Mutual Funds: How a Profession with Elements of a Business Became a Business with Elements of a Profession

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I'm honored to be invited to be with you today, most especially since your membership includes some of the top professional security analysts in the field of institutional investing. I'm particularly impressed that your roll now includes Paul A. Samuelson, perhaps the most distinguished of all contemporary "investment economists" (to coin a phase), MIT professor, 1970 Nobel Laureate in economics, and prolific author of books and articles, to whom you awarded an honorary membership last November.

I've known Dr. Samuelson, in a sense, during all my adult lifetime, ever since I opened the first edition of his *Economics: An Introductory Analysis* at age 19, a sophomore at Princeton University taking my first course in the subject. That I received a crushingly bad mid-term grade is beside the point. His book was the springboard into my major, leading to my senior thesis ("The Economic Role of the Investment Company"), which in turn resulted in my joining the mutual fund field with Wellington Management Company, immediately following my graduation in 1951, becoming its president in 1967. (As some of you may know, my career there ended, somewhat unceremoniously, in January 1974.)

Not only was Dr. Samuelson with me at the beginning of my long career, his ideas were also there for me at its crucial turning points. His brilliant 1974 article "Challenge to Judgment" in the *Journal of Portfolio Management* called for the formation of "a no-load, no-management fee, virtually-no-transaction-turnover fund," gave major impetus in inspiring me to do exactly that in 1975. In his *Newsweek* column in August, 1976, he described how he received in the mail the "crisp new prospectus for the First Index Investment Trust" (the original name of what is now Vanguard 500 Index Fund), and happily reported that "sooner than I dared expect, my implicit prayer has been answered." That index fund was the first innovation of the Vanguard Group, founded in September 1974, itself a precedent-breaking structure in which the mutual funds in the group would be operated, not by an external manager, but by their own staff, and managed on an "at-cost" basis.

Later in my career, when I began to write my own books, Dr. Samuelson honored me by writing a beautiful foreword to *Bogle on Mutual Funds: New Perspectives for the Intelligent Investor* in 1993, and then a powerful endorsement of *Common Sense on Mutual Funds: New Imperatives for the Intelligent Investor* in 1999—saluting my ideas a full half-century after I had first been exposed to his. Most recently, he makes a cameo appearance in my newest book, *The Battle for the Soul of Capitalism*, published by Yale University Press last November.

Managers Triumph Over Owners

The overarching theme of *Battle* is the pathological mutation from *owners*' capitalism—where the rewards of investing were largely directed to those who put up the capital and assumed the risks—to a new *managers*' capitalism, in which the hired managers of corporate America, investment America, and mutual fund America have arrogated to themselves an excessive share of the rewards of investing. It will not surprise you to learn that, yes, Dr. Samuelson was among the earliest to recognize this very change in the way that the mutual fund industry operated.

Here's how I describe it in my new book: "Observing this change in 1967, economist and Nobel laureate Paul Samuelson sized it up pungently: 'There was only one place to make money in the mutual fund business—as there is only one place for a temperate man in a saloon—*behind* the bar and not *in front* of it . . . so I invested in a management company.' When he realized that public ownership of management companies would not only be a boon for the managers who worked behind the bar, as it were, but be a bane for the fund owners who enjoyed their libations in the front of the bar, he was wiser then he could have imagined."

Despite being an industry inside as leader of Wellington Management Company (which, you may be surprised to know, had itself gone public in 1960), I shared, with considerable concern, the insight that Dr. Samuelson expressed in his bartender analogy. In a 1971 speech to our management group, I sounded the alarm: "All things considered, it is undesirable for professional enterprises to have public stockholders. This constraint is as applicable to money managers as it is to doctors, or lawyers, or accountants, or architects. In their cases, as in ours (i.e., Wellington's), it is hard to see what unique contribution public investors bring to the enterprise. They do not (contribute) capital; they do not add expertise; they do not enhance the well-being of our clients . . . *Indeed, it is possible to envision circumstances in which the pressure for earnings and earnings growth engendered by public ownership is antithetical to the responsible operation of a professional organization and . . . to the exercise of our fiduciary duty."*

My concern was merely a recognition of the obvious: With the coming of public ownership, the fund industry would operate under a structure that would inevitably favor the interests of managers over the interests of owners, a direct contradiction of the stated purpose expressed in the Investment Company Act of 1940: to assure that mutual funds are "organized, operated, and managed" in the interest of their shareholders "*rather than* in the interests of their managers and distributors."

