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A Perspective

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Remarks of the Founder and former Chief Executive of The Vanguard Group on receiving the 2005 Outstanding Financial Executive Award from Financial Management Associates International (FMA) Chicago, IL, October 15, 2005.

The Uncanny Ability to Recognize the Obvious

John C. Bogle

■ I'm deeply honored to receive your 2005 Outstanding Financial Executive Award. Coming as it does from a global organization renowned for its development and dissemination of knowledge and financial decision making, it's a very special treat. I'm profoundly humbled to stand before so many of you, among the most noted finance academicians, investment practitioners, and policy makers in the field, and bask today in the reflected glory of the true "stars" of our field who have previously won this coveted award.

Confession being good for the soul, I'm also somewhat surprised to be your choice for this prestigious award. While I have spent nearly five and one-half decades in this field—including more than three decades as the leader of two wonderful mutual fund management organizations (Wellington in 1965–1974 and Vanguard in 1974–1996), I have never thought of myself as a particularly competent executive—an assessment that I imagine my long-suffering colleagues shared. But I was always surrounded by a crew—bless them *all*, not just the higher-ups—who knew how to get the things done that needed to be done.

I also confess that while I've been enlightened, indeed often transfixed, by the scores—no, hundreds—

of articles I've read in the academic journals over the years (mostly the *Financial Analysts Journal* and the *Journal of Portfolio Management*; much of your own *Financial Management* journal is well over my head) and even written nearly a dozen myself, my intellectual credentials fall far short of those of most of you here today. Truth told, when I see a page that is filled only with formulas—Sigmas and Deltas and Lambdas—to the near exclusion of text, I move quickly on to the next article.

Continuing my confessional litany, I have little knowledge of the convoluted intricacies of financial analysis and accounting standards, and have not done investment research on stocks and bonds since my early years as a rookie in this wonderful field. Worse—or, come to think of it, *better!*—I created a method of investing which deliberately and purposefully *ignored* analysis, accounting, and research. For in substance, the index mutual fund simply buys the entire stock market portfolio—blue chips, blithe spirits, downtrodden dogs, and even bankruptcy candidates—and holds it for Warren Buffett's favorite holding period: "Forever."

Of course I didn't invent the *idea* of indexing. (I'm not sure any individual did.) But the founding of the world's first index mutual fund in 1975—initially "First Index Investment Trust" and now "Vanguard 500"—was, I think, a seminal moment in the history of indexing. Although nearly two decades were to pass

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Note: The opinions expressed in this speech do not necessarily represent the views of Vanguard's present management.

before its position in the mutual fund firmament was largely accepted, we can now say that the original heresy that was indexing has at last become dogma. Proof? Known as “Bogle’s Folly” at the outset, it is now the largest mutual fund in the world. Including its sister “500” funds, its first cousin “5000” stock index funds, its brother bond index funds, and its in-law index sector funds, investors at Vanguard have some \$375 billion invested in passive strategies, one-half of the long-term assets we supervise.

I. Indexing as the Core

Whatever the case, using the index mutual fund as the core—if not the entirety—of a diversified equity portfolio is now dogma in college and business school finance classes, and I thank you for that. It is advocated, as far as I can tell, by almost every American who has won the Nobel Prize in economics. And most recently, even the leader of one of America’s most successful endowment funds—Harvard—sang, indeed shouted, its praises. Here’s what Jack Meyer said: “The investment business is a giant scam. Most people think they can find fund managers who can outperform, but most people are wrong. You should simply hold index funds. *No doubt about it.*”

Of course anyone who ever thought about the issue of indexing could easily have started the first index fund before I did. The opportunity was there for the taking. But only the newly-formed Vanguard—we began operations in May 1975 and by September the proposal to form “First Index” was on the Board’s agenda—had both the opportunity *and* the motive. Why the motive? Because the creation of Vanguard was in itself a first—a unique, truly *mutual* mutual fund group, controlled not by a separate management company but by its owner/shareholders, and operated on an “at cost” basis.

