standards, standards of trust ;and of fiduciary duty. If we fail to do so—if we follow the lead of marketing companies in conventional consumer businesses, if we continue to create investment expectations we cannot possibly meet, often overlaid with high risks and laden down with exorbitant costs—the future of mutual funds is not bright. But if we return to the philosophy that a fully-informed investor paying a fully-disclosed cost for a sensible investment program is the best possible base for building an ever more successful business, our finest hours lie yet ahead.

Dealing with this dichotomy—between an industry and a trust—is surely the critical challenge of change that we face. Indeed, what I have presented today is more accurately described as “the challenge *to* change.” For change we must—surely in the operations that we focus on at this meeting, but also in our communications, our pricing structure, our product line, our promotional techniques—if we wish to be not just another multi-billion dollar “industry” but rather a multi-billion dollar “trust.” We are challenged, in a sense, to regain our bearings, to return to the sound and sensible principles that got us to our present eminence in the first place.

Let me conclude with a challenge to you of The National Investment Company Services Association. Ten years ago, I looked ahead with you, with mixed success—some hits, some errors, some misses. Today, I have tried to look ahead again; and I anticipate with excitement, curiosity, and enthusiasm the new chapter in our history that will be written in the coming decade. When it ends, you shall be celebrating your 35th anniversary, and I my 50th year of observing this marvelous industry. My challenge to you is this: invite me back in 1997. It would be fascinating, to say nothing of amusing, to review together how we rose both to the challenge *of* change, and the challenge *to* change!