<u>Reflections on the Spirit of Entrepreneurship</u>

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before the

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Thank you so much for this opportunity to address you on the subject of "the spirit of entrepreneurship." This was the title suggested by your Chairman, and one on which I'm delighted to reflect today.

This happens to be a particularly timely moment for my reflections. For, while I'd never spent much time thinking about entrepreneurship in personal terms, my insouciance was shattered just a month ago. I received in the mail a copy of a 25-page paper discussing my career, written by a Yale senior. It described me (I'm embarrassed about saying this, but, obviously, not too embarrassed to say it!) as a "classic Schumpeterian entrepreneur."

It was Austrian economist and Harvard professor Joseph A. Schumpeter who, in his 1911 work, *The Theory of Economic Development*, first identified the entrepreneur as the moving force of economic development. That Schumpeter has become sort of a pop-hero of the so-called "supply side" political movement is not to denigrate his seminal approach to economics. Indeed, entrepreneurship is clearly one of the driving forces in the economic boom that is sweeping the globe today, most obviously manifested in the flowering of the technological revolution. It is hardly hyperbole to describe these years that bridge the transition from the twentieth century to the twenty-first as "the age of the entrepreneur."

But few expected it to be that way. Thirty years ago, when, unknown to himself, even in his dreams, a young kid with a crew-cut was beginning to move from a tried-and-true, buttoned-down career of conventional corporate advancement to a once-in-a-lifetime opportunity to be an entrepreneur, many believed that entrepreneurship was dead. In 1967, John Kenneth Galbreath—in *The New Industrial State*—delivered the eulogy. Referring to the entrepreneurial corporation largely in the past tense, he postulated a new economy that would be characterized by planning, oligopoly and scale. The "Fortune 500" companies would be in the saddle, and would drive the American economy, and the conglomerate (if you have forgotten this concept—or never heard of it, you can learn more about it in your business history books) would be the paradigm for the future.

A Merger that Led to a Revolutionary Structure

I suppose it was partly business necessity, partly impetuousness, and partly the bullish spirit of that era that persuaded me that the best hope for the company I was put in charge of in 1966 was to engage in an astonishing merger. I had been told to do "whatever it takes" to get Wellington Management Company back on the tracks. It had been a wonderful, proud company and an industry leader since its founding in 1928 by Walter L. Morgan—one of the grand old entrepreneurs of the mutual fund industry, alive and well today at age 99, and still a powerful source of friendship and support for me.

The merger occurred quickly—in 1967. Our giant (for those ancient days) $2 billion firm joined forces with a tiny Boston firm called Thorndike, Doran, Paine and Lewis. It brought what I thought at the time was remarkable investment talent to Wellington, and also "conglomerated" this conservative and narrowly-focused firm, giving us entry into the private investment counsel business and the "hot product' side of the mutual fund industry. The combination received considerable public attention. *Business Week* described "a free-form financial corporation offering a complete line of financial services—worldwide. . . that may shake the entire industry." The fledgling *Institutional Investor* magazine ran a cover story entitled "The Whiz Kids Take Over at Wellington."

We started off with a bang, and by the time 1967 was over, Ivest Fund was to have the best five-year record in the fund industry. But this was the "Go-Go Era" on Wall Street, which, as it turned out, was on the verge of collapse. What is more, the new investment group proved a painful disappointment. My determination to move quickly, my naiveté, and my eagerness to ignore the clear lessons of history had led me into a serious lapse of judgment. My error had resulted in failure—but just maybe reflected the attributes of a budding entrepreneur.

In a sense, of course, life is often fair. I made a big error and I paid a high price. With the bust of the Go-Go Era in 1968, and then the terrible 1973-1974 bear market (down 50% from high to low; yes, it *could* happen again), the bloom was off the rose. The merged firm's assets under management, which had increased from $2 billion to $3 billion, had fallen back below the $2 billion mark as 1974 began. The strange bedfellows, who had fallen from whiz-kids to goats in just seven years, had a falling out, and my Boston partners mustered the power to fire me as President of Wellington Management Company on January 23, 1974. (Now, why do I remember that exact date?) The vote was 10 to 2, with only myself and director John Neff—then portfolio manager of Windsor Fund, and to this day a legendary contrarian investor—dissenting.