To do its job, the basic index fund takes diversification to the nth degree. It owns essentially the entire market, and thus assures that its investors are guaranteed to capture the gross return of the stock market (or the bond market, or any discrete segment of each.) But what makes indexing work is not the assured *earning* of the market’s gross return. As a group, all fund managers do *exactly* the same thing. While they are but a subset—albeit a large subset, now owning a remarkable 28% of all US stocks—the record is clear that together, fund managers provide average gross returns that match the market’s. Hard as it may be for these smart, experienced, intelligent investment professionals who manage mutual funds to admit it, as a group, *we’re average.*

II. The Real Magic of Indexing

The real magic that gives indexing its inviolate edge,

then, is more than broad diversification. It is rock-bottom expenses, enabling a minimal-cost index fund not merely to *earn*, but to *deliver* almost *all* of whatever returns it may earn. The *net* return, in short, approaches 100% of the *gross* return. In effect, Vanguard rebates to its owners the enormous profits that other investment managers sock away for themselves. Having provided shareholders with this at-cost operating structure, we also dedicated ourselves to eliminating extraneous costs and maximizing operating efficiency, and quickly became the fund industry’s low-cost provider by a wide margin. Today, our index funds operate at an *average* expense ratio of about 15 basis points (0.15 of 1%), while the average equity fund carries a ratio of about 1.50%, or ten *times* higher.

Amazingly, that 1.35 percentage point advantage is only the beginning. Passively managed index funds that buy and hold the market portfolio—remember “*Forever*”?—incur essentially zero transaction costs. With portfolio turnover of actively-managed equity funds now averaging nearly 100% per year, their estimated transaction costs come to as much as 1%. Adding, say, another percentage point to the index fund cost advantage brings its edge to 2.4%.

But there’s more! Index funds are readily available on a “no-load” basis without sales commissions. (It would be unwise, even insane, to buy any other kind!) Most actively-managed (and heavily marketed) funds, on the other hand, have front-end sales commissions averaging perhaps 5%. Even if held for a full decade (most aren’t!), add another 50 basis points of cost. We’re now up to 2.9%.

And there’s still *more*. Passively-managed index funds are highly *tax-efficient*, while their actively-managed cousins, trading madly, are highly *tax-inefficient*. For taxable investors, a difference of, say, another 150 basis points, bringing the total cost advantage held by the index fund to 4.4% points per year. (And if you pay a financial adviser *another* 1% . . . well, you can do the math. But I’ll leave that cost aside.)

Does it matter? Think about the numbers: if the stock market is generous enough to reward equity investors with an 8% annual return over the years ahead, and if our administration in the nation’s capital and our central bankers have the guts and discipline to hold inflation to 2 ½%, then the real return on stocks would be 5 ½%. If actively-managed funds persist in foisting on their investors high-cost “products” (as the industry is wont to call their mutual funds), the real return on the average actively-managed fund—after costs and after taxes—could come to just 1.1% per year.

Compounded over the long term (here I’m using 25 years), \$1,000 simply invested in stocks at 5 ½% grows

to \$3,810; at 1.1%, to just \$1,310. Welcome to the *real* world, in which the relentless rules of humble arithmetic in the financial markets—essentially, *gross* fund return, minus costs and taxes, equals net *investor* return—doom actively-managed funds as a group to an abysmal failure for their investor/owners. In the mutual fund business in the aggregate, you get *precisely* what you don't pay for.

Look, I know that “failure” is a tough indictment. So don't take my word for it. In his new book, *Unconventional Success*, another brilliant endowment fund manager, David Swensen of Yale University describes “the colossal failure of the mutual fund industry; resulting from (its) systematic exploitation of individual investors . . . as funds extract enormous sums from investors in exchange for providing a shocking disservice.” He adds that “excessive management fees take their toll, and (manager) profits dominate fiduciary responsibility . . . Thievery,” Mr. Swensen continues, “even when dressed in the cloak of SEC-approved governance, remains thievery . . . as the powerful financial services industry exploits vulnerable individual investors.” These are strong words. But when challenged by *The Wall Street Journal* that his conclusions were “pretty harsh,” Mr. Swensen simply replied: “the evidence is there.” And so it is.

Even an active mutual fund manager—in this case, Fidelity's Peter Lynch, who managed Magellan Fund with such remarkable success from 1973 to 1993—concedes the point driven home by Harvard's Mr. Meyer and Yale's Mr. Swensen: “Most investors,” Mr. Lynch acknowledges, “would be better off in an index fund.” Surprising as it may seem; that's more than a mere concession; it is his recognition of an undeniable tautology.

Warren Buffett, the inestimable oracle of Omaha also buys into this reasoning: “When the dumb investor realizes how dumb he is and buys a low-cost index fund, he becomes smarter than the smartest investors.” So it could easily be said that you honor me because I'm a dumb guy who created a dumb fund—and a dumb fund management company—for dumb investors. How, you must wonder, did *that* happen? Largely because, as a detractor said about me a decade or so ago, the only thing I have going for me is “the uncanny ability to recognize the obvious.” (When you realize that, by definition, the *obvious* is something that *anyone* can recognize, we have a splendid paradox!) Now that you know this truth, I fervently hope that it's too late for you to rescind the high honor you've just bestowed on me.

