

After the Fall: What's Next for the Stock Market and the Mutual Fund Industry?

**Remarks by John C. Bogle
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at the National Press Club
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Wow! Late last December, when I accepted the National Press Club's invitation to speak today, I selected a theme that would reflect my expectation that the stock market would continue to fall. But I surely didn't expect it to fall this far, this fast!

Since December, however, U.S. stocks have moved into the worst "bear market"—a decline of at least 20% from high to low—since 1987. It has now lasted fully twelve months, the second longest bear market since the 21-month, 50% drop from the January 1973 high to the October 1974 low. In all, the aggregate value of U.S. equities has tumbled by nearly \$5 *trillion*, from \$17 trillion a year ago to just over \$12 trillion currently.

The brunt of the decline has been borne by technology stocks, the mainstay of the NASDAQ Index. That volatile index has tumbled from 5048 a year ago to 1857 at yesterday's low, a 63% drop that clearly confirms that the bubble in New Economy stocks has burst. The large-stock-dominated Standard & Poor's 500 Stock Index, a much broader representation of the *total* market, is now off 24% from its high. You can get a pretty good idea of the nature of the decline by observing that technology stocks, representing 34% of the value of the S&P 500 a year ago, constitute just 19% today.

A Bubble About to Burst

How did the huge technology-led bubble come to pass? A once-in-a-generation combination of a booming economy and the optimism of the new millennium; the ebullience engendered by a quarter-century without a single protracted market decline; a time of unity (mostly) in the U.S. and peace (mostly) around the globe; robust growth in "operating" corporate earnings (but not without some aggressive earnings management); and the siren song of a New Era—"the Information Age"—with growth projections for high tech companies that lost all touch with reality.

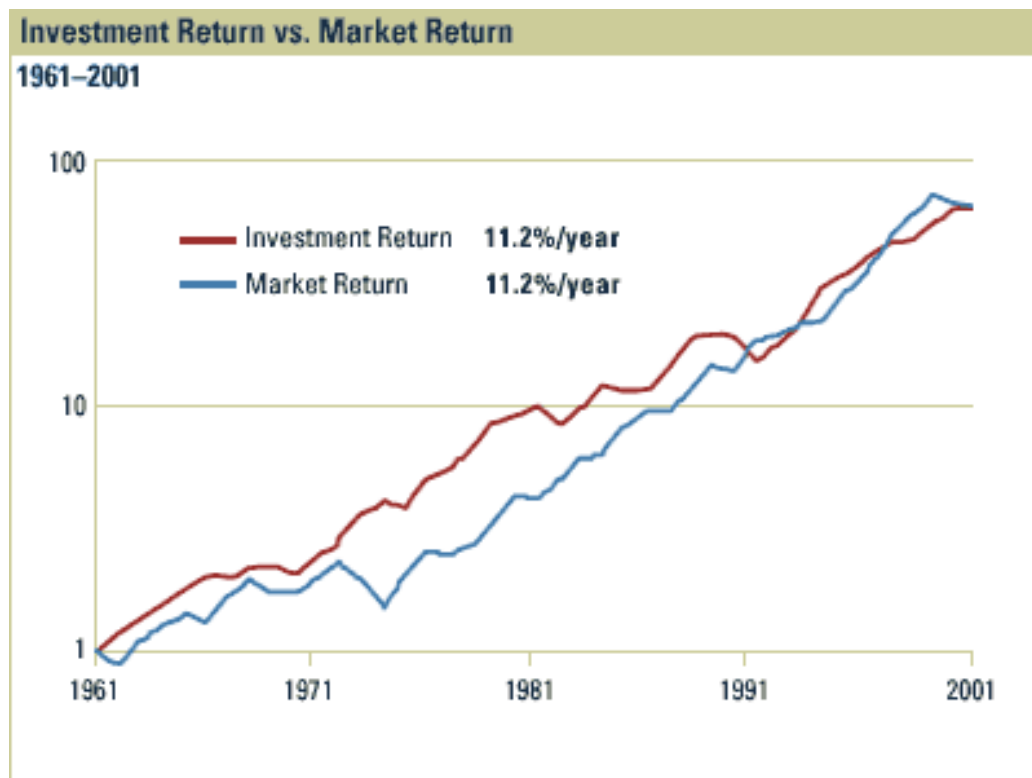
The fact of the matter is that it was not difficult to know we were in a speculative bubble. Indeed, right at the high of the market a year ago, I prepared a speech on "Risk Control in an Era of Greed," pointing out that, "when reward is at its pinnacle, risk is near at hand," and reminding my audience that speculation has been around for at least 2,200 years. I quoted the Roman orator Cato: *"There must certainly be a vast Fund of Stupidity in Human Nature, else Men would not be caught as they are, a thousand times over, by the same Snare, and while they yet remember their past Misfortunes, go on to court and encourage the Causes to which they were owing, and which will again produce them."*

After examining the stock market metrics in March of 2000, I concluded: *"So, let me be clear: You can place me firmly in the camp of those who are deeply concerned that the stock market is all too likely to be riding for a painful fall—indeed a fall that may well have begun as I began to write this speech ten days ago. Viewed a decade hence, today's stock market may just be one more chapter in "Extraordinary Popular Delusions and the Madness of Crowds."*

It was just dumb luck that the timing of my prescient forecast hit the nail on the head. Indeed, I am hardly alone among investment professionals who often have a good idea of *what* is going to happen in the financial markets, but very little, if any, idea of *when* it's going to happen. Still, today I'd like to look ahead at what returns we might expect in the U.S. stock market during the coming decade.

