

Rebuilding Faith: Wealth Management in the New Era

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“Investing is an act of faith.” So reads the very first sentence in my *Common Sense on Mutual Funds: New Imperatives for the Intelligent Investor*, published in 1999. “When we purchase Corporate America’s stocks and bonds,” I pointed out, “we are professing our faith that the long-term success of the U.S. economy and the nation’s financial markets will continue—and that our corporate stewards will generate high returns on our investments.” We are also, I added, “expressing our faith that our professional (money) managers will be vigilant stewards of the assets we entrust to them.”

Perhaps it goes without saying that in recent years these three articles of faith, faith in the stock market, faith in the corporate executives who run our publicly-held enterprises, and faith in the trustees who manage our money—have been tested. *And found wanting.* If there is a single overriding task that lies before us—especially each one of us in this room today—it is restoring our citizens’ faith in investing.

Today I’d like to examine each of those three key building blocks of investing and consider: 1) the prospects for future returns on stocks and bonds in the aftermath of the burst in the technology bubble; 2) the necessary resolution of the problems borne of financial manipulation that has clearly taken place in America’s corporate community and in the investment community alike; and 3) the extent to which our wealth management institutions have provided their clients with their fair share of financial market returns. In each case, I’ll present some policy recommendations that I believe will help wealth management firms to serve their clients far more effectively in the years ahead. With U.S. households owning some \$32 trillion of financial assets—fully one-third of which is held by millionaires—the wealth management industry, as it were, has a huge stake in doing exactly that.

1. Faith in the Financial Markets

I'm confident that few, if any, of you in this sophisticated audience have any doubt that we have moved into a new era for the financial markets. I expect that it will be an era in which the returns of stocks and bonds alike will be substantially lower than the unprecedented double-digit returns we've experienced in the past, indeed—unless you've put in more than two decades in this wonderful business—the very past that comprises your entire first-hand experience in the markets. And you need *three* decades to have known first-hand what the 50% market crash in 1973-74 was like. (This one's now at 40%).

Suffice it to say that it was almost exactly twenty-years ago—on August 18, 1982, in the aftermath of a nine-year bear market—that interest rates turned downward and stock prices leaped upward. The T-bill rate, 11% when August began, promptly tumbled to 8%. The Standard & Poor's 500 Stock Composite Index leaped from 103 to 113 during that single week, and to 120 by month's end, in the blink of an eye, a gain of 17%. We were on the way. In the great boom, which culminated with a great bubble in March 2000, the Index was to rise to 1527. By then, the annual return on stocks had reached a level unprecedented in any comparable period in history—just short of 20% per year. And the bond market, which earned a return of more than 10% annually over this long period, also performed far better than ever before.

But it's easy to say that we shall not soon again see the recurrence of such an outpouring of wealth creation. To understand why, we need only heed Lord Keynes' words, written nearly 70 years ago: "It is dangerous . . . to apply to the future inductive arguments based on past experience, *unless one can distinguish the broad reasons why past experience was what it was.*" But his warning also suggests that if we can distinguish the reasons *why* the past was what it was, we can then apply that very line of reasoning to the development of reasonable expectations about what may lie ahead. Keynes helped us make this distinction by pointing out that the state of long-term expectation is a combination of *enterprise* ("forecasting the prospective yield of assets over their whole life") and *speculation* ("forecasting the psychology of the market"). I'm well familiar with those words, for 52 years ago I incorporated them in my Princeton University thesis on mutual funds, then a tiny \$2½ billion industry.

Investment Return and Speculative Return

This dual nature of investment returns is clearly reflected in the stock market history, and remains basic in appraising the state of the stock market today. I continue to use the term *speculative return* to refer to the portion of the stock market's total return that is derived from "changes in the public valuation"—that is, the changes in the price that investors are willing to pay for each dollar of earnings per share. But rather than using Keynes' term *enterprise* to describe the yield of an investment over the years, I use the term *investment return*—the sum of the initial dividend yield plus the annual growth rate of earnings; that is, the return that *corporations* actually deliver to investors. Added together, investment return plus speculative return represent the *total stock market return* we experience.

