Vanguard Turns 40!
Happy Birthday! And Thanks to our Crew!

September 24, 2014

Today, the Vanguard Group of Investment Companies celebrates its 40th Anniversary. On September 24, 1974, the date of our incorporation, this firm began its life. Despite an industry consensus that we might not survive, we had high hopes. Indeed, I described our new enterprise as "the Vanguard Experiment" in mutual fund governance, testing the hypothesis that mutual funds could organize, operate, and manage themselves without the need for an external management company to perform their functions and control their affairs.

This truly *mutual* mutual fund structure, as you all know, was the first of what would be a dozen or so major Vanguard innovations that would follow—*every single one reflecting a new strategy that followed our still-unique structure. "Strategy Follows Structure.*" Yes, it does. And even two decades after I gave a speech with that title at a Harvard Business School seminar in New York City on February 14, 1995, I continue to marvel at the obvious simplicity of that principle. The central strategy that followed from our "at-cost" operating structure was, of course, the index fund. It was that innovation—a Vanguard "first"—that set the stage for almost all of the innovations that would follow.

The management contracts that put the final touch on that novel Vanguard structure became effective on May 1, 1975.[1] The first item on my strategy agenda—a proposal that Vanguard create the world's first index mutual fund—was presented to the Vanguard board of directors on September 18, 1975. The proposal was approved, and "First Index Investment Trust" (now Vanguard 500 Index Fund) was incorporated on December 31, 1975. (The directors' approval was clearly reluctant; perhaps the board was a bit punch-drunk after the long struggle to get Vanguard started. I know that I was!) As it turned out, investors were not as enthusiastic as I was about indexing. The initial public offering (IPO) on August 31, 1976, was a flop. The underwriters raised only $11 million, not even enough to purchase round (100-share) lots of each of the 500 stocks in the index. While the beginning was fraught, that little acorn, over time, would become the great oak of our firm.

[1] For additional information on the important dates in Vanguard's early history, see **EXHIBIT I**.

A Phoenix Arises from the Ashes

Back then, the world, one might say, did little note those two disruptive innovations. But ultimately the world would long remember them. Together, they changed the face of investing—a change that still has a long way to go. (Yes it does!) Table 1 that follows tells the story.

Table 1: Vanguard over the Decades*

Year	U.S. Assets Year-End (millions)	Share of Industry Assets**	Ten-Year Cash Flow as % of Assets***	Index Fund Share of Vanguard Assets
1974	$ 1,457	5.9	N/A	N/A
1984	9,925	6.6	7.8%	2.9%
1994	130,743	6.5	20.8	14.7
2004	818,513	12.4	11.3	43.2
2014‡	2,745,045	18.0	7.5	66.4

*For year-by-year data, see **EXHIBIT II**.
**Share of assets of stock and bond mutual funds.
***Annualized.
‡Through August 31, 2014.

I know of few, if any, companies that have ever grown at a 21% annual rate over a forty-year period—as Vanguard has—from some $10 billion in 1984 to $3 trillion, our global asset base today. Remarkable as that growth is, it's even more remarkable when one considers the miracles that were required to pave the way for Vanguard's creation.

Our birth was really a rebirth, a phoenix rising from the ashes of one of the most foolish mergers in the history of Corporate America. In retrospect, I think, even worse than the catastrophic merger of AOL and Time Warner Corporation at the very peak of the technology stock lunacy in 2000. (Let's just say, sadly, that "paper covered rock.") And I was pretty much solely responsible for that incredible bomb.

In the mid-1960s, the stock market had ended what would be known as the "Go-Go Years," an era in which nearly all mutual fund managers and other mutual fund investors totally lost their perspective. (Think of the stupidity of believing that ephemeral stock prices were more important than eternal intrinsic values.[2]) I fell for it. So did so many others, including my great mentor, Wellington Fund founder Walter L. Morgan, who was quoted in a 1968 cover-page article about the merger in *Institutional Investor*, "I was too conservative."