As Dr. Samuelson had perceptively recognized in 1967, the fund industry was in the midst of a transition from *a profession with elements of a business* to *a business with elements of a profession,* the title of my remarks today. When I joined the industry in 1951, it was composed of relatively *small*, *privately*-held firms run by *investment professionals;* today it is dominated by *giant, publicly*-held firms, largely conglomerates run by *corporate managers* who are usually far removed from the investment process. Simply put, these firms are in this business primarily to earn a return on *their* capital, not to earn a return on *your* capital as a fund investor.

From Bartenders to Chains of Bartenders

While Dr. Samuelson's formulation was ahead of its time, most of today's bartenders are no longer self-employed patriarchs of family businesses. Rather they are employed by national chains, sort of like TGIFriday's, Hooters, or Ruby Tuesday. Yet this pathological mutation in the mutual fund business, so similar to the mutation that took place in corporate America, need never have happened.

The change from private ownership to public ownership in the mutual fund field depended on a single landmark legal case, now long-forgotten except perhaps by those (like me) who witnessed it. In 1956, the owners of Insurance Securities Incorporated (ISI), manager of ISI Trust Fund—a mutual fund investing largely in the stocks of insurance companies—sold their controlling shareholdings in the management company to a new purchasing group for 15 *times* the firm's book value. (While the book value of ISI was $300,000, the shares were sold for $4,300,000. In those days, this industry was much smaller and the dollar was much bigger!)

Following management's recommendation in the proxy statement, the Trust Fund owners approved the transfer. The Securities and Exchange Commission challenged the deal, arguing that the sale of a fiduciary office was a "gross abuse of trust" under Section 36 of the 1940 Act. Since "the value attached to the (management) contract is an asset of the fund," its sale to others violated "general equitable principles." The SEC also argued, prophetically, that when an excess value is paid, it might "prompt the new owners to pursue a hazardous or doubtful policy in an effort to recoup the purchase price."

The SEC arguments failed to carry the day. The lower court ruled in favor of allowing the sale. Appealed to the Court of Appeals in the Ninth Circuit, the ruling was upheld in April 1958, and the U.S. Supreme Court declined to review the decision. The die was cast. And the floodgates opened. A rush of public offerings of fund management companies followed, and by the mid-1960s, a score of fund managers had become publicly held, including industry leaders like Wellington, Vance Sanders, Dreyfus, and Putnam.

But public ownership was only the beginning. Over the decades that followed, in yet another pathological mutation, ownership of most of the industry's major management firms were acquired by giant financial conglomerates, largely U.S. and international bank holding companies that included Bank of America, JPMorganChase, Deutsche Bank, AXA, and UBS. This era also marked the entry of major investment banking and brokerage firms—including Merrill Lynch, Morgan Stanley, and Goldman Sachs—into the field of fund management and distribution. The fund business became *big* business, another "profit-center" much sought for its predictable and growing asset-based revenue stream.

The Industry Today

Today, among the 30 largest mutual fund companies (listed in order of assets managed at year-end 2005) controlling 74% of the industry's assets, only *four* firms remain privately-held (including fund-shareholder-owned Vanguard). **Chart 1**. Of the remaining 26 firms, 19 are owned by financial conglomerates and 7 are owned by public investors. It's high time that we focus on the change in the very nature of mutual fund management wrought by this remarkable change in the control of the assets of our nation's funds, and ask whether these changes have served the interests of fund investors. I fear that they have not.

Ownership of the Top 30 Fund Managers - 2006 1.

Rank	Manager	Rank	Manager
1	Fidelity (PRIVATE)	16	Morgan Stanley (MORG. STAN.)
2	Vanguard (PRIVATE)	17	Goldman Sachs (GOLD. SACHS)
3	American Funds (PRIVATE)	18	Wells Fargo (WELLS FARGO)
4	Franklin Templeton (PUBLIC)	19	Putnam (MARSH & MCLENNAN)
5	JPMorgan (JP MORGAN CHASE)	20	BlackRock (PNC FINC'L)
6	Columbia (BANK OF AMERICA)	21	Scudder (DEUTSCHE BANK)
7	PIMCO (ALLIANZ)	22	AIM Investments (AMVESCAP)
8	Federated (PUBLIC)	23	Evergreen (WACHOVIA)
9	Merrill Lynch (MERRILL LYNCH)	24	Dodge & Cox (PRIVATE)
10	T Rowe Price (PUBLIC)	25	American Century (JPM CHASE)
11	Barclays Global (BARCLAYS BANK)	26	Van Kampen (MORG. STAN.)
12	Dreyfus (MELLON FINC'L)	27	MFS (SUN LIFE FINC'L)
13	OppenheimerFunds (MASSMUTUAL)	28	Janus (PUBLIC)
14	Schwab (PUBLIC)	29	Eaton Vance (PUBLIC)
15	Citigroup (LEGG MASON)	30	Nuveen (PUBLIC)

