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The Mutual Fund Industry Today: "Conflicts, Conflicts Everywhere"* John C. Bogle

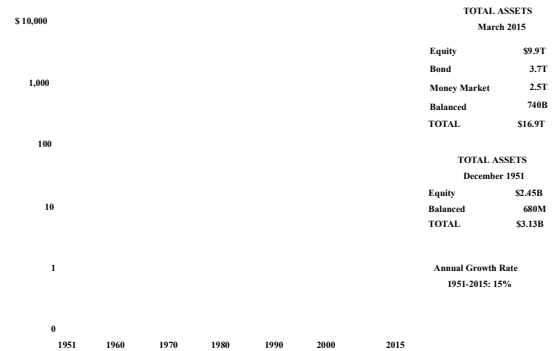
United States Securities
And Exchange Commission
Asset Management Unit

April 28, 2015

*Title of a speech by Julie Riewe, Co-Chief of Asset Management Unit, Division of Enforcement

NOTE: The views I express in this speech and the visuals that follow are my own and do not necessarily reflect the views of Vanguard's present management.

A Tiny Industry Grows into a Behemoth



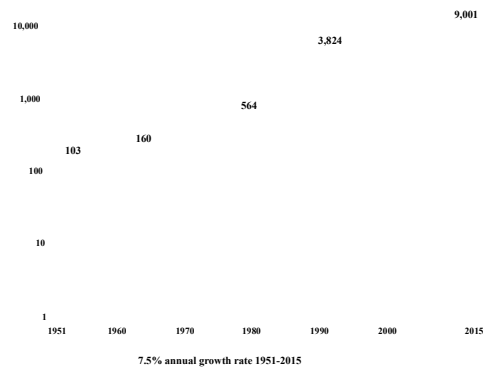
2.

Mutual Fund Industry Leaders: Then and Now

Rank	1951 Fund Name	Total Assets* (Millions)	2015 Manager Name	Total Assets (Billions)
1	MLL	\$472	Vanguard	\$2,088
2	Investors Mutual	365	Fidelity	1,615
3	Keystone Funds	213	BlackRock	1,230
4	Tri-Continental	209	American Funds	1,216
5	Affiliated Funds	209	JPMorgan Funds	519
6	Wellington Fund	194	State Street	497
7	Dividend Shares	186	T Rowe Price	493
8	Fundamental Investors	179	Franklin Templeton	480
9	State Street Investment	166	PIMCO	375
10	Boston Fund	166	Federated	272
Total		\$2,239	Total	\$9,686
Percentage of Industry		72%	Percentage of Industry	57%
Total industry assets: \$3.1 billion.			Total industry assets: \$16.9 trillion	
*Includes associated funds.				

3.

Huge Growth in the Number of Funds



4.

Number of Funds—1951 & Today

Original Name	1951			2014		
	Total Assets (Millions)	No. of Funds Managed	Current Name	Total Assets (Billions)	No. of Funds Managed	
MLL	\$472	2	MFS	\$180	78	
Investors Mutual	365	3	Columbia	165	116	
Affiliated	209	3	Lord Abbett	108	37	

5.

Mutual Fund Expense Ratios 1951 and 2015

	1951	2015	Change
Conventional Industry Model			
MIT/MFS (C)	0.42%	1.29%	+208%
Investors Mutual/Columbia (C)	0.56	1.15	105
Eaton Howard/Eaton Vance (SH)	0.64	1.27	99
Putnam (C)	0.66	1.31	98
Fidelity (P)	0.63	1.06	68
T. Rowe Price (SH)	0.50	0.84	68

6.

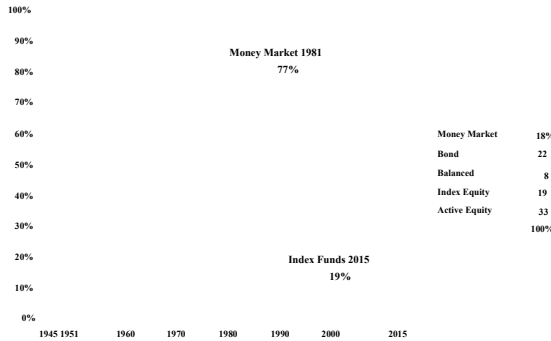
Wellington	194	1	Vanguard	2,988	140
Eaton & Howard	90	2	Eaton Vance	101	130
Fidelity	64	1	Fidelity	1,615	321
Putnam	52	1	Putnam	81	77
American	27	2	American	1216	35
T. Rowe Price	1	1	T. Rowe Price	493	116
Dreyfus	0.8	1	Dreyfus	248	151
Total/Average	\$1,475	1.7	Total/Average	\$7,195	120