Almost at the moment the merger was completed in 1967, things quickly began to fall apart. The "Go-Go" era, well, "went-went." It was superseded by something at least as bad: "The Nifty Fifty" craze in which the prices of the stocks of the nation's fastest growing companies lost all touch with their intrinsic values. Firms such as Xerox, Polaroid, IBM, Avon, and Digital Equipment Corp. soared, then tumbled, leading a great bear market downward. After a 50% decline in the stock market, the crash finally spent itself. The market low was reached on October 3, 1974, almost contemporaneous with our founding. The opportunity of a lifetime (well-disguised) to start a new investment firm.

Wellington Management Company

The newly aggressive Wellington Management Company failed its investors. Each one of the four new funds brought into our fold (or soon formed) collapsed. From high to low, Ivest Fund—now barely a footnote to financial history—fell by 65%, and its new Go-Go cousins did equally badly. Three of those funds were soon put out of business. (Yes, despite a dismal start, Explorer Fund survived. But who besides me remembers Technivest Fund?) Worst of all, under its new managers, the once-conservative Wellington tumbled. During the 1966-1976 decade, the fund turned in the worst performance of any balanced fund in the land: "Last among equals."[3]

Bad markets, buttressed by power politics, destroyed any semblance of trust among Wellington's mostly merger-acquired money managers. The happy partners of yore quickly found a scapegoat—not among themselves, despite their responsibility for our funds' terrible performance—but me, the chief executive, responsible for the merger that wreaked such havoc on the investors who had once trusted us. In the midst of the bear market, on January 23, 1974, they banded together and fired me.

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[2] I tell the story of the "Go-Go Years" in Chapter 11 of my book, *Don't Count On It!* The highlight of the story was a quotation from veteran money manager David Babson, one of the few fund managers not caught up in the madness. At the *Institutional Investor* Conference in 1970, he singled out "the new breed of investment managers who bought and churned the worst collection of new issues and other junk in history . . . new investment geniuses, a group of neophytes who had no sense of responsibility." The audience—managers of other people's money—was not amused. But Babson had hit the nail squarely on the head.

[3] I was not about to let Wellington Fund die. In 1978, with the approval of the Vanguard board of directors, I directed Wellington Management to return the fund to its original conservative strategy. Since then, the fund has prospered, and is once again the nation's largest balanced fund.

There is a line from “Bui Doi,” a song in *Miss Saigon* about the children left behind in Vietnam when their American soldiers/fathers returned home: “Conceived in hell, and born in strife.” Even today, however painful, that line strikes me as a near-perfect description of the merger that, even as it almost ruined Wellington, set the stage for the birth of Vanguard that we celebrate today.

At the time, Vanguard’s birth went largely unnoticed by the press. Today, one searches in vain for any recognition in the financial media that a new company had been born. Later, attention began to come, and it was not kind. FORBES magazine, May 1975: “A Plague on Both Your Houses?”[4] But despite the contempt that we had clearly earned among our fund shareholders, we did our best to move forward. A decade after the struggle, Vanguard began to grow, and grow, and grow. Why? Simply because we had a winning structure and a winning strategy; a passion for our mission to serve investors; a determination to press on regardless; and a willingness—heck, an eagerness—to fight for the principles in which we believed.

All those years ago, I received so few comments on our new structure and strategy that the two that I do remember are etched in my memory:

- **Jon Lovelace**, a fine investor and wise leader, now gone. By 1974, he had succeeded his father as chief of the American Funds/Capital Group in Los Angeles. But he was concerned about the rumors he had heard about a new (as yet unnamed) firm. I was about to depart the West Coast, leaving for Philadelphia on the 7:30 AM plane. He said it was urgent that he see me, but the only available time remaining for me before I left was at breakfast at Los Angeles Airport. I suggested 6 A.M., and there we were, sitting behind a counter on a couple of high stools. After exchanging a few pleasantries, Jon got to the point: “If you start a new firm with the mutual structure you are considering, you will destroy this industry.”

