

**Mutual Funds at the Millennium:
Fund Directors and Fund Myths**

Remarks by

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To the '40 Act Institute of PLI*

New York, NY

May 15, 2000

As I was doing the research for my Princeton thesis on the mutual fund industry in 1950, a mere half-century ago, I discovered a report from the Securities and Exchange Commission which described mutual funds as “the most important financial development in the U.S. during the past 50 years.” Just how the SEC reached this powerful conclusion about an industry which had but \$2½ billion of assets and represented only 1½% of the financial assets of American families was not at all clear to me. But, by golly, they were right! Since then, the fund industry has lived up to that early promise—and then some. Today, with assets totaling \$7.2 trillion, and accounting for a stunning 90% of the net additions to family liquid savings over the past five years, mutual funds have become the largest aggregation of financial assets in the land.

But this industry has lost its way. A half-century ago, it was far more an *investment* business than a *marketing* business. Today, the reverse is true. Measured not only by the fund industry’s very nature and focus, but by its relative expenditures on each function, the industry is primarily a marketing business. Then, funds were long-term investments, fund managers were long-term investors, and fund shareholders held their shares for an average of 15 years. Today funds come and go at a remarkable pace: Each business day, three new mutual funds are born and one existing fund dies, its performance usually poor, its purpose passé. Fifty years ago, fund costs were well within the ambit of fairness. Now, despite the industry’s quantum 2900-fold increase in assets, *unit* expenses of funds have risen by one-third, giving rise to a far larger 4300-fold (!) increase in the dollar amount of direct fund operating expenses—from \$15 million in 1950 to \$65 *billion* in 1999.

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Today I'm going to present to you graphic evidence of these trends, which, I fear, bode ill for this industry, and for the financial markets as well. While I have been speaking out on these trends for more than a decade now, they've only gotten worse. On the other hand, confession being good for the soul, I acknowledge that there is little evidence of their baneful effects on the stock market—so far at least.

Protecting the Interests of Those Whose Funds They Command . . .

Nonetheless, these trends—the focus on marketing, the soaring levels of fund investment activity, and the huge increase in fund expenses—could combine to engender, a year or two or three down the road, the kind of statement made in 1934 by Justice Harlan Fiske Stone as he reviewed the events that led to the Great Crash of 1929 and the Great Depression that followed.

“When the history of the financial era which has just drawn to a close comes to be written, most of the mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that ‘a man cannot serve two masters’ . . .

The development of the corporate structure so as to vest in small groups control over the resources of great numbers of small and uninformed investors, make imperative a fresh and active devotion to that principle if the modern world of business is to perform its proper function.

Yet those who serve nominally as trustees, but relieved, by clever legal devices, from the obligation to protect those whose interests they purport to represent . . . consider only last the interests of those whose funds they command, suggest how far we have ignored the necessary implications of that principle.”¹

In this industry, then as now, small groups “control the resources of great numbers of investors,” and it is fund managers who must accept the lion's share of the responsibilities for the baneful trends I will discuss today. But fund directors—“those who serve nominally as

¹ I last used that quotation in my “State of the Firm” address to the officers of Wellington Management Company in 1971, more than three years before I founded Vanguard. I was reflecting on the harm the fund industry inflicted on investors during the “Go-Go Era” of the 1960s, the precursor of the devastating 50% market crash of 1973-74.

trustees—” must bear their share as well, given the responsibilities they are assigned under Federal and State law. And it is a heavy burden, given not only what they have done but what they have failed to do. Whether affiliated with the fund management company or *not*, they are serving two masters: The management company and the fund shareholders, and that is the root cause of the problem. Yes, we need entrepreneurs to start fund organizations, and, yes, they have a right to make a profit. After all, that’s the American way. But when that profit is excessive, it creates an unacceptable burden on the returns earned by fund shareholders, who are, after all, the owners of the fund.

I am not prepared to argue that today’s fund directors have been, as were the trustee’s of Justice Stone’s era, “relieved of their trusteeship obligation by clever legal devices.” Indeed, their trusteeship obligation clearly exists; the problem is that it is given short shrift. There is compelling evidence that the interests of the managers/marketers *are* being placed first. To the extent that is true, it suggests that fund directors today “consider only last the interests of those whose funds they command . . . and whose interests they purport to represent.”

I’m going to develop my analysis of recent industry trends by demythologizing, if you will, the traditional attributes ascribed to mutual funds—attributes that it would be impossible for anyone to seriously argue prevail today. I’ll deal with five of them:

Myth 1. That mutual *funds* are long-term *investments*.

Myth 2. That mutual fund *managers* are long-term *investors*.

Myth 3. That mutual fund *shareholders* are long-term *owners*.

