

The Mutual Fund Industry 60 Years Later: For Better or Worse?

**Remarks by John C. Bogle
Founder and Former Chairman, The Vanguard Group
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The mutual fund industry has undergone tremendous change in the past 60 years. Total assets, number of funds, and fund costs have increased exponentially, while both the duration of the funds' portfolio holdings and the duration of their shareholders' holdings have tumbled. The industry's ownership of corporate stocks is at an all-time high, yet mutual fund managers have been noticeably absent from the corporate governance debate. This article details 10 fundamental changes that have taken place in the mutual fund industry since 1945 and finds that, in the aggregate, they have benefited mutual fund managers to the direct and commensurate detriment of mutual fund investors.

Over the course of the past 60 years, the mutual fund industry has undergone tremendous change. In 1945, it was a tiny industry offering a relative handful of funds—largely diversified equity and balanced funds. As 2005 begins, it is a multi-trillion-dollar titan offering thousands of funds with a dizzying array of investment policies and strategies. I have been actively engaged in this field since 1949—fully 55 years of the *Financial Analyst Journal's* 60-year existence—when I researched and then wrote my Princeton University senior thesis about mutual funds. I have spent my entire career in the mutual fund industry.

The staggering increase in the size of the industry and the huge expansion in the number and types of funds are but the obvious manifestations of the radical changes in the mutual fund industry. It has also undergone a multifaceted change in character. In 1945, it was an industry engaged primarily in the profession of serving investors and striving to meet the standards of the recently enacted Investment Company Act of 1940, which established the policy that funds must be "organized, operated, and managed" in the interests of their shareholders rather than in the interests of their managers and distributors. It was an industry that focused primarily on stewardship. Today, in contrast, the industry is a vast and highly successful marketing business, an industry focused primarily on salesmanship. As countless independent commentators have observed, asset gathering has become the fund industry's driving force.

Beneath the surface of this broad change lie numerous specific developments. This essay reviews 10 of the major changes that have taken place in the mutual fund industry during the past 60 years, and then evaluates the impact of those changes, not only on the returns earned by the mutual funds themselves, but on

the returns earned by their investors.

1. Bigger, More Varied, and More Numerous

The mutual fund industry has become a giant. [\(1\)](#) From a base of \$882 at the beginning of 1945, fund assets soared to \$7.5 trillion in 2004, a compound annual growth rate of 16 percent. If the industry had merely matched the 7 percent nominal growth rate of our economy, assets would be only \$50 billion today. (Such is the magic of compounding!) In 1945, 90 percent of industry assets were represented by stock funds and stock-oriented balanced funds. Today, such funds compose about 57 percent of industry assets. Bond funds now represent 17 percent of assets, and money market funds—dating back only to 1970—constitute the remaining 26 percent. So, what was once an equity fund industry now spans all three broad categories of marketable securities—stocks, bonds, and money market instruments. This change has been a boon to fund investors as well as to fund managers.

As [Table 1](#) shows, the number of funds has also. The 68 mutual funds of yesteryear have multiplied to today's nearly 8,200, and they offer investment objectives and policies designed to meet almost any imaginable investment goal. As funds have become, overwhelmingly, the investment of choice for our nation's families, fund choice, fund selection, and asset allocation have become the watchwords of today's mutual fund industry.

Table 1. The Mutual Fund Industry: Growth in Funds and Assets

Type of Fund	1945		2004	
	Number of funds	Assets [mil]*	Number of funds	Assets [bil]
Stock/hybrid funds	49	\$794.0	5,100	\$4,267
Bond funds	19	88.0	2,100	1,247
Money market funds	0	-0-	970	1,962
Total	68	\$882	8,170	\$7,476

*Total assets of stock funds in 1945 are estimated as 90% of industry total.

Source: Wiesenberger and Investment Company Institute.