- **Brandon Barringer**, member of the Wellington Fund Investment Committee from 1930 to 1959, trust company executive, and private investor. Mr. Barringer had established a reputation for deep wisdom and a broad perspective about finance, and about the then-emerging mutual fund industry. In late 1974, he heard about the formation of Vanguard. Ailing, he called me from

[4] Decades later, FORBES issued not one, but two apologies for this article, both written by editor William Baldwin. The first was on February 8, 1999: “With the benefit of hindsight, we should not have published that snide article about The Vanguard Group.” The second apology was dated August 26, 2010: “I’d like to officially retract a story FORBES published in May, 1975, “A Plague on Both Houses?” … [John] Bogle … is as vociferous as ever an evangelist for cost-cutting. I think he has done more for investors than any other financier of the past century.”

Pennsylvania Hospital. His words: "You have just revolutionized the mutual fund industry, Jack. Congratulations on your accomplishment."

Both of those comments, if perhaps overstated, were right on the mark. Rule: accept wisdom, wherever you may find it.

Disruptive Innovation

What Vanguard had done, perhaps inadvertently, was to create a truly mutual structure that comports with the great principle of business success: *Treat your customers as if they were your owners.* The magic of Vanguard (if that's not too bold of a description) is that our customers, in fact, are our owners. The alignment of our clients' interests with our own flows naturally from our unique structure. As Vanguard was the first—and still the only—firm in our industry to take this radical step, we needed to be innovative, developing investment programs that put our clients' interests first.

Vanguard is what we are today because we quickly became the most innovative firm in our field. Our unique new structure—still uncopied and unmatched—was, in substance, the triumph of the interests of fund shareholders over the interests of fund managers. **1974.** Our at-cost mutual structure, which demanded that we focus on delivering investment results at the lowest reasonable cost.[5] **1975.** Our S&P 500 index fund, the obvious strategy that honored the simple rationale for owners of (almost) the entire U.S. stock market at low cost. The new fund was the first manifestation of that principle, and a harbinger of how disruptive that innovation would prove to be.

In time, that Vanguard innovation was succeeded by one index mutual fund after another, **1985**, the first Institutional Index Fund. **1986.** The first bond market index fund. **1987.** The first extended market index fund (the mid- and small-cap companies not included in the S&P 500). **1992.** The first total stock market index fund, and the first balanced index fund. And more index funds were to follow. **(See EXHIBIT III.)** When I relinquished my position as CEO in 1996, 17 index funds proudly flew the Vanguard ensign.

These enhancements to our first S&P 500 index fund were *not* designed to provide higher risk-adjusted returns. That, to me, would be a fool's errand. Rather, they were designed as targeted index

[5] As an example of Vanguard's commitment to operating at low costs—even at the earliest stage of our development—our initial capital when the firm was founded was only $300,000.

portfolios to meet the legitimate needs of long-term investors. Even the best of innovations can be enhanced by broadening their sound use by consumer/investors.

Innovations can also be enhanced by improving their efficiency, with better terms and conditions for their consumer/investors. Here the Vanguard light has glowed ever brighter. In 1977, the expense ratio of Index 500 was 0.43%. By 1990, it had fallen to 0.22%. By 2000, 0.18%. And by 2014, 0.05% (for its Admiral shares and ETFs). A near-90% reduction in cost to investors is hardly to be sneezed at!

The Role of Costs

This ongoing focus on rock-bottom costs has been a powerful force in our growth. Today, assets in the Investor share class of all of our funds—the undiscounted price, if you will—total $782 billion, just 25% of our book of business. Admiral share assets are close to $1 trillion; institutional shares $700 billion; and ETFs $400 billion. Index funds remain the core of our low-cost commitment to our clients. Yes, it's good to give investors their fair share of market returns, to assure that these investors get a fair shake in their search for investment success.

While index funds were at the core of our strategy, the concept of rock-bottom costs was the principle underlying nearly all of our other ground-breaking innovations. **1977.** The defined-maturity structure of our first three municipal bond funds. **1985.** STAR Fund, the first fund-of-funds without extra costs. **1992**. The Admiral Funds, with lower expense ratios for investors with substantial assets. **1994**. The first defined-maturity taxable bond index funds and the LifeStrategy funds, the industry's first such series.