Investment Return Calls the Tune

First, it is absolutely critical to recognize that the mathematics of the market are eternal. Complex and mysterious as the stock market may seem, its returns are determined by the elementary interaction of just *two* simple elements, albeit two elements whose qualities are as different as the night from the day. The first is *investment* return, determined by dividend yields and earnings growth. Investment return tends to be recurrent and steady. The second is *speculative* return, reflected in any change in the price that investors are willing to pay for each dollar of earnings. Speculative return, however, is intermittent and spasmodic. Add them together and you have *market* return. It's that simple. It really is! Over time, it is earnings and dividends—*investment* return—that determine the *total* return achieved by the stock market. Consider the past 40 years. Dividend yield plus earnings growth came to a total of 11.2% per year. The actual return of the stock market came to an *identical* 11.2%. *In the long run, it turns out, earnings and dividends call the market's tune.*

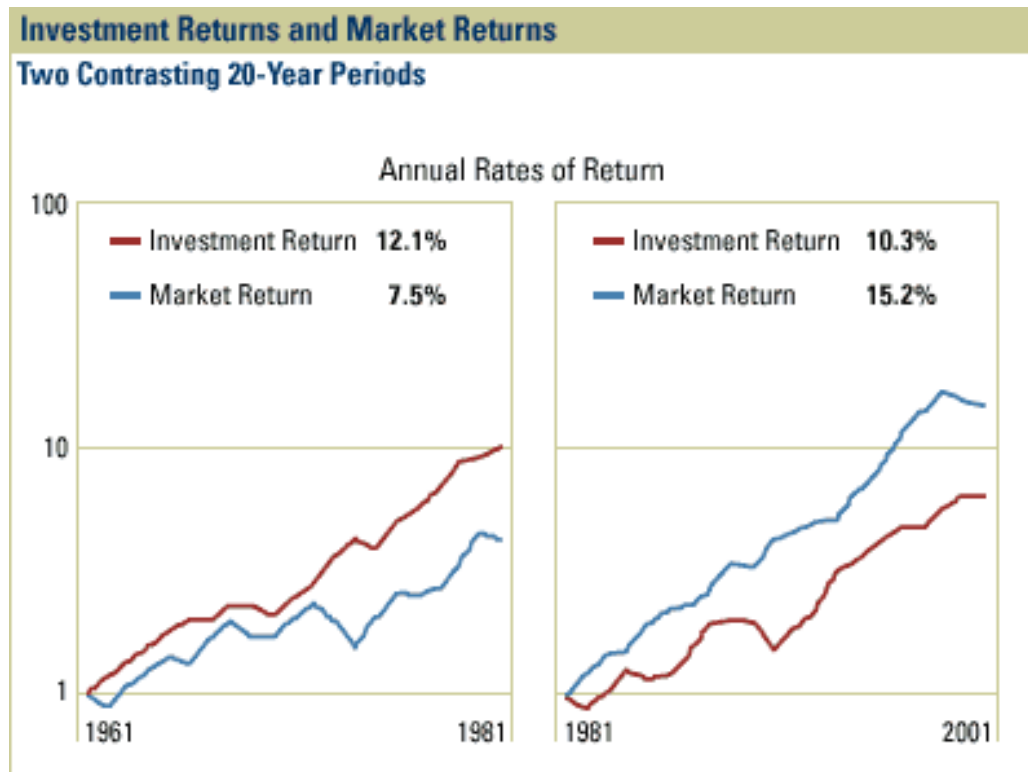


But speculative return can be the driving force over the short-term, and even over extended periods. For example, during 1961-1981, the

p/e ratio tumbled from 22 to 8 times, resulting in speculative return of minus 4 ½% annually, reducing the *investment* return of 12% to a *market* return of 7 ½%. During 1981-2001, however—the period in which most American families have acquired their investment experience—the p/e ratio soared as high as 33 before retreating to the present level of 24, still enough to add 5% per year in speculative return, raising the annual *investment* return of 10% to a market return of 15%.

***Speculative* Return Giveth . . . and Taketh Away**

Curiously, despite the all-time high market returns we've reveled in during 1981-2001, the fundamentals of earnings and dividends were actually a bit *lower* than in 1961-1981 (10% vs. 12%). But, the annual *market* return more than doubled, from 7% to 15%. Why? Simply because the pendulum of market speculation, which pulled returns *down* as it swung from the grand ebullience of 1961 to the deep pessimism of 1981, sent returns *soaring* as it swung back to the roaring optimism that culminated as we celebrated the new millennium.



And what a difference it made! Consider the magic of compounding

returns on an investment of \$10,000 at the start of each period. The 1961 investor, earning a **7 ½%** compound market return, enjoyed a **\$32,000** profit at the end of 1981. The 1981 investor, on the other hand, earned a **15%** return, producing a **\$140,000** profit by March 2001. *That remarkable near-five-fold increase came, not from corporate profits or dividends, but solely because of a change in the attitude of investors.*

The point is that the *economics* of market returns—the earnings and dividends of America's corporations over two centuries—are almost always both *predictable* and *productive*. The *emotions* of market returns, on the other hand—the price that investors will be willing to pay for each dollar of earnings—are *unpredictable*, at times remarkably *productive*; at other times, remarkably *counterproductive*.

We can use this dramatic example of the two forces that determine stock returns—the *oasis of investment vs. the mirage of speculation*—to look ahead and consider what returns we might expect over the coming decade. We begin with a dividend yield that is only 1%, a fraction of the historical norm of 4%. That, to put it bluntly, is not a lot of gas in the market's tank. But if we assume that corporate earnings growth will continue at its 7% annual rate of the past 40 years, stocks would enjoy a total *investment* return of 8% annually during the coming decade.