Note: 12 of today's 20 largest firms did not exist (or did not manage mutual funds) in 1951, including BlackRock, PIMCO, State Street Global, and JP Morgan

Affiliated/Lord Abbett (P)	0.75	1.12	49
American (P)	0.84	0.99	17
Average	0.62%	1.13%	+80%
New Industry Model			
Wellington/Vanguard (M)	0.55%	0.17	-69%
Dollars			
Conventional Model	\$7.1M	\$41.1B	5.8x
New Model	\$1.1M	\$5.1B	4.6x

Ownership types: (C) Conglomerate, (SH) public shareholders, (P) private, (M) mutual

Changing Composition by Asset Class 1945-2015



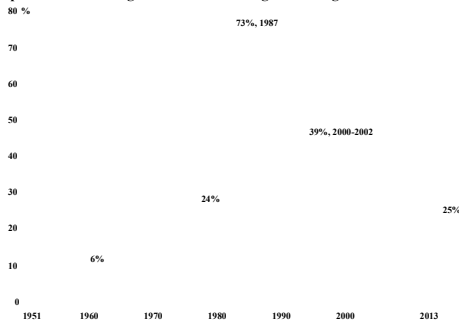
Equity Funds—Less Predictability More Risk

Relative Volatility*	1951-56	2009-15**	Difference
Over 1.11	0%	18%	+18%
0.95-1.11	34	53	+19
0.85-0.94	30	16	-14
0.70-0.84	36	10	-24
Below 0.70	0	4	+4

*S&P 500 = 1.00
**Sample of the 200 largest equity funds.

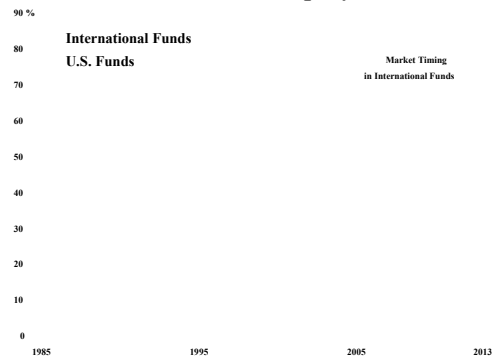
Then, Long-Term Shareholders, Now . . . ? Equity Fund Redemption Rates

Redemptions and Exchanges Out as a Percentage of Average Net Assets



Source: Investment Company Institute

Redemption Rates U.S. and International Equity Funds

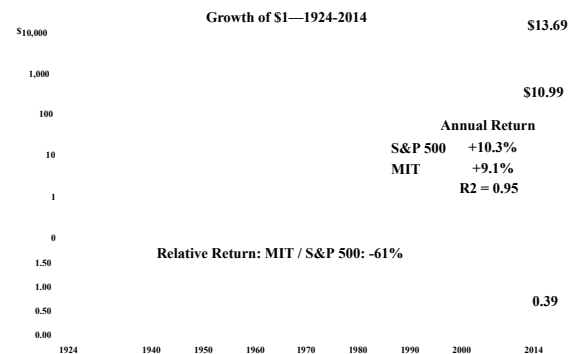


Challenges Faced by Investors in Active Funds

1. High Costs—2% annual cost = 63% of the 50-year return on stocks.
2. Critical erosion (60%+) of dividend income.
3. Giant Size—Mutual funds own 33% of U.S. equities. "A fat wallet ... enemy of superior returns."
4. High Turnover—130% of assets (purchases and sales).
5. Marketing—"We make what will sell." Fund failure rate 50% per decade.
6. Investor (and salesman) focus on past returns.
7. Outside ownership of managers (39 of top 50).