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The vehicles through which mutual funds are purchased have also changed. Funds are the underlying securities in variable annuities and, thanks to favorable federal tax legislation, are now held not only directly by investors but also in individual retirement accounts and in profit-sharing and employee savings plans. Assets in these tax-deferred plans today total \$2.7 trillion, or nearly 40 percent of industry assets. [\(2\)](#)

2. Stock Funds: To the Four Corners of the Earth

Stock funds remain the industry's backbone and driving force, and are the principal focus of this historical review. As their number soared, so did the variety of objectives and policies they follow. As [Table 2](#) shows, in 1945, the stock fund sector was dominated by funds that invested largely in highly diversified portfolios of U.S. corporations with large market capitalizations and with volatility roughly commensurate with that of the stock

market itself. Today, such middle-of-the-road funds are a distinct minority, and most other categories entail higher risks. Only 579 of the 4,200 stock funds measured by Morningstar now closely resemble their widely diversified blue-chip ancestors. [\(3\)](#)

Table 2. Stock Funds: Number and Type

Category	1945		2004 ^a	
	No. of Funds	% of Total	No. of Funds	% of Total
U.S. Large-cap blend	38	77%	579	14%
Other U.S. diversified equity	0	—	2,484	59
Specialized	11	23	455	11
International	0	—	686	16
Total	49	100%	4,204	100%

^aIncludes all equity funds covered by Morningstar.

Source: Wiesenberger and Morningstar.

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What's more, the industry now also boasts 455 specialized funds focused on narrow industry segments—from technology to telecommunications (these two groups were particular favorites during the late stock market bubble). Some 686 international funds run the gamut from diversified funds owning shares of companies all over the globe to highly specialized funds focusing on particular nations, such as China, Russia, or Israel.

Sixty years ago, an investor could have thrown a dart at a broad listing of stock funds and had three chances out of four of picking a fund whose return was apt to closely parallel that of the U.S. stock market. Today, that investor has just one chance out of seven. For better or worse, the selection of mutual funds has become an art form. Indeed, it is fair to say that choosing a mutual fund has come to require the same assiduous analysis as selecting an individual common stock. Indeed, most investors now hold portfolios of *funds* rather than yesteryear's portfolios of *stocks*. [\(4\)](#)

One curious counterpoint to this trend is worth noting. Unmanaged index funds essentially representing the entire U.S. stock market (through the Wilshire Total Stock Market Index or the Standard & Poor's Composite Stock Price Index) did not enter the field until 1975, but they have accounted for more than one-third of equity fund cash inflow since 2000 and now represent fully one-seventh of equity fund assets. [\(5\)](#) Such funds may be said to provide the *n*th degree of diversification.

3. Investment Committee to Portfolio Manager

The vast changes in fund objectives and policies have been accompanied by equally vast changes in how mutual funds are managed. In 1945, the major funds were managed almost entirely by investment committees. But the demonstrated wisdom of the collective was soon overwhelmed by the perceived brilliance of the individual. The Go-Go Era of the mid-1960s and the recent so-called New Economy bubble brought us hundreds of ferociously aggressive "performance funds," and the new game seemed to call for free-wheeling individual talent. The term "investment committee" virtually vanished, and the "portfolio manager" gradually became the industry standard, the model for some 3,387 of the 4,194 stock

funds currently listed in Morningstar, as [Table 3](#) reports. ("Management teams," often portfolios overseen by multiple managers, are said to run the other 807 funds.)

The coming of the age of the portfolio manager whose tenure lasted only as long as the individual produced superior performance moved fund management from the stodgy old consensus-oriented investment committee to a more entrepreneurial, free-form, aggressive (and less risk-averse) investment approach. Before long, moreover, the managers with the hottest short-term records were publicized by their firms, and with the cooperation of the media, turned into "stars." A full-fledged star system gradually came to pass. A few portfolio managers actually *were* stars—Fidelity Investment's Peter Lynch, Vanguard's John Neff, Legg Mason's Bill Miller, for example—but most proved to be comets, illuminating the fund firmament for but a moment before flaming out. Even after the devastation of the recent bear market and the stunning fact that the average manager now lasts for only five years, the portfolio manager system remains largely intact. The continuity provided by the earlier investment committee is but a vestige of memory.

Table 3. Equity Fund Management Modes

Type	1945	2004
Committee	47	0
Single portfolio manager	2	3,387
Management team	0	807
Total	49	4,194

Note: No management form was listed for 10 funds in 2004.

Source: Wiesenberger and Morningstar.

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4. Investment or Speculation?

Together, the coming of more aggressive funds, the burgeoning emphasis on short-term performance, and the move from investment committee to portfolio manager had a profound impact on mutual fund investment strategies, most obviously in soaring portfolio turnover—as shown in [Table 4](#). In 1945, mutual fund managers did not *talk* about long-term investing. They simply *did* it. That's what trusteeship is all about. But over the next 60 years, that basic tenet was turned on its head and short-term speculation became the order of the day.