Will *speculative* return enhance or reduce that figure? If, ten years hence, investors continue to pay the same \$24 for each \$1 of earnings as they pay today (a price-earnings ratio of 24), then the market return will be that same 8%. If the p/e ratio were to fall by one-fourth, to 18, that would result in a *negative* speculative return of minus 3% per year, bringing the 8% investment return down to 5%. If, on the other hand, the p/e were to *rise* by one-fourth to 30, we'd have a *positive* speculative return of 2%, bringing the market return to 10%. Since the current (and still-relatively-high) p/e of 24 seems much more likely to decline than to rise, I believe that 5% is a better guess than 10%. (Warren Buffett, using a different but equally disciplined methodology, comes up with an estimated return similar to mine. You'll have to decide how much comfort to take from that!)

What would it take to again enjoy a 15% return on stocks during the coming decade? Again, assuming an *investment* return of 8%, it would require a *speculative* return of 7%. That, in turn, would require a final p/e ratio of 47 times. To be clear, I simply don't believe that number is in the cards.

Market Returns in the Coming Decade? (March 2001-March 2011)				
	Impact of Speculative Return			
	Negative- P/E 18x	Neutral- P/E 24x	Positive- P/E 30x	Wow! P/E 47x
Dividend Yield	1%	1%	1%	1%
Earnings Growth	<u>7</u>	<u>7</u>	<u>7</u>	<u>7</u>
Investment Return	8%	8%	8%	8%
Speculative Return	<u>-3</u>	—	<u>+2</u>	<u>+7</u>
Market Return	5%	8%	10%	15%

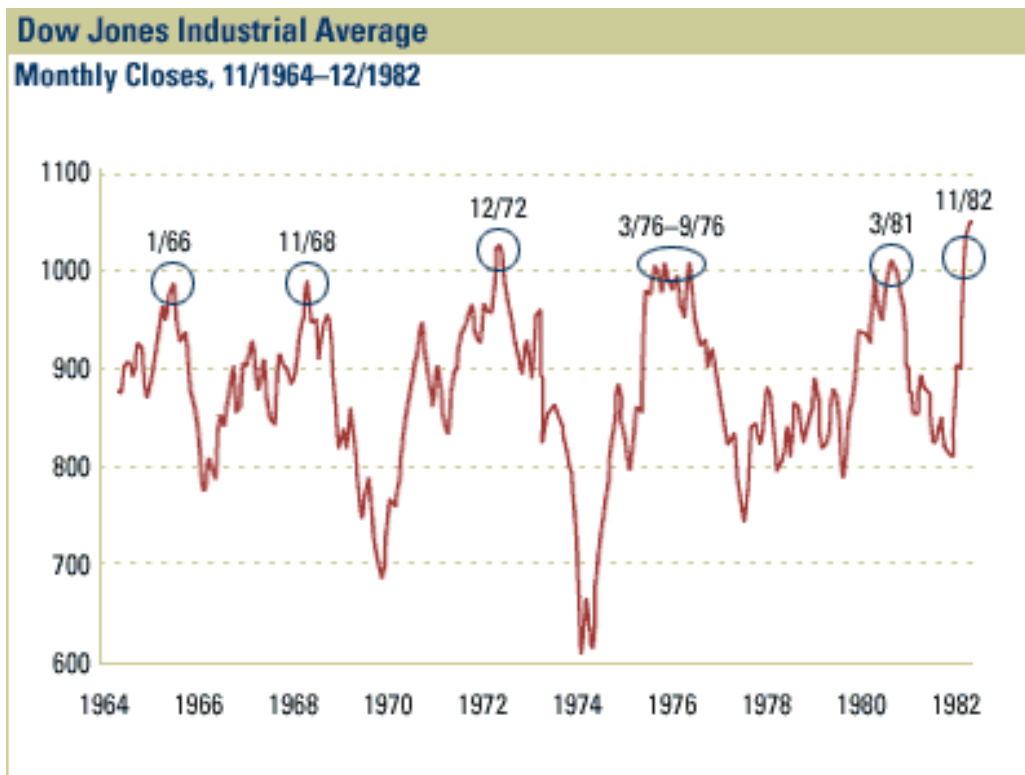
The point I'm trying to make is that future market predictions are largely guesses, not about earnings and dividends, but about market sentiment—investor confidence. In that sense, the market is one big *confidence game*. (I didn't say "con game," but I could have.)

I think we would all be well served if the popular seers of the day would articulate their forecasts in the same two segments of return that I have—how much is investment, and how much is speculation. For example, when one of today's most respected seers predicts, as she does, a level of 1650 in the Standard & Poor's 500 Index at year-end (50% above yesterday's level of 1110), she's actually forecasting a p/e ratio of 32 times. I share her hope, but not her conviction.

The Party's Over

In short, we have departed a two-decade-long golden era for equity investors in which, "we never had it so good," and are entering an era in which "the party's over." I do not believe we have yet seen the stock market's lows. Although we are approaching prices that represent fair value, don't forget that the market overdoes *everything*. Having swung so far above fair value, the market pendulum is unlikely to come to rest there, but to over-swing on the downside as well.

A new environment for investing which is more likely to be bland than spicy would hardly be without precedent. The Dow-Jones Industrial Average, for example, first hit 1000 in 1966; it got there again (or close) in 1968, again in 1972, again in 1976, *again* in 1981, and once again in 1982—a 17—year plateau—before permanently moving into the ever higher ground on which we seemed so firmly planted just one year ago. Despite the promise of James Glassman's *Dow 36,000*, it is at least possible that we'll find the market in a trading range—plus or minus 25% from today's level of 10,000-plus—if not for 17 years, for an extended period of time.