It may be politic to describe our mantra as "broadly diversified low-cost mutual funds." I'd say, "the champion of the index fund" is more accurate. However we define who we are, *low-cost investing is indexing investing*. Of the 230 traditional equity mutual funds that carry an expense ratio of 25 basis points or less, only one is actively managed (Vanguard Equity Income Fund Admiral Shares, expense ratio 0.21%).

Of course the pace (and novelty) of our innovations eventually slowed. After all, it is mathematically impossible to improve on low-cost indexing for investors *as a group*. And there are only so many "variations on a theme" that hold the promise of providing optimal returns to investors.

The limits are even greater when an innovation is designed to serve *fund investors* rather than *fund investment managers, fund marketers, and financial buccaneers*. And it's easy for any financial firm to copy the innovations of others. Obviously, this is what we did in the exchange-traded fund arena, with considerable marketing success. We introduced our "VIPERs" (now "Vanguard ETFs") in 2001, fully eight years after State Street Global's creation of the "Spiders" (based on the S&P 500 Index), the first ETF, in 1993.[6] As we all know, we are now challenging our peers for domination of this index sector.

Vanguard also continues to be an innovator in so many other areas of our organization. Together, continuing this string of innovations, Vanguard has successfully implemented many initiatives that enable us to operate at lower costs to our clients. While hardly disruptive to our competitors, these operational innovations are equally important—indeed, vitally important—to our owner/clients. This philosophy of continuous innovation and continuous improvement has made an enormous contribution to our success.

Remembering Where We Came From

I hope that you'll forgive me for this long march through our history, but it's important, I think, to know how our structure was determined, and how our strategy grew almost organically from it. After all, there is a warning in my book *Character Counts* on taking a founding history for granted. There, I quoted Carl Sandburg: "When an institution goes down or a society perishes, one condition may always be found. They forget where they came from."

The story of Vanguard is the story of opportunity, sometimes deeply hidden; the story of contrarian opinion; the story of introspection about an industry that was losing its way; the story, I suppose, of courage and stubbornness; and, in so many ways, the story about serving (you know this) honest-to-God, down-to-earth human beings with their own hopes and fears and financial goals. It is a story of trusting and being trusted; and realizing that through all that gray fog of muddy values, there remain issues that are white or black—right or wrong.

I'm not sure that, forty years ago, I spent much time wondering about whether or not I'd be here to celebrate this 40th anniversary. (Not everyone lives beyond 85, and the odds are not improved when

[6] We had the opportunity to be the innovator that created the ETF. In 1992, I received a proposal that we start the first ETF, but I couldn't reconcile trading the S&P 500 "all day long, in real time" with my conviction that such a strategy would be counterproductive for our index investors. The inventor of the idea, Nathan Most, then took his idea to State Street, and the rest is history. I have no regrets whatsoever about my decision.

one has been beset by profound cardiac challenges that began 14 years before Vanguard was born.) But when we began, I must have been wearing blinders to have ignored the odds. Maybe that's characteristic of my nature. In a recent *New Yorker* article, James Surowecki notes that entrepreneurs are "as risk-averse as everyone else.… The fundamental characteristic of entrepreneurs isn't risk-seeking, it's self-confidence…. Entrepreneurs may recognize that, in general, starting a business is risky. They just believe that their innate skills will win out…. One-third of entrepreneurs thought there was no chance they would fail." Looking back over my own decisions in our early years, that strikes me as a perceptive observation. I just don't scare easily.

Yes, some great ideas on structure and strategy (as so many now concede) were central to Vanguard's ability "to change the world of investing for the better." But, I repeat, yet again: "ideas are a dime a dozen; but implementation is everything." So on our 40th Anniversary, I take this opportunity to salute each of you who, with your fellow crewmembers, continue to provide the leadership, the commitment, the loyalty, the professional skills, and the human values that have been essential—and remain essential—to Vanguard's success, and in whatever further success we might achieve before we celebrate our 50th Anniversary and, God willing, our 100th Anniversary.