Myth 4. That mutual fund *costs* are declining.

Myth 5. That mutual fund *returns* are meeting the reasonable expectations of investors.

I’ll challenge these myths by presenting the realities of how radically this industry has changed over the years, especially in what we might consider the “modern era” of funds, beginning in the mid-1980s, when fund assets first crossed the \$500 billion mark. Then, lest I leave you with all problems and no solutions, I’ll conclude with a Golden Rule and Ten Commandments for directors that would help to begin the arduous process of putting the fund shareholders back where they belong: In the driver’s seat of this critically important financial machine.

Myth #1. Mutual Funds are Long-Term Investments

Once, mutual funds were considered investments for a lifetime. The idea was to buy a mutual fund as a complete, diversified investment program and hold it, well, *forever*—Warren Buffett’s favorite holding period for a stock—much as wealthy families use trust companies and private trustees. But over the years this industry has moved from a focus on sound investment management to the marketing of what have come to be known as “financial products” (I don’t care for the choice of words, but the phrase surely hits the nail on the head!). This trend means, as I recall one firm putting it, “we’re in the ice cream business. We prefer vanilla and chocolate, but if the customers want pistachio-maple-walnut, we’ll give it to them.”

This change in strategy does much to explain the creation of the go-go funds of the 1960s, those lamentable “Government-plus” funds and the global short-term income funds of the 1980s (all of which came and now are gone), and of the internet, technology, and so-called focus (20-stock limit) funds of the turn of the century. During the past five years, more than 2000 new equity funds have been formed, most of them designed to capitalize on the public appetite to duplicate in the future the fabulous returns captured in the past by stocks in this so-called New Economy of technology, telecommunications, and science. If history is any guide, few of these funds will be with us a decade hence.

During the more quiescent years of the 1960s, just 28 funds out of but 200 didn’t survive the decade, an acceptable fund failure rate of 14% for the decade. During the 1970s, in the inevitable hangover that followed the wild spree of the earlier decade, 297 funds, including most of the go-go funds, gave up the ghost, and the failure rate soared to an astonishing 62%. Thus cleansed, the industry was more sedate during the 1980s, and the rate receded to 21%. But despite the great bull market, fund failures accelerated during the 1990s, to a surprising 55% for the decade. In the past two years alone, an estimated 450 funds have disappeared.

Clearly, too many funds have been formed with the principal purpose of being sold to investors. Often lacking durable investment principles and doomed to performance failure, they were born simply to die. If in the first decade of this century the failure rate of the last decade of the previous century holds, more than, 2300 of today’s 4500 funds won’t be around in 2010. Mutual fund directors, whether or not they are aware of what is happening or aware of their fiduciary duties, have presided over this change in the very nature of the mutual fund—from

being a sound long-term investment to a product offering a short-term marketing opportunity; from providing stewardship for a lifetime to the participating in the momentum of the marketplace.

Myth #2. Mutual Fund Managers are Long-Term Investors

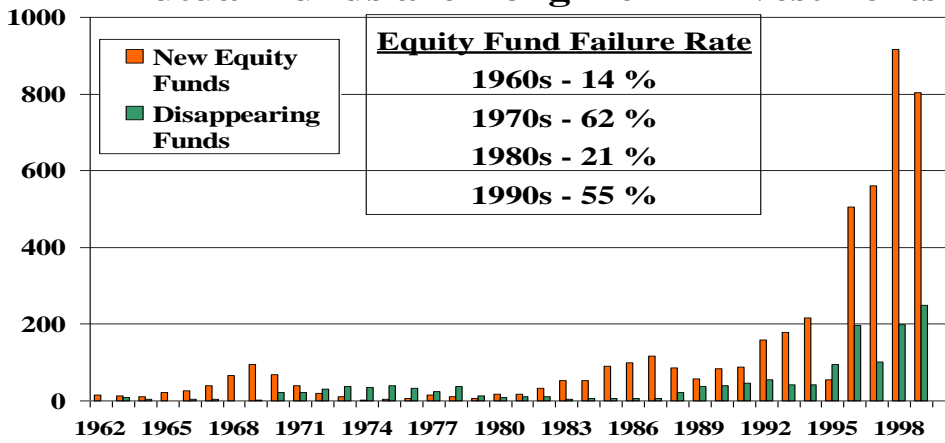
Equally depressing, at least to me, is the baneful change in focus of mutual fund managers. I mince no words: *Fund managers, once long-term investors, have become short-term speculators.* From the time I wrote my Princeton thesis until the mid-1960s, average fund portfolio turnover normally ran in the 15%-20% range, a putative holding period of five to seven years for the average stock fund. In recent years, turnover has consistently run over 80%, and was 90% last year. Alas, in this era of day traders—one-day traders—fund managers can be accurately described as “406-day traders.” If “speculator” is too strong a word for the typical fund manager, it’s surely infinitely closer to the mark than “long-term investor.”

