Bogle Financial Markets Research Center
John C. Bogle, President
P.O. Box 2600, V22
Valley Forge, PA 19482

Via Electronic Submission

Rule-Comment@SEC.gov, File Number 4.606

July 2, 2013

Re: File Number 4-606, Duties of Brokers, Dealers, and Investment Advisers

To: Securities and Exchange Commission, Washington, DC

I am the founder (in 1974) of The Vanguard Group of Investment Companies (all of which are open-end funds registered under the Investment Company Act of 1940), serving as chief executive from 1974 to 1996; the creator of the first index mutual fund in 1975; the President (since 1999) of Vanguard's Bogle Financial Markets Research Center; and author of ten books focused largely on the mutual fund industry. I am writing on my personal behalf in support of establishing a uniform standard of fiduciary duty for brokers, dealers, and investment advisers, including advisers to mutual funds. My views do not necessarily reflect the views of Vanguard's present management.

I am well aware that SEC Release No. 34-69013 is focused on investment advisers "providing personalized investment advice about securities." But as paragraph I.4. of the staff's discussion notes, in paragraph two, "all investment advisers are fiduciaries to their clients." The amounts of assets advised for clients (shareholders) of mutual funds are nearly ten times the assets advised ($12 trillion vs. $1.5 trillion) by firms providing personalized investment advice. To focus on the latter group to the exclusion of the much larger former group would leave a yawning gap in SEC regulation that would ill-serve fund investors.

Investment advisers to mutual funds are registered under the Investment Advisers Act of 1940, and the mutual funds they advise are registered under the Investment Company Act of 1940. In explicit terms, the policies established under Section 1(b)2 of the latter Act establish that mutual funds must "be organized, operated, and managed in the interests of their shareholders" rather than "in the interests of officers, directors, investment advisers, (or) underwriters."[1]

[1] This principle was explicitly reaffirmed by the commission on February 25, 1981 in the case of The Vanguard Group. Release No. 11645, File No. 3-5281

Both my June 27, 2013, letter to SEC Chairman White and my essay—"Big Money in Boston"— that is scheduled to be published this fall in the *Journal of Portfolio Management,* are attached as part of this electronic submission. The letter to Chairman White details my concerns with the lack of a clear and enforceable standard of fiduciary duty for mutual funds and their advisers, and the essay provides a brief overview of the many changes in this industry I have seen during my long career, changes that have eroded the long-term financial security of mutual fund investors.

The fact is that, since the enactment of the original Investment Company Act in 1940, the business model and focus of mutual funds and their advisers and distributors have changed in major ways. In my letter to Chairman White, I outline some of the most significant changes—from tiny industry to colossus (holding some one-third of all U.S. corporate stocks); from an industry of mutual funds to one of mutual fund complexes; from charging lower fees to charging fees nearly twice as high; from free-standing management companies largely owned by their investment professionals, to firms largely controlled by public shareholders and giant financial conglomerates. The Commission vigorously opposed the first such change to public ownership—Insurance Securities, Inc.—in 1958, arguing that the sale of the trustee's office was a breach of fiduciary duty. But the courts ruled against the SEC, and the sale was consummated. The floodgates of public ownership then opened, and the consequences to fund investors have been dire.

What today's "new" mutual fund industry needs, more than anything else, is a clear affirmation of the fiduciary standard that was specified in the 1940 Acts. While the express inclusion of advisers to mutual funds may not seem to fit under the rubric of Section (9)(2)(1) of the Dodd-Frank Act, I see nothing in that section that precludes such consideration in the pending situation. It is vital that the Commission take this opportunity to make it clear that fund advisers (and their parent companies) are unequivocally subject to the principle of fiduciary duty reflected in the clear language and obvious intent of the 1940 Acts.

Thank you for your consideration of the views expressed in this letter and attachments. I would be pleased to provide any further information that the Commissioner and staff may require.

Sincerely,

John C Bogle

John C. Bogle

Attachment I: Letter to Chairman White, June 24, 2013
Attachment II: Essay "Big Money in Boston"

Attachment I

THE Vanguard GROUP

June 24, 2013

John C. Bogle
Founder
Chairman and Chief Executive, 1974-1996

Ms. Mary Jo White, Chairman
U.S. Securities & Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Chairman White,

As founder of the Vanguard Group of Investment Companies in 1974, creator of the first index mutual fund, and, having entered this field in 1951, likely the "dean" of the mutual fund industry, I appreciate this opportunity to add my personal voice on the subject of fiduciary duty.[1] My conclusion: the most troublesome issue facing the mutual fund industry today is the clear and present conflict between the interests of the managers of mutual funds and their fund shareholders.

This conflict flies directly in the face of the Declaration of Policy in the Investment Company Act of 1940, which set this clear standard in Section 1(b)2: Mutual funds should be "organized, operated, [and] managed" in the interests of their shareholders, rather than "in the interest of directors, officers, investment advisers, ... [or] underwriters."[2]

That principle has barely been given even lip service by fund industry leaders, and most fund complexes are organized, operated, and managed in the interests of their management companies. Why? Because today nearly all managers have two distinct fiduciary duties that are in direct conflict: (1) a duty of loyalty to the mutual fund shareholders that they serve, and (2) a duty of loyalty to the owners of the management company.

When the management company is privately-owned by its investment managers and operating executives—the prevailing structure (with but a single exception) of the industry when the 1940 Act became the law of the land—such a conflict *may* be possible to resolve. Today, however, such a structure is no longer the norm. Public ownership is the industry norm today. Among the 50 largest fund management companies, only ten remain privately held, including Vanguard (with our mutual structure) and the two largest other firms. 40 operate under a public-ownership structure. In ten of these cases, ownership is broad-based (numerous non-management public shareholders). In the other 30 cases, the fund management companies are wholly-owned

[1] The opinions expressed in this letter do not necessarily represent the views of Vanguard's present management.
[2] The convoluted language of the 1940 Act was later made clear by the Commission in The Vanguard Group, Inc., Release No. 11645, File No. 3-5281, February 25, 1981: "Funds should be managed and operated in the best interests of their shareholders, rather than in the interests of advisers, underwriters, or others."

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and controlled by publicly-held financial conglomerates. (The large majority has been acquired; a minority represents firms built from within by major U.S. broker-dealers.)

In 1958, a Turn for the Worse

When the issue of public ownership first arose, it was vigorously opposed by the SEC. The Commission's position was that a sale of a fund's management was a breach of fiduciary duty, and would lead to "trafficking" in fund management companies. However, in the case of ISI (Insurance Securities, Inc., now long gone), decided in 1958 by the Ninth District Court of Appeals, the Appellate Court said, in essence, that the sale of a management company's control at a premium over book value was not a breach of fiduciary duty. (The U.S. Supreme Court denied an appeal by the SEC.) The flood-gates of public ownership were breached. Privately-held firms, run largely by investment professionals who owned them, became largely publicly held, and control of management companies is now traded back and forth with considerable frequency—precisely what concerned the Commission all those years ago.

This new business model, of course, was but one of many changes which—contrary to the policies articulated in the Investment Company Act of 1940—has led to the preeminence of the interests of managers over the interests of fund shareholders. Other factors also played a role:

1. The sheer growth of the fund industry, from $3 billion in 1940 to $12 *trillion* today, now with a huge constituency of 91 million shareholders.

2. The sea change from a focus on prudent long-term investment toward short-term speculation. (During the same period, fund portfolio turnover leaped five-fold from 30 percent to 150 percent.)

3. The single-fund focus by managers in 1940 (few managers supervised more than one or two funds) became a multi-fund focus. Marketing replaced management in the driver's seat; an industry that once sold what it made became an industry that made what would sell. Major fund managers now average almost 120 funds per fund complex, raising provocative questions about how a single "independent" fund director could possibly fulfill his or her fiduciary duty to oversee so many investment portfolios.

4. *Rising* expense ratios and *soaring* expenses. Yes, expense ratios have declined during the past decade, but since 1951, the average expense ratio among a group of the eight largest fund groups has risen from 0.62 percent to 1.15 percent in 2012, a leap of 84 percent. (Clearly the huge economies of scale in money management have benefitted managers, rather than shareholders.) With the industry's growth, total expenses of mutual funds have risen 400-fold, from $58 million in 1951 (adjusted for inflation) to $26 *billion* in 2012.

Over the years, I've written on these issues in depth, culminating in a landmark essay by this 62-year industry veteran, entitled "Big Money in Boston." (I sent a copy to you and each of the other commissioners on June 11, 2013. Of course I realize how busy you are, so in this letter I'm incorporating the essay by reference.)