III. Extending the Implications of Indexing

It also took no more than this obvious arithmetic to recognize that the implications of indexing go far

beyond the simple all-stock-market index fund and all bond-market index fund. While our mutual structure and our low costs inevitably destined that the honor of forming the first index mutual fund would be Vanguard's, those same elements also led to two other precedent-breaking innovations: One came in the bond fund sector. (From 1985 through 1990, amazingly, assets in bond funds were actually *larger* than equity fund assets. How times change!) In early 1977, bond funds were just that: “managed” portfolios of bonds whose maturities could be extended or reduced depending on the portfolio manager's outlook for interest rates.

But, skeptical that bond managers had—or ever *could* have—such prescience, we again did the obvious. We launched the industry's first *defined-maturity* series of bond funds, including a long-term portfolio, a short-term portfolio, and (I'm sure you know what's next!) an intermediate-term portfolio. My idea was to hold broadly diversified portfolios of top quality bonds (first tax-exempt municipals, later taxables), and maintain essentially constant maturities in each category. While these three portfolios were *not*, technically speaking, index funds, in a complex municipal market where the existing indexes were flawed, they were—and are—as close as I could get to making them exactly that. The simple—yes, even dumb—concept of specifically defined maturities revolutionized the bond fund sector, and virtually the entire industry quickly followed suit. The three-tier bond portfolio is now the industry standard.

Low cost, low turnover, and indexing were also the keys to another Vanguard innovation that, like our bond innovation, would quickly be widely imitated (except, of course, for the low costs). In 1993, we created the industry's first series of tax-managed funds: 1) a growth and income fund (based on the S&P 500, except that avoiding taxable gains would override a precise replication of the index); 2) a capital appreciation fund (focused on an index of lower-yielding large-cap stocks, so as to minimize taxable dividends); and 3) a balanced fund (50% intermediate municipal bonds and 50% the lower-yielding stock index portfolio). However obvious, this then-unique *creation* may have been a smart idea. But the fact that we should have created it at least a decade earlier than we did suggests that its *timing*, so delayed by my inexcusable stupidity and inertia,¹ again merits the label “dumb.”

IV. An Opportunity to Serve Investors

But it doesn't really matter whether the Vanguard

¹As early as 1985, R.H. (Tad) Jeffrey, the investment-savvy former head of The Jeffrey Company, implored me to focus on tax-efficiency. Alas, it took me almost a decade to succumb to his exhortations.

structure, its mission, its index funds, its bond strategies, and its tax-management innovations were dumb or brilliant, obvious or obscure, timely or late. Each is of a piece with a concept that would capitalize on the obvious weaknesses of an industry that had lost its way, an idea at least hinted at in the Princeton University thesis that I wrote more than a half-century ago: “the principal role of the mutual fund is to serve its investors.”

Simply put, as now must be obvious to every person in this packed room, fund *managers* have not done that, consuming a grossly excessive share of the returns generated in our financial markets, at the direct expense of fund *owners*. And it is that fact that explains “the massive failure” (Mr. Swensen’s words) of fund managers to serve the investors who have entrusted it with their hard-earned savings.

In fact, the mutual fund industry is the poster-boy for one of the most baneful chapters in the modern history of capitalism. That may sound strong to you, and of course it is strong. But in the latter part of the twentieth century, we witnessed what has been called “a pathological mutation” in capitalism, a mutation from traditional *owners’* capitalism—focused on rewarding the investors who put up the capital and assume the risks—to a new form of *managers’* capitalism, in which not only our fund managers but our corporate managers, aided and abetted by our financial system, arrogated to themselves share of capitalism’s rewards.

V. “The Battle for the Soul of Capitalism”

You now can understand why my new book is entitled *The Battle for the Soul of Capitalism*. It is an expression of my concern about what went wrong in corporate America, in investment America, and in mutual fund America, and (in each case) why it went wrong, and how to go about fixing it. My opening epigram is from St. Paul’s letter to the Romans: “if the sound of the trumpet shall be uncertain, who shall prepare himself to the battle?” It is a book about the battle, and because I believe that the very soul of our capitalistic system is at stake, you will find the trumpet that I sound to be a certain one.

Let me focus the brief remainder of my remarks on some of the major flaws that reflect this mutation in our capitalistic system, each described in some depth in my book.