Not that the long-term focus did not resist change. Indeed, between 1945 and 1965, annual portfolio turnover averaged a steady 17 percent, suggesting that the average fund held its average stock for about six years. But turnover then rose steadily; fund managers now turn their portfolios over at an average rate of 110 percent annually. Result: Compared with the six-year standard that prevailed for some two decades, the average stock is now held by the average fund for an average of only 11 months.

Table 4. Equity Fund Portfolio Turnover Rates

Year	Rate
1945	24% (est.)
1950	25
1955	14
1960	14
1965	20
1970	39
1975	36
1980	51
1985	83
1990	90
1995	77
2000	108
2003	110
2004 ^a	112

^a2004 data are for all funds that had reported as of 31 October.

Turnover: The lesser of portfolio sources or sales as a percentage of fund assets.

Sources: 1945-1987: Investment Company Institute, based on industry aggregates. 1988-2004: Morningstar, based on turnover of average equity fund.

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Moreover, turnover rates do not tell the full story of the role of mutual funds in the financial markets. The dollars involved are enormous. For example, at a 100 percent rate, today's managers of \$4 trillion in equity assets would sell \$4 trillion of stocks in a single year and then reinvest that \$4 trillion in other stocks, \$8 trillion in all. Even though more competitive (and increasingly electronic) markets have slashed unit transaction costs, it is difficult to imagine that such turnover levels, in which trades often take place between two competing funds, can result in a net gain to fund shareholders collectively.

If a six-year holding period can be characterized as long-term investment, and if an 11-month holding period can be characterized as short-term speculation, mutual fund managers today are not investors. They are speculators. I do not use the word "speculation" lightly. Nearly 70 years ago, John Maynard Keynes contrasted *speculation* ("forecasting the psychology of the market") with *enterprise* ("forecasting the prospective yield of an asset") and predicted that the influence of speculation among professional investors would rise as they emulated the uninformed public—that is, seeking to anticipate changes in public opinion rather than focusing on earnings, dividends, and book values.

In my 1951 thesis on the mutual fund industry, I was bold enough to disagree with Keynes' baleful prediction. As funds grew, I opined, they would move away from speculation and move toward enterprise by focusing, not on the momentary, short-term price of the share, but on the long-term intrinsic value of the corporation. As a result, I concluded, fund managers would supply the stock market "with a demand for securities that is steady, sophisticated, enlightened, and analytic." I could not have been more wrong. Mutual funds, once stock *owners*, became stock *traders* and moved far away from what Warren Buffett describes as his favorite holding period: Forever.

5. America's Largest Shareholders

In 1945, as [Table 5](#) shows, funds owned only slightly more than 1 percent of the shares of all U.S. corporations. Today, they own nearly 25 percent. They could wield a potent "big stick" but, with a few exceptions, have failed to do so. With their long record of passivity and lassitude about corporate governance issues, fund managers must accept a large share of the responsibility for the ethical failures in corporate governance and accounting oversight that were among the major forces creating the recent stock market bubble and the bear market that followed.

Table 5. Mutual Fund Ownership of U.S. Stocks

Year	Percent of Equities Owned
1945	1.4%
1950	3.1
1955	3.3
1960	4.8
1965	5.7
1970	6.2
1975	4.9
1980	3.0
1985	5.2
1990	8.1
1995	16.0
2000	22.4
2003	23.1
2004 ^a	24.9

^a2004 data are as of 30 June.
Source: NYSE, Wilshire Associates, and Federal Reserve Flow of Funds Report.

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It was not always this way. In the old days, when mutual funds were responsible owners, the 1949 *Fortune* article that inspired my ancient thesis described them as "the ideal champion of . . . the small stockholder in conversations with corporate management, needling corporations on dividend policies, blocking mergers, and pitching in on proxy fights." [\(6\)](#)

Indeed, in 1940, the SEC called on mutual funds to serve as "the useful role of representatives of the great number of inarticulate and ineffective individual investors in corporations in which funds are interested." [\(7\)](#)

It was not to be. Once an own-a-stock industry, funds became a rent-a-stock industry. The change in the industry's focus from investment to speculation can hardly be unrelated to its failure to observe the responsibilities of corporate citizenship. A fund that acts as a trader, focusing on the price of a share and holding a stock for less than a year, may not even own a company's shares when the time comes to vote them at the corporation's next annual meeting. In contrast, a fund that acts as an owner, focusing on the long-term value of the enterprise, has little choice but to regard the governance of the corporation as of surpassing importance.