Over this six-plus-decade period, times have changed, and the fund industry has changed. There have been many challenges to effective SEC regulation. The 1940 Act, aimed at regulating investment *companies,* has struggled to deal with the new world of investment company *complexes.* The SEC's early hope that the expected rise in importance of mutual funds would lead to increased activism in corporate governance by the funds has been dashed[3], even as fund ownership of U.S. equities has risen from 3 percent to 35 percent.

What's more, the fund management industry has now effectively been merged with the pension management industry, with *every one* of the 25 largest institutional investors managing *both* mutual funds *and* pension funds, a bloc likely representing a 65 percent ownership of our nation's corporations—absolute control. Finally, defined benefit (DB) retirement plans have shrunk dramatically in favor of defined contribution (DC) thrift plans. The largest concentration of DC plan assets is now found in the Individual Retirement Account (IRA). As 2013 began, DC thrift plans, $5.1 trillion; IRAs $5.4 trillion.

Of course, dealing with this new world presents awesome challenges to the SEC. Still, the Declaration of Policy in the 1940 Act remains: "the national public interest and the interests of investors are adversely affected . . . when funds are operated in the interest of their managers." That statement about the tiny industry of all those years ago has become even more of a public interest in the dominant industry of today.

With all these forces at work, change—a return to basic principles—will not come easily. But change must begin somewhere, and I suggest that reaffirming the principle of fiduciary duty—shareholders first, fund managers only second—is the optimal place to begin. And that principle must apply not only to registered investment advisers providing personalized investment advice to retail customers, but to registered investment advisers (including mutual fund managers) providing investment advice and services to large fund shareholders.

Building a Fiduciary Society

While the challenges facing mutual funds and other institutional money managers today are inevitably different from those of the past, the principles are age-old, summed up by Adam Smith's eighteenth-century warning: "Managers of other people's money rarely watch over it with the same anxious vigilance with which . . . they watch over their own."

The failure to place investors first continues to prevail among far too many of our nation's money manager/agents, often to the point of disregard of their duty and responsibility to their shareowner/principals.[4] Too few of today's institutional money managers seem to display

[3] The Commission's 1940 Report to Congress called on mutual funds to serve "the useful role of representatives of the great number of inarticulate and ineffective individual investors in industrial corporations in which investment companies are also interested." (Securities and Exchange Commission, *Investment Trusts and Investment Companies*, January 16, 1940.) Funds have rarely served that useful role.

[4] One major (and obvious) example of this failure was the participation of many major fund managers in the "market timing" scandals uncovered in 2003—a clear conspiracy between fund managers and hedge fund operators to sacrifice the interests of long-term fund investors in favor of short-term speculators.

the "anxious vigilance" over other people's money that once defined the conduct of investment professionals.

What we must do—and the SEC's leadership is essential—is work toward developing a fiduciary society, one that assures that our last-line owners—not only those mutual fund shareholders whose life savings are at stake, but pension fund beneficiaries as well—have their rights as investment principals protected. These rights should include:

1. The right to have money manager/agents act solely on behalf of their principals. The client, in short, must be king.
2. The right to rely on prudential standards, including due diligence and professional conduct, on the part of money manager/agents who shape investment strategy and their securities analysts who appraise securities for the investment portfolios that are ultimately owned by their shareholder/principals.
3. The assurance that agents will act as responsible corporate citizens, restoring to their principals the neglected rights of ownership of stocks, and demanding that corporate directors and managers meet their fiduciary duty to their own shareholders.
4. The right to demand some sort of discipline and integrity in the financial "products" that our manager/agents offer.
5. The establishment of advisory fee structures that meet a "reasonableness" standard based not only on *rates* but on *dollar amounts,* and their relationship to the fees and structures available to other clients of the manager who are able to bargain at arm's length.
6. The elimination of all conflicts of interest that could preclude the achievement of these goals.[5]

In my opinion, the time to begin this quest is *now*. The place to begin is by simply establishing a *general* standard of fiduciary duty for *all* investment advisers. Obviously, the definitive standards cited above would be controversial, so the first step must be simply to clearly state the principle of fiduciary duty embodied in the 1940 Act, but not articulated. The particulars can be worked out over time, in the way that "common law" has developed over the centuries. As it is said, "Well begun is half done."

"This Is a Fiduciary Business"

I've often felt isolated in my long-standing quest to have mutual fund managers honor their duty as fiduciaries. So it was with considerable delight that I read *The Rise of Mutual Funds, An Insider's View,* by Matthew P. Fink, long-time President (now retired) of the Investment Company Institute, the mutual fund association and industry lobbyist that is rarely known for taking strong stands on principles. Here, this consummate "industry insider" presents his unequivocal statement on the issue:

> *Mutual funds are not like other businesses. This is a fiduciary business. We and the management company are trustees. Therefore, the independent directors' role*

[5] Notice how closely these standards match the Institute for the Fiduciary Standard's Six Core Fiduciary Duties: 1) Serve the client's best interest; 2) Act in utmost good faith; 3) Act prudently—with the care, skill, and judgment of a professional; 4) Avoid conflicts of interest; 5) Disclose all material facts; and 6) Control investment expenses.

is to make sure that the fund management company acts as a fiduciary. The key to being a fiduciary is that the beneficiary's interests must come ahead of your own. That's the only test. Directors of a mutual fund have a unique role in a unique governance context.

In the explosive growth of the money management industry, that fiduciary standard has been largely lost. One solution would be to rely on the marketplace of investors to force a return of the fiduciary standard by "voting with their feet" in favor of firms that meet this standard. But action by masses of individual investors to reshape the industry would take many years, probably many decades. *We need action now.* The first action that I advocate is the enactment of an SEC regulation calling for a standard of fiduciary duty for *all* investment advisers, likely followed by a statutory standard.

It is time to foster the creation of a new culture for mutual funds and their managers, one that returns to its old values, one that is part of the fiduciary society with standards such as I cited above. Finally, we need an explicit statement in the law that makes unmistakable the principle that the federal government intends, and is capable of enforcing, standards of trusteeship and fiduciary duty that require money managers to operate with the sole purpose of serving the interests of their beneficiaries. The adoption of such a regulation concept would fall well within the ambit of SEC Release No. 34-69013.

Acting Like Owners

What is essential, finally, is that the interest of last-line owners—the investors themselves—are served by investment advisers *of all types* with high standards of trusteeship from those who represent their ownership interests. In mutual funds, those 91 million direct owners have no individual power, but awesome collective power. Yes, it's vitally important to develop a fiduciary standard for registered advisers "who provide personalized investment advice to retail customers." But—with such RIAs overseeing about $1.4 trillion of client assets versus a mutual fund industry overseeing some $12 *trillion* of client assets—we cannot afford to ignore registered advisers who provide collective advice to their clients. The SEC simply cannot ignore the huge elephant in the investment room.

Thank you for hearing me out, Chairman White.

Most sincerely,

John C. Bogle

Attachment: *Big Money in Boston,* scheduled for publication in the Journal of Portfolio Management.

JOURNAL OF PORTFOLIO MANAGEMENT

JUNE 18, 2013

"BIG MONEY IN BOSTON" . . .

The Commercialization of the "Mutual" Fund Industry

John C. Bogle is the founder and former chairman of the Vanguard Group

This is a story about the radical change in the culture of the "mutual" fund industry. For more than 63 years, I have not only witnessed it, but I have been an active part of it for almost that long. During that span, the fund culture has moved in a direction that has ill-served its mutual fund shareholders. It's time to recognize that change, and understand how it all happened.

The story begins in December, 1949, a long, long time ago. Then, almost halfway through my junior year at Princeton University, in the newly built Firestone Library, I was striving to keep up with current developments in economics, my major course of study,rea ding the December issue of FORTUNE magazine. When I turned to page 116, there was an article entitled "Big Money in Boston." That serendipitous moment would shape my entire career and life.

"Big Money in Boston"

> The bold-faced type beneath the story's headline explained what was to follow:
> *"But money isn't everything, according to the Massachusetts Investors Trust, which has prospered by selling the small investor peace of mind. It's invention: the open-end fund. The future: wide open."*

In the ten fact-filled pages that followed, "Big Money . . ." described the history, policies, and practices of Massachusetts Investors Trust. M.I.T. was the first and by far the largest "open-end fund,"[i] founded in 1924, a quarter-century earlier. In its discussion of the embryonic industry's future, FORTUNE was optimistic that this tiny industry—"pretty small change ...

rapidly expanding and somewhat contentious, could become immensely influential . . . the ideal champion of the small stockholder in controversies with . . . corporate management." [ii]

In those ancient days, the term "mutual fund" had not yet come into general use, perhaps because "mutual" funds, with one notable exception, are *not* mutual. In fact, contrary to the principles spelled out in The Investment Company Act of 1940[iii], they are "organized, operated, and managed" in the interests of the management companies that control them, rather in the interests of their shareowners.[iv] So FORTUNE relied largely on terms such as "investment companies," "trusts," and "funds."