These past 40 years have brought great joy in my life. The joy was in the battle during those tough early years. In recent years, much of the joy has been working on the firing line with you on the crew of my beloved Vanguard, you who do the hard, sometimes thankless work of serving our client/owners. Joy is having lunch in the Galley and waving to you; chatting with you; meeting with you on so many fine teams, large and small; visiting with you and your colleagues on the anniversaries of your Vanguard service and, with mixed emotions, on your retirements.

You know—must know—that I'm far more interested in human beings than in algorithms, and I do my best to keep Vanguard a place where judgment has at least a fighting chance to triumph over process. I wish you and your leaders well in dealing with these challenges, even as we have grown from a tiny entity to a giant institution.

As Helen Keller so wisely wrote: "The world is moved along, not only by the mighty shoves of its heroes, but also by the aggregate of the tiny pushes of each honest worker." In a sense, the main thing that I have tried to do—ever since our founding in 1974—was to create a working environment based on integrity, service, and ethical values. A place where each of us, after Lincoln, "are touched by the better angels of our nature."[7]

To each one of you, I say thank you! I wish you Godspeed, good fortune, and continued success. "Stay the Course!"

Always,

Jack

Important Note: This memorandum is addressed to Vanguard principals and veterans (15-plus years of service). But please do not hesitate to send copies along to your colleagues, friends, and direct reports. Also, it will be posted on my eBlog —www.johncbogle.com—on October 1, 2014, a week from now.

[7] The final words of Abraham Lincoln's first Inaugural Address, March 4, 1861.

EXHIBIT I

Vanguard's Birthday

Of course Vanguard's birthday marks the day that our firm was born. We were incorporated on September 24, 1974. Yes, some regard May 1, 1975, as our birthday, and indeed that date marked some sort of anniversary for us. It was on that date that we "began operations," a formulation that has often described what supposedly happened on that "May Day" in 1975.

Even I had used that formulation. But as I look back, I was clearly wrong. Our operations did *not* begin on May 1, 1975. As I wrote in a memorandum to our crew dated September 12, 1974, "the establishment of our new . . . organization will become effective on September 16, 1974." From that date forward—even before our "Vanguard" name was chosen—our staff would provide all administrative, financial, and record-keeping services to the Funds. The Vanguard board of directors was meeting regularly; and we were also overseeing the investment and distribution services provided by Wellington Management Company.

What did happen on May 1, 1975? Mostly technicalities. After the approval by fund shareholders, the original management contract with Wellington was terminated, and new contracts with lower fees went into effect. With a portion of those savings, The Vanguard Group assumed the expenses of operating the Vanguard funds, and continued to do the job the staff had been doing over the previous eight months.

So, yes, *something* happened on May Day 1975. But it was hardly the birthday of this then-tiny, shrinking, and profoundly challenged new enterprise. The birthday of the firm would, finally, take the investment world by storm was September 24, 1974, the date of our incorporation. By 2005, that little newborn child had become a giant, the largest firm in the entire mutual fund industry.

September 24, 2014

EXHIBIT II Vanguard by the Numbers[8]