Costs Matter!

But whatever returns the stock market may earn, please don't make

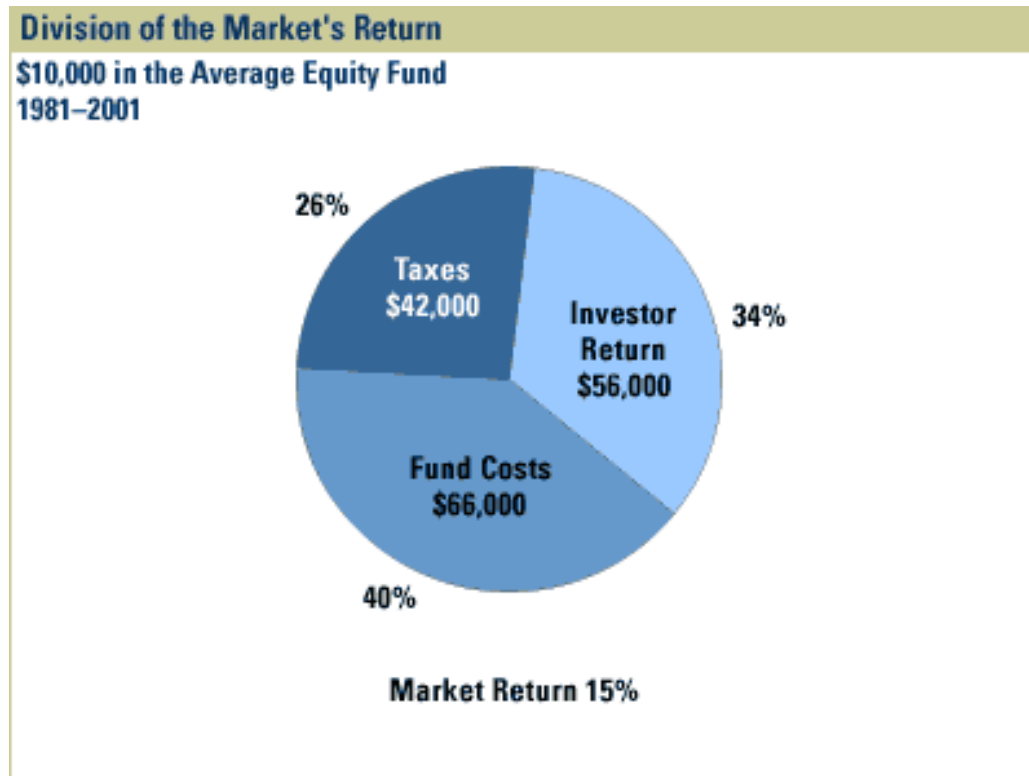
the mistake of thinking that investors will actually earn those returns. The fact is that few investors ever capture 100% of the market's long-run rate of return. Why? *Because investing costs money.* The fact is that a huge proportion of long-term investment success is represented by the allocation of financial market returns between investors on the one hand and financial intermediaries and tax collectors on the other. For investors as a group, market return, minus intermediation costs and taxes, equals investor return. It *is* as simple as that.

Costs matter! They matter most where they are at once very *large*, easily *measurable* relative to the value of the services provided, and *compounded* over time—three of the defining characteristics of the mutual fund industry. Fund costs are numerous and substantial. Let me add them up: Management fees and operating expenses now average **1.6%** per year; sales charges, at least **0.5%** annualized; hidden portfolio transaction costs, with funds now turning their portfolios over at an average of more than 100% per year, **0.7%**; opportunity cost (funds are rarely fully invested in stocks) perhaps **0.3%**. Aggregate costs: **3.1%**.

That may not seem like much, but such costs would consume fully 31% of a 10% market return. The extra taxes investors are socked with as a result of that hyperactive portfolio trading could easily consume another **1.5%**, leaving only half of the market's annual return for the fund investor. *Simply put, there are too many croupiers in the mutual fund casino, and their rakes sweep too wide a swath from financial market returns.*

Fund investors have not yet focused on the confiscatory power of costs. Why? Simply because the stock market's return has been so generous. In the **15%** market return environment of the past two decades, the average mutual fund provided a *gross* return of about **15%** (just about what you would rationally expect). But after costs and taxes, it delivered an estimated *net* return of **9%**. Result: \$10,000 invested in the average mutual fund produced a profit of **\$46,000**, less than one-third of the profit on the same investment in the stock market itself, which, without costs or taxes, grew by **\$154,000**. Despite this abysmal shortfall, however, fund investors felt

pretty comfortable simply because they had made a lot of *dollars* in mutual funds, albeit had hardly received a fair *share* of the market's beneficence.



But what if a future environment provides a 5% annual market return? Assuming that fund costs do not decline, but that tax costs (in a lower return environment) do, the *average* fund *investor* could receive but a 1% return, with many shareholders garnering negative returns. While \$10,000 invested in the stock market today would earn \$6,000 in a decade, the average fund investor would earn but \$1,000!

"Disappointment" would be far too mild a characterization of the shareholder's reaction. So, in a future market environment of much lower returns, the confiscatory power of excessive mutual fund costs and unnecessary taxes will severely challenge the mutual fund industry.

Mutual Funds in the New Environment

In many respects, this industry is a child of the great bull market of the past two decades. Soaring stock prices not only raised portfolio values, but enticed millions of investors into the fold, lifting equity fund assets from \$41 billion in 1981 to \$3.7 *trillion* today. But in a

bland market environment, will simply have to get its act together. Significant reductions in management fees are long overdue, and even if fund directors lack the willpower and knowledge to demand them, I expect investors will finally vote with their feet and abandon funds with excessive costs, finally forcing down fund fees and operating costs.