Their high turnover rate, interestingly, is remarkably pervasive. It ranges from an average of 146% for mid-cap growth funds to 62% for small-cap value funds. And even the *median* large-cap fund turns its portfolio over at 63% (excluding stock index funds, which turn over at only about 9%). High turnover is not a statistical aberration; it is almost as prevalent as the air we breathe.

Again, this industry’s shift to a marketing ethos bears an important share of the responsibility for soaring portfolio turnover. Only a few decades ago, it was the *investment committee* that managed the fund and focused on the long-term, but today it is the *portfolio manager* that is in charge. Portfolio managers, focusing on the short-term, can be “hot,” and when there is heat, huge capital inflows are not far behind. And larger assets mean larger fees. So, ever since the mid-1960s, we’ve lionized our hot portfolio managers; they became our stars, glamorous and glittering. “A star is born” has become the watchword. Alas, as we now know, most *stars* have proved to be *comets*, illuminating the financial firmament for but a few moments in time and then burning out, their ashes gently descending to earth.

Myth #1:

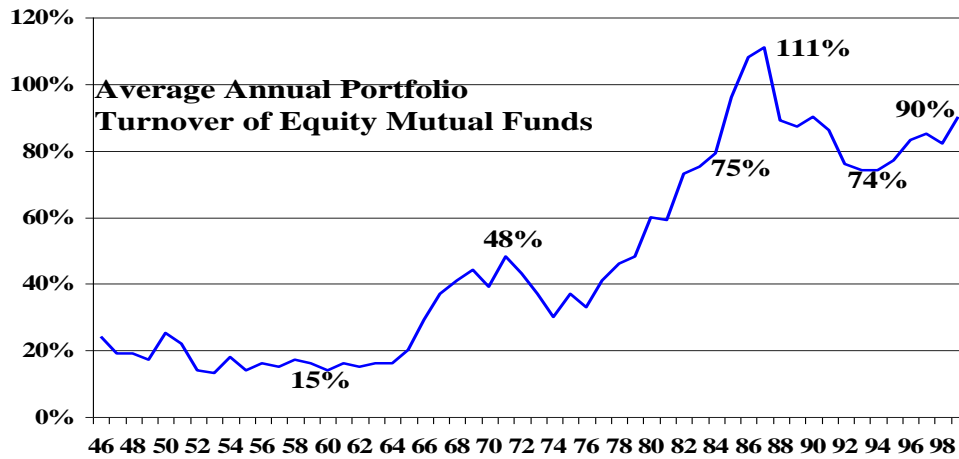
Mutual Funds are Long-Term Investments



Source: 1962 - 1995, Carhart; 1996 - 1999, Vanguard estimate

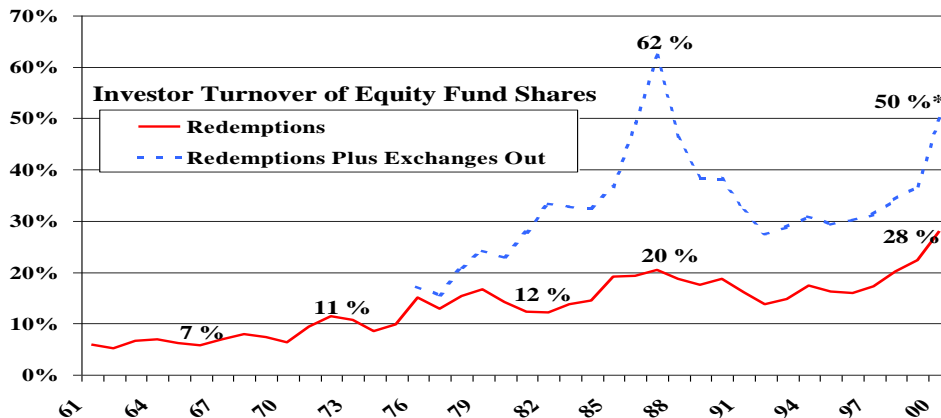
Myth #2:

Mutual Fund Managers Are Long-Term Investors



Myth #3

Mutual Fund Investors Hold Shares for the Long-Term



*2000 - 1Q annualized

Unlike those staid old committees, the new breed of manager was lighting-quick on the trigger. The portfolio managers just can't seem to sit still for very long, echoing Pascal's maxim: "All human evil comes from this, from man's inability to sit quietly in a room." What is more, the managers don't hold their jobs for very long, and considerable *portfolio* turnover arises simply from portfolio *manager* turnover. The average manager of an equity fund with at least five years of operations is but six short years, and when he or she moves on—a failure, or such an ostensible success that the hedge fund sirens beckon, or simply a reorganization of the investment department—the broom of the new manager sweeps the portfolio clean.