History illuminates this division of stock market returns with great clarity. The *reason* that stocks returned nearly 20% per year during the great bull market are clear: The dividend yield on the S&P 500 Index averaged almost 5%, the subsequent annual earnings growth was just short of 7%; the combined *investment* return, then, was almost 12%. But as the fear of investors at the outset changed to hope and finally to greed, the price-to-earnings ratio quadrupled—from nine to 36—adding more than eight percentage points of *speculative* return. The math is not very complicated: An average annual return on stocks of almost 20%.

Make no mistake about it, then: It was speculative return that drove the Great Bull Market. The fact is that, based solely on investment return, \$1 invested in the S&P 500 at the outset would have grown to \$7—a handsome seven-fold enhancement. But the leap in the P/E multiple alone increased that *investment* return to a *market* return of \$24—nearly twenty-four times over, 3½ times (!) the hardly inconsequential investment gain. Yes, we had literally *never* had it so good.

Can it happen again? I can't imagine how. To understand why, let's take Lord Keynes' advice and look at the sources of the past returns on stocks and then apply them to the decade ahead. Today, the S&P 500 Index yields not 5% but 1½%, reducing this key contributor to stock returns by fully 3½ percentage points. When we add an assumed 6% earnings growth (corporate earnings, truth told, grow at about the same pace as our economy), the *investment* return on stocks would be just 7½% per year. Will *speculative* return add to or detract from this figure? While the 33% decline in the S&P 500 since the March 2000 high has brought the P/E ratio down to 21 (based on "normalized" earnings

at that), that's still quite high relative to the long-term norm of 16 times. So, I think the P/E is unlikely to rise, and could easily decline, perhaps to 18 to 20 times.

No one—*no one*—can be confident about how much investors will pay for a dollar of earnings ten years hence. But *if* my expectation is reasonable, the resultant easing of the P/E from current levels would create a *negative* speculative return of about 1% per year, reducing the annual return on stocks to about 6½%. I'm not much for such precision, however, so let's assume a wide range of returns on stocks in the years ahead, say 4% to 9%. In any event, we'd best all count on a coming era of lower returns in the stock market, and then hope we're wrong. But I hardly need remind you: *Relying on hope is not a sensible investment strategy.*

What About Bonds?

How will these returns compare with those of other financial assets? Bonds are the customary alternative to stocks, and expectations for bond returns over the coming decade are reasonably easy to establish. Again, Keynes' analysis helps us here, for the *investment* return on bonds—“forecasting the prospective yield of assets over their whole life”—depends largely on the interest payments they generate. And since bonds have a fixed maturity date, speculative return plays little role over the long-run. Result: *A remarkably high proportion of the subsequent ten-year investment return of bonds is explained simply by the current yield.* In fact, the correlation between the initial yield and subsequent ten-year return of bonds is a healthy 0.91. Not bad, once we realize that *perfect* correlation is 1.00. The reason for this close correlation is not complicated: If interest rates remain unchanged, of course the returns would be identical. But while rising rates would depress bond prices, the higher reinvestment rate on each year's interest payment would have a countervailing impact. And *vice versa*.

In mid-1982, the yield on bonds—the Lehman Aggregate Bond Index of U.S. Government and investment-grade corporate bonds—was 14%; during the subsequent decade the annual return on bonds came to 13%, and to 10% over the past *two* decades. Today, with the bond yield at just over 6%, bond returns in the coming decade should run between, say, 5% and 7%. What we know—or at least can be highly confident about—is that we are looking at future bond returns that are also a pale imitation of those we have enjoyed in recent decades.

It is hardly farfetched, then, to expect future bond returns that are likely to parallel those of stocks. If so, the traditional 3% equity risk premium—the amount by which stock returns have exceeded bond returns over the past century—may be far smaller, perhaps even non-existent. There are, of course, those who say that there is some God-given mandate that an equity premium must exist. Yet history tells us that bond returns have exceeded stock returns in one out of every five decades. The reality is that restoring an equity premium to stocks will require either (a) lower interest rates, or (b) some combination of higher earnings growth, higher dividend yields, and lower P/E ratios, which is likely only if there is *another* downward leg in the stock market. In any event, my view is that we are entering an era of lower returns on financial assets.