RESULT: Stewardship descends, salesmanship ascends

Do Costs Matter? A Powerful Example

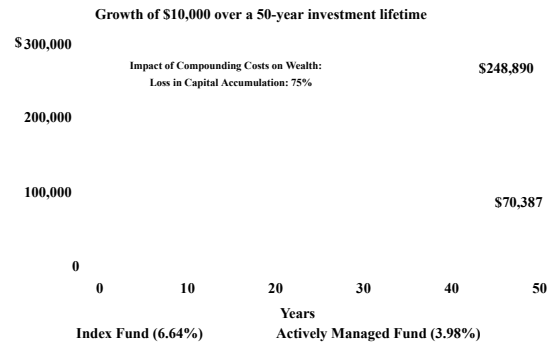


"The Arithmetic of All-In Investment Expenses"
Financial Analysts Journal

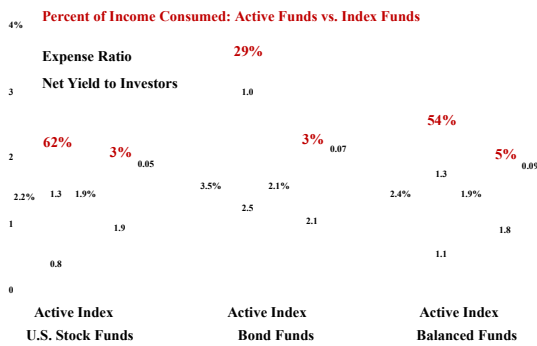
	Actively Managed Fund	Index Fund
Expense Ratio	1.12%	0.06%
Transaction Costs	0.50	0.00
Cash Drag	0.15	0.00
Sales Charges/Fees	0.50	0.00
All-In Expenses	2.27%	0.06%
Tax Inefficiency	0.75	0.30
Total Costs	3.02%	0.36%
Gross Return (assumed)	7.00%	7.00%
Net Return	3.98%	6.64%
Loss in Annual Return	-2.66%	

Note: Counterproductive investor behavior (buying high and selling low) has historically reduced returns to active fund investors by another 1.5-2.0% annually according to Morningstar.

**The Miracle of Compounding Long-Term Returns
 Without the Tyranny of Compounding Long-Term Costs**



Dividend Yields and Expense Ratios

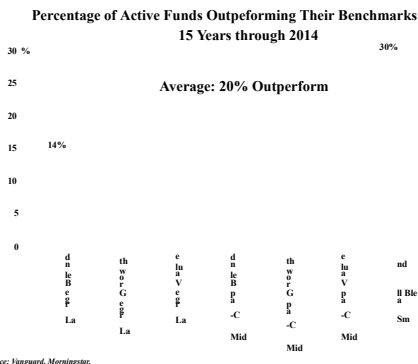


Better than the Morningstar Rating System?

"Investors should make expense ratios a primary test in fund selection. They are still the most dependable predictor of performance."

**Russel Kinnel
 Morningstar, August 2010**

Result: Underperformance
80% of Active Funds Underperform Over the Long Term



**Lack of Persistence in Performance
 of Active Mutual Funds**

Rankings for the 5 years ending 2009	5-Year Return*	Number of Funds	Where they ranked in the subsequent 5 years		
			Highest Quintile	Lowest Quintile	Merged/Closed
1	Highest	1,091	14%	24%	10%
2	High	1,083	12	16	22
3	Medium	1,084	15	13	26
4	Low	1,085	14	10	38
5	Lowest	1,032	14	9	45
	Total	5,375	14%	14%	28%

*Excess return vs. benchmark.
 Note: Number of failed funds—1,499

It's Not Just Me... Fama French, 2010

"The 3% Solution"
 "...[G]oing forward we expect that a portfolio of low cost index funds will perform **about as well as a portfolio of the top three percentiles of past active winners, and better than the rest of the active fund universe.**"

Source: "Luck versus Skill in the Cross-Section of Mutual Fund Returns," The Journal of Finance, October 2010

19.

Aren't There Mutual Funds That Avoid These Problems?

Yes, but not very many.

Typical characteristics these funds share:

1. Managers, not marketers.
2. Reasonable expense ratios.
3. Low portfolio turnover.
4. Self-imposed stern limits on size.
5. Interim returns that may vary sharply from the market's return.
6. Investment professionals own and operate the management company.

20.

