

Nothing Fails Like Success: The Investment Implications Of The Great Mutual Fund Boom

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Introduction

In the short space of two decades, mutual funds have gone from mom-and-pop cottage industry to financial behemoth. The great American mutual fund boom has multiplied equity fund assets fully 65 times, from \$34 billion 20 years ago to \$2.2 trillion today. The old saying that "nothing succeeds like success" surely describes our industry today. As the great 15-year bull market has soared, investors have flocked to mutual funds in numbers not even dreamed of two decades ago.

But there is a parallel saying, too: "Nothing fails like success." As we approach the turn of yet another century, the massive asset size and transaction volume (by portfolio managers and shareholders alike) of mutual funds could create potential problems and an important set of limitations for our industry. If "small is beautiful," we are not as pretty as once we were.

This is a different industry than it used to be. Not just different in degree, but different in kind. As a result, many elements of our past are unlikely to prove prologue to our future. So, the way we look at mutual funds must change to reflect today's realities and those that we will continue to face in the years ahead. What I propose to do this morning is to examine the investment implications of the industry's

growth.

The Implications Of Industry Size

I open with the most overpowering statistic of all, yet one that is rarely noted. Mutual funds—now holding \$2 trillion of U.S. equity securities—control nearly 22% of corporate America, almost eight times our 2.7% ownership position at the start of 1982, just before the great bull market began. (See Exhibit I.) By the century's end, one of every four shares of stock may well be owned by mutual funds themselves, four of ten shares if we include shares held in other investment accounts run by mutual fund managers.

Exhibit I

Equity Fund Stock Ownership			
Year	U.S Equity Market Cap (Trillions)	Mutual Fund U.S. Equities (Est) (Trillions)	Fund Ownership
1981	\$ 1.3	\$.035	\$.035
1982	1.5	.044	3.0
1983	1.9	.068	3.6
1984	1.8	.077	4.3
1985	2.2	.112	5.1
1986	2.4	.143	5.9
1987	2.4	.162	6.7
1988	2.6	.158	6.1
1989	3.2	.219	6.9
1990	2.9	.196	6.8
1991	3.9	.340	8.7
1992	4.2	.429	10.2
1993	4.8	.620	12.9
1994	4.7	.719	15.3
1995	6.4	1.060	16.6
1996	7.9	1.505	19.1
1997 (E)	9.5	2.052	21.6

In 1982, mutual funds were a sort of "stand-alone" industry, focusing almost entirely on their own business, and not units of financial conglomerates that also provide asset management services directly to individuals and institutions. Today, only two of the fifty largest

fund complexes provide their services solely to mutual funds. The conglomeration of fund complexes with one another, and with banks, trust companies, insurance companies, and brokerage firms (to say nothing of railroads, glass-makers, and airlines), national and international alike, has reached epic proportions.

As a result, the ownership of equity securities by mutual funds alone severely understates—by fully one-fourth—the importance of the investment power and impact of the firms that manage funds. For firms running mutual funds also manage separate investment accounts for institutional and wealthy individuals valued at \$1 trillion, bringing total ownership to \$3 trillion. This total represents control of one-third of the \$9.5 trillion market capitalization of U.S. equities—a concentration of ownership without parallel in history.

But that, in a sense, is the least of the issue. For, given the vigorous, highly active investment strategies adopted by most mutual funds—annual portfolio turnover in equity funds presently runs to nearly 90%, compared with 30% 20 years ago—it seems likely that as much as one-half of all stock transaction activity is accounted for by this relatively small handful of institutions. It is not ridiculous to assert that they are the market.

Just what are the implications of that situation? Let's begin by focusing on mutual fund ownership of individual securities, and see what we can see. Exhibit II, showing fund holdings of the ten stocks with the largest U.S. market capitalizations, presents a curiously wide range of holdings. They range from less than 4% of Coca-Cola and some 6% to 9% in Exxon, General Electric, Microsoft, and Merck, to 14% of Intel and 20% of Philip Morris, compared to the overall norm of 22%. These high-performing—and obviously underowned—stocks have led the way in the 1996-1997 bull market, and have helped drive the index fund boom. Index funds and index pools hold a market-weighted percentage of 7.6% in each stock in the Standard & Poor's 500 Composite Stock Price Index. The prices of these giant issues, in turn, may have been given even more upward momentum by the demand created by active managers, fearful of their underweightings and anxious to lose no further ground to the spectacular index fund returns.