Private – 4 Firms   Public – 7 Firms   Conglomerate – 19 Firms

While it's not possible to precisely associate cause with effect, some things are clear: The fund industry, once a field focused largely on professional management, has indeed become a business of product marketing. Like all successful marketers, fund distributors watch the actions of consumers like a hawk, and rush to create supply to respond to—even to foment—demand by investors for the investment fads and fashions of the day. Once satisfied to sell what we made, we became an industry that makes whatever will sell. (During the market bubble, for example, we created 494 "new economy" funds—technology and telecommunications funds, and aggressive growth funds dominated by these sectors.)

I don't want to suggest that the conglomerates and the other publicly-held firms bear the sole responsibility for this change. The three giant private firms hardly ignored the marketplace, and must accept their share of the responsibility too. But the pressures of outside ownership of management companies—the need to serve two very distinct masters, if you will—surely played the major role in the transformation that has ill-served mutual fund investors.

Fund advertisements, once limited to "tombstones" in black-and-white on the financial pages, now appear in living color on our television sets and in magazines, often focused on once-prohibited quasi-endorsements (most recently from Paul McCartney and Lance Armstrong), and buttressed by sophisticated measurement techniques. And when a fund's performance fades and it loses its appeal in the marketplace, it is given a hasty burial.

The investment process, too, is affected by this change. The reliance on investment judgment by those small professional firms gradually becomes institutionalized and process-oriented. As the marketing effort produces burgeoning cash inflows from new investors, fund assets grow to levels that jeopardize the ability to generate superior returns. The investment management function is redefined as "manufacturing." Gradually, marketing replaces management as the talisman, and ethical standards are compromised. (Is it an accident that all six of the largest public- or conglomerate-owned firms but none of the four major private firms were implicated in the mutual fund market-timing scandals?)

And when, in a miasma of faltering fund performance, new corporate management, or rethought strategy, the utility of the fund management company fades, its owner does the obvious. It sells to a *new* owner who does what new owners traditionally do: "rightsize," reshape the product line, increase the marketing budget, and raise existing fees and/or add new fees, all with a view toward earning a higher return on the capital it has invested.. Salesmanship replaces stewardship, and fund management companies change hands over and over again. The worst nightmares of our regulators come true: the very "trafficking" in advisory contracts that so concerned our government regulators when they fought—and lost—the ISI case a half-century ago.

Let's Look at the Record

Is this criticism fair? First, let's look at the relative performance of the funds run by private managers vs. funds run by public managers, using a study prepared for Fidelity Management a few years ago, in which each fund manager is given a ten-year percentile rank compared to its peers (i.e., its large-cap-value equity fund vs. its peers, its long-term municipal bond fund vs. *its* peers, etc.). (**Chart 2** on next page) No comparison is perfect, but this peer-based, decade-long approach is probably about as fair as it gets. This record shows, unequivocally, that funds operated under the aegis of the largest financial conglomerates have provided distinctly inferior returns to the shareholders of their funds compared to those provided by the private companies.

Here are the data: on average, the funds run by the 13 private firms provided near top-quartile performance (29th percentile), while the funds run by the 34 conglomerates were third quartile (55th percentile) performers. In fact, all 7 top performers—and 8 of the top 9—were private firms, with only

Private or Conglomerate?

Relative Returns vs. Organizational Structure

Firm	Percentile Rank	Firm	Percentile Rank	Firm	Percentile Rank
Dodge & Cox (P)	2	Waddell & Reed (P-H)	39	Goldman Sachs (C)	51
First Eagle (P)	3	USAA (P)	39	Morgan Stan Adv (C)	51
Calamos (P)	9	Oppenheimer (C)	40	Eaton Vance (P-H)	51
So.Eastern/Longleaf (P)	10	Prudential (C)	41	The Hartford (C)	52
Royce (P)	21	MFS (C)	41	John Hancock (C)	53
American Funds (P)	21	New York Life (C)	42	Putnam (C)	53
Harris Associates (P)	23	US Bancorp (C)	43	Dreyfus (C)	55
PIMCO (C)	24	Columbia Mgmt (C)	44	Strong (C)	56
Vanguard (P)	24	AllianceBernstein (C)	45	Delaware (C)	56
T Rowe Price (P-H)	29	Banc One (C)	46	Thrivent Fin'l (P)	56
Franklin Templeton (P-H)	29	Neuberger Berman (C)	46	Trusco Cap (C)	57
Janus (P-H)	30	Lord Abbett (P)	47	Merrill Lynch (C)	60
ING (C)	31	Van Kampen (C)	48	Aim (C)	61
Nuveen (P-H)	35	Scudder (C)	48	Nations Funds (C)	62
American Century (C)	36	Federated (P-H)	48	American Exp (C)	63
WM Advisors (C)	36	Evergreen (C)	49	BlackRock (C)	64
Davis (P)	38	Wells Fargo (C)	50	Pioneer (C)	67
Fidelity (P)	38	Citigroup (C)	50	JP Morgan (C)	68