"The Colossal Failure"

"[T]he colossal failure of the mutual fund industry; resulting from [its] systematic exploitation of individual investors . . . extract[ing] enormous sums from investors in exchange for providing a shocking disservice. . . . Thievery, even when dressed in the cloak of SEC-approved governance, remains thievery . . . as the powerful financial services industry exploits vulnerable individual investors."

David Swensen, manager of Yale University's endowment fund

21.

Mutual Funds Are the Only Practical Option for Individual Investors

"The vast majority of American families are sentenced to a lifetime of investing in the existing mutual fund penal system. But if they're smart, they'll do their time in an index fund."

John Bogle
 Grant's "Great Debate"
 April 7, 2015

22.

Enter Vanguard

"The Vanguard plan actually furthers the objectives [of the Investment Company Act of 1940] by ensuring that the Funds' directors ... are better able to evaluate the quality of services rendered to the funds ... improved disclosure to shareholders ... promotes savings from economies of scale ... clearly enhances the Funds' independence ... provides them with conflict-free control over distribution ... and promotes a healthy and viable fund complex within which each fund can better prosper." (Unanimous decision, 1981)

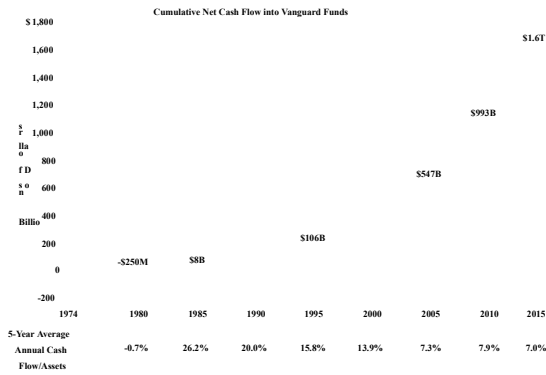
23.

Strategy Follows Structure

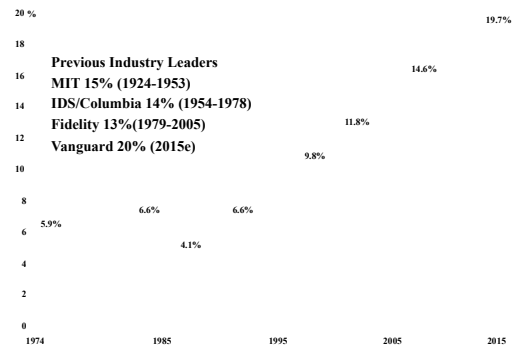
MUTUAL STRUCTURE		INDUSTRY STRUCTURE	
STRATEGY	Long-term result	STRATEGY	Long-term result
Prioritize fund shareholders	Increasing market share	Prioritize management company	Decreasing market share
Leads to	Leads to	Leads to	Leads to
Pricing	Impact to manager	Pricing	Impact to manager
Lower costs for fund owners	Lower revenue and no profit	Higher costs for fund owners (e.g., 108 bps)	Higher revenue and profit
Leads to	Leads to	Leads to	Leads to
Fund Focus	Impact to investors	Greater Risks	Impact to investors
Index Funds	Leads to Higher profits for fund investors	For Fund Owners to Offset Costs	Leads to Lower profits for fund investors
Equity 5 bps			
Bond 8 bps			

24.