What's so evil about this turnover frenzy? First, it cannot possibly serve fund investors as a group, because as much as half of all turnover—perhaps even more—takes place among mutual funds themselves. Second, it costs money to trade securities—commissions, spreads, and market impact costs—conservatively estimated at one-half to one percentage point per year of return. Third, its tax impact is, well, devastating. Capital gains, about one-third of which are realized on a short-term basis and thus taxed as ordinary income—have resulted in a hit to fund returns of almost three full percentage points of return each year during this bull market.

Yes, as some naive defenders of the present ethos argue, some 40% of equity fund assets are held in tax-deferred accounts, so taxes don't matter. *But there is no evidence whatsoever that all of this flailing around enhances returns.* Thus, the high turnover that is radically diminishing the returns of 60% of fund shareholders does nothing that benefits the remaining 40%. The shift from long-term investing to short-term speculation, then, is hurting the very shareholders that fund directors are duly-bound to serve.

Myth #3. Mutual Fund Shareholders are Long-Term Owners

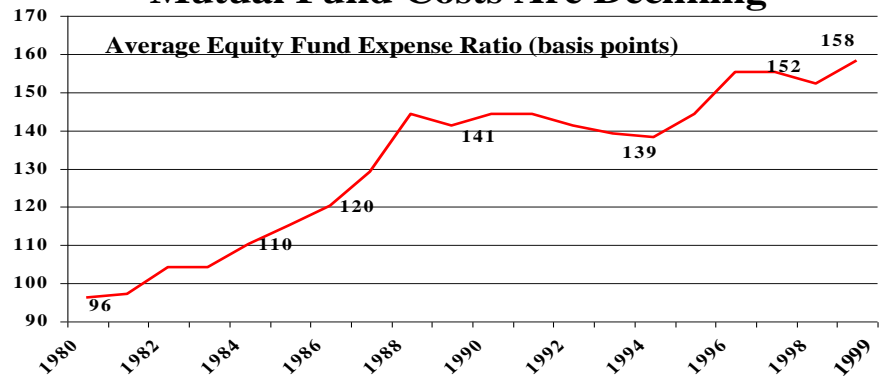
Like the "ILOVEYOU" virus, the virus that has so adversely infected the duration of the lives of *mutual funds* and the duration of the horizons of fund *portfolio managers* seems to be wildly contagious. Mutual fund shareholders are now suffering from the same malady—a game of "follow the leader" that is, I am confident, utterly unproductive. When I wrote my thesis, and for twenty years thereafter, share redemptions by fund shareholders averaged about 7% per year, suggesting an average holding period of slightly over 14 years. (The reciprocal of the redemption rate is a crude, but reasonably accurate, indicator of the holding period.) This figure gradually drifted upward to the 15% range by the mid-1980s, a seven-year holding period.

But in the late 1970s, another source of shareholder activity began. As the concept of the fund family took hold, the *exchange privilege* came into wide use. Investors could redeem shares in, say, the family's value fund and buy its growth fund or, for that matter, its money market fund—still clearly a redemption, but not “counted,” as it were, in the official data, understating the true redemption rate of fund investors by more than half. From the mid-1980s through 1997, regular redemptions of equity funds averaged some 17% of assets. But exchange redemptions ran at an even higher 19% rate, bringing the typical year's all-in redemption rate to 36%, a holding period of less than three years for the average shareholder, fully 80% shorter than the 14 year average of the 1950-1975 era.

In 1987, with the short-lived market crash and its aftermath, there was a rare departure from this norm. Redemptions jumped to 20% of assets and exchange redemptions (largely into money market funds) leaped to 42%, a combined redemption rate of 62%. In October alone, the annualized rate soared to 120%. (That's right, a rate that, had it persisted for a year, would have been larger than the entire equity fund asset base!) That rate may well be a harbinger of what lies ahead if stock market conditions move from unsettled, as they are today, to bearish. In any event, the upward trend seems to be accelerating. The all-in redemption rate rose to nearly 40% in 1999, and in the first three months of 2000 has soared to 50%, reflecting an abandonment of value funds, a surge in technology funds, and, to a small degree, a flight to money market funds.

This sea change in the character of fund owners, from long-term to short-term, violates the most fundamental principle of investment success: *Invest for the long pull*. I am confident that this frequent switching causes investors to relinquish far more investment return than can be explained by the high out-of-pocket transaction costs and taxes they incur. Rapidly jumping from one fund to another is *not* a formula for investment success. Yet these appalling figures of aggregate redemptions are, as far as I know, almost *never* presented to fund directors, who remain unaware of the shifting nature of their constituency and the added risks and costs to which the funds they serve are exposed.