Summary

	Firms	Rank*
Private (P)	13	29%
Conglomerate (C)	34	55%
Publicly Held (P-H)	7	40%

*Performance data are adjusted because Fidelity study ignored initial sales charges and B-class shares.

two represented among the bottom 34 firms. The other 32 lower-ranking fund groups were managed by public- or conglomerate-owned firms. It's at least arguable that these distinct performance patterns suggest that public ownership has proven antithetical to the exercise of fiduciary duty.

To what extent is this obvious disparity in relative fund returns explained by a firm's focus on marketing? The difference between how these different types of firms approach their fund "product lines" is clear: the marketing-ization of the fund industry has been driven by the conglomerates. Of the ten firms running the largest number of funds—averaging 112 separate mutual funds of just about every size, shape, and variety—nine are publicly held. **Chart 3.** Of the ten firms running the fewest funds (averaging only ten), eight are privately owned, including all seven of the top performers listed in the earlier chart, on which only two private firms ranked below the 39th percentile. (Note that Calamos was privately owned during the period covered in the study, but is publicly held now.)

Two Approaches to "Product Lines" 3.

Most Funds Offered		Fewest Funds Offered	
Manager	# of Funds*	Manager	# of Funds*
Fidelity	206	So.Eastern/Longleaf	3
Dreyfus	141	Dodge & Cox	4
Columbia	132	First Eagle	5
Morgan Stanley	124	Harris Assoc	7
Franklin Templeton	113	Davis	9
Wells Fargo	111	Calamos Advisors	10
Eaton Vance	104	WM Advisors	15
Merrill Lynch	103	Royce	17
Scudder	102	American	28
Citigroup	98	Thrivent Finc'l	30
Median	112	Median	10

Private Public Conglomerate

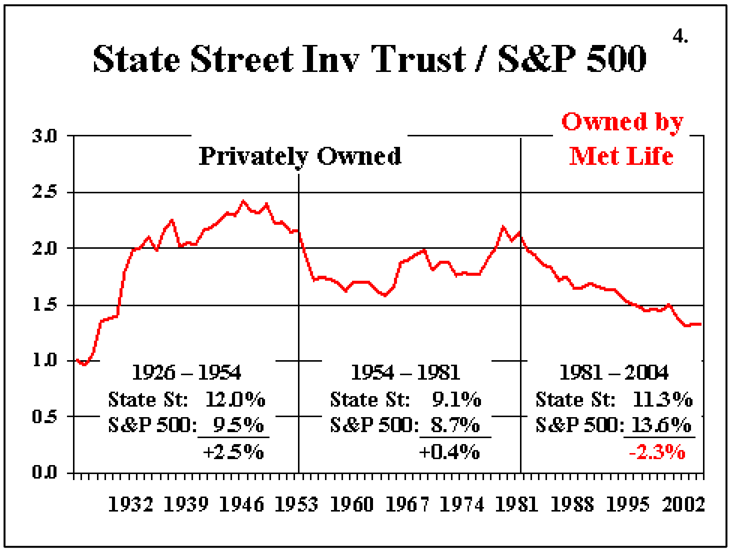
*Excludes money market funds.

Perhaps a single case study will buttress the message of these persuasive statistics on marketing focus and investment success. The second oldest fund in this industry, State Street Investment Trust, was founded in 1925. During its first three decades, its record relative to the stock market was outstanding, with its annual return of 12% during 1926-1954 nicely outpacing the 9 ½% return of the S&P 500 Index**.** (**Chart 4**. The red line charts cumulative relative performance; up is good for State Street, down is bad.) While the fund stumbled a bit during the 1954-1981 era, it more than held its own, returning 9.1% in an 8.7% market, in part because its management held to traditional prudent standards during the stock market's crazy "go-go" and favorite fifty" foolishness of 1964-1972[1]). The antithesis of a marketing firm, State Street eschewed the salesmanship game, not even offering its shares for sale for more than a half century! The firm also pretty much ignored the growing trend toward "product proliferation" in the fund industry, with State Street as its only offering—the anti-marketing firm writ large!