After a golden era of truly extraordinary returns, investors have to realize that reality is now the rule of the day. But the faith of investors in our financial markets will be restored far more quickly if we do three things: First, encourage our clients to develop realistic expectations about future market returns. Second, help them to invest carefully, to increase their savings, and to observe the time-honored principles of diversification and asset allocation. And third, be cautious, and make certain each client understands the role of income as well as the role of capital appreciation, keeping in mind, not only the *probabilities* of earning high stock returns, but the *consequences* of assuming excessive risks.

2. Faith in Our Corporate Stewards

I would note that caution is the order of the day not only because of the likelihood that we are facing an era of lower returns in the financial markets. We are also facing the huge challenge of helping our clients put their wealth to work productively because, in the aftermath of the bubble, they have likely lost faith in the stewards to whom we have entrusted the management of our corporations.

Part of the problem is the mania that resulted in the recent bubble. As Edward Chancellor, author of “Devil Take the Hindmost: A History of Speculation,” reminded us, manias bring out the worst aspects of our system: “Speculative bubbles frequently occur during periods of financial innovation and deregulation . . . lax regulation is another common feature . . . *there is a tendency for businesses to be managed for the immediate gratification of speculators rather than the long-term interests of investors.*” And surely that’s what we’ve seen. Here’s how *The New York Times* described the Enron mess: “A catastrophic corporate implosion . . . that encompassed the company’s auditors, lawyers, and directors . . . regulators, financial analysts, credit rating agencies, the media, and

Congress . . . a massive failure in the governance system.” But while Enron may prove to be the worst failure of our corporate stewards, I need not tell you it is hardly alone in its failure to merit the faith of investors.

Casino Capitalism

Lord Keynes warned us long ago of what happens when speculation achieves predominance over enterprise, and I also quoted some of these words in my ancient university thesis: “In one of the greatest investment markets in the world, namely, New York, the influence of speculation is enormous . . . it is rare for an American to ‘invest for income,’ and he will not readily purchase an investment except in the hope of capital appreciation. This is only another way of saying that he is attaching his hopes to a favorable change in the conventional basis of valuation, i.e., that he is a speculator. But the position is serious when enterprise becomes a mere bubble on a whirlpool of speculation. *When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done.*”

The analogy of the casino to the recent era in our financial markets is hardly far-fetched. *Investors have focused on short-term speculation based on the hope that the price of a stock will rise, rather than long-term investment based on the faith that value of a corporation will grow.* Wall Street’s conflicted sell-side analysts have lost their objectivity; the buy-side analysts of our large financial institutions have put aside their skepticism; too many of our corporations have forced the fulfillment of their aggressive earnings guidance by fair means or foul; off-balance-sheet special purpose enterprises have been created largely to conceal debt; and illusory transactions have raised reported growth in sales.

And that’s hardly the end of the list: Enormous compensation from stock options has enriched corporate executives who have succeeded in hyping the *price* of their *stocks* without increasing the *value* of their *corporations*; auditors have had important business incentives to be partners of management rather than independent professional evaluators of management’s financial reporting; and millions of employees have lost faith in their retirement plan investments. As these forces came together, investors came to realize that they had assumed risks that were far larger than those for which they bargained. They are demanding a higher risk premium, which in turn has raised the cost of capital. Unless we resolve these nettlesome issues in favor of the stockholder, that higher cost will ultimately drag down our economy.

A Failure of Character

But there's more at stake than that. This nation's founding fathers believed in high principles, in a moral society, and in the virtuous conduct of our affairs. Those beliefs shaped the very character of our nation. If *character counts*—and, as my book underscores, I have absolutely no doubt that character *does* count—the failings of today's business and financial model, the willingness of those of us in the field of wealth management to accept practices that we know are wrong, the conformity that keeps us silent, the selfishness that lets greed overwhelm reason, all erode the character we'll require in the years ahead, especially in the post-September 11 era. The motivations of those who seek the rewards earned by engaging in commerce and finance struck the imagination of no less a man than Adam Smith as “something grand and beautiful and noble, well worth the toil and anxiety.” I can't imagine that anyone in this room today would use those words to describe our corporate governance system at the outset of the 21st century.