Myth #4: Mutual Fund Costs Are Declining



ICI Shareholder Costs - 1998:	Average	193 bps
	Avg. Sales-Weighted:	135 bps
	Avg. Asset-Weighted:	132 bps
	1998 Total Cost:	\$ 44.0 B
	1980 Total Cost:	\$ 0.8 B

Myth #4: Mutual Fund Costs Are Declining

ICI Position: Ownership cost of equity funds down 40%.
 • 1980 231 bps; 1998 135 bps (Load 200 bps, no-load 83 bps).

Specific Flaws:

1. Weighted by sales volume. Unweighted expense ratio up 64% — 96 to 158 bps.
2. Lowest cost decile up 28% from 71 bps to 90 bps (1997).
3. Ignores hidden cost of portfolio turnover (50 to 125 bps).
4. Ignores opportunity cost (60 bps).
5. Ignores fees on “wrap accounts.”
6. Amortization of sales loads based on 25 year-old data. If updated, 1998 cost up by 50 bps, to 185 bps (estimated).

Fundamental Flaw: Price competition is (correctly) defined by the actions of producers, **not** the actions of consumers. Thus price competition is not “intense” in fund industry; it is barely alive.

Myth #4. Mutual Fund Costs are Declining

Back in 1950, when I was writing my thesis, the expense ratio of the average equity fund was 0.77%. It has been rising ever since, hitting 0.96% in 1980, 1.20% in 1987, leveling off at about 1.40% through 1995, and then, with the rapid formation of new—and higher-cost, always higher-cost—funds, rising to 1.58% last year. In all, the expense ratio of the average equity fund has risen by more than 100%—a doubling of unit costs.

Yet, sparked by heavily-publicized industry data, a myth that fund costs are actually declining has developed. Specifically, one industry study says, using a thoroughly inaccurate formulation, that the “costs of fund *ownership*” are declining. What it *meant to say* is that the costs of *purchasing* funds is declining. The industry study concedes that the average *unit* cost of equity funds is now 1.93% (35% *higher* than even my 1.58% figure). But it alleges that the average cost of *purchasing* equity funds—when weighted by each fund’s sales volume—has declined from 2.26% in 1980 to 1.35% in 1998.

The study leaves, dare I say, much to be desired. Loading the dice by making sales volume the basis of cost measurement, the study merely captures the remarkable shift in investor choice from high-cost funds to a relative handful of no-load funds, low-expense-ratio funds, and minimal-cost index funds. *But price competition is defined, not by the actions of consumers, but by the actions of producers.* So the trend that this tortuous methodology measures is hardly evidence of what is described as “vigorous price competition” in the fund industry. Indeed, since few, if any, fund groups have slashed their fees to take on the low-cost funds in the marketplace, price competition is hardly intense; it is barely alive.

And the study has still *more* weaknesses. It completely ignores a *huge* cost of fund ownership, *fund portfolio turnover*. That would add 0.50% to 1.00%-plus to the putative 1.35% total. It amortizes sales loads based on 25-year old data, ignoring today’s infinitely shorter (and therefore far costlier) holding period. It ignores the *opportunity cost* that funds incur by their failure to be fully invested in stocks—another 0.60% cost. And it no longer even *reports* the fact, buried deep in the first of its two studies, that the average expense ratio of the lowest cost decile of funds has actually *risen* by 27% since 1980—from 0.71% to 0.90% in 1997—perhaps up 35-40% if Vanguard were excluded. Even the lowest cost funds will not be denied their fee increases. Since fund costs have soared from \$800 million to \$65 billion over the past two

decades—increasing at an annual rate of 25%—it is clearer that declining costs are just one more myth.

Myth #5. Mutual Funds are Meeting the Reasonable Expectations of Investors.

Given the high fees and operating costs, the short-term investment horizons, and the substantial transaction and tax costs that go hand-in-hand with this rise in investment activity, it is small wonder that mutual fund returns have lagged so far behind the substantial returns generated by U.S. stocks during this greatest of all bull markets. Assuming only that the expectation of most fund investors is at least to enjoy a fair participation in the long-term returns generated by common stocks—and that seems a minimal assumption indeed—the idea that mutual funds have met the reasonable expectations of investors proves to be yet another myth.