If I had within my *persona* an entrepreneurial spark, that date marked its bursting into flame. Rather than accepting defeat and quietly fading away to another career, I pulled out an idea I had been actively nurturing for five years, and had publicly vetted in another *Institutional Investor* article in January 1972 ("A Wellington Whiz Kid Grows Older"), indeed an idea that arguably hung in the background of my senior thesis that I wrote at Princeton University in 1951 on the tiny mutual fund industry. The idea, simply put, was that the mutual fund industry would do better for itself if it gave investors a fair shake. The collapse of my career in 1974 presented the opportunity to put in place a new structure that would do exactly that.

I sprung my big, indeed rather revolutionary, idea at the board meeting of the directors of the Wellington-managed mutual funds, which, as it happened, had been scheduled to take place the very next day, January 24. In this context, you should understand that under Federal law, a majority of a mutual fund's board must be independent of its investment manager. So, while I had lost on Tuesday at one board table, I figured that I had a fighting chance of winning on Wednesday at the other, where my adversaries still had considerable power, but not omnipotence.

Whether it was entrepreneurial spirit, foresight, or an extraordinary instinct for self-preservation, I sprang the idea of a new structure for the firm on the fund directors. The idea was simple in concept: the funds would now manage themselves, with an eye solely on the interests of their shareholders, rather than entrust the management role to an external company seeking profit for itself. To do so, the funds would simply acquire the mutual fund activities of Wellington Management Company and operate on an "at-cost" basis. (At then-market prices, the purchase would have had a two-year payback. It would have been a great deal!) Such an acquisition, which would have "mutualized" the mutual funds, would have been a move without precedent in the history of the mutual fund industry.

<u>The Struggle to Develop a New Structure</u>

Alas, ever the optimist, I failed to take into account the power of inertia. Unprecedented extreme moves are rarely the province of a thoughtful, conservative board of directors, especially a board where the stakes are high and the board philosophically and politically—Philadelphia vs. Boston—divided. The idea failed, but I had a fallback plan. We would internalize the *business* side of the business—operations, administration, legal, and accounting (hardly the entrepreneurial side)—and leave investment management and marketing—the fun side—to Wellington Management Company. The compromise was struck, and I and some 28 souls who trusted me to make it all work moved from Wellington to become full-time employees of the funds—Wellington, Windsor and eight others.

I confess to being a bit devious—but only in a worthy cause!—at this point. While I accepted the compromise, I had no thought whatsoever that the structure just put in place would remain intact. Rather—though I said very little about it—I was certain that our future required full mutualization, also running the investment management and marketing activities in-house. Only in this way could whatever entrepreneurial spark I had fully flourish.

The first step was to give the new fund-owned company a strong name. (To my horror then—but a blessing in disguise—the fund directors had determined that the Wellington name—except for Wellington Fund itself—would remain with my adversaries.) I picked a name borne partly out of Duke-of-Wellington-era British battle history, partly out of my lifelong love of the sea, and partly out of the conviction that we were truly onto a new and better way of running a mutual fund complex. It was, of course, the name "Vanguard."

After heated debate, the Board approved the name. "The Vanguard Group, Inc." was incorporated on September 24, 1974. By this time, the bottom of the bear market was at hand, and our assets, which had fallen from the $3 billion peak, through $2 billion, were down to $1.4 billion—a decline of more than 50%. And hard times were to face us for eight years, until the summer of 1982, when the great bull market, that I must credit for the lion's share of our growth, began. That bull market, unprecedented in financial history, remains intact this today.