Exhibit II

Ownership Of The Ten Largest Stocks		
	Held by Active Mutual Funds	Indexed Pools
General Electric Co.	8.1 %	7.6 %
Coca-Cola Co.	3.6	7.6
The Exxon Corp.	5.9	7.6
Microsoft Corp.	7.3	7.6
Merck & Co., Inc.	8.8	7.6
Intel Corp.	14.3	7.6
Philip Morris Cos., Inc	19.6	7.6
Proctor & Gamble Co.	7.4	7.6
Internatinal Business Machines Corp.	13.7	7.6
Johnson & Johnson	9.9	7.6

In all, the fund industry has a substantial relative bias in ownership against the equities with the largest market capitalizations, and in favor of mid-cap and small-cap shares. Exhibit III shows this pattern of ownership that rises as capitalization levels decline. Compared to a "par" of about 22%—their share of all U.S. stocks—funds own but 13% of the 100 stocks with market capitalizations over \$19 billion, rising steadily to 35% of all the 100 stocks ranked 901 to 1,000 in size, then reverting to the 22% mean on the remaining 6,300 stocks with capitalizations of less than \$600 million. The Wilshire 5000 (as it were) Equity Index, which represents the total U.S. stock market, includes 7,300 securities.

Exhibit III

Fund Ownership By Market Capitalization	
Equities Grouped by Size	Equity Fund Holdings
1-100	13.4 %
101-200	15.5
201-300	18.7
301-400	20.0
401-500	20.6
501-600	21.3
601-700	22.7
701-800	25.3

801-900	26.9
901-1000	34.5
1001-7300	21.6

One implication of the industry's giant size is that these dominant ownership percentages represent the "big stick" now carried by mutual funds (and their associated asset pools) in corporate governance. While funds so far have followed President Theodore Roosevelt's advice to "speak softly" when carrying this "big stick," their institutional brethren in the state and local government pension fund arena have had no similar restraint. Nonetheless, it is fair to say that the latent power of fund ownership, added to the dynamic power represented by state and local government ownership, has helped bring about a truly revolutionary focus on creating shareholder economic value that has transformed corporate America. In this sense, funds can be said to have helped create this component of the great boom in earnings our corporations have enjoyed in recent years.

Another implication of giant size is the increasingly powerful role of the mutual fund shareholder in shaping market returns. It almost goes without saying that, along with the ownership of 22% of U.S. stocks, fund shareholders themselves have helped fuel the demand for stocks that has helped drive these stocks upward. But these same fund shareholders have also created new risks to market liquidity. To the extent that they demonstrate a "herd instinct," shareholders could endanger the very liquidity that mutual funds pledge to offer. That this obvious and implicit risk has so far manifested itself only by fueling the high demand for stocks—demand that has clearly created upward pressure on prices—should not blind us to the fact that any significant run of liquidations would create downward pressure—perhaps of major dimension.

But the final implication of the dominant fund ownership of stocks—fund performance relative to the market—is my main focus today. I believe that our industry's giant size is apt to impede any potential that mutual funds may have to offer superior returns. Paradoxically, if the growth of mutual funds, by helping to add value in the corporate world, has had a positive impact on stock returns, it has also had a negative impact on the value added that the fund

industry can create for its own shareholders. Simply put, it is possible to imagine that a mutual fund subset owning less than 3% of the stock market could outpace the market itself, but virtually inconceivable that a fund subset owning 22% could do so. And to suggest that a subset of 33% (including funds and their associated asset pools) could turn the trick would tax one's credulity.