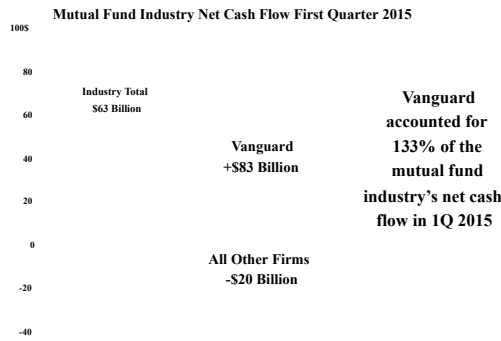
Vanguard Cash Flow Growth



Vanguard's Market Share of Stock and Bond Funds



Vanguard Dominating Industry Cash Flow

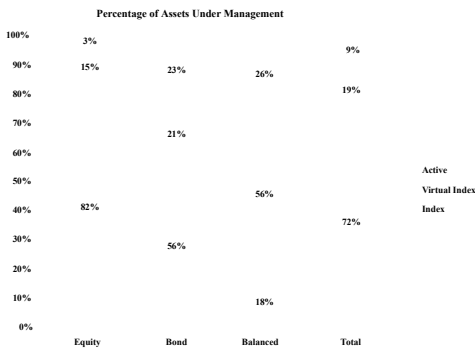


Vanguard's Key Strategy: Indexing 1975—First Index Investment Trust

Initial Reaction

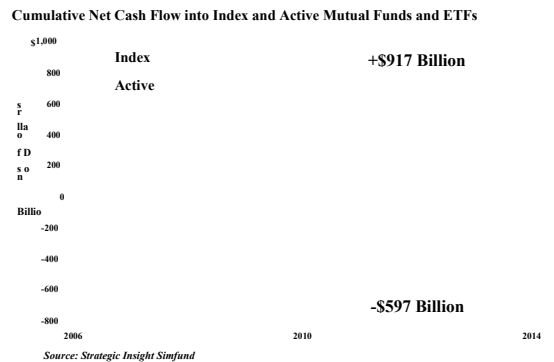
*Name changed to Vanguard 500 Index Fund in 1980.

Index Funds Dominate Vanguard's Assets



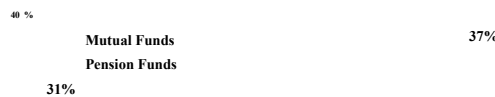
Note: *Virtual Index Fund** – R-Squared of 0.9% or higher relative to its best-fit index.

U.S. Equity Fund Cumulative Net Cash Flow, 2006-2014

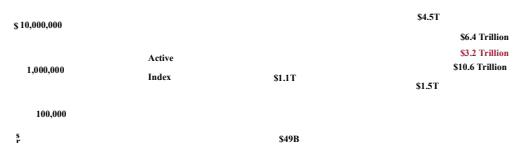


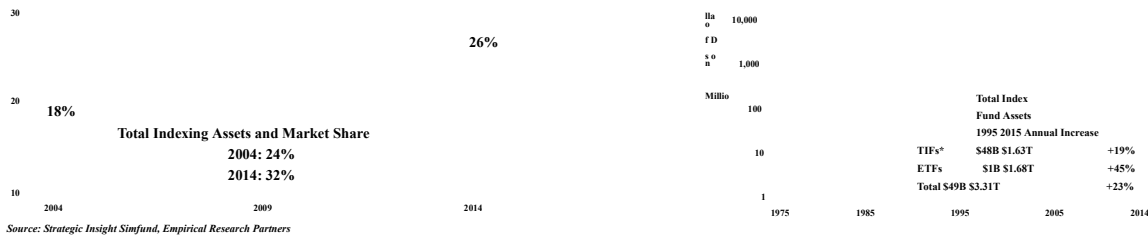
Indexing Market Share

Index Strategies as a Percentage of Total U.S. Institutional Equity Assets



Growth of Equity Index Fund Assets





A Speech Title Sums It Up

Convergence!
The Great Paradox: Just as Active Fund Management Becomes More and More Like Passive Indexing, So Passive Indexing Becomes More and More like Active Fund Management

John C. Bogle
"The Art of Indexing" Conference
Washington, DC
September 30, 2004

"What Have They Done to My Song, Ma?" Enter the Exchange-Traded Fund (ETF)

First Index Mutual Fund (1974)—Principles

- Own the U.S. stock market
- Diversify to the Nth degree
- Minimize transaction costs
- Tiny expense ratio—500 Index: 0.05% (Admiral)
- Bought to be held "forever" (redemption rate 10%)

Exchange-Traded Index Funds (1993)—Principles

- Pick your own index (1,100 now available)
- Diversify within sector you chose
- Lower expenses ... but not too low (0.50%)
- Bought to be traded (average annual turnover of large ETFs: 1244%)

ETF Turnover

2014 Dollar Turnover as a Percentage of Average Annual Assets

SPDR S&P 500 ETF	2724%	Asset-Weighted Turnover, 20 Largest ETFs: 1244%
iShares Core S&P 500	337%	
iShares MSCI EAFE	524%	
Vanguard Total Stock Market ETF	144%	
Vanguard FTSE Emerging Markets ETF	319%	
Vanguard S&P 500 ETF	274%	
iShares Russell 2000	4274%	
SPDR Gold Shares	725%	