1951 – The Princeton thesis

That article was the springboard for my decision—made on the spot—to write my senior thesis on the history and future prospects of open-end investment companies, with the simplified title: "The Economic Role of the Investment Company:" After an intense analysis of the industry, I reached some clear conclusions:

> *Investment companies should be operated in the most efficient, honest, and economical way possible . . . Future growth can be maximized by reducing sales charges and management fees . . . Funds can make no claim to superiority over the market averages [indexes] . . . the principal function of investment companies is the management of [their] investment portfolios. Everything else is incidental . . . The principal role of the investment company should be to serve its shareholders.*

Over the centuries (or so it seems), such idealism has likely been typical of a young scholar. But, as you'll see in this paper, despite the passage of more than 63 years since I read that FORTUNE article, my idealism has hardly diminished. Indeed, likely *because* of my lifelong experience in the field, it is even more passionate and unyielding today.

Following my graduation in 1951, Walter L. Morgan, Princeton Class of 1920, read my thesis. Mr. Morgan—my mentor and great hero of my long career, and the founder of industry pioneer Wellington Fund—offered me a job. I decided to join his small but growing firm, then managing but a single fund with assets of $150 million. "Largely as a result of his thesis," he wrote to our staff, "we have added Mr. Bogle to our Wellington organization." Although I wasn't so sure at the time, it was the opportunity of a lifetime.

When I joined the fund industry in 1951, there were but 125 mutual funds, with assets aggregating $3 billion. As can be seen in Exhibit 1, the field was dominated by a few large (for those days) firms, accounting for about two-thirds of industry assets. With assets of $472 million—a market share equal to 15% of industry assets—M.I.T. was overpoweringly dominant, by far the industry's largest fund, and by far the lowest cost provider (expense ratio 0.42%). Indeed while "Big Money in Boston" focused on M.I.T., Boston itself was the center of the mutual fund universe. The funds operated in that fair city dwarfed their peers—22 of the 50 largest funds, managing 46% of the largest firms' assets. (For the record, New York funds then represented 27% of industry assets; Minneapolis 13%; and Philadelphia only 7%.)[v] See Exhibit 2.

Most firms, including Wellington, managed but a single fund, or a second fund that was usually tiny. For example, the five M.I.T. trustees also managed Massachusetts Investors Second Fund (hardly a name that would appeal to today's mutual fund marketers!) with assets of just $34 million, only 7% of M.I.T.'s $472 million total.[vi]

EXHIBIT 1.

Mutual Fund Industry Assets, 1951

Rank	Fund Name	Total Assets* (million)	Notable Smaller Funds	Total Assets* (million)
1	M.I.T.	$472	Eaton & Howard	$90
2	Investors Mutual	365	National Securities	85
3	Keystone Funds	213	United Funds	71
4	Tri-Continental	209	Fidelity	64
5	Affiliated Funds	209	Group Securities	60
6	Wellington Fund	194	Putnam	52
7	Dividend Shares	186	Scudder Stevens & Clai	39
8	Fundamental Investors	179	American	26
9	State Street Investment	106	Franklin	25
10	Boston Fund	106	Loomis Sayles	23
			T. Rowe Price	1
			Dreyfus	0.8
	Total	$2,239	Total	$537
	Percentage of Industry**	72%	Percentage of Industry	17%

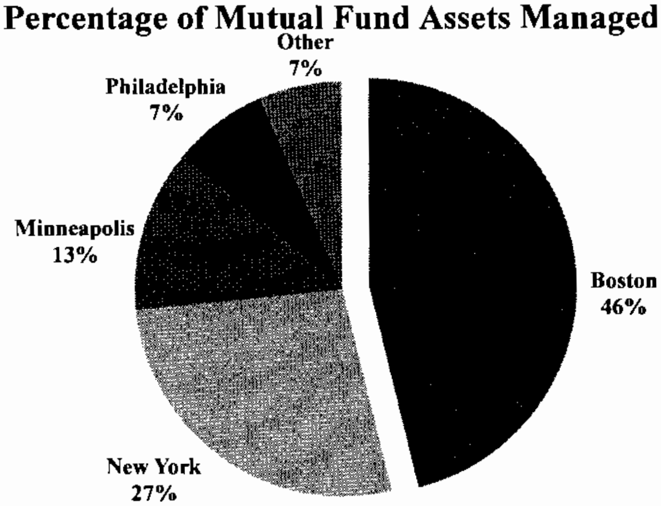
*Includes associated funds.

**Total industry assets: $3.1 billion.

EXHIBIT 2.

"Big Money in Boston"—1951

Percentage of Mutual Fund Assets Managed*



*By location of firm headquarters.

The Old Model . . . the New Model

The idea of trusteeship—indeed, the so-called "Boston trustee"—dominated the industry's image, as a photo of the five M.I.T. trustees in the FORTUNE story suggested. Chairman Merrill Griswold, unsmiling, seated in the center, dark suits with vests, serious in demeanor, all looking, well, "trustworthy." The original operating model of the fund industry was much like that of M.I.T.: professional investors who owned their own small firms, often relying on unaffiliated distributors to sell their shares. (In those days distribution was a profitable business.) "Puritan" seems an apt description of that firm's mutual funds.

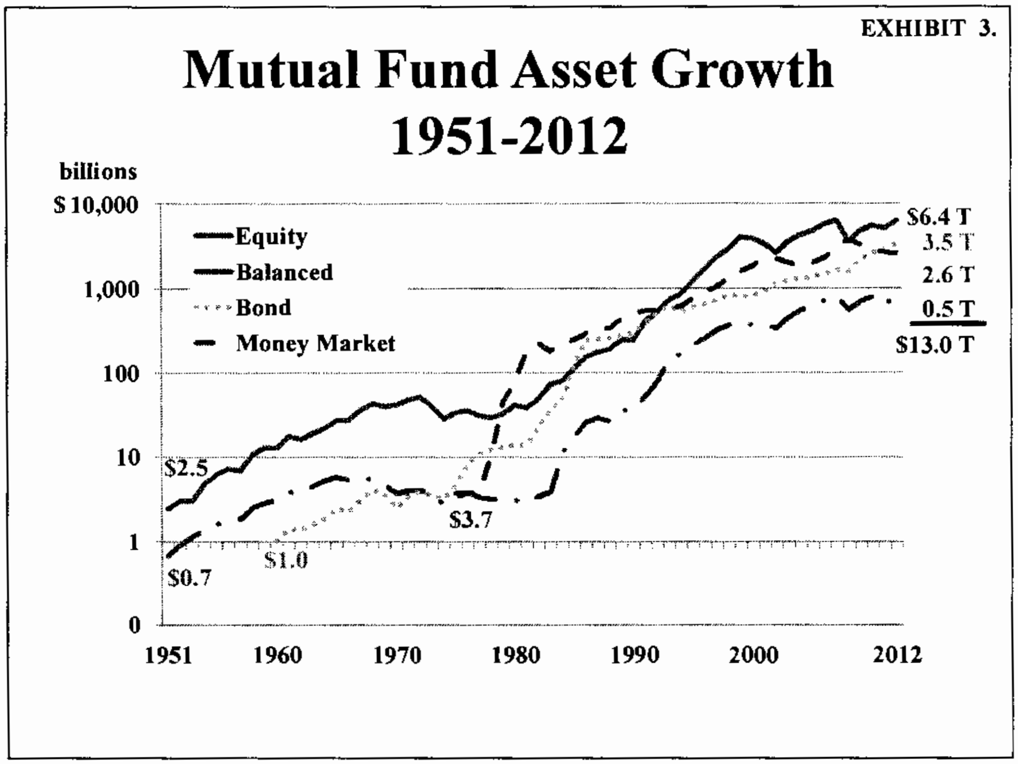
But the industry culture was soon to change, and change radically. In 1951—and in the years that immediately followed—the fund industry that I read about in FORTUNE was a *profession* with elements of a *business,* but would soon begin its journey to becoming a *business* with elements of a *profession* (and, I would argue, not enough of those elements). The old notion of fiduciary duty and *stewardship* was crowded out by an overbearing focus on *salesmanship*, as *management* played second fiddle to *marketing*—gathering assets to manage. That is the industry that exists today.