So, yes, too many of our corporate stewards have failed to earn our faith. By focusing on short-term speculation at the expense of long-term investing, we institutional managers have, I fear, gotten the corporate governance that we deserve. Yet most giant institutional investors have been conspicuous only by their silence. If we simply act as good corporate citizens and recognize that ownership entails not only rights but responsibilities, we will again get the governance we deserve. And our clients will benefit accordingly. If we all take the initiative to stand up and be counted, we will at last return to an era in which the great creative energy of American business and finance shifts from its short-term focus on the price of a stock—speculation—to a long-term focus on the value of the corporation—enterprise. When we do, our corporate stewards will respond appropriately, and that change will well-serve both investors and our nation.

3. Faith In Our Trustees

For in addition to the troubled financial markets and the failings of the stewards who run our corporations, the trustees of the investment dollars of American families—the pension funds, the mutual funds, and other financial institutions—have also failed to live up to the faith investors have placed in them. To explain how this situation has come about, we need first to understand the simple mathematics of investing: The returns earned by investors in the aggregate inevitably fall well short of the returns that are realized in our financial markets. *The great paradox of investing is that the very*

costs incurred by those who would help investors to beat the market themselves constitute the reason that investment managers as a group are destined to fail at the task.

Why? It is only to state the obvious when I point out that all investors as a group must of necessity earn the market returns—but only before the costs of investing are deducted. *After* these costs are taken into account—after all of the fees, the transaction costs, the distribution costs, the marketing costs, the operating costs, and the hidden costs of financial intermediation—investors must—and will—incur a *loss*, indeed a loss precisely equal to the aggregate amount of those costs. Beating the market *before* costs is a *zero-sum* game; beating the market *after* costs is a *loser's* game.

Management of Embedded Alpha

At long last, this reality has taken root, even among financial market participants who are not among the lowest-cost players in the game. Consider the paper entitled *Success in Investment Management: Building the Complete Firm*, prepared two years ago by Merrill Lynch and BARRA Strategic Consulting Group after consultation with a distinguished list of money managers that included Fidelity, Putnam, and Citigroup. The study reached this major conclusion: *Management of Embedded Alpha, the frictional costs of running a portfolio, will emerge as an essential contributor to investment performance.* (It's about time!) Those frictional costs, the study suggests, constitute a dead-weight burden that detracts from the return that can be theoretically produced by an investment portfolio in a frictionless securities market. So firms are urged to “cut those hidden costs,” including:

1. **“Tangible Costs** . . . management fees and trading commissions. Each dollar given away for, say, management fees is a dollar explicitly detracted from the portfolio net return.
2. **“Managed Costs** . . . unintended risk exposures, tax costs, and Not-Equitized-Cash, an opportunity cost for not keeping funds fully invested.
3. **“Invisible Cost** . . . the adverse market impact of trading and the opportunity cost of delaying trade execution.”

Result: “Simply put, every incremental basis point increase in rate of return translates into competitive advantage (by which) a firm improves its absolute performance and its ranking relative to its peers.” In the study's words, the firm that “will lead the way . . . will diligently seek to minimize

these performance detractors.” Thus spaketh, I remind you, not Vanguard/BOGLE, but Merrill Lynch/BARRA.

Perhaps surprisingly, the study presents no data whatsoever on the dimension of Embedded Alpha. So it won’t astonish you to learn that I’ve taken it upon myself to do exactly that, examining the mutual fund business and the costs that fund investors incur. The pictures:

<u>Average Equity Mutual Fund</u>	<u>% of Average Assets</u>
1. Advisory Fees	0.8%
2. Other Operating Expenses	<u>0.5</u>
Total Expense Ratio¹	1.3%
3. Transaction Costs	0.7
4. Opportunity Cost	<u>0.4</u>
Total	2.4%

You don’t need me to tell you that 240 basis points is a lot of Embedded Alpha. And I haven’t even taken into account the impact of fund sales charges and the heavy cost of taxes for non-retirement plan investors! Embedded alpha is admittedly lower for pension funds—its estimated at 1.3%—but it nonetheless takes a powerful toll there as well. Indeed, a recent study by a major pension consultant projected that even costs at the 1.3% level reduce the probability that a given active manager can beat the market over the long term at 5%—just one chance in twenty.