6. Compressed Investor Holding Periods

The change in the mutual fund industry's character has radically affected the behavior of the mutual fund shareholder. Sixty years ago, shareholders bought shares in broadly diversified

funds and held them. As [Table 6](#) shows, in the 1950s and for a dozen years thereafter, fund redemptions (liquidations of fund shares) averaged 6 percent of assets annually, which suggests that the average fund investor held his or her shares for 16 years. Like the managers of the funds they owned, shareholders were investing for the long pull.

But as the industry introduced new funds that were more and more performance oriented, often speculative, specialized, and concentrated—funds that behaved increasingly like individual stocks—it attracted more and more investors for whom the long term didn't seem to be relevant. By 2002, the redemption rate had soared to 41 percent of assets, an average holding period of slightly more than three years. The time horizon for the typical fund investor had tumbled by fully 80 percent.

Table 6. Annual Turnover of Shares by Equity Fund Investors

Year	Shares Redeemed as Percent of Assets
1945	10.1%
1950	12.5
1955	6.4
1960	5.1
1965	6.1
1970	6.2
1975	9.7
1980	22.8
1985	36.5
1990	38.2
1995	29.3
2000	39.6
2002	41.0
2003	30.9
2004 ^a	24.8

^a2004 data are through September, annualized.

Source: Wiesenberger and Investment Company Institute.

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Much of this reduction in investor holding periods, we now know, resulted from the pervasive use of timing strategies by investors that were based on such aspects as time-zone trading. Following the timing scandals that were revealed late in 2003, however, fund managers tightened up their controls designed to preclude excessive trading in fund shares, and the shareholder redemption rate has tumbled to about 25 percent; nonetheless, the resulting average holding period is just four years.

As the old buy-and-hold mantra turned to "pick and choose," *freedom of choice* became the industry watchword, and "fund supermarkets" with their "open architecture" made moving quickly from one fund to another easy. The cost of these transactions was hidden in the form of access fees for the shelf space offered by these supermarkets. Access fees are paid by the funds themselves, so swapping funds seems to be free, which tacitly encourages shareholders to trade from one fund to another. But although picking tomorrow's winners based on yesterday's performance is attractive in theory, there are no data that suggest the strategy works in practice. Quite the contrary!

7. New Funds Appear, Old Funds Vanish

Part of the astonishing telescoping of holding periods can be traced to opportunistic, gullible, and emotional fund investors as well as the change in the character of our financial markets (especially in the boom and bust of the stock market bubble during 1997–2002). But by departing from the industry's time-honored tenet of "we sell what we make" and jumping on the "we make what will sell" bandwagon—that is, creating new funds to match the market fads of the moment—this industry must also assume much responsibility for the soaring investment activity of fund investors.

As [Table 7](#) reports, the 1990s were a banner decade for fund formation; 1,600 new general equity funds alone came into existence, which was more than twice the number of funds in existence at the decade's outset. And the new funds typically carried higher risks than their predecessors. As New Economy stocks led the market upward in the latter part of the decade, mutual fund managers formed 494 new technology, telecom, and Internet funds and aggressive growth funds favoring these sectors. [\(8\)](#)

Not only did the industry create such funds, it marketed them with unprecedented vigor and enthusiasm, both through stockbrokers and through advertising. At the market's peak in March 2000, the 44 mutual funds that advertised their performance in *Money* magazine bragged about amazing returns averaging +85.6 percent during the previous 12 months. During 1998–2000, equity funds took in \$650 billion of new money—well over half a trillion dollars—overwhelmingly invested in the new breed of speculative, high-performance, aggressive growth funds. [\(9\)](#) Most of the money, of course, poured into those winners of yesteryear *after* they led the market upward. They would also soon lead the market on its subsequent downward leg, with their shareholders suffering losses of hundreds of billions of dollars.

Table 7. Formation and Liquidation of Equity Funds

Decade	No. of New Funds	Fund Creation Rate	No. of Dying Funds	Fund Failure Rate
1950s	28 (est.)	80% (est.)	10 (est.)	13%
1960s	211	88	37	21
1970s	123	34	202	61
1980s	534	110	78	17
1990s	1,604	125	462	36
2000s ^a	980	52	1,045	56

Note: Creation and failure rates for each decade are summed annual rates.