Then came a seminal event in the firm's history. In 1982, the management company was sold to Metropolitan Life Insurance Company, the insurance giant making a valiant attempt to broaden its, well,

[1] My salute to State Street for that discipline is especially impassioned. For I fell head over heels for the "new era" and its attendant marketing foolishness, even merging Wellington Management Company with the go-go Ivest Fund management, ultimately paying the final price for my stupid mistake: I got fired.

product line. In 1990 the shares of State Street were again offered to the public, for the first time since 1935. Under the Met's aegis, the firm started 32 new funds, largely aggressive growth equity funds.



Some of these new funds enjoyed dazzling returns during the "new economy" market madness of the late 1990s. But, sadly, they met the temper of the times, and the fund assets managed by State Street management exploded, from $500 million in 1981 to $7.5 billion as 2000 began. During the ensuing crash, however, they plummeted, and their investors lost billions of dollars of their capital. Even the once-prudent original State Street Investment Trust itself suffered market-lagging returns in the decline. All told, under the Met's ownership during 1981-2004, the fund's annual return was just 11.3%, a lag of nearly 2 ½ percentage points per year behind the market, almost completely erasing some 70 years(!) of superiority. Nearly $3 billion of investor capital poured out of the funds, reducing fund assets to $3 billion in 2004, 60% below their peak.

After two decades of stumbling so badly, the Met had had enough. In 2004, it sold the State Street management contracts to the BlackRock financial conglomerate for $375 million (a tidy profit for the Met, despite the losses incurred by its fund shareholders!), more of that very trafficking in advisory contracts that the SEC fought against all those years ago. Among BlackRock's first decisions was to kill that wounded old veteran of the mutual fund wars, merging it into a much smaller fund. The demise of State Street Investment Trust after 80 years of life—snuffing out the tradition and the long-ago excellence of this second oldest of all funds—was for this student of mutual fund history, "a death in the family."

Conglomeration as a Business Strategy

With inferior returns that reflected its failure to serve fund shareholders, the conglomerate model also appears to be failing as a business strategy. Since the end of 1999, investor cash flows have dried up for conglomerates, even as the private firms have enjoyed enormous inflows. (More about that later.) Any strategy, one must assume, that fails both fund owners *and* fund managers is, sooner or later, going to be rethought. And so it is that our profession of yore (admittedly, with some elements of a business), reborn as a business (with too few elements of a profession), is rethinking itself.

To use the conventional buzzword, the financial conglomerates are now engaged "rebranding," and often disgorgement of their fund management firms. The management company for *American*

Express funds has been spun off from its parent, and is now independent, *Ameriprise* management company managing the *RiverSource* funds. (The new firm remains publicly held, expected of course to provide high returns for its new owners.) The funds once managed by *Citigroup* have been sold to money manager *Legg Mason*, and will presumably emphasize the old *Smith Barney* name.

Last week, in an apparent attempt to eliminate the obvious conflict that exists when brokers sell their own firms' funds, *Merrill Lynch* sold its fund management company to *BlackRock*, which in turn will be about one-half owned by Merrill. [2] (This sale, I hope, will spell the death knell for Merrill's plan to rename their funds the *Princeton* funds, presumably to capitalize on the aura of intellectual strength surrounding the University and the investment excellence achieved by its Princeton Investment Management Company.) *Zurich Financial Services*, having bought the *Kemper* Funds, which then bought the *Scudder* Funds, sold the package to *Deutsche Bank*, which then renamed them all *Scudder* (don't ask me to explain!) and is now placing the whole batch under the *DWS* banner. (No, I don't know what the W stands for.) *Morgan Stanley* is also rumored to be considering some sort of separation of its fund management from its brokerage group, which, Wall Street being Wall Street, will surely be accelerated by the Merrill Lynch/BlackRock transaction.

The joint statement from Merrill and BlackRock emphasizes the creation of "one of the world's largest asset management firms," "a truly transformational opportunity" for the managers, "a strategic partnership" with "a robust operating platform," "enhanced growth prospects," and "accretive (to Merrill's earnings) assuming redeployment of capital." While the transaction has been approved by the boards of both companies, there is no mention of any approval by the boards of the mutual funds involved, nor by the fund shareholders. (I'm no lawyer, but that lack astonishes me.)