The hard times we faced were reflected in tough financial markets, magnified by the poor performance of Ivest Fund and Wellington Fund, although Windsor, under John Neff's aegis, performed admirably. Believe it or not, the Dow Jones Industrial Average, which had reached 1000 in 1966 still languished at 1000 in 1982—sixteen years later. (In the *next* sixteen years a rather different market environment would take it to 8000!) Our firm experienced 80 consecutive months of capital outflow (more shares redeemed by investors than purchased, every single month). But bad times helped us in critical ways. With business so poor, the directors were open to suggestions for improvement. I had long believed that having the lowest expense ratios would not be good enough to establish us as the legitimate, low-cost provider of mutual fund services. We would have to also eliminate all sales charges. So I urged the board to abandon the old broker-based channel to a new direct channel, the better to serve a public which, I posited, would be increasingly savvy about investing, well-educated, and self-motivated. Wellington Management Company resisted, and we were able to wrest control of marketing and distribution from them, cut expenses again, and make an unprecedented conversion to no-load distribution in early 1977. (Another close call, 8 to 5, at a still-divided board.)

Now we were both administrator and distributor. So we turned our attention to the third leg—investment management—of the three-legged stool on which mutual fund activities rest. The boom in money market funds, which were to grow to more than 50% of industry assets in 1985, gave us our entree. The board approved (9 to 2—a landslide for a change) our assumption of responsibility internally for our money market and bond funds in 1981. Slashing the expenses of these funds by doing the job ourselves at rock-bottom cost, we raised net income accordingly. Our resultant superior yields, combined with our existing strategies of peerless investment quality and defined maturities, has made us the dominant force in the fixed-income fund field today.

So by 1981—just six years after we began as a tiny administrative business—we had become the full-fledged mutual fund organization that I had sought to become, without success, in 1974. The modern Vanguard was in place. There was, really, just one more action we took that established the firm that the world knows today, and that was our very first action after we got up and running in 1975. We formed the first index mutual fund.

The Inescapable Logic of our Index Fund

I've always had a bit of an intellectual bent to go with the opportunism and determination that were required to conceptualize, form, and develop the full Vanguard structure. As an avid reader of the academic journals, I had become intrigued by the concept of index investing, and had watched it gain a toe-hold among a few banks and pension funds during the mid-1970s. The idea of index investing was simply to match the market and, by keeping costs at minimal levels, to winning the game in the long-run. The idea of creating the first index mutual fund was exciting. It wouldn't involve "investment management" for our new firm. The board had decreed that as a taboo at the outset. But I knew absolutely that "non-management" had to work. An "at cost" operation like ours could make the most of the opportunity, and we grabbed it.

So, when Vanguard finally began operations in May 1975, we quickly developed a plan for the formation, management, and distribution of the first index mutual fund in history. The board (again, after considerable controversy) approved it four months later in September, and it was incorporated in December of the same year. Then named "First Index Investment Trust"—though known more familiarly in the industry as "Bogle's Folly"—the fund began operations with $11 mission of assets in August 1976. It's had a good run, solidly outpacing the returns of actively-managed funds. And the now-well-known 500 Portfolio of the renamed Vanguard Index Trust, with assets nearing $50 billion, is the second largest mutual fund in the world. It constitutes about one-half of our index book of business of 26 passively-managed stock and bond funds, now approaching $100 billion in assets. These assets, in turn, comprise nearly one-third of our $300 billion asset total today. Standing alone, our index funds would be the nation's seventh largest mutual fund complex. All in all, it wasn't too bad an idea.

Schumpeter's Three Entrepreneurial Standards

As I hope you can sense, laying this solid foundation was an exciting business, replete with a sense of purpose, success and failure, elation and disappointment, close calls, a bit of foresight, and no small amount of luck. Looking at this history, our Yale senior sought to reach his conclusion. If I were to be deemed an entrepreneur, I would have to fulfill the three tests of entrepreneurial drive set forth by Schumpeter: first, the dream and the will to found a kingdom; second, the will to conquer and the impulse to fight; and third the joy of creating and exercising one's ingenuity. Here's what the Yale paper found:

"First, the dream and the will to found a kingdom . . ." Here, the paper, using Schumpeter's words, generously dates my dream as first arising in my Princeton thesis. He notes, correctly to be sure, that "the dream was in and of itself not remarkable, . . . particularly for a young idealist. What was remarkable was that he had the determination to stick with it until he had created . . . . a new sort of investment company, 'of, by, and for the investors'—not the investment managers." And he is right. That is just what Vanguard is today.