I am speaking not only of the failure of the average fund to match the returns of the Standard & Poor's 500 Stock Index. While that large-cap index is not a *bad* comparison—after all, it represents 75% of the stock market, and its return has been *identical* to that of the total stock market over the past 30 years—it is a *crude* comparison, given that nearly one-half of all equity funds today focus principally on mid-cap and small-cap stocks. The net result is that the performance of the average fund was somewhat *better* than it appeared during the surge in large-cap stocks from 1994 through 1998, even as it was *worse* than it appeared during the small-cap outperformance of 1990-1993 and in the past 16 months.

But more sophisticated comparisons are readily available. For example, we can compare *large-cap* funds with a *large-cap* index (the S&P 500 is fair enough), and compare mid- and small-cap funds with indexes of mid- and small-cap stocks. Result: on a pre-tax basis, over the past 15 years, large cap funds have lagged their benchmark by 2.9 percentage points per year, mid-cap funds by 4.7 points, and small-cap funds by 2.0 points. (Given the high failure rate of funds, I've tried to adjust conservatively for survivor bias, using an average of 1.2%, but—generously!—ignored sales charges.*) On an after-tax basis, as you might expect, the lags increase substantially, to 4.5, 6.2, and 3.0 points

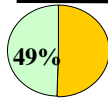
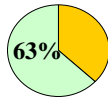
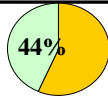
*I believe my adjustment for survivor bias is extremely conservative. Princeton's Burton Malkiel calculated survivor bias during 1976-1991 at 4.2% per year.

respectively. The brute fact: All-in fund costs have consumed about one-third of the *annual* investment returns earned by their bogeys, *even after the benchmarks are adjusted for estimated index fund expenses and taxes.*

Alas for the fund shareholder, that’s the least of it. Even as we have the famously accretive *magic of compounding* of investment returns, so we have subtly decreative *tyranny of compounding* investment costs. Result: the *cumulative* investment returns earned by mutual funds over the past 15 years have been a pale shadow of the cumulative returns by comparable market indexes: Large-cap funds have provided 51% of the cumulative after-tax profit generated by the S&P 500 Index: Mid-cap funds have provided 37% of the profit generated by the S&P 400 Mid-Cap Index. Small–cap fund have provided 56% of return generated by the Russell 2000 Small Cap Index. That’s just not good enough.

Myth #5: Mutual Funds are Meeting the Reasonable Expectations of Investors

15 Year Returns on \$10,000 Investment - Blend Funds vs. Index Funds

Fund Type	Annual Return		Final Value		The Cost of Cost*
	Pre-tax	After-tax	Pre-tax	After-tax	
Large-cap	15.0%	12.2%	\$ 81,400	\$ 56,200	
S&P 500	17.9	16.7	118,200	101,400	
Mid-cap	12.8%	9.8%	\$ 60,900	\$ 40,600	
S&P 400	17.5	16.0	112,300	92,700	
Small-cap	10.2%	7.5%	\$ 42,900	\$ 29,600	
Russell 2000	12.2	10.5	56,200	44,700	

*Appreciation of active fund investment as % of index fund.
Fund returns adjusted for survivor bias of 0.3, 1.2 and 2.0 percent, respectively.
Benchmarks adjusted for index fund expenses and estimated taxes.

It is as hard to imagine fund directors basking in the glory of this record of their stewardship as it is easy to imagine their general concern, even their embarrassment, although there is no evidence of either. So it is easiest of all to imagine that the fund directors unaffiliated with fund management are completely unaware of these facts. (To be sure, their affiliated director counterparts must be all too aware of them). Yes, I'm reasonably confident that nearly all directors receive presentations showing returns on an annual basis and a cumulative annualized basis, but I wonder how many boards are exposed to cumulative after-tax returns on a comprehensive comparative basis.

Yet despite what the data shows, we have virtually no examples of the termination of contracts of fund managers primarily by reason of consistent inferior performance. That strongly suggests that directors either don't know, or don't care, or don't think it is their role to take action. If they don't know, they are derelict in their duty. If they don't care, they are financially illiterate. And if they don't think their role is to take action, who else do they think will fulfill that role?

Where Do We Go From Here?

Taken together, the shift of industry focus from management to marketing; the rising rate of fund failures; the incredibly short horizons of portfolio managers; the increasing use of funds as vehicles for trading, not investment; and the soaring costs and tax bills; together they have combined to ill-serve fund shareholders and create a clear record of performance inadequacy. What's to be done? I suggest that independent directors have a major role to play in the resolution of these seemingly intractable problems. After all, who but fund directors are in a position to bring funds into compliance with the clear mandate of the Investment Company Act of 1940:

“The national public interest and the interest of investors are adversely affected . . . when investment companies are organized, operated and managed in the interest of investment advisers, rather than in the interest of shareholders . . . or when investment companies are not subjected to adequate independent scrutiny.”