As these conglomerate transactions occur and recur, we're often told that it's a "win/win" for the parties, that it will be accretive to per share earnings, and that it will lead to asset gathering success. But I've yet to see any discussion of how the change will affect the mutual fund shareholders, chattels except for their inevitably perfunctory duty to approve the recommendation of the management of their *funds*, dominated by executives of the funds' *adviser*. The statement that I seek might read something like this:

> "We recognize that our long-term success depends entirely on our ability to serve effectively the mutual fund investors who have entrusted their hard-earned assets to us. While we cannot control the future returns delivered by the financial markets, it is well within our power to enhance the share of those returns carried by our mutual fund investors. Therefore, immediately following the completion of our combination, we will take the following steps toward achieving that goal: 1) reduce the advisory fees we charge. 2) implement fee schedules with rates that sharply decline in order that our fund owners share in the future economies of scale that will accompany the growth in assets that we expect to achieve. And 3) return the focus of our investment strategies to long-term investing rather than short-term trading, thus reducing transaction costs and taxes."

I fear that hell will freeze over before I see such a statement published.

The Challenge to the Professional Analyst

While these business developments suggest that the conglomerate model is not working in the interests of fund shareholders, I'm also concerned about the potential conflicts of interest that may exist when professional security analysts—whose responsibility is to assess, among other things, the

[2] How the obvious conflict between managing funds and distributing them would be resolved by this change is a mystery to me.

managements of the corporations whose securities they evaluate—are themselves employed, at least indirectly, by large publicly-held corporations. While I am too far removed from the scene to know whether the analysts for conglomerates operate any differently from those employed by private firms, I find myself wondering if there aren't different behavior patterns.

For example, how difficult is it to imagine that an analyst whose own parent company is relying upon unrealistically-inflated return assumptions on its pension plan might think twice before challenging the returns projected by other pension plans? Or to pursue the issue of shareholder voting access to corporate proxies when his or her own uber-boss has made it clear at the Business Roundtable that shareholders should just get out of the way and let management do its job? Or to take a stand on separating the roles of chairman of the board and president and chief executive when the owner of the analyst's parent has made it clear that's not *his* way of doing things. Or, perhaps even worse (for the analyst's career), to challenge the basis and amount of CEO compensation? Or even to be reluctant to request information from the corporation's tax returns in order to reconcile reported income with taxable income.

These are not merely peripheral issues. I raise them today even as I raised them (and many others!) in my *Battle* book. They get right to the heart of whether our corporations are to be run primarily in the interest of their managers, or primarily in the interests of their owners. So the issue posed is an important one: to what degree can the professional security analysts employed by the fund managers that are owned by giant corporations take a stand against the managers of other giant corporations and in favor of their shareowners, who just happen to be the principals of their agent—the manager who is employing that analyst. Put another way, do the investment professionals employed by the financial conglomerates offer the same due diligence in their analytical responsibilities as their peers employed by privately-held managers? I hope so, and I expect so. But I also believe that fund investors would be well-served if these subtle pressures and potential conflicts were eliminated.

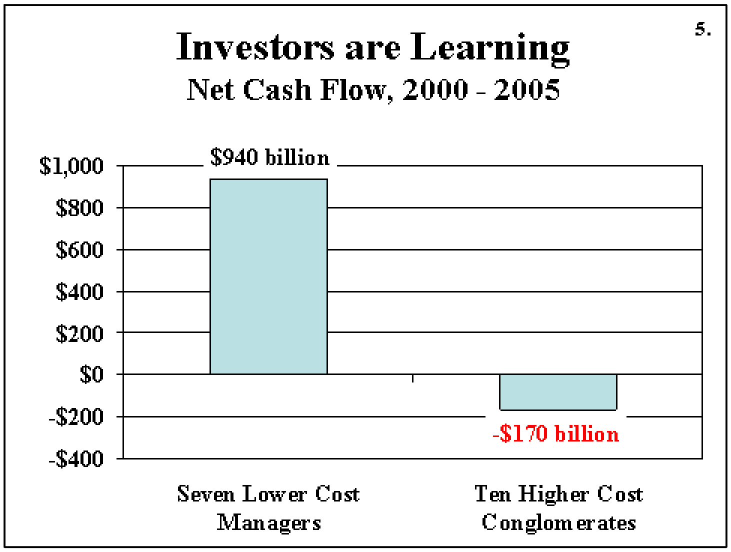
This is not to suggest that the role of the professional security analyst is not under pressure at *any* giant firm, whether private, publicly-owned, or conglomerate-controlled. Any fund management company that worships at the altar of the Great God Market Share becomes, wittingly or unwittingly, a marketing firm, even as the burden of giant size not only limits the number of stocks that can be effectively owned but places great constraints on the timely execution of portfolio transactions. Yet even the largest asset gatherers still seek "more." The pledge of today's largest manager of equity funds—as it happens, a privately-held firm—that it will continue to offer shares of its funds no matter how enormous their assets grow is an ominous warning about the pervasive drive for asset gathering and rising fee revenues for the manager's benefit, even when they come at the clear expense of the fund shareholders.