Transaction costs also must decline, as the counterproductive short-term speculation that is the focus of so many fund portfolio managers today finally abates. (Even the *average* fund now holds an average equity position for but eleven months.) A return to the industry's once-traditional long-term orientation (then the average holding period for a stock was six *years*) is long overdue, and would reduce not only fund transaction costs, but the heavy tax burden that such turnover foists on often unsuspecting shareholders. It is by no means coincidental that this gradual shift from investment to speculation has come hand-in-hand with the shift in portfolio supervision from investment committees to portfolio managers, and the development of a "star system." Alas, however, *the fund industry has produced infinitely fewer stars than comets.*

Totaling up the Tolls

The devastating toll this extraordinary level of portfolio turnover has taken on fund shareholders can hardly be underestimated. The *direct* turnover costs themselves (estimated at \$28 billion last year) paid to brokers, market makers, and investment bankers are the least of it. Despite the fact that fund investors suffered capital *losses* estimated at \$240 billion last year, equity fund shareholders received \$345 billion in taxable capital *gains* distributions. When these unnecessary distributions are paid to investors in tax-deferred 401(k) plans and IRAs, there is little harm done. But the unnecessary realization of gains through excessive portfolio turnover, borne of speculative investment strategies—and the fact that nearly one-third of all gains are realized on a short-term basis and taxed at ordinary income rates—constitutes a heavy and unrecoverable burden on the funds' *taxable* shareholders.

Industry sales charges could also stand reduction. But the trend today is in the opposite direction. Not so much because funds which carry sales charges are raising them, but because one no-load fund group after another is starting a new series of load funds, often foreclosing purchases of the original *no-load* shares to all but existing fund shareholders. Quite clearly, sales charges represent one more dead weight to the returns delivered by mutual funds to their investors in the aggregate.

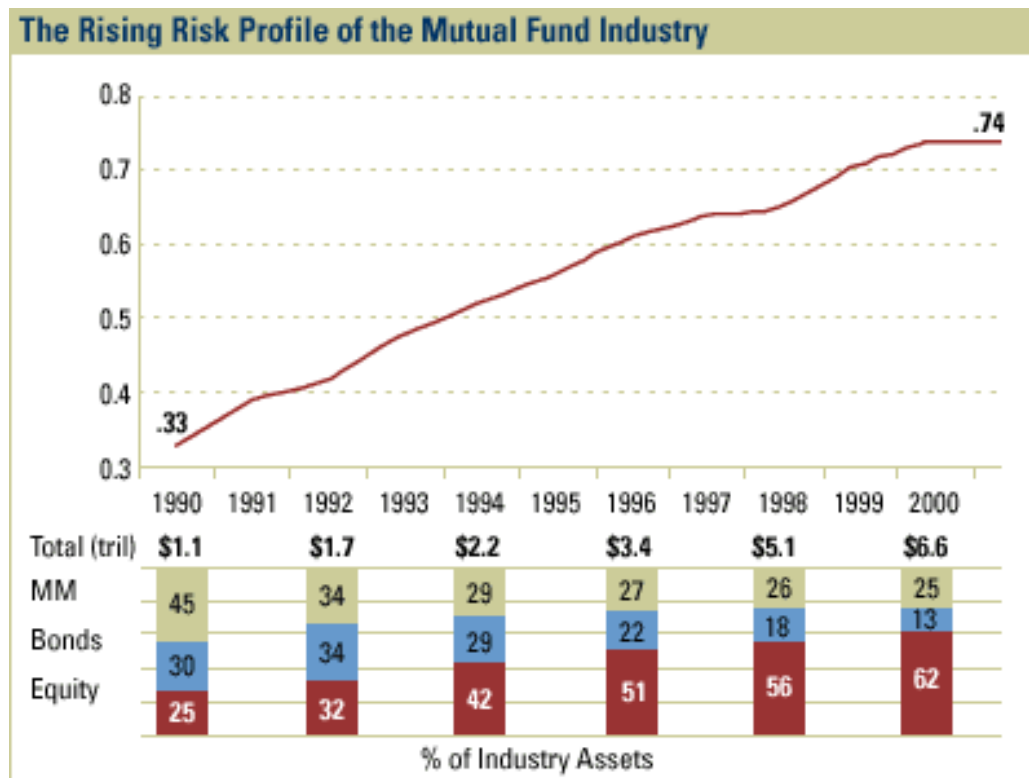
Central to the fund industry's problems is that the accumulation of assets under management has become the name of the game; the magnetic attraction of distribution seems irresistible. *And so it is that aggressive marketing has long since superceded prudent management as the fund industry's central ethic.*

Marketing Supercedes Management

We all know what is the best marketing strategy: Offering the public *exactly* what it wants. And in its ability to follow the crowd, the mutual fund industry has few peers. If the investing public demands cake, well, let them eat cake. The problem is that the most desirable "cake" is inevitably the cake that has been sweetest in the recent past, never mind that exceptional past returns achieved by individual funds or by investment styles is all too rarely prologue to exceptional future returns. Indeed, quite the reverse is true. St. Matthew had it right two long millennia ago: *Many that are first shall be last; and the last shall be first.*

Taken to its logical conclusion, such a marketing strategy inevitably places mutual fund managers in the wrong place at the wrong time. Consider the past decade: It began in 1990 with the stocks on the bargain counter, yet the *smallest component* of the industry's \$1.1 trillion asset base was its equity funds, comprising just 25% of the total. At 30% of assets, bond funds were considerably larger, and money market funds, at 45%, comprised nearly one-half of the industry total. Caution, clearly, was the order of the day, for investors and for the industry.