ETFs—The New Way to Speculate

2014 Trading Volume
 100 Largest Stocks: \$18.6 Trillion
 100 Largest ETFs: \$15.7 Trillion

2014 Turnover Rate
 100 Largest Stocks: 179%
 100 Largest ETFs: 1428%

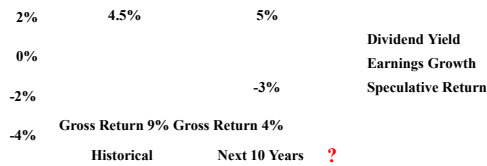
Costs and Indexing—More Important than Ever

10%	4.5%	2%	Historical Returns	Prospective Active Index
8%				
6%				
4%				
4%				
	Gross Return	9%	4%	4%
	Costs	-1	-2	-0.05
	Net Return	8%	2%	3.95%

What's a Competitor to Vanguard to Do?

What's a race car driver to do when he's in last position?

- Increase speed—i.e., improve performance, more aggressive marketing, more money to distributors (a la life insurance)
- Reduce friction—i.e., cut fees, cut staff, cut research



- Copy the car in front—i.e., more indexing, less innovation
- Get a new car—i.e., focus on other lines of business, recordkeeping, benefit plans, venture capital, limousine services, etc.

The “Golden Rule” of the ‘40 Act

Put the Shareholder First!

“... the national public interest and the interest of investors are adversely affected ... when investment companies are organized, operated [and] managed ... in the interest of directors, officers, investment advisers ... [or] underwriters ... *rather than* in the interest of ... such companies’ security holders ...”

Investment Company Act of 1940, Section 1.B.2.

Copernicus Turned Upside-Down

Average Mutual Fund Group
Total Net Assets \$25 Billion

Why isn’t the sun—500 times the size of the planet—at the center of *this* universe?

Average Fund Management Company
Total Net Assets \$50 Million

1993 data from Bogle on Mutual Funds: New Perspectives for the Intelligent Investor

Tiny Transaction Transforms Giant Industry

Transaction: Owners of ISI (book value \$300,000) sold the manager to other investors for 14 times book value (\$4.2 million).

SEC v. Insurance Securities, Inc., 1958

The Ninth Circuit Court of Appeals ruled that ISI could sell it’s fiduciary obligation to its fund shareholders, opening the floodgates to IPOs, mergers, “trafficking” in management contracts, and acquisitions of fund management companies.

By the mid-1960s, a score of fund management firms went public, including industry leaders Wellington, Vance Sanders, Dreyfus, Franklin and Putnam. Later, MFS, T. Rowe Price, State Street, American Century, Oppenheimer, Alliance, AIM, Delaware, and many others.

It Wasn’t Supposed to Be That Way...

For Paul Cabot, president of State Street Investment Trust, the private ownership of fund managers was essential. Indeed it represented a moral imperative for him, and he sharply criticized firms that would sell out to insurance companies and other financial institutions.* In 1971, he recalled the negotiations over the Investment Company Act of 1940: “Both the SEC and our industry committee agreed that the management contract between the fund and the management group was something that belonged ... to the fund ... and therefore the management group had no right to sell it ... or to make money on the disposition of this contract ... the fiduciary does not have the right to sell his job to somebody else at a profit.”

*In 1982, the private owners of State Street Management sold their company to the (ironically then-mutual) Metropolitan Life Insurance for a profit of \$100 million.

Ownership of 50 Largest Mutual Fund Management Companies—2015



Total Firms with Public Ownership: 39

Public Ownership and Professional Organizations

From my 1971 speech to the partners of Wellington Management Company:

I reveal an ancient prejudice of mine: All things considered ... it is undesirable for professional enterprises to have public stockholders ... The pressure for earnings and earnings growth engendered by public ownership is antithetical to the responsible operation of a professional organization.

Note: Wellington, now private, was then publicly-owned.

Fiduciary Duty A Precept as Old as Holy Writ

No man can serve two masters: for either he will hate the one, and love the other; or else he will hold to the one, and despise the other.