A Quick Arithmetic Lesson

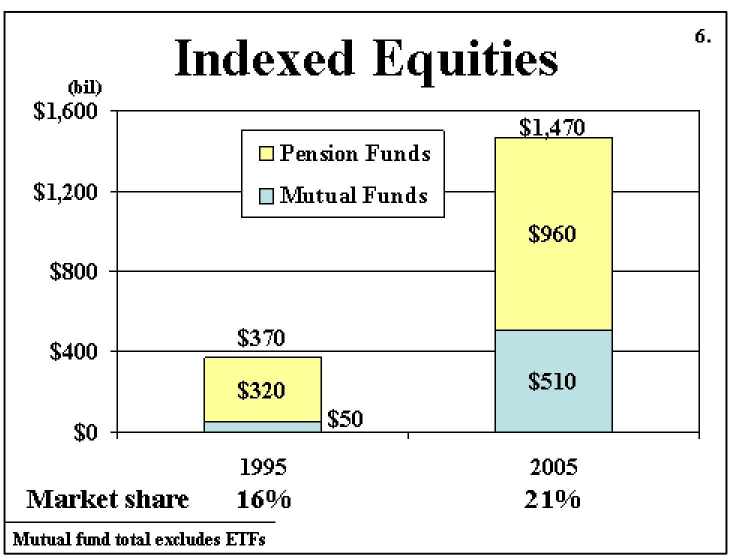
Whatever else the data on fund performance show, they show that as a group, all fund managers are average. How could it be otherwise? For, the *gross* return earned by the average fund (on an asset-weighted basis) must equal the return earned by the stock market itself. Yet because of the costs of managing funds—the management fees, the operating expenses, the marketing costs, the sales loads, the hidden costs of portfolio turnover—the net return earned by the *average fund* must fall short of the return earned by the market itself. Thus, as a group, all fund *investors* are *below* average by the amount of the costs they incur. The arithmetic is simple: *gross return minus cost equals net return.*

Even as investors are adding little to their assets in the costly funds run by conglomerate managers, they are adding hundreds of billions of dollars to their holdings in funds run by a tiny handful of relatively low-cost managers. Here, the data are truly stunning. **Chart 5.** Since the stock market peaked near the end of 1999, fully $940 billion of cash *inflow* into long-term mutual funds managed by just seven firms: *very* low-cost Vanguard and Barclays, in *low*-cost Dodge & Cox and PIMCO (largely in its bond funds), and in *below-average*-cost Capital Group, Fidelity and T. Rowe Price.

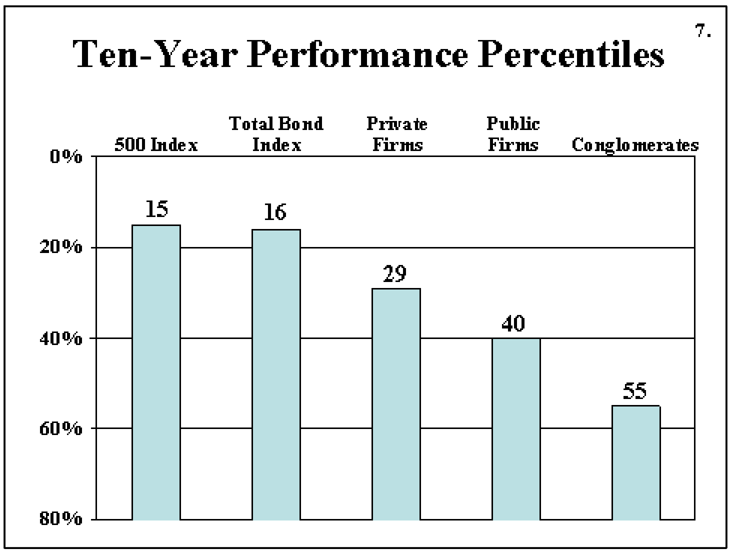
At the same time, the ten giant conglomerates who run the *higher-cost* funds—Putnam, Merrill Lynch, American Century, Scudder, MFS, JP Morgan, Dreyfus, Morgan Stanley, AIM, and Columbia (Bank of America's new brand, itself an amalgam of the half-dozen management companies it acquired over the years)—have gone essentially nowhere, some with marginal inflows, some with substantial outflows. In the aggregate they have actually experienced $170 billion of cash *outflow* from their long-term funds. To state the abundantly obvious, the fund investor is sending us a message: *cost matters*.