What explains this profound change in the culture of mutual funds?[vii] I'd argue that these were the major four factors: (1) Gargantuan growth and new lines of business. (2) Widespread use of aggressive, higher-risk strategies, leading to less focus on long-term investment and more focus on short-term speculation. (3) The rise of "product proliferation," with thousands of new funds formed each year, embracing aggressive share distribution as integral to the manager's interest in gathering assets and increasing fee revenues. (4) The conglomeratization of the mutual fund industry, a development that served the monetary interests of mutual fund *managers* but disserved the interests of mutual fund *shareholders*. But a fifth factor emerged that has the potential to take our industry back toward its Puritan past: (5) The triumph of the index fund, which did precisely the opposite: shareholders first, managers second. Let's review each of these changes.

The Stunning Growth of Mutual Fund Assets

When I joined the industry in 1951, fund assets totaled just $3 billion[viii]. Today, assets total $13 *trillion*, a remarkable 15% annual growth rate. When a small industry—dare I say a cottage industry?—becomes something like a behemoth, almost everything changes. "Big business," as hard experience teaches us, represents not just a difference in degree from small business—simply more numbers to the left of the decimal point—but a difference in kind: More process, less human judgment; more conformity, less tolerance of dissent; more business values, fewer professional values.

For almost the entire first half-century of industry history that followed the founding of M.I.T. in 1924, equity funds were its backbone—some 95% of total assets.Tho se assets topped $56 billion in 1972, and then, after a great bear market, tumbled to $31 billion in 1974, an unpleasant reminder of stock market risk and investor sensitivity to market declines. Recovering with the long bull market that followed, equity assets soared to $4 trillion in 1999. Despite two subsequent bear markets (off some 50%, twice), equity fund assets have now reached the $6 trillion level, still the engine that drives the industry. See Exhibit 3. The data on balanced funds are sort of spasmodic; suffice it to say that their important role in the industry dwindled with the coming of the "Go-Go" era during the mid-1960s and then, following the 1973-74 bear market, was overwhelmed by the boom in bond funds.

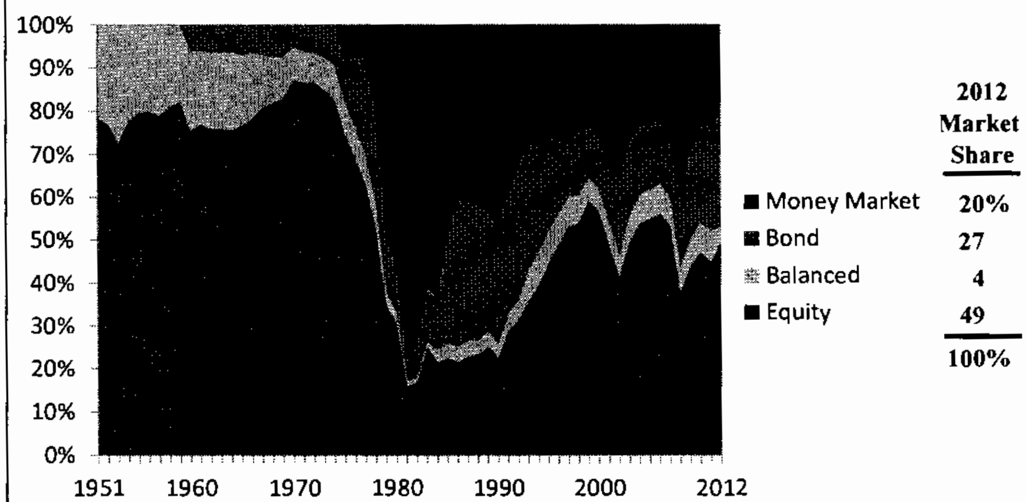


During the 1960s, assets of bond funds seemed stuck at around $3 billion, with little sustained growth. But in 1975, bond funds began to assert themselves. As the financial markets changed, so did investors' needs. Income became a high priority. After that unpleasantness in the stock market, bond fund assets grew substantially,rea ching $250 billion in 1987, actually exceeding the $175 billion total for equity funds. Bond funds then retreated to a less significant role during the 1990s. But today, following years of generous interest rates that were to tumble in recent years, bond fund assets have risen to $3.5 trillion, 25% of the industry total.

As the dominance of equity funds waned, money market funds—the fund industry's great innovation of the mid-1970s—bailed out the shrinking equity fund base. See Exhibit 4. They quickly replaced stock funds as the prime driver. By 1981, money fund assets of $186 billion represented fully 77% (!) of industry assets. While that share has declined to 20% today, it remains a formidable business line, with $2.6 trillion of assets. But given today's pathetic yields and the possibility of a new business model for money funds (one that might require a floating net asset value, reflecting the fact that money market asset values do, in fact, vary each day in accordance with changes in interest rates and credit quality), it won't be easy.

EXHIBIT 4.

Mutual Fund Industry Share by Asset Class—1951-2012



With the rise of bond funds and money market funds, nearly all of the major fund managers—which for a half-century had primarily operated as professional *investment* managers for one or two equity funds —became *business* managers, offering a smorgasbord of investment options, "financial department stores" that focused heavily on administration, marketing, and in this current age of information, shareholder services.

The Sea Change in Equity Fund Management

In addition to the growth and changing composition of the mutual fund asset base, a second force in changing this industry culture developed: a sea change in the industry's investment operations. The *modus operandi* of our equity funds, once largely supervised by conservative investment committees with a long-term focus and a culture of prudent investment—that original M.I.T. approach—gradually gave way to individual portfolio managers, often operating with a short-term focus and a more speculative culture of aggressive investing.

This change from a group approach to an individual approach has fostered a surge in portfolio turnover. The turnover rate of actively-managed funds has leaped from the 30% rate of the 1950s and early 1960s to the 150% rate of the past few decades.[ix] While most fund managers were once investors, they now seem to be speculators. The new financial culture of ever-higher trading activity in stocks was embraced by investors of all types. These institutional traders, of course, were simply swapping shares with one another, with no net gain for their clients as a group; indeed, trading ensures a loss relative to the stock market's return after accounting for transaction costs.

What's more, the traditional equity fund model of blue-chip stocks in market-like portfolios—and commensurately market-like performance (before costs, of course)—evolved into a new, more aggressive model. The relative volatility of individual funds increased, measured in the modern era by "Beta," the volatility of a fund's asset value relative to the stock market as a whole. This increase in riskiness is easily measured. The volatility of returns among actively-managed equity funds increased sharply, from an average of 0.84 during the 1950s (16% *less* volatile than the market) to 1.11 during recent years (11% *more* volatile). That's a 30% increase in the relative volatility of the average fund. In the earlier era, *no* equity fund had volatility above 1.11; during recent years, 38% of equity funds exceeded that level. See Exhibit 5.

Exhibit 5.

Relative Volatility of Equity Mutual Funds

Relative Volatility*	1950-1956	2008-2011**	Difference
Over 1.11	0 %	38 %	+38 %
0.95-1.11	34	38	+4
0.85-0.94	30	10	-20
0.70-0.84	36	6	-30
Below 0.70	0	9	+9

*S&P 500 = 1.00
**Largest 200 Equity Funds

That shift toward higher volatility began during the "Go-Go Years" of the late 1960s, when "hot" managers were treated like Hollywood stars and marketed in the same fashion. It has largely continued ever since. (The creation of index funds was a rare and notable exception. An all-market index fund, by definition, has a Beta of 1.00.) But as the inevitable "reversion to the mean" in fund performance came into play, these aggressive manager *stars*—who focused on changes in short-term corporate earnings expectations, stock price momentum, and other quantitative measures—proved more akin to *comets,* speculators who too often seemed to soar into the sky and then flame out. Too often, the managers forgot about prudence, due diligence, research, balance sheet analysis, and other old-fashioned notions of intrinsic value and investing for the long-term.

With all the publicity focused on the success of these momentary stars, and the accompanying publicity about "the best" funds for the year or even the quarter, along with the huge fees and compensation paid to fund management companies and the huge compensation paid to fund portfolio managers of the "hot" funds, of course the manager culture changed too.

But even a short-term failing in performance became a career risk, so it was deemed smart to be agile and flexible, and for managers to watch over their portfolio in, as they say, "real time."

Large numbers of aggressive funds were formed and equity fund assets soared. Steady and deliberate decision making was no longer the watchword. As managers tried to earn their keep through feverish trading activity, portfolio turnover leaped upward, never mind that it seemed to improve fund performance only randomly, and—because of advisory fees and trading costs—couldn't work for all managers as a group. The tautology that for each winner there is a loser remains intact.