This Act's preamble clearly makes two demands: (1) That it is shareholders who come first, with funds organized, operated, and managed with *their* interests the highest priority; and (2) that it is

independent directors who have the responsibility for careful scrutiny that assures the primacy of those interests.

The Ten Commandments

You don't have to tell me how tough a job it will be for this industry to reach that worthy goal. I've been doing my best, even in the years before "The Vanguard Experiment" began, but the tangible results are disappointingly few. Vanguard began its thousand mile journey with a single step in 1974, and lots more steps have followed. (Few of you know how arduous and demanding each of those steps have been, and continue to be.) But let me suggest some further steps along the way to meeting the clear—and wholly desirable—mandate of the '40 Act. While I wish we could take a giant step—establishing a federal standard of fiduciary for fund directors would be my choice—the fact is that a series of small but deliberate steps is more realistic. So I would propose that we begin by setting down these Ten Commandments for independent directors:

- 1) **Thou Shalt Retain Thy Own Independent Counsel.** Recommended by the Securities & Exchange Commission, this step seems so obvious and so essential that it is hard to imagine why it hasn't been mandatory ever since this industry began in 1924. Just imagine, in any other business, the anomaly of a firm being represented, not by its own counsel, but by counsel for its largest supplier of services, who depends on it for its very existence. Yes, I read all the arguments against independent counsel—there aren't enough lawyers; they won't be as experienced; they won't be the best; they won't have enough financial incentives; and believe it or not, in the face of the failings I've described, the industry "is not aware of any problems that have arisen as a result of current practices." Although I have no doubt that the present proposal can be sharpened, these make-weight arguments must be disregarded, and the independent counsel proposal implemented.

- 2) **Thou Shalt Elect An Independent Director As Thy Fund Chairman.** The present fund chairman, by and large, is chairman or president of the fund's management company. But it must be clear that the management company is a business corporation, and the primary responsibility of its chairman is to keep the

business running soundly and to earn the largest possible profit for its owners. The *fund* chairman's primary responsibility is, in a sense, precisely the same. . . . *but for a completely different constituency*: To keep the *fund* running soundly and to earn the largest possible profit for *its* owners. The two responsibilities directly conflict: the more the manager charges in fees, the less remains for fund shareholders. Only by separating these two distinct responsibilities can we possibly begin the process of bringing management fees and profit margins under control. After all, when the *fund* chairman negotiates fees with the *management company* chairman, and they are the same person, we can hardly expect shareholders to come first. Warren Buffett put it perfectly: "Negotiating with oneself rarely produces a barroom brawl."

- 3) **Thou Shalt Get The Facts About Performance.** Demand full, fair comparisons. Consider risks, peers, and appropriate market indexes. Look at *cumulative* returns over extended periods, and don't forget *after-tax* returns.

- 4) **Thou Shalt Get The Facts About Costs.** For each fund you serve as a director, "follow the money." Review the adviser's profit-and-loss statement. How much did the fund pay? How much was spent on investment management? How much on marketing, and on administration? (Press hard on exactly how those expenditures on advertising—directly or indirectly, through 12b-1 plans—benefit the shareholder.) What was the manager's pre-tax profit margin—before and after marketing costs—on each fund you serve? On all funds in the complex? This information should be readily accessible. Indeed, 30 years ago, we regularly provided such information to the directors of the mutual funds managed by Wellington Management Company. *You can't intelligently consider fund fees without knowing where the money goes.* And, while I'm on the subject of costs, let me reiterate my call for the Securities & Exchange Commission to undertake a comprehensive economic study of the mutual fund industry, first determining and then publishing industry-wide data on where \$65 billion of fees and expenses paid by fund shareholders went last year. Examining sources and uses is the only way to follow the money.