^aFigures for the 2000 decade represent the first four years annualized.

Source: CRSP database and author's estimates.

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After the fall, the formation of opportunistic new funds began to unwind and a record number of funds went out of business, usually merging into other, better-performing funds in the same family. During 1994–2003, fully 1,900 funds vanished—largely, the New Economy funds. The conservative equity funds of six decades ago were, as the saying goes, "built to last," whereas their aggressive new cousins seemed "born to die." The 10–20 percent failure rates that characterized

the decades of the 1950s to the 1980s (except for the 1970s, following the 1973–74 bear market) reached 36 percent during the 1990s. Should present fund dissolution rates continue, some 2,800 of today's equity funds—more than one-half—will no longer exist a decade hence.

8. Cost of Fund Ownership

In 1945, as [Table 8](#) shows, the average expense ratio (total management fees and operating expenses as a percentage of fund assets) for the largest 25 funds, with aggregate assets of but \$700 million, was 0.76 percent, generating aggregate costs of \$4.7 million for fund investors. Six decades later, in 2004, the assets of the equity funds managed by the 25 largest fund complexes had soared to \$2.5 trillion, but the average expense ratio had soared by 105 percent to 1.56 percent, generating costs of \$31 billion.⁽¹⁰⁾ In other words, while their assets were rising 3,600-fold, costs were rising 6,600-fold. (The dollar amount of direct fund expenses borne by shareholders of all equity funds has risen from an estimated \$5 million annually in the 1940s to something like \$35 billion in 2004, or 7,000-fold.) Despite the substantial economies of scale that exist in mutual fund management, fund investors have not only *not* shared in these economies, they have actually incurred higher costs of ownership.

Table 8. Direct Costs of Fund Ownership: 25 Largest Fund Managers

Measure	1945	2004	Change
Total assets	\$0.7 billion	\$2,500 billion	3,600×
Fees and operating expenses* (est.)	\$4.7 million	\$31 billion	6,600×
Average expense ratio	0.76%	1.56%	+105%

*Excluding portfolio transaction costs, sales charges, and opportunity costs.

Source: Wiesenberger and Strategic Insight.

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Some of that enormous rise in the average expense ratio is a result of the inclusion of marketing expenses paid for by the fees allowed under Rule 12-b(1) of the Investment Company Act of 1940 adopted in 1980. These distribution fees have, in part, replaced traditional front-end sales charges. And although reductions in management fees that fully reflect the economies of scale are virtually nonexistent, investors have increasingly chosen no-load funds and low-cost funds. When portfolio transaction costs—an inseparable part of owning most funds—are added to expense ratios and sales charges, however (plus fees paid to financial advisers to select funds, which have also partly replaced earlier front-end loads), the costs of mutual fund ownership remain a substantial impediment to the ability of equity funds and their shareholders to capture the returns generated by the stock market.

9. Rise of Fund Entrepreneurship

Sixty years ago, the mutual fund industry placed its emphasis on fund management as a profession—the

trusteeship of other people's money. Today, there is much evidence that salesmanship has superseded trusteeship as our industry's prime focus. What was it that caused this sea change? Perhaps trusteeship was essential for an industry whose birth in 1924 was quickly followed by tough times—the Depression and then World War II. Perhaps salesmanship became the winning strategy in the easy times thereafter, an era of almost unremitting economic prosperity. Probably, however, the most powerful force behind the change was that mutual fund management emerged as one of the most profitable businesses in our nation. Entrepreneurs could make big money managing mutual funds.

In 1958, only 13 years after the inaugural issue of the *FAJ*, the whole dynamic of entrepreneurship in the fund industry changed. Until then, a trustee could make a tidy profit by managing money but could not *capitalize* that profit by selling shares of the management company to outside investors. The S.E.C. held that the sale of a management company represented payment for the sale of a fiduciary office, an illegal appropriation of fund assets. If such sales were allowed, the S.E.C. feared, it would lead to "trafficking" in advisory contracts, a gross abuse of the trust of fund shareholders. But a California management company challenged regulatory agency's position. The S.E.C. went to court—and lost.

