The Wayback Machine - https://web.archive.org/web/20070911224220/http://johncbogle.com:80/wordpress/200…

NOT-SO-MUTUAL FUNDS

JCB - Mar 15, 2006
The Wall Street Journal - November 14, 2003

The rapidly cascading mutual fund scandals have brought unwelcome attention to 11 major firms that manage about $1 trillion. For an industry that only six months ago was bragging that "We've never had a major scandal," it's been an astonishingly rapid comeuppance. Yet who could have imagined that the fund managers who aided and abetted the pervasive market-timing scandal would be brought to the bar of justice by "Blue Sky" laws? For most members of the financial establishment, these laws had been consigned to the dustbin of market history.

Long before the adoption of the federal securities legislation of the 1930s and '40s, Blue Sky laws were adopted by states to protect the public against bogus sales of stocks of companies whose investment merits had no more substance than "the blue sky above." One passed in 1921 — New York's Martin Act — defines the "willful and knowing" commission of an illegal act as fraud, and the 1996 National Securities Markets Improvement Act specifically reaffirms the right of a state to bring such enforcement actions.

With that mandate, all that was required to give the fund market timing scandals the attention they deserved was a principled and aggressive state attorney general who cared deeply about the protection of the nation's 95 million fund investors, and was willing to take the heat by appearing to pre-empt federal regulators. New York's Eliot Spitzer turned out to be just such a person, and rightly deserves to receive (if such a medal were actually to exist), the first "Mutual Fund Shareholders' Medal of Honor."

To all appearances, the fund managers who ignored or condoned the market timing activity that resulted in the skimming of the assets of their trusting shareholders deserve the harsh financial penalties that the ancient Martin Act seems to contemplate. Indeed, in his Senate testimony, Mr. Spitzer suggested that the fund companies implicated in these nefarious schemes be required to disgorge all of the management fees that they'd been paid during the entire period in which the illicit timing activities took place, often dating back to the mid-'90s, easily hundreds of millions of dollars.

Important as they are in showing how a large portion of a giant financial sector has betrayed the trust of its investors, the timing scandals carry more important long-term implications. For they've illuminated the pervasive conflict between the interests of fund managers and fund shareowners that permeate the mutual fund industry — conflicts that, overwhelmingly, have long been resolved in favor of managers. These conflicts arise from the industry's incestuous structure. Each mutual fund, in effect, concedes control to the supplier of the services it requires to exist — investment management, share distribution, and the administration of its affairs. This supplier dominates and controls its board of directors, names its chairman as the fund's chairman, and dictates the contractual provisions that define the relationship, including the fees the fund pays for its services.

This bizarre structure has resulted in a total level of fund costs that destroys any chance that the industry can provide to its fund shareholders their fair share of financial market returns. In 2002, the total costs incurred by investors in stock, bond, and money market funds came to more than $130 billion. Since the record is clear that, over time, fund managers earn the markets' gross returns before costs, that $130 billion approximates the amount by which fund net returns fall short of market returns.

Over long periods, the correlation between low fund costs and high fund returns (and vice versa) for equity funds is powerful. Even over short periods, it is powerful for bond funds. And it holds each day (how could it be otherwise?) for money market funds. In the mutual fund industry, "you get what you don't pay for." Yet even as the fund industry has grown, its appetite for higher management fees remains unsated. In their quest to gather assets, managers organize funds focusing on narrow objectives and market sectors, often capitalizing on the fads of the day at exactly the wrong time. Result: huge revenues to fund managers; staggering losses to fund investors.

While Blue Sky laws deserve great credit for their role in the scandal, it will take federal regulations to establish the safeguards necessary to bring the fund industry to heel. But it will take federal legislation to resolve the industry's conflicts of interests. We need to put meat on the bones of the 1940 Investment Company Act, which calls for mutual funds to be "organized, operated, and managed" in the interest of shareholders, rather than in the interest of "officers, directors, investment advisers, and underwriters (distributors)." That principle may have prevailed in 1940, when this was a tiny industry, served by trustees and managers who focused on the profession of investing. But today, the fund industry is a colossus served largely by giant financial conglomerates focused on the business of marketing, and that simple early principle of stewardship has been subverted.

We need to amend the 1940 Act and establish a clear structure that puts fund shareholders in the driver's seat by giving funds an existence separate from their managers, free to negotiate fees and to replace faltering or unethical managers, with an independent chairman, board, and staff. Another option is to facilitate the development of truly mutual mutual funds, operated at cost by their own organization and officers, managing themselves, solely in the interest of their own shareholders.

In its wisdom, the 1940 Act actually contemplated just such a mutual structure. While the two fund organizations that used this structure then have long since abandoned it, a new firm — mine, Vanguard — adopted it in 1974 and has stuck with it ever since. At the recent mutual fund hearings, Sen. Peter Fitzgerald picked up the cudgels for reform, suggesting that Congress consider "facilitating the creation of more funds that are truly mutual . . . where the funds actually run the firm." The work in the trenches of state law, then, has called attention to broad principles that will require federal law for implementation. Restructuring the fund industry in favor of its shareowners is an idea whose time has come.

The opinions presented in www.johncbogle.com do not necessarily represent those of Vanguard's current management.
© Copyright 2006 by John C. Bogle