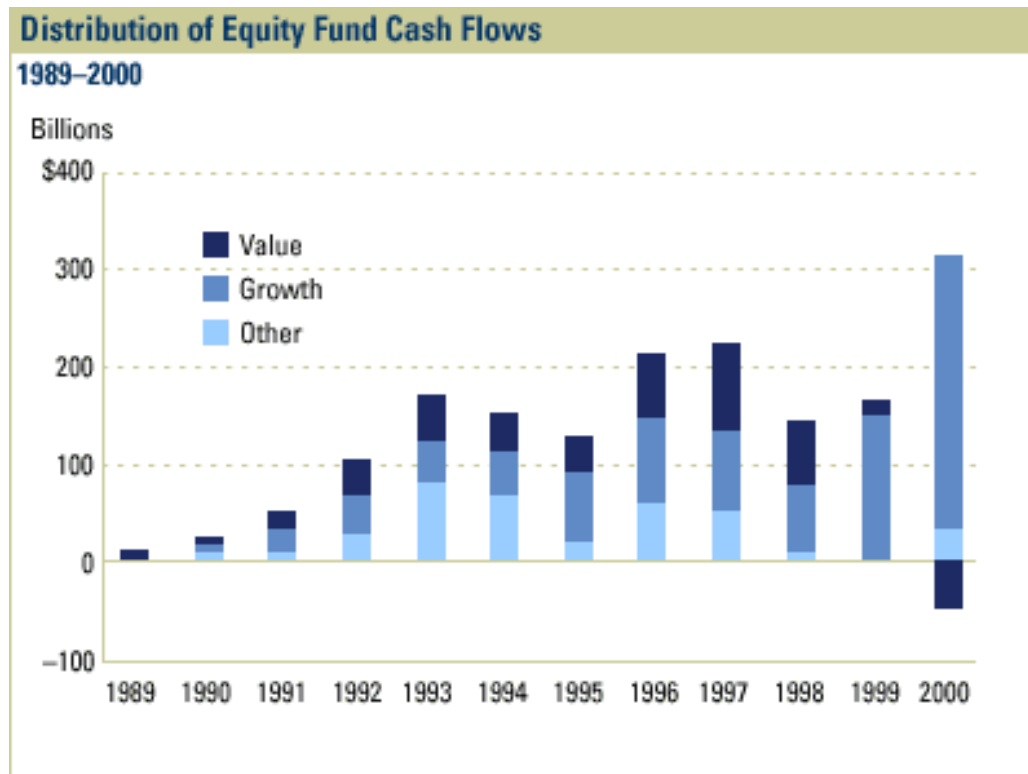
Now advance the calendar to the first quarter of 2000. Since 1990, the stock market had risen by nearly 500%(!) and was, at least in retrospect, richly valued. But the equity fund share of fund assets had more than doubled to 62% of the industry's then \$6.6 trillion of assets. Conversely, the bond fund share had tumbled by more than half, to just 13%, and the conservative money market share had fallen by nearly half, to just 25%. Taking into account the relative price volatility of the various types of funds and investment styles, the mutual fund industry's exposure to market risk had risen nearly 2½ times over. *When stocks were near the cheapest levels in modern history, fund investors had a 33% exposure to stock market risk; when prices reached the dearest levels ever recorded, they had a 74% risk exposure.*



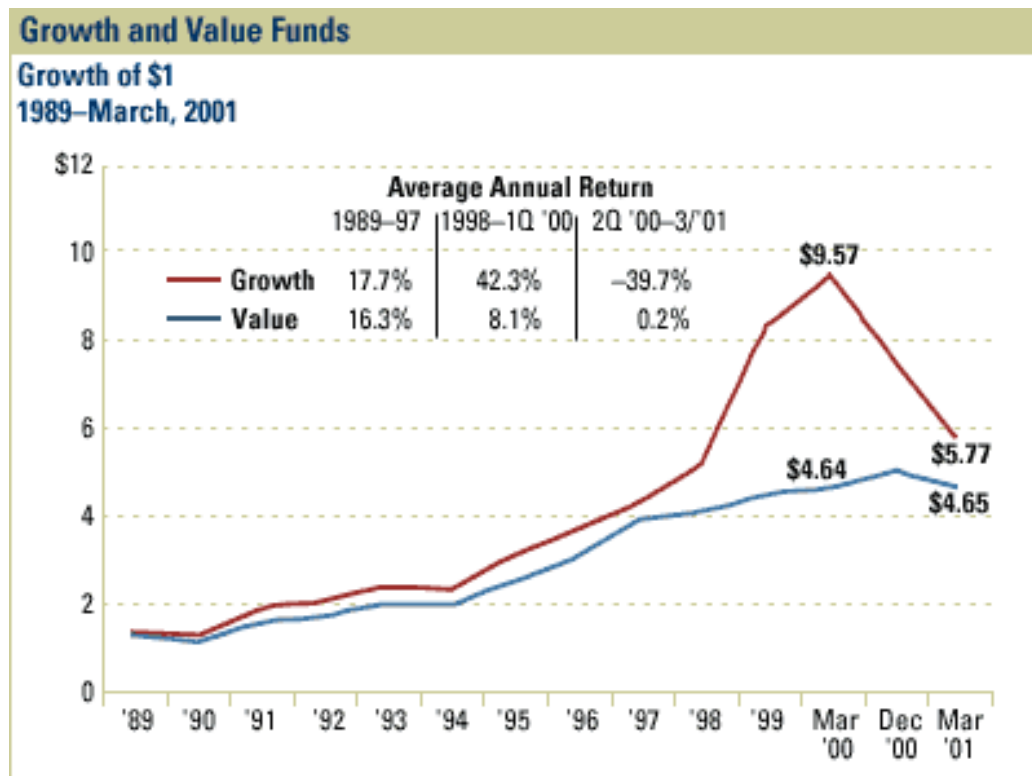
Money Follows Returns

For that counterproductive increase in risk, we can give much of the credit to the fund industry itself. To understand what a marketing industry we have become, just consider the shift in equity fund capital flows during the years leading up to the stock market peak last March. From 1989 through 1998, net investor purchases were fairly evenly divided between relatively conservative middle-of-the road value-