Thus, as 1958 ended, the gates that had prevented public ownership since the industry began 34 years earlier came tumbling down. A rush of initial public offerings followed, with the shares of a dozen management companies quickly brought to market. Investors bought management company shares for the same reasons that they bought Microsoft Corporation and IBM Corporation and, for that matter, Enron: Because they thought their earnings would grow and their stock prices would rise accordingly.

The IPOs were just the beginning. Publicly-held and even privately-held management companies were acquired by giant banks and insurance companies that were eager to take the new opportunity to buy into the burgeoning fund business at a healthy premium (averaging 10 times book value or more). The term "trafficking" was not far off the mark; there have been at least 40 such acquisitions during the past decade alone, and the ownership of some fund firms has been transferred numerous times. Today, among the fifty largest fund managers, only eight remain privately held (plus mutually-owned Vanguard). Six firms are publicly held, and the remaining thirty-five management companies are owned by giant financial conglomerates—twenty-two by banks and insurance companies, six by major brokerage firms, and seven by foreign financial institutions.

Obviously, when a corporation buys a business, fund manager or not, it expects to earn a hurdle rate on its capital. So, if the cost of an acquisition is \$1 billion, and the hurdle rate is 12 percent, the acquirer will require at least \$120 million of annual earnings. In a bull market, that goal may be easy for a mutual fund firm to

achieve. But when the bear comes, we can expect a combination of (1) cutting management costs, (2) adding new types of fees (distribution fees, for example), (3) maintaining, or even increasing, management fee rates, and even (4) getting the buyer's capital back by selling the management firm to another owner (the SEC's trafficking in advisory contracts writ large).

It would be surprising if this shift in control of the mutual fund industry from private to public hands, largely those of giant financial conglomerates, had *not* accelerated the industry's change from profession to business. Such staggering aggregations of managed assets—often hundreds of billions of dollars under a single roof—surely serves both to facilitate the marketing of a fund complex's brand name in the consumer goods market and to build its market share. Conglomeration seems unlikely to make the money management process more effective, however, nor to drive investor costs down, nor to enhance the industry's original notion of stewardship and service.

10. Scandal

For 78 years—from its start back in 1924 through 2002—the mutual fund industry was free of major taint or scandal. But as asset-gathering became the name of the game, as return on managers' capital challenged return on fund shareholders' capital as the preeminent goal, as conglomeration became the dominant structure, and as stewardship took a backseat to salesmanship, many fund managers were not only all too willing to accept substantial investments from short-term investors and allow those investors to capitalize on price differentials in international time zones, as well as engage in other unrelated but profitable activities. They were also willing to abet and even institutionalize these practices.

To improve their own earnings, managers put their own interests ahead of the interests of their fund shareholders. They allowed short-term traders in their funds to earn illicit higher returns at a direct, dollar-for-dollar cost to their fellow investors holding for the long-term. Brought to light by New York Attorney General Eliot L. Spitzer in September 2003, the industry's first major scandal went well beyond a few bad apples. More than a score of firms, managing a total \$1.6 trillion of fund assets, including some of the oldest, largest, and once most respected firms in the industry, have been implicated in wrongdoing. This scandal exemplifies the extent to which salesmanship has triumphed over stewardship.

11. For Better or Worse?

Clearly, the mutual fund industry of 2005 is different not only in degree but in kind from the industry of 60 years earlier—indefinitely larger and more diverse, with more speculative funds focused on ever-shorter investment horizons. It is less aware of its responsibility for corporate citizenship; its funds are held by investors for shorter time periods; and it is far more focused on asset gathering and marketing. The fund industry is

increasingly operated as a business rather than a profession and, despite the awesome increase in its asset base, has far higher unit costs. The culmination of these changes is a scandal that crystallizes the extent to which the interest of the managers has superseded the interest of fund shareholders. Way back in 1967, Nobel Laureate Paul Samuelson was smarter than he could have imagined when he concluded, "there was only one place to make money in the mutual fund business—as there is only one place for a temperate man to be in a saloon, behind the bar and not in front of it . . . so I invested in a management company." [\(11\)](#)

Determining how well the investor—the intemperate customer on the other side of the bar in that saloon—has been served by the old industry versus by the new—is a fairly simple statistical matter. Although equity fund shareholders have, of course, made substantial profits during the industry's modern era, [Table 9](#) shows that the profits have been but a small fraction of what they could have captured simply by buying and holding a low-cost all-U.S.-equity index fund.