The Rise of "Product Proliferation"

Closely linked to the change in the investment culture was the turn toward product proliferation. Such proliferation reflects a strategy for fund management companies that, in essence, says "We want to run enough different funds so that at least *one* will always do well." An industry that used to sell what we made became an industry that makes what will sell. And in the mutual fund industry, what will sell—the latest investment fad, the hottest sub-sector—is too often exactly what investors should avoid. This problem began to take hold during the Go-Go Years, but soared as the great bull market of 1982-2000 created ever higher investment expectations—especially in the late 1990s as technology stocks blossomed (before they wilted). The number of funds exploded.

When I entered the industry in 1951, there were but 125 mutual funds, dominated by a few leaders. Today, the total number of equity funds comes to a staggering 5,091. Add to that another 2,262 bond funds and 595 money market funds, and there are now a mind-boggling 7,948 traditional mutual funds, plus another 1,446 exchange-traded index funds (which are generally themselves mutual funds).I f you have difficulty choosing from such a staggering number of investment options, just throw a dart! It remains to be seen whether this quantum increase in investment options—ranging from the simple and prudent to the complex and absurd—will serve the interest of fund investors. I have my doubts, and so far the facts seem to back me up.

The good news is that many of those new funds were bond funds and money market funds, potentially offering investors a new range of sound investment options. The bad news is that in the equity fund sector of the industry, the massive proliferation of so many untested strategies (and often untested managers) has resulted in confusion for investors. "If you want to win, just pick the right fund or manager" seemed to be the desideratum. But how could investors or their advisers possibly know *in advance* which funds or managers will win? How many advisers stoked the expectation that it would be easy to succeed and difficult to fail?

The proliferation of fund "products" was followed (unsurprisingly!) by nearly all of today's largest fund groups, resulting in a quantum increase in the number of funds offered. In 1951, industry leaders offered an average of 1.7 funds. Today, these firms offer an average of 117 funds. Fidelity once managed just a single fund; the firm now manages 294 funds. Similarly, Vanguard also began the period with a single fund (Wellington), and is now responsible for 140 funds. See Exhibit 6. Shareholders can only trust that each member of the board of directors—in both cases—takes seriously his or her fiduciary duty to know and to understand each one of the scores of funds under the board's aegis.

EXHIBIT 6.

Number of Funds—1951 & Today

Major Mutual Fund Groups

	1951			2013	
Original Name	Total Assets (million)	No. of Funds Managed	Current Name	Total Assets (billion)	No. of Funds Managed
M.I.T.	$472	2	MFS	$128	80
Investors Mutual	365	3	Columbia	162	116
Affiliated	209	3	Lord Abbett	97	38
Wellington	194	1	Vanguard	2,136	140
Eaton & Howard	90	2	Eaton Vance	107	139
Fidelity	64	1	Fidelity	1,372	294
Putnam	52	1	Putnam	59	76
American	27	2	American	994	33
T. Rowe Price	1	1	T. Rowe Price	375	106
Dreyfus	0.8	1	Dreyfus	228	152
Total/Average	$1,475	1.7	Total/Average	$5,658	117

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

With the rise of all of that product proliferation, the fund industry has come to suffer a rate of fund failures without precedent. Back in the 1960s, about 1% of funds disappeared each year, about 10% over the decade. By 2001-2012, however, the failure rate of funds had soared seven-fold to 7% per year; over that entire period, 90%. With some 6,500 mutual funds in existence during that time, 5,500 have been liquidated or merged in other funds, almost always into members of the same fund family (with more imposing past records!). Assuming (as I do) that a failure rate of at least 50% will persist over the coming decade, by 2023 some 2,500 of today's 5,000 equity funds will no longer exist—the death of one fund on every business day. While the mutual fund industry proudly posits that its mutual funds are designed for *long-term* investors, how can one invest for the *long term* in funds that may exist only for the *short term*?

Another implication of proliferation is the extraordinary (and, again, truly absurd) rise in expense ratios. Just consider eight of the major fund managers of 1951 that survive today, each operating under the conventional industry model and actively managing their fund portfolios. Five are owned by public shareholders,with onl y three remaining privately held by firm insiders. Despite the quantum growth in the assets they manage, the expense ratios of the funds managed by these eight giants have soared by 84% —from an average of 0.62% of assets in 1951 to 1.15% in 2012. (The four largest fee increases came in firms that were publicly-owned.) See Exhibit 7. By contrast, the only mutually-owned firm (Vanguard) actually drove expenses *down* from 0.55% to 0.17%, a drop in unit costs of fully 69%. *Look*— when the expense ratios of funds that operate under the original industry model *rise* by 84%, and the expense ratio of the one fund group that operates under a new business model *falls* by 69%, it is at least possible that there's a message there.

Exhibit 7: Mutual Fund Expense Ratios 1951 and 2012

Conventional Industry Model

	1951	2012	Change
MIT/MFS (C)	0.42%	1.33%	+220%
Investors Mutual/Columbia (C)	0.56	1.23	+121
Eaton Howard/Eaton Vance (SH)	0.64	1.32	+108
Putnam (C)	0.66	1.31	+98
Fidelity (P)	0.63	1.04	+65
T. Rowe Price (SH)	0.50	0.81	+62
Affiliated/Lord Abbett (P)	0.75	1.14	+53
American (P)	0.84	0.98	+17
Average	0.62%	1.15%	+84%

New Industry Model

	1951	2012	Change
Wellington/Vanguard (M)	0.55%	0.17%	-69%

Ownership Type: (C) conglomerate; (SH) public shareholders; (P) private; (M) mutual

The data in the chart reflect the average *expense ratios* of funds offered by each manager, unweighted by assets. While asset-weighted ratios can only be approximated, one can conclude that the *aggregate dollar fees* paid to these eight firms rose from $58 *million* in 1951 (measured in 2012 dollars) to $26 *billion* in 2013—more than a four-hundred fold jump (!) in the price that investors pay for fund management. Expense ratios may seem small. But actual expenses are another story. One might have hoped that with that staggering increase in the dollars available to improve the quality of stock selection, price discovery, and portfolio strategy, the returns earned by fund managers for their shareholders would have improved. Alas, there is no "brute evidence" whatsoever that such has been the case.[x] None.

The Conglomeratization of the Fund Industry

April 7, 1958—A date that will live in infamy. Part I

In my opinion, the coming of public ownership of management companies played a major role—perhaps *the* major role—in changing the nature and structure of our industry. This baneful development began with an unfortunate decision by the U.S. Court of Appeals, Ninth Circuit (San Francisco) that affirmed the right of a fund adviser (Insurance Securities Incorporated, or ISI) to sell a controlling interest in its stock at a premium to its book value. The Securities and Exchange Commission (SEC) argued that the transaction was a sale of the responsibilities of trusteeship, and hence a violation of fiduciary duty. The date of that decision, April 7, 1958, then, was a date that will live in infamy for mutual fund shareholders. That seminal event, now long forgotten, changed the rules of the game. It opened the floodgates to public ownership of management companies, providing the huge rewards of entrepreneurship to fund managers, inevitably at the expense of fund shareholders.

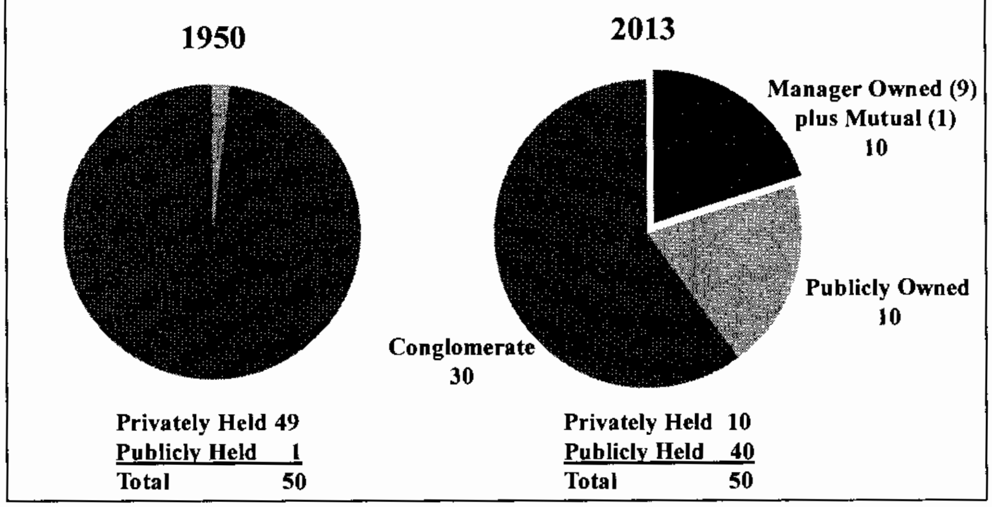
From 1924 through the 1950s, as I recall, all but one[xi] of the industry's 50 largest fund management companies was operated primarily by investment professionals, either through a partnership or a closely-held corporation. But within a decade after the District Court's decision, scores of mutual fund management companies would go public, selling their shares (but with their managers usually retaining voting control). It was only a matter of time until U.S. and international financial conglomerates acquired most of these newly publicly-owned firms, and many of the industry's privately-owned firms as well. These acquiring firms, obviously (one could even concede appropriately), are in business to earn a high return on *their capital*, and they looked at the burgeoning fund industry as a goldmine for managers. (It was!) But that high return came at the expense of the return on *the capital entrusted to them* by the mutual fund investors whom they were duty bound to serve.