In corporate America:

- The staggering increase in managers’ compensation, with the pay of the five highest paid executives of public companies more than

doubling, from 4.8% of profits in the early 1990s to 10.3% recently, a period in which earnings themselves—the measure our CEOs love to brag about—grew at a puny 1.9% annual rate.

- The rise of financial engineering—call it “manipulation”—in which earnings are managed to meet the “guidance” that these executives give to Wall Street, quarter by quarter. One of the prize tools: raising the assumptions for future returns on corporate pension plans even as prospective returns eroded. Just think of it: In 1981, when the long-term US Treasury bond yielded 13.9%, the projective plan return was 7%. Currently, with bond yield at 4.7%, the projected return averages about 8.5%. It’s not going to happen, and pension plan inadequacy will be our next financial scandal.

- The failure of our traditional gatekeepers—auditors (who became partners, if not co-conspirators, with managements through their provision of highly profitable consulting activities), regulators, legislators (who in 1993 forced the SEC to back down on requiring that option costs to be treated as—of all things!—corporation expenses), and especially our corporate directors who failed to provide “adult supervision” of “the geniuses” who managed the firms. (The quotes are explained in my book.)

In investment America:

- As our ownership society of direct holdings of stocks by individual investors nearly vanished—they held 92% of all stocks in 1950 but hold only 32% today—corporate control fell into the hands of giant financial institutions—largely pension funds and mutual funds—whose share rose commensurably, from 8% to 68%. But these agents, beset by conflicts of interest and their own agendas, failed to represent their principals.

- Part of this failure came because institutional investing moved from an *own-a-stock* industry (holding an average stock for six years during my first 15 years in this field) to being a *rent-a-stock* industry, now holding a typical stock for but a single year, or even less. Owners *must* give a damn about the rights and responsibilities of corporate governance. Renters could hardly care less.

- As our professional security analysts came to focus far more heavily on *illusion*—the monetary precision of the price of the stock—and increasingly ignoring the *reality*—what really matters is the inevitably vague, but eternally priceless, intrinsic value of the corporation. Using Oscar Wilde’s wonderful description of the cynic,

our money managers came “to know the price of *everything*, but the value of *nothing*.”

In mutual fund America:

- A once-noble industry that had been a profession with elements of a business became a business with elements of a profession. Our traditional guiding star of *stewardship* was transmogrified into a new star—*salesmanship*. Once a business of management, we became largely a business in which marketing called the tune, and our investors have paid a terrible price.

- Over the past two decades, the return of the average equity *fund* has lagged the return of the S&P 500 Index by about three percentage points per year—10% versus 13%—largely because of costs. But largely because of poor timing and poor fund selection, the average fund *investor* has lagged by *another* 3%age points. Result: in this grand era for investing, the average investor has captured but 27% of the market’s compounded return. Clearly, as Mr. Buffett warns, the principal enemies of equity investors are *expenses* and *emotions*.

- When I entered this field all those years ago, virtually 100% of mutual fund management companies were relatively small, professionally-managed, privately-held firms. Since then, they have experienced their own pathological mutation. Today, 41 of the 50 largest firms are publicly-held, including 35 that are owned by giant US and global financial conglomerates. To state the obvious, these conglomerates are in business to earn a return on *their* capital, not a return on *your* (the fund investor’s) capital. Remember: the more the

managers *take*, the less the investors *make*.

VI. Wrapping Up

Please don’t be intimidated by this litany of flaws that have come to pervade today’s debased version of capitalism. We can fix them. Our nation is moving, if haltingly, toward returning the system to its traditional roots of trusting and being trusted. Our *ownership* society is gone and will not return. Our *agency* society has failed to serve its principals, as corporate managers and fund managers alike have placed their own interests above the interests of their beneficiaries and owners. It is time to begin the world anew, and build a *fiduciary* society in which stewardship is our talisman. My *Battle* book is replete with recommendations to speed this metamorphosis. (But you’ll have to read the book to learn what they are!)

If this mission is to succeed, all of you here today, and the tens of thousands of other professionals you represent in the study and practice of financial management, can—and must—help. Your vital role is to educate—to *educate*—investors everywhere—individual and institutional, large and small—on the nature of traditional capitalism, on the wisdom of long-term investing, on the folly of short-term speculation, and the productive power of compound interest and the confiscatory power of compound costs, and on relentless rules of humble arithmetic. With your leadership, your integrity, your independence, and your passion, that mission will be completed.

The sooner, the better.

Thank you again for your wonderful award, and for your kind attention. ■