- In 1945–1965, the average fund delivered 89 percent of the market's annual return. The small shortfall that did exist between the annual rate of return of the average equity fund and that of the S&P 500 Index was doubtless largely accounted for by the moderate costs of fund ownership in those two decades.
- In 1983–2003, with the shortfall at 2.7 percentage points, the average fund delivered only 79 percent of the market's annual return.

That a consistent gap exists between equity fund returns and stock market returns should not be a surprise. For in the long run, the record is clear: Equity mutual funds are commodities (and with relatively low survival rates, at that) that are differentiated largely by their costs. After all, with fund managers competing among themselves in selecting stocks, aggregate equity fund returns must inevitably parallel those of the equity market itself and thus fall short of those returns by the amount of their management, marketing, and turnover costs.

Although the data are lacking to account with precision for the gap between stock market returns and equity fund returns, the 20-year differentials between the return of the average fund and the index in both the old era and the new—as well as the increase in the spread—appear to be largely, if not entirely, a result of fund costs. For example, in the 1945–65 period, equity fund expense ratios averaged about 0.8 percent and the cost of portfolio turnover (averaging about 16 percent a year) added perhaps another 0.8 percent, producing a 1.6 percent total, very close to the 1.7 pp lag shown in Table 9. In the 1983–2003 period, the average expense ratio was about 1.4 percent, portfolio turnover (90 percent annually on the average but at much lower unit trading costs than in the earlier period) added an estimated 1.0

percent, for a 2.4 percent cost, again very close to the 2.7 pp lag. (Because funds are rarely fully invested in stocks, opportunity costs may well account for the remaining differences between the cost and the shortfall. [\(12\)](#))

So, it is largely the increase in fund costs that led to the substantial reduction shown in Table 9 in the share of the stock market's return earned by the average equity fund. [\(13\)](#) But the average equity fund *shareholder* has fared far worse. Based on studies comparing traditional time-weighted (per share) returns and dollar-weighted (investor) returns over the past decade, the average fund investor earned an annual return fully 2.4 pps less than that of the average fund.

Table 9. Mutual Fund Returns vs. the Stock Market

Measure	1945-1965	1983-2003
Stock market return ^a	14.9%	13.0%
Average equity fund return	13.2%	10.3%
Shortfall	1.7 pps	2.7 pps
Fund share of market return	89%	79%

^aS&P 500.

Source: Lipper. Fund return in the second period was reduced by 0.3 percentage points as a minimal estimate of survivorship bias.

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The change in the industry's character bears a heavy responsibility for the reduced earnings of the average fund shareholder. First, because shareholders investing in equity funds have paid a heavy timing penalty: They invested too little of their savings in equity funds when stocks represented good values during the 1980s and early 1990s. Then, enticed by the great bull market and the wiles of mutual fund marketers as the bull market neared its peak, they invested too much of their savings in equity funds. Second, they have paid a *selection* penalty by pouring money into aggressive growth funds investing in the New Economy during the bubble while withdrawing money from value funds favoring the Old Economy.

While the stock market was providing an annual return of 13 percent during the past 20 years and the average equity fund was earning an annual return of 10.3 percent, the average fund *investor* (assuming that the 2.4 pp shortfall prevailed for the full period) was earning only 7.9 percent a year. Compounded over two decades, the 2.7 percent penalty of costs was huge. But the penalty of *character* was almost as large—another 2.4 pps. [Table 10](#) shows that \$1.00 invested in the market and compounded at 13 percent grew to \$11.50; the investor's \$1.00 grew to \$4.57, at best a modest reward for assuming the risks of equity investing during a period in which the stock market was providing returns well above long-term norms.

Table 10. Comparison of Market Returns, Fund Returns, and Investors Returns, 1983-2003

Measure	Annual Return	Growth of \$1.00
Stock market return	13.0%	\$11.50
Average equity fund return	10.3%	7.10
Gap between average fund and market	2.7 pps	4.40
Estimated equity fund investor return*	7.9%	4.57
Gap between average investor and average fund	2.4 pps	2.53
Total gap between average investor and market	5.1 pps	6.93

*Author's calculation based on an analysis comparing *time-weighted* returns with the *dollar-weighted* returns earned by the fund investors for 600 general equity funds during 1993-2003.