Matthew 6:24

Reducing Conflicts: Structural Changes

- Funds' board chairman must be an independent director*
- Board must have independent staff, reporting to the chairman*
- Regulation should move its focus from individual funds (industry, 1924-1940) to fund complexes (today's industry)
- Ultimately, *mutualization* (full or partial)

*Applicable only to managers supervising assets of long-term funds of \$25 billion or more, and operating 20 or more funds. In 2015, the 50 largest fund managers have aggregate assets of \$12.4 trillion, 86% of the industry's long-term assets.

What's All This about "Basis Points?"

Jones v. Harris Associates
Brief for John C. Bogle as *Amicus Curiae*
in Support of Petitioners

It is important to distinguish between the already-high *rates* (as a percentage of assets) that advisers charge and the even more excessive dollar *amounts* that are produced by those fee rates. It was the huge increase in mutual fund assets and, therefore, the amount of mutual fund fees, that concerned the SEC in 1966, since the cost of providing advisory services (essentially, managing an investment portfolio) rises far more slowly than the fees generated by taking a percentage of the increase in assets. Yet courts have generally acceded to the advisers' desire to frame any debate about fees in percentage—not dollar—terms, thereby giving advisers a license to charge fees that are unjustifiable by any standard.

What's To Be Done?

1. Reduce Conflicts

2. Disclose Conflicts

Sunlight—Disclosing Conflicts

Improvements in Prospectus Disclosure

All investors should have access to these data:

- Redemption Rate—Redemptions + exchanges out as a percentage of average fund assets
- Fund expenses—percentage of investment income
- Fund return (time-wtd) vs. investor return (asset-wtd)
- Long-term vs. short-term capital gains distributions
- Turnover—Total purchases + total sales as a percentage of average fund assets
- All-in compensation of 5 highest-paid fund officers (comprehensive)
- Investment Advisory Fees—Rates and dollars (10-year history of each) *Jones v. Harris Associates*

High-Priced Index Funds and Fiduciary Duty

What were directors of these funds thinking?
S&P 500 Index Funds with Expense Ratios of 0.40% or More

Fund	Assets	Expense Ratio
Principal Large Cap S&P 500 Index	\$4.7 B	0.74%
Voya US Stock Index	4.6 B	0.66
Columbia Large Cap Index	3.7 B	0.83
MM S&P 500 Index	3.6 B	0.68
Dreyfus S&P 500 Index	2.9 B	0.50
JP Morgan Equity Index*	1.9 B	1.20
Total (87 Funds)	\$19.3 B	0.85%
Vanguard 500 Index-Admiral Shares \$143 B		0.05%
-Institutional Plus Shares \$85 B		0.02%

* "A" series shares carry an expense ratio of 0.45% and a sales load of 5.25%

The Wisdom of Warren Buffett

About Mutual Fund "Independent" Directors:

"Companies are not looking for Dobermans on the board; they are looking for cocker spaniels. Then they make sure their tails are wagging."

"Negotiating with oneself seldom produces a barroom brawl."

Warren Buffett

51.

Corporate Pensions: The Elusive 8%

Corporate pension funds make unreasonable assumptions about future returns

Pension de-risking and high expected returns are not compatible.

Example: IBM

Asset Allocation	Asset Allocation	Required Return	Reasonable Assumptions
Bonds	56%	3.75%	3%
Stocks	25	13.6	4
Others (Hedge Funds, Private Equity, etc.)	19	18.5	10
Total/Gross Return	100%	9.0%	4.6%
Less Investment Costs		-1.0%	-1.0%
Net Return		8.0%	3.6%

52.

The Road to Fiduciary Duty

1. Price Competition
 - Investor experience
 - Investor awareness
 - Complete disclosure
2. Awaken the Independent Directors
 - Awareness
 - Board structure
 - Mutualize?
3. Lawmakers/Regulators
 - DOL—Retirement Plans
 - SEC—Mutual Funds
 - Dodd-Frank

Believe me—WE **WILL** GET THERE!

53.

The Wisdom of Adam Smith

"Consumption is the sole end and purpose of all production; and the interest of the producer ought to be attended to only so far as it may be necessary for promoting that of the consumer. The maxim is so perfectly self-evident that it would be absurd to attempt to prove it."

The Wealth of Nations
1776

54.