The Long-Term Toll of Costs

Now let’s look long-term. Despite today’s environment of frighteningly short-term investment horizons, most pension funds have seemingly perpetual lifetimes. And most individual investors now start their programs in an IRA or 401(k) at a young age, and will still be investing, not only 50, but even 70, years from now. What toll would a 240 basis point cost have taken on the 12% return earned on the Standard & Poor’s 500 Stock Index over the past 50 years? A mutual fund incurring these costs would earn 2.4% less than the market, or 9.6%. When compounded, each dollar in the S&P 500 itself would grow to \$287; each dollar in the fund, after costs, would grow to \$96—a \$191 dead-weight loss engendered solely by reason of the costs of financial intermediation.

¹ *Asset-weighted* mutual fund ratio. The *unweighted* ratio is about 1.6%. Transaction costs and opportunity costs are estimated.

But intermediation costs are paid in *current* dollars, while the investor's final capital must be measured in *constant* dollars. During the past half-century, the inflation rate was 4.2%. Result: *Real* annual return for the S&P 500, 7.8%; real return for the fund investor, 5.4%. The final purchasing power of each initial dollar falls to \$43 in the Index, and to less than \$14 in the fund. Since the mutual fund's annual return *before* costs was not the 12.0% stated return earned by the S&P Index, but a real return of 7.8%, the 2.4% intermediation cost reduced each year's *real* return, not by 20%, but by almost 33%!

When we apply to the annual data that remarkable magnifying glass called compounding, we can describe the investment returns earned by the average fund—on cost assumptions that are hardly excessive—as shocking. After intermediation costs and inflation (and ignoring taxes!), the nominal value of \$287 had dwindled away to less than \$14, just 5%—five percent!—of the compound market return we calculate from the textbook data—say, the Ibbotson tome—that shows the annual returns of the stock market. Yes, Embedded Alpha is a powerful destructive force.

Other Destructive Forces

But it turns out that there are other forces that are every bit as destructive as costs in undermining the returns earned by mutual fund investors. Indeed, while investment costs of 3% during 1984-2000 (with average fund costs at higher levels than in the 1950s, '60s, and '70s) reduced the stock market return of 16% for that period to 13% for the average fund, the average fund *investor* earned just 5%. How was that shortfall possible? First, because investors were victimized by *unfortunate market timing*, making modest purchases of equity fund shares when stock prices were cheap during the early years of the period and then making huge purchases when prices were dear as the bubble inflated during the later years. Second, because of *adverse fund selection*, as investors poured their savings into technology funds and tech-oriented growth funds and pulled them out of value funds at precisely the wrong time, with most of their dollars going into existing funds with the hottest records of performance and new funds that promised full participation in the “exciting Information Age” that supposedly was before us.

To regain the faith of equity investors, the mutual fund industry must face up to the obvious issue of excessive costs. There's plenty of room for fee reduction, and if the industry would at last turn from its focus on short-term speculation— that is, I think, a fair characterization of the average fund's current 111% turnover rate—to long-term investing, transaction costs would tumble

accordingly. If the fund industry doesn't wish to recognize the need for these changes and reduce its embedded alpha, it is only a matter of time until investors will recognize it—and they will vote with their feet. Yes, as the theme of this conference indicates, the economics of wealth are a 'changing.

But it's more than economics. Investors' faith in their fund trustees has been shaken even more emphatically by the fact that fund managers have moved away from being prudent guardians of their shareholders' resources and toward being imprudent promoters of their own wares. We pander to the public taste by bringing out new funds to capitalize on each new market fad, and we magnify the problem by heavily advertising the returns earned by our hottest funds. The first step in restoring the investing public's faith is to focus far less on salesmanship and far more on stewardship. If we simply put our clients first, just imagine how well we can serve investors in the New Era.

Looking Ahead

In the New Era for wealth management we are facing, restoring faith must be at the top of the agenda. We have to present to our clients realistic expectations for future returns, and emphasize that while *emotions* can overwhelm *economics* in the short run—sometimes for the better, sometimes for the worse—in the long run, it is the fundamental *economics* of the stock and bond markets that carry the day. We have to press the vested corporate interests to at last realign the interests of the managers with those of the owners, and turn their focus to enhancing, not stock prices, but building corporate values. And our managers—our investment fiduciaries—must get their act together, and focus not on *marketing*, but on *management*.