Year	Total U.S. Assets (millions)	Share of Industry Long-Term Assets	Total Fund Costs (millions)	Net Cash Flow (millions)	Annual Net Cash Flow % of Assets 5-Yr. Average	Index Fund Share of Vanguard Long-Term Assets
1974	$1,457	5.9%	$10	-$108	--	--
1975	1,781	5.7	12	-103	--	--
1976	2,049	5.8	12	-171	--	0.7%
1977	1,849	5.4	11	-138	--	1.1
1978	1,919	5.4	12	-1	-5.9%	3.4
1979	2,380	5.6	14	153	-3.1	3.3
1980	3,026	5.4	17	115	-0.7	3.3
1981	4,110	5.8	22	881	7.0	2.2
1982	5,617	5.7	35	746	12.0	2.0
1983	7,258	5.9	44	751	14.7	3.2
1984	9,925	6.6	55	2,042	18.7	2.9
1985	16,408	5.2	86	4,214	26.2	2.4
1986	24,961	4.7	122	5,925	27.6	2.1
1987	27,007	4.1	106	2,077	25.7	3.3
1988	34,172	4.4	134	3,526	25.6	3.4
1989	47,562	5.1	168	8,505	25.0	4.5
1990	55,711	5.4	186	8,388	20.0	5.9
1991	77,027	6.2	244	12,438	17.2	9.1
1992	97,412	6.6	288	14,879	19.4	11.1
1993	125,755	6.5	378	17,832	20.5	13.1
1994	130,743	6.5	399	6,491	16.5	14.7
1995	178,317	7.2	559	18,049	15.8	19.6
1996	236,006	7.8	691	32,573	15.0	25.5
1997	322,441	8.7	880	40,133	14.5	31.1
1998	431,693	9.8	1,195	56,814	14.4	35.6
1999	537,405	10.0	1,441	51,282	15.7	42.3
2000	561,236	10.6	1,511	25,260	13.9	40.4
2001	577,942	11.4	1,544	46,134	11.9	38.9
2002	555,789	12.0	1,438	40,122	9.9	36.1
2003	689,980	12.0	1,798	31,001	7.5	40.6
2004	818,513	12.4	1,903	58,787	6.8	43.2
2005	928,862	12.6	2,007	58,116	7.3	44.3
2006	1,122,722	12.8	2,394	75,007	7.2	46.5
2007	1,304,606	13.1	2,451	108,679	7.8	48.3
2008	1,045,935	15.1	1,834	84,900	8.0	44.5
2009	1,336,082	15.2	2,703	100,067	8.2	48.8
2010	1,563,797	15.7	2,798	77,850	7.9	54.3
2011	1,649,177	16.7	2,619	77,188	7.3	56.1
2012	1,973,502	17.4	2,880	142,204	7.1	59.7
2013	2,461,105	17.8	3,446	137,084	7.2	64.2
2014[9]	2,745,045	18.0	3,773	123,915	6.8	66.4
Total				$1,473,609	12.6%	

[8] For additional data series since our inception, please see pages 395-396 in *The Man in the Arena*.
[9] Through August 31, 2014.

EXHIBIT III

Vanguard—A History of Innovation

1. **September 24, 1974. The Vanguard Group is founded**. The industry's first mutual "at-cost" structure is still unique.
2. **December 31, 1975**. **First Index Investment Trust**. The world's first index mutual fund incorporated, Vanguard 500 Index Fund. Initial Public Offering (IPO), August 31, 1976.
3. **February 7, 1977. The "No-Load" Conversion**. All sales charges and commissions on investor purchases of Vanguard funds eliminated. The first conversion from "load funds" to no-load funds in industry history.
4. **September 1, 1977. Vanguard Municipal Bond Funds**. The first "defined-maturity" municipal bond funds with three series—long-term, short-term, intermediate-term.
5. **March 29, 1985. Vanguard STAR Fund** ("Special Tax-Advantaged Retirement Fund"). First fund-of-funds operated without direct expenses.
6. **July 31, 1985. Vanguard Institutional Index Fund.** The first index fund designed for large institutional investors, carrying rock-bottom expenses.
7. **December 11, 1986. Vanguard Total Bond Market Index Fund**. The industry's first bond index fund.
8. **December 14, 1993. Vanguard Admiral Funds**. The first mutual funds (in this case, the U.S. Treasury Bond and Money Market Funds) designed to serve individual investors with lower costs for larger investments. Beginning in 2000, expanded to encompass existing Vanguard funds.
9. **March 1, 1994. Vanguard Bond Index Funds**. A series of defined-maturity funds invested in a broadly diversified mix of government and investment-grade corporate bonds.
10. **September 6, 1994. Vanguard Tax-Managed Funds**. Funds that used several techniques to minimize the impact of taxes on returns.
11. **September 30, 1994. Vanguard LifeStrategy Funds.** Four low-cost balanced funds with different levels of risk for the different stages of an investor's life.

Note: Other Vanguard innovations include the international stock index funds (European and Pacific, June 18, 1990), Total Stock Market Index Fund (April 27, 1992), and Balanced Index Fund (November 9, 1992).