oriented funds (37% of cash flows), and riskier, more aggressive growth-oriented funds (37% of flows). (The remainder went to international funds and balanced funds.) But in 1999, the growth fund share leaped to 92%, and then to 113%(!) during the first quarter of 2000. On the other side of the coin, the share of cash flow into value funds dropped to 8% in 1999 and to *minus* 37% during the first quarter of 2000. (That is, investors purchased \$127 billion of growth funds and *liquidated* \$42 billion of value funds.) At the very moment when they should have been minimizing it, fund investors were maximizing their speculative risk.



Clearly, it was relative fund performance that clearly drove this shift in investor preferences. While growth funds and value funds provided comparable returns from 1990 through 1997, growth funds soared into the lead through early 2000, providing annualized returns averaging 42%, compared to just 8% for value funds. But reversion to the mean—that seemingly—universal rule that "the last shall be first and the first shall be last," over and over again—promptly took over. Since last March, growth fund prices have *declined* nearly 40% on average, while value fund prices have seen a slight rise.



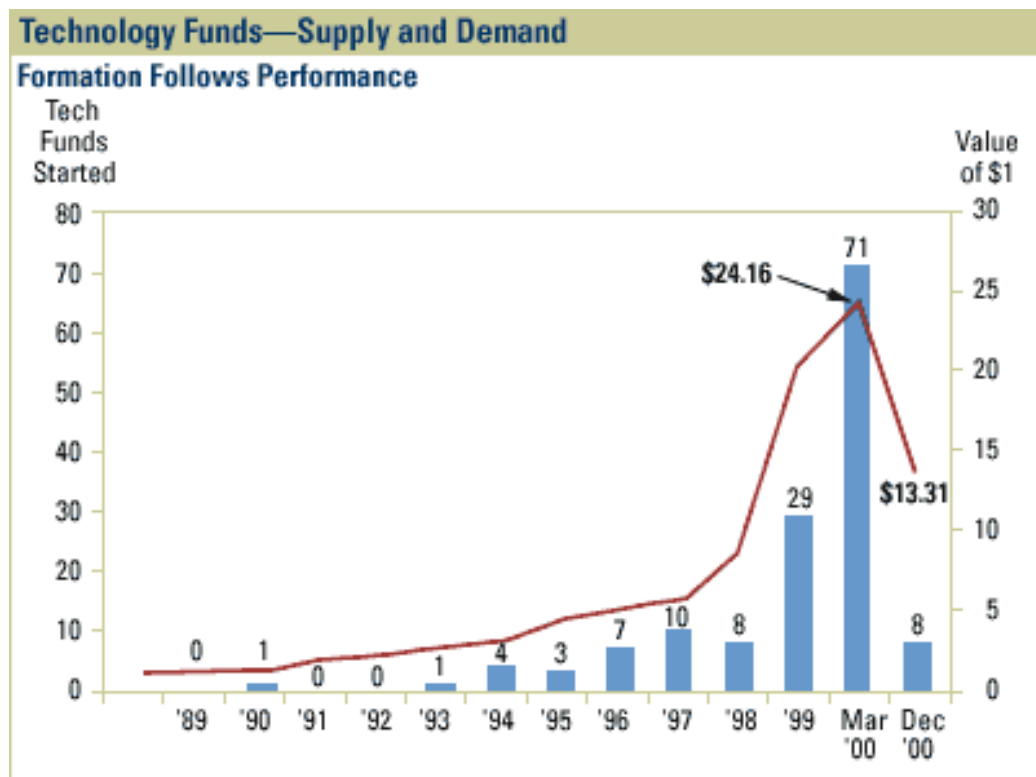
Pandering to the Public Taste

It would be easy, far too easy, to argue that the investor—ever following past performance, ever following the crowd—is his own worst enemy. But the fund industry must bear a large share of the blame. First, it pandered to the public taste by creating 494 new growth funds during that 2 ¼ year period, compared to just 110 value funds. Second, not only did funds vastly step up their advertising budgets to encourage investors to jump on the stock market bandwagon, but advertised the heady past performance of some of the industry's "hottest" funds, many with annual returns exceeding 100%.

What's wrong with that? At least these two things: First, *winners rarely, if ever, repeat*. And those who produce advertisements hyping past performance are as aware of that inevitable fact as the countless academics whose studies attest to it. Second, *advertising is expensive*. Directly or indirectly, it is the mutual fund shareholder who foots the bill. In 1999-2000 the industry's seemingly unbridled marketing budget likely included some \$1 billion for media advertising alone (*not* including \$120 million that one fund group recently spent to have a football stadium carry its name!). To put it bluntly, fund *shareholders* had \$1 billion of *their* money spent on advertising. How this

expenditure advanced their interests—or their returns—is not at all clear.