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The point of this statistical examination of the returns earned by the stock market, the average fund, and the average fund owner is not precision, but direction. Whatever the precise data, the evidence is compelling that equity fund returns lag the stock market by a substantial amount, largely accounted for by cost, and that fund investor returns lag fund returns by a substantial amount, largely accounted for by counterproductive market timing and fund selection.

12. Where Do We Go from Here?

In the aggregate, the tens of millions of our citizens who have entrusted their hard-earned trillions to the care of mutual fund managers have not been well served by the myriad changes that have taken place in mutual funds during the past 60 years.. What about mutual funds yet to come? My answer should not surprise you: It is time to go back to our roots; to put mutual fund shareholders back in the driver's seat, to return to the principles of the 1940 Investment Company Act and demand that funds be organized, operated, and managed in the interest of their shareholders rather than the interest of their managers and distributors.

Some of the steps that must be taken would be relatively painless for fund managers—reducing turnover costs by, for example bringing turnover rates down to reasonable levels—and some would be rather painful—reducing management fees and sales commissions and cutting operating and marketing costs. Because there is no reason to expect that today's \$7.5 trillion fund industry can increase the portion of the market's returns earned by their funds by suddenly finding the ability to provide market-superior returns (after all, fund managers are essentially competing with one another), such cost reductions are the only realistic way to enhance the returns of the average fund.

To enhance the share of fund returns earned by fund *shareholders*, the industry needs to reorder its product strategies to focus once again on broadly diversified funds with sound objectives, prudent policies, and long-term strategies. The industry needs to take its foot

off the marketing pedal and press down firmly on the stewardship pedal. At the same time, the industry must give investors better information about asset allocation, fund selection, risks, potential returns, and costs—all with complete candor. To do otherwise will doom the industry to a dismal future. For whatever the profession, finally, the client must be served. Whatever the business, finally, the customer must be served. As an article in a recent issue of *Fortune* quoted me as saying, "Of course there's hope (the industry will change). There's a guarantee it will get better. Investors won't act contrary to their own economic interests forever." [\(14\)](#)

The need for change is obvious; the steps that must be taken equally obvious. It is high time for the mutual fund industry to return funds present to funds past, to restore the industry to its original character of stewardship and prudence. If funds come to refocus on serving shareholders—serving them "in the most efficient, honest, and economical way possible," as I wrote in my thesis 54 years ago—the future for this industry will be not simply bright but brilliant.

1- The term "mutual fund" refers to open-end investment companies with redeemable shares, registered under the Investment Company Act of 1940 with the U.S. Securities and Exchange Commission. [back](#)

2- These data are from the Investment Company Institute's *2004 Mutual Fund Fact Book*. [back](#)

3- Today's accepted terminology for equity funds reflects this change. We have come to accept a nine-box matrix of funds arranged by market capitalization (large, medium, or small) on one axis and by investment style **(growth, value, or a blend of the two) on the other. Yesterday's middle-of-the-road funds would today find themselves in the "large-cap blend" box, which now constitutes only 14 percent of the equity funds in the Morningstar database.** [back](#)

4- Sign of the times: As the public interest moved from individual stocks to stock funds, the New York Times took appropriate action. On 30 June 1999, the daily mutual fund price listings were moved ahead of those of the NYSE and NASDAQ. Several years later, only the fund listings remained in the main financial section. [back](#)

5- Strategic Insight Mutual Fund Research and Consulting. [back](#)

6- December 1949 *Fortune* magazine, page 118. [back](#)

7- SEC's 1940 "Investment Trusts and Investment Companies," Part 2, p 371. [back](#)

8- Strategic Insight. [back](#)

9- 2004 *Mutual Fund Fact Book*. [back](#)

10- Asset-weighted expense ratios were used in calculating total costs. [back](#)

11- June 1969 issue of "Notre Dame Lawyer," page 918. [back](#)

12- If stock returns average 12 percent and U.S. T-bills average 4 percent, the

8 percent spread on an average 5 percent cash position would represent an opportunity cost of 40 basis points. In any event, the fund returns exclude the impact of front-end sales charges, and therefore are overstated in both comparisons. [back](#)

13- Federal and state income taxes represent yet a further toll on the returns earned by taxable fund shareholders. High portfolio turnover generates considerable tax inefficiency; during the past 15 years, equity fund after-tax returns lagged pretax returns by 2.2 pps a year—an additional burden that nearly doubled the confiscatory impact of the other fund costs. [back](#)

14- Jan 23 2003 issue, page 113. [back](#)

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

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