I can't close without commenting on the ultimate beneficiary of this *cost matters* hypothesis: *the index fund*. In the past decade, assets of classic low-cost index mutual funds. (I'm excluding here the boomlet in exchange-traded funds, traded largely for speculative purposes, which carry moderate expense ratios but high commission costs when they are bought and sold.) Since 1995, index mutual funds have grown from $50 billion (4% of equity fund assets) to $510 billion (10%). **Chart 6.** At the same time, equity index assets of the 200 largest pension funds have grown from $320 billion (30% of equities) to $960 billion (42%). In total, these indexed assets alone total nearly $1.5 trillion—21% of the equity assets of mutual funds and large pension funds.



Index funds offer no hope of beating the stock market . . . only the certainty of losing to it by the trivial amount of their costs. In short, index funds make a promise that they are almost certain to deliver on: *to guarantee investors their fair share of whatever returns over financial markets are generous enough to provide*. That guarantee, in turn, means that these passively-managed funds are irrefutably certain to out-perform most of the costly actively-managed funds in the mutual fund industry. *It is true*: In the study of performance I presented earlier, the best group—the funds run by private managers—ranked, as you will recall, in the 29^{th} percentile, the publicly-owned firms in the 40^{th}, and the conglomerates 55^{th}. **Chart 7.** By way of contrast, Vanguard's S&P 500 Index Fund ranked in the 15^{th} percentile among its peers, and the Vanguard Total Bond Market Index fund ranked in the 16^{th} percentile as well, that is, outpacing 85% and 84% of their respective peers. "The proof of the pudding is in the eating."



Yet, despite the fact that the passive index fund has enjoyed remarkable artistic success (outstanding returns relative to actively-managed funds) and equally remarkable commercial success (growth in assets), I continue to believe that its rise to acceptance has so far only scratched the surface of its potential. To me, holding 21 percent of all U.S. equity securities hardly seems like a triumph. Why not 25%? Even 50%? Whatever the case, there will surely be a "tipping point" one day, following which today's success will pale by comparison.

Yet that tipping point didn't arrive decades ago when Warren Buffett gave the index funds his blessing. Nor when the giant Federal Employees Thrift Plan cast its lot with the index fund model. Nor even when that model was the Administration's choice last year for its proposed personal savings accounts. Nor even when firms permeated with active managers who must have hated to do so, started their own, albeit high cost, index funds—T. Rowe Price, Scudder, Morgan Stanley, Merrill Lynch. Nor in 1993, when Peter Lynch said "Most investors would be better off in an index fund." Nor even when Fidelity got serious last year and slashed the fees on its index fund, signaling head-to-head price competition with index fund creator and leader Vanguard.

Nor when Harvard Endowment fund star Jack R. Meyer said, "the investment business is a giant scam. Most people think they can find managers who can outperform, but most people are wrong. (They) should simply have index funds to keep their fees low and their taxes down. *No doubt about it*." Nor, finally, even last summer when, in his new book, David Swensen, Meyer's equally able counterpart at Yale, described "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. . . . Excessive management fees take their toll," he added, "and (manager) profits dominate fiduciary responsibility." His conclusion: "invest in low-turnover, passively managed index funds . . . and stay away from profit-driven investment management organizations."

But maybe the tipping point that will awaken the mass of investors to indexing has already come, unobserved so far, from your new honorary member, Dr. Samuelson. When he spoke to you last November, you'll recall that he generously described the creation of that first index fund thirty years ago "as equal to the invention of the alphabet and the wheel," buttressing what he wrote years earlier in an endorsement to my *Common Sense on Mutual Funds*: "Index funds can enable a few million of us savers to become in twenty years the envy of our suburban neighbors—while at the same time we have slept well in these eventful times."

Even if you don't agree with my harsh assessment of today's mutual fund industry and my evaluation of the causes of its change, please at least reflect on what I've said. For change is on the way . . . maybe even the long-awaited tipping point. Be ready!

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