The author also lauds Vanguard for having "a real and tangible sense of purpose." However, he points out that my initial vision was a blurry one, and concludes that the public version of our founding is to a degree a myth—albeit "a good one." But in all, I pass his first test: "Bogle has realized his dream."

"Second, the will to conquer, the impulse to fight, to succeed for the sake, not of the fruits of success, but of success itself." The Schumpeterian phrase is used in the paper to discuss how I faced a bad situation, by dint, in the author's words, of "sheer force of will." But he notes, that *without* these external circumstances, there is a question as to whether that internal will would have had the opportunity to function. He concludes, doubtless correctly, that "were he not forced to act out of the ordinary, he would not have acted out of the ordinary. . . . because his conservative nature (I'm sure *that's* accurate) ensured that his entrepreneurial passions would remain largely checked until circumstances called for their release." He also believes that my motivations were "not so purely altruistic as the Vanguard myth would suggest." Fair enough.

He also describes me as a fighter, noting that "the fight first to secure Vanguard's independence and then to see it triumph has been the story of Bogle's life since 1974." Further, he refers to the state of war that is said to exist between Vanguard and Fidelity. I may have called it that, but I really look at it as a fair competition between two firms with approaches toward investors that are polar opposites—philosophically, conceptually, and strategically. He adds a word about my 35-year fight to conquer a failing heart, capped by the miracle of receiving a new one just one just eighteen months ago. I guess those three examples are a fair basis for him to affirm my fighting impulse.

The Yale senior concludes this section by agreeing that I've enjoyed success for its own sake, not for its fruits, for I own none of a company worth (his guess, and fair enough) between five and ten billion dollars. When he says, in a neat term of phrase, "once a man has more than enough for himself, only the fool measures his success in terms of coin and treasure." Entrepreneurs or not, we should all take heed of that thought.

"Third, the joy of creating, getting things done, of simply exercising one's energy and ingenuity." These words, the author argues, are at the heart of the Schumpeterian understanding of the entrepreneur. He finds this evident in the innovative Vanguard structure and in the creation of the first index fund. This innovation, he points out, "was scorned by the investment community . . . but today is hailed as the hallmark of responsible investing." He adds—again, it seems to me, accurately—that 'the entrepreneur must be able to give his creations—his gems of vision—the force of hard work so that they might last and be noticed."

In the context of Schumpeter's three standards of entrepreneurship—the dream of a kingdom; the will to conquer and the impulse to fight for success, primarily for its own sake; the joy of creating and exercising energy and ingenuity—the paper concludes that I qualify. While I warned him that "I do not have a great mind," he credits me with something that may be a good substitute: the gift of "making the obscure seem obvious and the opaque transparent." He goes on to observe that a gift for spreading the word over the years in speeches to the Vanguard crew, to industry gatherings, to the press, and to the public, combined with a certain energy and determination, have served me well, in my passionate mission—my dream, my will, my joy (to whatever degree the myth is accurate)—to create a better world for mutual fund investors.

A Slice of the World in Context

In his one interview with me, I described Vanguard's success as "importantly derived from an uncanny ability to recognize the obvious." And I think, honestly, that's all I've done. He credits that gift as arising from a naturally curious mind combined with a liberal education, facilitating an understanding of the nature and context of a business, and putting his own slice of the world in context." You now know enough about Vanguard, I hope, to decide for yourselves whether that's accurate, and indeed to decide whether or not I am truly an entrepreneur as you understand the term.

Given the writer's challenge, let me conclude by putting this saga of my slice of the world in some sort of context. Times have changed since Vanguard began in 1974. A fairly consistent 30% annual growth rate has turned a tiny firm into a giant corporation. The original crew of 28 now totals 5800. The dream has become the reality. Clearly, if an entrepreneur is defined as a leader who turns an idea into an enterprise, the day of the entrepreneur at Vanguard has passed. The skills of the manager, not the leader, are—must be—in the driver's seat. The creator, however, remains the spirit and the missionary, and the mission remains unchanged: a fair shake for fund shareholders.

And that's, I suppose, my story—so far.