The dimension of that change has been extraordinary, as can be seen in Exhibit 8. Among today's 50 largest mutual fund complexes, only nine remain private. 40 are publicly held, including 30 owned by financial conglomerates. The only different ownership model is the sole *mutual* mutual fund structure at Vanguard, where the fund management company is owned by the fund shareholders. All of the public fund management companies have external owners, and obviously face a potential conflict of interest that has deeply concerned me for at least four decades. As I wrote to Wellington's officers in 1971 (when our firm was owned largely by public shareholders):

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.

EXHIBIT 8.

Ownership of 50 Largest Mutual Fund Management Companies, 1950 and 2013



Despite the far-reaching consequences of its unfortunate birth, "conglomeratization" has been the least recognized of all of the changes that have beset the mutual fund industry. Financial conglomerates now own 30 of the 50 largest fund management companies, and with the 10 publicly-traded firms, a total of 40 are publicly held. This manager-serving trend was part and parcel of the industry's growth. In 1951, there was, as far as I can tell, only a single conglomerate owner. After all, assets of most funds then totaled $1,000,000 or even less, hardly enough to whet the appetites of hungry acquisitors. But not all of today's giant firms have heeded the call of the conglomerateurs. All three today's largest fund complexes—Vanguard, Fidelity, and American Funds—have remained independent. These three firms alone manage $4.4 trillion, or some 30% of all mutual fund assets.

While most of the private firms have grown organically, many of the public firms have grown by acquisition, a pattern hardly unfamiliar to the business behemoths of Corporate America. For example, The Amerprise/Columbia Funds have acquired fully twelve previously independent fund managers. BlackRock obtained substantially its entire fund asset base through its acquisition of Barclays Global Investors in 2009, Merrill Lynch Asset Management in 2006, and its early acquisition of State Street Management and Research Corporation, previously owned by Met Life. (That acquisition was followed by the demise of the industry's second oldest fund, State Street Investment Corporation.I still mourn its demise as a "death in the family.") Franklin Resources, another huge firm, is the product of the 1992 merger of giant Franklin Group and the giant Templeton Group. And so on.

So,y es, opening the doors to public ownership produced exactly what the SEC was concerned about a half-century ago in the ISI Case: "trafficking" in management contracts, and the likelihood that it would dramatically erode the sense of fiduciary duty that largely characterized the industry during its early era. And product proliferation hardly helped. So I reiterate: How can an independent fund director feel a fiduciary duty to the hundred or more fund boards on which he or she serves?

What's the problem? It's summarized in Matthew 6:24: *No man can serve two masters.* Yet when a management firm is owned by a giant conglomerate (or even by public owners), the conflict of interest is palpable. Even when a conglomerate builds internally a fund management company, the conglomerate's goal is to earn the highest possible return on the capital they've invested in the mutual fund business. That's the American way! The idea: maximize fees by gathering assets and creating new products, and resist reductions in fee rates that would enable fund shareholders to benefit from the economies of scale.

Fund shareholders, of course, have precisely the opposite interests. They benefit from lower fee rates, which would increase their returns, dollar for dollar. Think of it this way: the officers and directors of financial conglomerates have a *fiduciary duty* to increase the returns earned by their corporate shareholders; yet they also have a *fiduciary duty* to increase returns to their mutual fund shareholders. As Matthew suggested, this obvious conflict in serving two masters will cause them "to love the one and hate the other," and it seems obvious that the manager is the master who gets the love. There can be only one resolution to this profound conflict: a federal statute that prohibits the ownership of fund managers by holding companies.

The Triumph of Indexing

December 31, 1975 – A date that will live in infamy. Part II

If April 7, 1958 is "a date that will live in infamy" for mutual fund *shareholders*, then surely December 31, 1975, is a date that will live in infamy for mutual fund *managers*. That is the date that Vanguard—a tiny, brand-new mutual fund firm that had begun operations less than seven months earlier—filed with the State of Delaware the Declaration of Trust for a new mutual fund that promised *not* to engage in the practice of active management. Originally named "First Index Investment Trust," it was the world's first *index mutual fund.*

Its birth was, curiously, the product of a divorce. (Now there's a paradox!) In 1966, as head of the long-established and then publicly-owned Wellington Management Company, I bet the firm's future, on, yes, a merger. We joined with a small Boston firm—Thorndike, Doran, Paine, and Lewis. Run by four aggressive equity managers, the firm operated a hot "Go-Go" fund named Ivest, managed a growing pension business, and had investment talent that, I believed, could more effectively manage the portfolio of our faltering Wellington Fund.

Yes, I was young and foolish, and (even worse!) I was wrong. For a time, the merged firm prospered, yet only until the "Go-Go" era came to its inevitable end. As 1973 began, the stock market began its terrible 50% crash, even worse for Ivest Fund, which never did recover. (It and two of its Boston sister funds no longer exist.) Worse, Wellington Fund's performance not only failed to improve, it was a disaster—the worst performing of *all* balanced mutual funds in 1967-1977. Our new business model faltered, and then it failed. In the merger, I had ceded substantial voting power to the new managers, and it was *they* who fired *me* as the leader of Wellington Management. On January 24, 1974, I was replaced by their leader, Robert W. Doran.

I leave it to wiser heads than mine to explain the perverse logic involved in that outcome. But I know that it was the most heartbreaking moment—actually, up until then, the *only* such moment—of my entire career. I decided to fight back. Fired by Wellington Management Company—actually "fired with enthusiasm"—I continued in my role as chairman of the board of Wellington Fund and its 11 sister funds. There was a considerable overlap in board membership between the funds and the manager (this is the mutual fund industry!), but the funds, as required by law, had a majority of independent directors. As far as I know, such a power struggle, if you will, had never before occurred in our industry. I doubt that it will ever occur again.

That's too long and complex a story for this paper. (For more detail, it's chronicled in *The Clash of the Cultures.*) But the outcome was a mighty near thing.E ven *The New York Times* couldn't figure out what was happening. In the early edition of the newspaper on March 14, 1974, the *Times* headline said "Ex-Fund Chief to Come Back." In the late edition, the story and the photo of me were unchanged. But the original headline now ended with a giant question mark. A few excerpts:

> *John C. Bogle, who was forced out of his $100,000-a-year job as president and chief executive officer of the Wellington Management Company in late January, is expected by his associates to try to fight his way back at the next board meeting, scheduled to be held within a week.*
>
> *Mr. Bogle is understood to believe that this may be the appropriate time for the funds to "mutualize," or take over, their investment advisers.*

But the haunting "?" silently described the struggle that was going on.

Six months later, the fund board, King-Solomon-like, made its decision: cut the baby in half (more or less). "Boston" would continue as investment adviser to and distributor of the funds. "Philadelphia," under my direction, took on the responsibility of running the funds' administrative, accounting, record-keeping, and compliance activities, as well as the responsibility for evaluating the performance of our adviser and distributor (then, of course, Wellington Management Company). So for the first time in industry history, mutual funds would be independent of their management company, free to operate solely in the interests of their own shareholders.

The fund board accepted my recommendation to operate as a truly "mutual" organization, with the new firm owned by the funds themselves,prov iding its services to shareholders on an "at-cost" basis. In yet another contentious vote during the long process of making our decision, the board also approved my choice of a name for the new firm: Vanguard.*T he Vanguard Group* of *Investment Companies* was born on September 24, 1974.[xii] As I took on my new job, I was "fired with enthusiasm" for the second time within eight months. (Think about that!)