This marketing opportunism found its finest—if most perverse—focus in the fund industry's response to the Information Revolution or, more accurately, to the soaring returns generated by information technology stocks—internet companies, cell phone makers, computer manufacturers, etc. In 1989-1995 an average of but *one* new technology fund was formed each year. In 1999, the number leaped to 29, and in the ebullient first quarter of 2000 *another* 71 new tech funds joined the fray. Investors took the bait, and in the first-quarter of 2000 technology funds *alone* gathered 30% of the industry's all-time record equity fund cash inflow of \$113 billion. Up to then, returns on technology funds had averaged 92%, *annualized*(!)—more than double the return of even the soaring *growth* funds. But in the aftermath of the tech stock boom, tech funds have tumbled by 63%, half-again the 42% tumble in the weak growth fund group. *Sweet marketing, it turns out, is usually sour investing.*



Last March, two funds were formed that will go down in history as paradigms of the paradox that the time to sell funds is not the time to buy them. A giant brokerage firm organized two highly concentrated

and aggressive "New Era Funds"—an Internet Strategies Fund and a Focus 20 Fund. Right at the market's high, in an initial public offering, the firm sold \$2 billion of their shares to clients. The base offering price was **\$10.55** per share. *Apré moi le deluge!* During the ensuing year, the net asset value of the Internet fund tumbled to **\$2.44** per share, trailed only slightly by the Focus 20 fund at **\$3.24**, together obliterating \$1.4 billion of investor assets into thin air. Viewed at the time as a *marketing* triumph, this offering, has become, at least for the moment, an investment disaster.

So the chickens have come home to roost in the mutual fund industry, and much change is required. I hope it is not ungracious to my hosts in the press if I point out that both the media's embrace of the New Economy and its focus on short-term investment thinking and past performance have helped lead mutual fund investors astray. Now that the party's over, I hope you will help to refocus the attention of serious investors on long-term investing, reasonable expectations, diversification and asset allocation, and cost- and tax- efficiency. Standing up for those eternal principles of investment success would be an invaluable public service.

Did He Say Bond Funds?

The equity fund deck of the huge mutual fund battleship—with its high expenses, excessive tax costs, short-term investment orientation and marketing-driven focus that have together so substantially impaired the returns earned by fund owners—is by no means the only deck in need of repairs. The bond fund deck is another. One failing is the industry's near-shunning of bond funds just when investors needed them most. Another is offering bond funds with such high costs that they *deserve* to be shunned. In a New Environment in which bond returns are apt to be more competitive with stock returns—all the while carrying far lower risk—the industry will be forced to rectify those failings.

It's hard to overstate how much refurbishing the bond fund deck of the industry ship requires. Excessive management fees and operating expenses and excessive sales charges wreak even greater hardships

on bond fund investors than on stock fund investors. Consider the simple mathematics. Today, the yield on the Lehman Bros. Aggregate Bond Index (government and investment-grade corporate) is 6.6%. If an investor pays a 4½% initial sales charge and a 1% annual expense ratio and holds the fund for five years, his average yield would be just 4.6%! Two-thirds of the return to the shareholder, one-third to the croupiers. (For a tax-exempt bond fund the penalty is even greater!) Clearly, that is a far cry from a fair shake.

And yet, nearly half of the industry's bond funds—**926** of 1,874 funds—carry a sales charge. The average expense ratio is **1.1%**, and only **75** funds—one out of 25 (!)—have expense ratios below **0.3%**, my idea of a fair shake. Yet when investors will to bond funds in the New Environment that will emerge once the fall in the stock market is over, they will have few choices that make even the most tenuous economic sense. Here again, the fund industry has much to do to earn the loyalty and trust of fund investors.

Too Broad a Brush?

Lest I paint the industry with too broad a brush, let me say that there are some firms who have resisted the temptations that I have catalogued today. It is a curious fact that those firms have generally avoided, not *some*, but *all* of those baneful practices. These firms have: 1) Minimized costly and aggressive marketing (though no firm can totally eliminate it). 2) Shared at least some significant portion of their staggering economies of scale with investors by holding the line on costs. 3) Maintained investment discipline in portfolio management and focused on the long term; and 4) Avoided the fads and fashions of the day, introducing new funds *not just because they make dollars for the manager but because they make sense for the shareholder*. While no firm—*no* firm—has had the discipline to bat 1.000 in this tough league, there are at least a few that are batting upwards of .750. But painfully few. Out of the 400 fund complexes in this business today, I don't think that I could name more than a dozen that meet my high, but I think reasonable, standards.

True Confession

Confession, it is said, is good for the soul. So I confess that I make my candid remarks today from a singular vantage point. When I founded the Vanguard Group more than 26 years ago, it was deliberately structured as a *mutual* mutual fund organization, controlled, not by an outside corporation, but by the fund shareholders themselves. Since cost so obviously matters (I guess that I've made *that* clear!), we operate on an at-cost basis, hold expenses to the bare bones minimum, and do not squander shareholder resources on marketing.

This focus quickly led me to the founding of the industry's first stock and bond market index funds (which *do* provide substantially 100% of those markets' annual returns), and to the elimination of all sales charges. It is putting the shareholder first in everything we do that has been the foundation of whatever success Vanguard may have enjoyed.

If the criticisms of the fund industry I've expressed today sound tough, it is not because of my *pugnacity*, but because of my *perspective*. While few firms will—indeed, realistically, few firms can—follow Vanguard's example, any firm that wants to be as successful in the New Environment *after the fall* as it has been in the Old Environment *before the fall* will have little choice but to move in our direction. . *It's high time we get back to the business of prudent, long-term investing*. And it's best, I think, to place stewardship—serving clients in the most honest, efficient, and economical way possible—at the top of the agenda. It is that single value—the stewardship of other people's money—that will place the mutual fund industry on the right side of history.

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