- 5) **Thou Shalt Compare the *Dollar Fees Thy Fund Pays with Those of Competitors.*** This industry has done a *marvelous* job at one thing: Placing public focus on fee *rates* rather than fee *dollars*. It brags that the cost of mutual fund ownership has fallen from 2.26% to 1.35% of assets since 1980. When the total dollar costs paid by all funds (excluding sales charges) have soared from \$800 million in 1980 to \$65 billion in 1999, it takes some kind of brass to make that argument. Expense *ratio* comparisons are fine as far as they go, but they don't go far enough. It is *dollars* that fund shareholders pay and *dollars* that the managers extract. A 1.00% expense ratio may *look* low—indeed is *almost* universally acclaimed as low—but on a \$25 billion fund, it produces \$250 million for the manager every year, \$1 billion over four years. Make sure you know how the *dollars* your fund spends compares with the dollars spent by its peers.
- 6) **Thou Shalt Challenge Thy Fee Consultants.** Many fund managers retain fund consultants to provide comparative data to the Board. But like executive compensation consultants, fund consultants know what their job is: To justify existing compensation (fee) levels, and to provide a basis for compensation (fee) increases. “Heaven forbid,” they suggest, “that your (sic) fund should be in the bottom quartile in expense ratio.” But let me assure you that when you're down there, it's really *good* for shareholders. Honest! So demand that the consultants calculate dollar fees as well as fee rates. While you're about it, demand that they include data for index funds, and data for funds run by differently-structured (low cost) fund organizations. I'm told that some consultants ignore such funds and firms on the grounds that they're “different,” and somehow unworthy of inclusion. Yes, index funds and mutual organizations are “different,” but only if you see the figures, can you be the judge of whether or not *different* is *better*.
- 7) **Thou Shalt Keep an Eagle Eye on Portfolio Turnover.** Consider the level of fund turnover, and demand to see the attendant costs of brokerage commissions and market impact, the amount of gains realized, the extent of short-term gains, and the dollars and cents burden in unnecessary federal, state, and local taxes borne by shareholders. Find out how turnover affected performance: Did it help? Did it hurt? By how much? Ask for a simple examination of the results of the

portfolio held at the year's outset, assuming that no changes been made all year. ("Static Portfolio Analysis.") Ask for an explanation of the frequent rotation of portfolio managers, and demand to know the extent and cost of anticipated portfolio changes when a new manager is appointed.

- 8) **Thou Shalt Not Ignore Incentive Fees.** We all—fund officers, directors, managers, shareholders—expect, or at least hope for, outstanding performance. It is a consummation devoutly to be wished, but, on the record, all too rarely achieved. *Don't pay for expectations or hopes.* Pay for achievement, a standard easily accomplished by adopting a fee schedule that awards premium fees for performance that exceeds agreed-upon benchmarks, and assesses penalty fees for performance that falls short. While the equity of such a system seems self-evident, incentive fees have almost vanished from the mutual fund scene.

- 9) **Thou Shalt Consider Redemption Fees.** One of the easiest, and fairest, ways to mitigate the use of mutual funds as speculative vehicles for short-term gains, and to return them to their traditional use as investment vehicles for long-term accumulation, is the imposition of reasonable redemption fees. Today, equity fund redemptions are running at an astonishing 50% annualized rate. Yet largely as the result of a redemption fee of 2% in the first year and 1% for the next four years, the funds in the industry's first tax-managed series, now in their sixth year, have an annual redemption rate running at just 5%. Surely there are lessons to be learned from this potential 90% reduction in redemption activity. (Alas, even as it effectively excludes short-term investors, the redemption fee retards marketing. So you serve the shareholders at the expense of the manager.)

- 10) **Thou Shalt Evaluate Thy Fund as If It Were Your Own Money.** Bring this attitude to your work as a director: Is this the way *my* money should be run? Is my performance satisfactory? How about my tax-efficiency? How about continuity of my portfolio management? How much would *I* be willing to pay for this service? When performance lags, how patient would *I* be? When would *I* terminate my own fiduciary relationship and move to another? In all, behave as if you *were* a large shareholder, and assume that the assets were important to you. Better yet, actually *own* shares of the funds you serve as trustee. The investment

of a significant portion of your own assets in the funds you serve is the single most meaningful step you can take in demonstrating both your commitment and your independence.

These are hardly radical steps, and most require no new laws or regulations. A statement of these principles by the Investment Company Institute, or by the new Mutual Fund Directors Education Council, or by the SEC—or even a speech by a senior SEC official—would start the ball rolling, and it would not soon stop. It’s high time we begin the process.

The Golden Rule

There are 80 million mutual fund shareholders out there. They need the support and commitment of independent directors to make those five old myths about mutual funds into five new realities—realities that recognize mutual funds as long-term investments, with managers who are long-term investors and shareholders who own their shares for an investment lifetime; operated at reasonable—and therefore far lower—levels of cost and far higher levels of tax-efficiency; providing shareholders with returns that meet, and even exceed, their expectations for a fair share of market returns.

So, before history repeats itself, and Justice Stone’s words come to describe the of *this* era and their causes, let’s make our philosophical anchor the preamble of the Investment Company Act of 1940 that has served this industry well in so many other arenas. Remember the Golden Rule of the ’40 Act: *Put fund shareholders first*. If fund directors will take seriously the Ten Commandments I’ve laid down today, and guide managers toward their own enlightened self-interest in serving investors “honestly, efficiently, and economically”—the very words I used in my Princeton thesis a half-century ago—we can avoid onerous and contentious regulation and legislation—and, for that matter, litigation—and we’ll have come a long, long, way toward finding our way back to our roots. It’s only common sense.