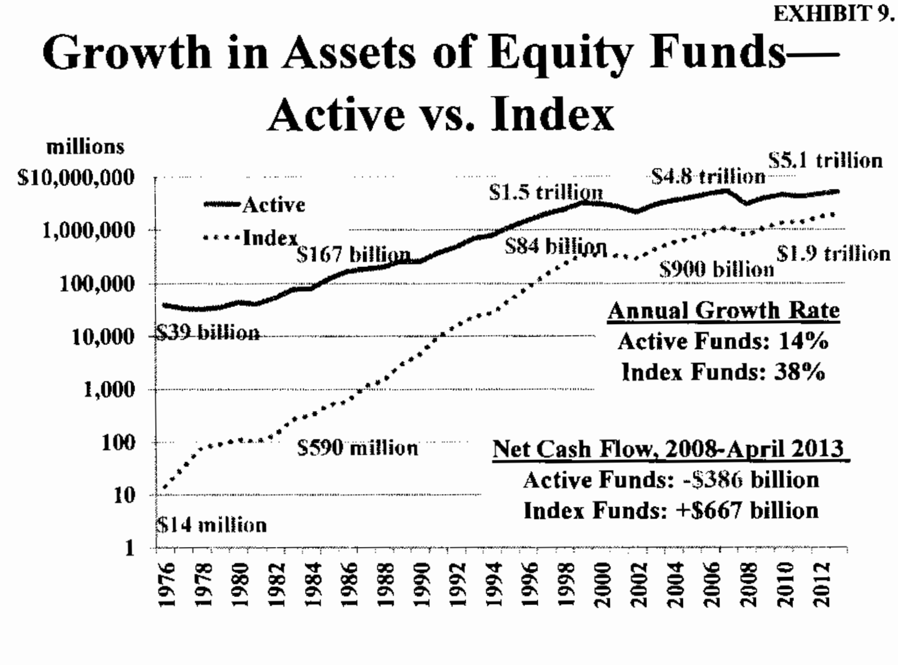
As I considered Vanguard's priorities in the years ahead—we were then overseeing just \$1.4 billion in fund assets—I recalled the analysis of the fund industry that I had presented in my senior thesis.I decided to buttress my conclusion that mutual funds can "make no claim to superiority over the market averages." With my hand calculator and my slide rule, I documented the failure of mutual fund managers generally to outpace the market (using the Standard & Poor's 500 Index) during the previous three decades. It clearly demonstrated the continued superiority of the indexing strategy. Equally important, I was inspired by powerful encouragement from Nobel Laureate Paul Samuelson, expressed in his previously mentioned essay "Challenge to Judgment," who virtually demanded that someone, somewhere start an index fund. His prayers were answered; within 18 months, Vanguard had formed the world's first index mutual fund.

Despite the persuasive data, our board was skeptical, for its mandate to the warring partners precluded Vanguard from providing investment advisory services to the funds. But when I explained that an index fund required no adviser, the board reluctantly acceded to my recommendation. That day of infamy for mutual fund managers *"changed a basic industry in the optimal direction,"* as Professor Samuelson wrote in his 1993 foreword to my first book.[xiii] It was the beginning of a far better direction, one aimed at placing front and center the interests of the mutual fund shareholders.

The IPO for the index fund took place on August 28, 1976. It was a flop. The underwriters raised initial assets of only $11 million. The fund barely grew for years, and industry leaders scorned it publicly. ("You wouldn't settle for an 'average' brain surgeon, so why would you settle for an 'average' mutual fund?")[xiv] A Midwest brokerage firm flooded Wall Street with posters illustrating an angry Uncle Sam using a large rubber stamp to cancel stock certificates. Its headline screamed, "INDEX FUNDS ARE UN-AMERICAN. HELP STAMP OUT INDEX FUNDS!"

To make matters worse, during the index fund's early years it appeared to lag the returns of the average fund manager,lar gely because of flaws in the data. The fund attracted few additional assets. Even with the acquisition of a $40 million actively-managed Vanguard fund, First Index didn't cross the $100 million mark until 1982.[xv] Indeed, it wasn't until 1984 that a second index mutual fund joined the industry. By 1990, total assets of, by then, five index funds reached $4.5 billion, less than 2% of equity fund assets. The experiment in indexing was stumbling.

EXHIBIT 9.



But as Thomas Paine reminded us all those years ago, "the harder the conflict, the more glorious the triumph." And just as Paul Samuelson predicted, indexing changed the fund industry in the optimal direction. Index fund assets leaped to $100 billion by 1997, and to $1 trillion by 2007, and to more than $2 trillion today. See Exhibit 9. So, no, I don't think that the word *triumph* in the subtitle of this section is hyperbolic. Consider that during the past five years, investors have liquidated some $386 billion of their actively-managed equity funds and poured $667 billion into passively-managed index equity funds—a *$1 trillion-plus* shift in investor preferences. Today, assets of passively-managed equity index funds are equal to almost 40% of the assets of their actively-managed peers, their performance superiority confirmed by scores—perhaps hundreds—of independent academic studies, *and denied by none*. Index fund growth seems certain to continue, and likely even accelerate, even from today's massive total.

"The Moral History of U.S. Business"

Those two days of infamy—one in 1958 and one in 1975—were polar opposites. Conglomeratization placed a heavy burden of costs on the returns earned by mutual fund investors; indexing, with its miniscule costs, provided an automatic boost in the returns that, as a group, fund investors earn. Here we have two subtle lessons for fund investors and their managers: the first reflects a diminution of the power of the fiduciary; the second reflects a clear buttressing of the concept of fiduciary duty. Could there be a lesson here about financial ethics and stewardship? Is the moral culture of our financial system involved? Will our society demand that business success be harmonized with social purpose? Ironically, that provocative question was raised in that very same December 1949 issue of FORTUNE in which "Big Money in Boston" appeared.

The lengthy essay was entitled, "The Moral History of U.S. Business." American business leaders, the article noted, "do not work for money alone. A dozen nonprofit motives lie behind their labors: love of power or prestige, altruism, pugnacity, patriotism, the hope of being remembered through a product or institution, etc. American business leaders in general have offered few pure specimens of economic man." … It is relevant to ask," FORTUNE added, "what are the leader's *moral* credentials for the social power he wields."

The essay presented a brief history of the values of U. S. business leaders, beginning in Colonial America. Here we meet Benjamin Franklin,[xvi] who looked upon his business as the foundation of all else he did. He set himself a course of conduct, using his favorite words, "industry and frugality," which he described as "the means of producing wealth, and thereby securing virtue."

FORTUNE also cited:

> *. . . the generic features of the businessman of that era, as described in* Lives of American Merchants *in 1844. Speaking of William Parsons, a New Yorker of probity, the book declared: "the good merchant is not in haste to be rich . . . He recollects that he is not merely a merchant, but a man, and that he has a mind to improve, a heart to cultivate,[xvii] a character to form. The good merchant, though an enterprising man and willing to run some risks, yet is not willing to risk everything, nor put all on the hazard of a single throw . . . Above all, he makes it a matter of conscience not to risk in hazardous enterprises the property of others entrusted to his keeping . . . He is careful to indulge in no extravagance, and to live within his means . . . Simple in his manner and unostentatious in his habits of life, he abstains from all frivolities and foolish expenditures . . .*

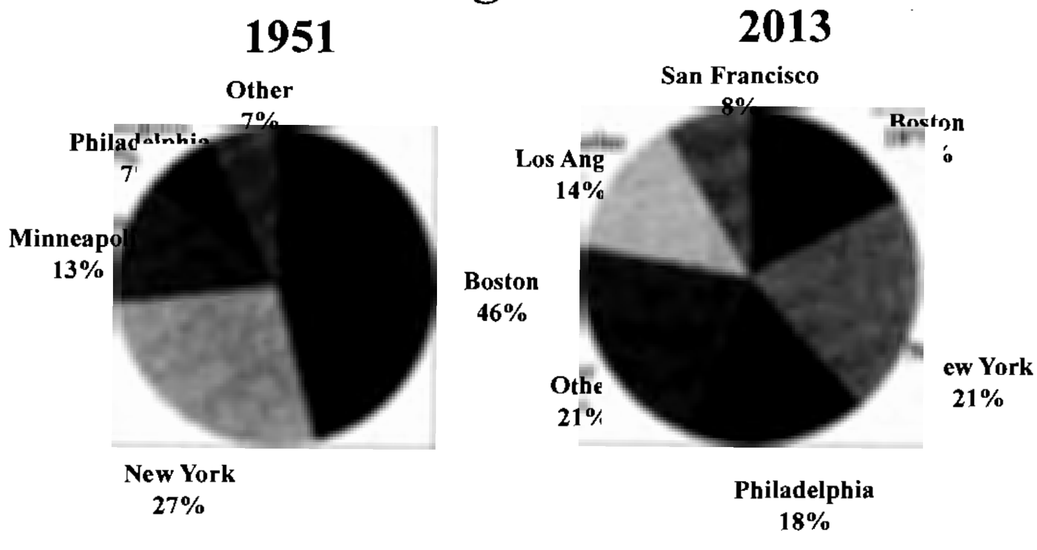
The spirit of character, of prudence, and of rectitude—described in a book written in 1844, more than 150 years ago—is worthy of careful consideration by today's mutual fund officers and directors. It is that spirit that must come to animate the values and conduct of the professional investors and financial institutions that now dominate the field of money management.