It's all about wealth *management*, and it's a tough *business*. The competition to provide out-of-the ordinary returns to our clients is intense, the odds against doing so long, and the competition to retain current assets and attract new assets fierce. The costs of operations are rising, in no small part because of rapidly changing technology and increased service requirements. And in the new era, the struggle to build the profits of our firms is hardly going to vanish.

But the field of wealth management is also a demanding *profession*. Our guiding principle must be to put the client first in everything we do. But the reality is that the dichotomy between maximizing the returns on our clients' capital and maximizing the returns on the capital of our own firms—and, so often in this day and age, the returns on the capital of the financial conglomerates which own so many of our wealth management firms—is no mean challenge. While a healthy profit

margin is required for any thriving business, no firm that fails to serve its clients first will long endure. The secret of success in wealth management, I think, is simple: *We must both make money for our clients, and give them their fair share of whatever returns the financial markets are generous enough to favor us with.*

We also must recognize our limitations. Wealth management today is a *huge* field, with mutual funds, pension and endowment funds, trust companies, investment counselors, and family offices managing portfolios holding 60% or more of all U.S. equities. Concentration is high, with 26 firms managing over \$100 billion of equities and the top ten managers averaging \$360 billion . . .each! With less diversity among our peers and more size to say grace over come greater market impact and less investment mobility . . . and the eternal reversion to the mean in investment performance occurs with both greater certainty and greater rapidity.

In these circumstances, there are many temptations for firms to try something new. We hear, without any supporting evidence, that managed separate accounts can offer higher returns and lower risks than mutual funds. (Certainly they offer higher costs!) We read about the magic attraction of hedge funds, without explanation of the often-hidden risks they assume, the diversity of their strategies, and the enormous diffusion of their returns. We are told about the magic of private equity and venture capital, but ignore the warnings from those who have managed them most successfully that their best days may be behind them. And we accept that all of these so-called alternative investments are a panacea that will somehow cure the ills of the more modest returns of stocks and bonds that seem so likely to lie before us. I'm not so sure.

There are also great temptations to offer new services. We hear about the magic of technology that facilitates moment-by-moment account appraisal; about “screen-scraping” that combines accounts of multiple investment providers and facilitates moving money around from one provider to another; about Monte Carlo simulations that, by constructing complex multi-fund asset allocation strategies, are said to add predictability to forecasts. The whole thrust of these developments is that our value to investors can be enhanced by more sophisticated services, and that the greater the investor's wealth, the more he or she will demand these services—but, I would add with some skepticism, only if these layers of complexity prove to be true *services*, and not *disservices* to investors. In my experiences, moving money around quickly is *not* the preferred route to wealth accumulation, and “don't just do something, stand there” is *not* the worst of all advice.

Simplicity, Stewardship and Character

So, I'll continue to have faith in the majesty of simplicity, helping investors to make uncertain but necessary judgments to determine their allocation between stocks—with all their capital opportunity and risk—and bonds—with all of their income productivity and stability—and then doing everything in our power to diversify these investments and minimize the costs—management fees, operating costs, marketing expenses, turnover impact—promising only to give them their fair share of financial market returns, no more, no less. And if index funds are the best way to assure the realization of these goals, so be it.

The ultimate objective of every firm represented in this room, I think, is to build *a company that stands for something*. As one who has been at that task for 28 years this coming September, I can tell you that it's a tough, demanding never-ending task. My own goal has been to build a company that stands for *stewardship*. Let me be clear, however, that this goal is not without a self-serving aspect. For only to the extent we adequately serve the human beings who have trusted us to help manage their wealth will Vanguard itself survive and prosper.

However each of you chooses to define your own firm, I hope that stewardship will be at least part of your character, because it will pay off for you. But, whatever you decide, I believe that you will succeed in direct proportion to your focus on the character and values of your firm—not only in your words, but in your deeds. Above all, your success will depend upon *keeping the faith*—the faith of those human beings who have entrusted you with their precious hard-earned dollars. Then go out and earn that faith, every single day.