"Puritan Boston and Quaker Philadelphia"[xviii]

Yes, six-plus decades after I read that FORTUNE article, there's still "Big Money in Boston" today. While no longer the center of the industry, Boston firms manage about $2.2 trillion of industry assets or 18%, well down from that dominant 1951 peak of 46%. But its loss has partly been offset by Philadelphia's gain—from 7% to 18%. See Exhibit 10. Whether we like it or not, there have been some significant changes, not only in the center of the industry's geographic core, but in the business model of many firms.

EXHIBIT 10.

Big Money in Boston--Still Huge, But No Longer Dominant*



*Percentage of mutual fund assets by location of firm headquarters.

How did Boston lose so much and Philadelphia gain so much? Largely because M.I.T. abandoned its, well, Puritan model even as Vanguard adopted its new Quaker-like model. In both cases, it came down to choices about the business model and strategy of the firm. The fund industry now has four business models—mutual, private ownership, public ownership, and conglomerate ownership—and those structures play an important role in shaping a firm's investment strategy (notably active money management versus passive indexing). In his introduction to my 1999 book *Common Sense on Mutual Funds*, economist and famed author Peter L. Bernstein clearly articulated this distinction.

> *... What happens to the wealth of individual investors cannot be separated from the structure of the industry that manages those assets. Bogle's insight into what the*

structure means to the fortunes of those individuals whose welfare concerns him so deeply is what makes this book most rewarding.

In 1969, M.I.T. turned away from its original business model, with its sharp focus on prudent trusteeship, and it became the nucleus of a new privately-owned profit-seeking firm, Massachusetts Financial Service (MFS), that managed the funds' affairs and distributed their shares. In 1976, MFS was sold by its relatively new owners to a publicly-owned Canadian insurance company.[xix] The firm's once rock-bottom costs have soared from a low of 0.17% in 1961 to 1.33% for the MFS funds in 2012, an astounding increase of 700 percent—and are among the highest in the industry.I ts once-record market share of 15% of industry assets in 1949 has tumbled to just 1%. (They have yet to offer investors an index fund.) Nonetheless, it has been a goldmine for the financial conglomerate that acquired it. Since 1995 alone, Sun Life has earned almost $4 billion of profits from its ownership of MFS. Readers can decide for themselves whether or not the SEC conclusion about the implications of trafficking in management contracts—trafficking in fiduciary duty, if you will—was justified.

The change in the business model of M.I.T.—that former exemplar of Puritan Boston—left a void that would be filled by Vanguard in Quaker Philadelphia[xx] five years later, in 1974. With a bow to the legendary Quaker thrift, Vanguard's mutual structure engenders rock-bottom costs—the firm's expense ratio of 0.17% (less than 1/20th of one percent) in 2012 is but one-eighth of the 1.33% expense ratio of the MFS funds. The fortuitous creation of Vanguard's index fund—which depends *entirely* on rock-bottom costs—has been the prime force in the firm's rise to industry's leadership.

Now overseeing $2.2 trillion of assets, Vanguard's remarkable growth is a reflection of the triumph of indexing and the pervasive realization that lower fund costs lead to higher fund returns. In 2012, Vanguard's share of assets of stock and bond mutual funds has set an all-time industry record high of 17%. And it is sure to continue growing. For since 2010 the firm has accounted for more than 70% of industry cash flows. (Don't worry. That share will surely decline.) It seems only a matter of time until a serious challenger emerges. The challenge is *simple*: just operate at far lower costs and manage more index funds. But, given the priority of building earnings for the public stockholders that characterizes the business model of so many management companies, it won't be *easy*.

A Final Word from Adam Smith

So the issue is joined. Which should be the higher priority for a fund manager? The interests of its fund shareholders or the interests of its management company owners? In *The Wealth of Nations,* Adam Smith gave us an unequivocal answer:

> *. . . 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 . . . [T]he interest of the consumer . . . [must be] the ultimate end and object of all industry and commerce.*

The challenge to change the industry's business model to serve the interests of consumers/shareholders is a huge one, but I wish our fund peers well—especially those in Boston, the industry's birthplace. And I wish all investment professionals success in following the central principle that has informed my long career. It all began with the incredible good luck—against all odds—of stumbling upon that 1949 story that began on page 116 in FORTUNE magazine, "Big Money in Boston," that inspired my Princeton thesis. There I concluded, in words similar to those used by Adam Smith in 1776, "The principal role of the investment company should be to serve its shareholders." In the years ahead, that principle must become the watchword of our industry.

ACKNOWLEDGMENT

This essay provided the basis for a speech that I delivered to The Boston Security Analysts Society on May 17, 2013. The opinions expressed in this essay do not necessarily represent the views of Vanguard's present management.

Endnotes

[i] M.I.T. was an "open-end" fund, one that redeemed its shares on demand. The "closed-end" fund has a fixed number of non-redeemable shares outstanding.

[ii] FORTUNE's optimism arose from the fact that in the late 1940s, funds played a role in a number of corporate management changes. Today, however, that promise has yet to be fulfilled. Despite holding virtual control over

Corporate America—mutual funds now collectively own more than one-third of U.S. stocks—they lack the spirit and the will to perform this central role in corporate governance.

[iii] Section 1(b)(2): Mutual funds must be "organized, operated, and managed" in the interests of their shareholders rather than in "the interests of directors, officers, investment advisers, ... underwriters, brokers, or dealers."

[iv] At the 1968 Federal Bar Conference on Mutual Funds, former SEC Chairman Manuel Cohen gave a speech entitled "The 'Mutual' Fund," putting quotation marks around the word *mutual,* since "its salient characteristics raise the serious question whether the word 'mutual' is an appropriate description."

[v] Minneapolis is the headquarters of the giant Ameriprise/Columbia Funds (originally named Investors Diversified Services, formed in 1894). In 1951, as in 2012, the firm accounted for virtually of the fund assets located there.

[vi] Five smaller fund managers of that era operated multiple funds, each providing a wide selection of investment objectives and specialized portfolios—often 20 or more—focused on a variety of single industries. Designed for market timing, at first they grew with the burgeoning industry. All had their moment in the sun during the 1960s, but not one remains today.

[vii] This subject is one of the major themes of my 2012 book *The Clash of the Cultures: Investment vs. Speculation.*

[viii] $3 billion in 1951 is equivalent to $28 billion in 2013 dollars.

[ix] Note: The turnover measure that I'm using represents the total portfolio purchases plus the total sales of equity funds each year as a percentage of assets, not today's conventional—if inexplicable—formula: the lesser of purchases and sales as a percentage of assets.

[x] In his 1974 paper "Challenge to Judgment," published in the first edition of the *Journal of Portfolio Management*, Nobel Laureate Paul Samuelson noted that academics had not been able to systematically identify superior active fund managers, and said that the burden of proof belonged to the proponents of active management to produce "brute evidence to the contrary."

[xi] IDS (which today is Ameriprise/Columbia) was the lone exception. It started its first mutual fund (Investors Mutual) in 1940. See endnote v for additional detail.

[xii] One could easily argue that "the date that will live in infamy" for fund managers was Vanguard's precedent-breaking formation on September 24, 1974. For it replaced the industry's business model with a truly mutual model, a model that was virtually essential in the creation of our index fund.

[xiii] *Bogle on Mutual Funds.* (John Wiley & Sons, 1993).

[xiv] Fidelity's Chairman Edward C. Johnson III doubted Fidelity would follow Vanguard's lead. "I can't believe," he told the press, "that the great mass of investors are [sic] going to be satisfied with just receiving average returns. The name of the game is to be the best." Today Fidelity oversees some $140 billion of index fund assets.

[xv] In 1980, the Trust's name was changed to Vanguard 500 Index Fund.

[xvi] Ironically (in light of what will soon follow), Franklin began his life in Boston, but in his youth moved to Philadelphia and spent his entire career there.

[xvii] As some readers may know, I was the beneficiary of a heart transplant in 1996, so I've been cultivating a new heart for the past 17 years.

[xviii] *Puritan Boston and Quaker Philadelphia* is the title of a book by E. Digby Baltzell (Free Press, 1979), describing the contrasting cultures of the two cities.

[xix] Similarly, staunch old Putnam Management Company was bought from its manager/trustees by U.S. insurance giant Marsh and McLennan in 1970, and resold in 2008,f or almost $4 billion, to yet another Canadian conglomerate. Its fund assets have stumbled from $250 billion in 1999 to $60 billion today.

[xx] While I believe profoundly in Quaker principles, I'm not a card-carrying member of the Society of Friends.

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