In this sense, then, the history of mutual fund performance relative to the market is not likely to be very relevant to how mutual funds perform in the future. To be sure, funds have not outpaced the market in the past. In 1975, I gave our directors data for the period 1945–1975 showing that the average equity fund had experienced an annual shortfall of -1.6% to the S&P 500 Index, a figure that then dropped to a cumulative -0.8% through 1981. Since then, funds—with steadily rising heavy expense ratios and costly portfolio turnover—have fallen behind the Index by a larger amount, some -1.8% annually in 1981–1997. In the years ahead, I believe that gap is likely to widen even more.

The industry as a whole, given its massive size, is truly in a straitjacket. The cheetah has become the pachyderm. Any chance that mutual funds as a group could outpace a suitably weighted market index (including large and small stocks alike) is, simply put, "gone with the wind." Put another way, the last best hope for equity funds as a group to outpace the market is to minimize the "fiscal drag" that makes winning the game so tough. Funds could (1) reduce advisory fees, marketing costs, and expense ratios; (2) reduce excessive and costly portfolio turnover; and (3) reduce cash holdings, so easy to do in an age when reserves can be equitized through futures. None of these trends have developed to date. But in the highly unlikely event that they do develop, they could help fund managers live up to their professional reputations and the expectations of fund shareholders. But even if those trends were to develop, with funds having such a dominant equity market participation today, it would change the picture only slightly. They could help reduce the industry's return shortfall against the indexes, but they could no longer eliminate it.

Asset Size And Individual Funds

And what's true for the industry is also true for its individual fund components. The dominant mutual funds have reached mammoth size—indeed two large funds (a \$60 billion actively managed fund and a \$45 billion index fund) today each have assets more than the \$41 billion equity mutual fund total as 1982 began. Thirteen more funds have assets above \$20 billion each, and, all told, the 38 funds with assets of \$10 billion and higher control \$800 billion of equities.

With the single exception of the index fund, these funds began with a large performance edge over the S&P 500 Index when they were relatively small (indeed an edge that fostered their growth), but lost that edge with their attainment of elephantine size. We've documented the returns of these giant actively managed funds, and we see just what you would expect: profound regression to the mean.

While regression to the mean is one of the most pervasive rules of the financial markets, there are exceptions that can persist for extended periods, sometimes for as long as 15 years or more. But the attainment of huge size turns that rule from near-pervasive to all-pervasive. Exhibit IV shows the average annual return, relative to the S&P 500 Index, of the five largest funds, along with their asset size relative to the total stock market. Clearly, huge performance premiums were earned in the early years, only to regress to the market mean in the mid-years, and finally below the mean in the years of giant size. In all, their return premium averaged +10% annually in the first three years when the average asset size of the five funds was \$500,000 per \$1 billion of total market cap; their return shortfall averaged -3% annually in the last three years, when relative size had risen eight-fold to nearly \$4 million per \$1 billion. It is hard to imagine that this size increase did not play a major role—and then some—in this remarkable example of mean reversion.



It is worth taking a moment to consider an issue that is almost never part of the public debate about fund size: what is the relevant unit of size. I strongly believe that the unit of measurement is not merely the size of an individual fund, but the total asset base of the organization that manages it. By this standard, a large fund may in

fact be two to three or more times the size that it appears to be. To the often pervasive extent that other funds in the same complex (or institutional accounts managed by the same organization) own the same stock—given firm-wide transaction allocation procedures, limitations on market liquidity, and policy constraints on percentage ownership of a given stock—the problems of size are magnified proportionally.

Here are two real world examples. One is by far the largest equity fund in the world, a \$60 billion fund that recently closed its offering to new individual shareholders (all the while leaving the door wide open to its millions of existing retirement plan investors). In five of its largest equities, it held a total of 40 million shares. But just ten of the sister funds supervised by its management company owned nearly 130 million shares. To the extent that the remainder of this giant fund's portfolio duplicates this ratio, it's fair to say that the fund (sort of) closed its doors at an effective asset level, not of \$60 billion, but of \$200 billion. That decision, if you believe the press releases, passes for "discipline" in this industry.

Another example: the second largest actively managed equity fund, with assets of \$39 billion. Along with just two sister funds managed by the same firm (the fourth largest equity fund, with \$35 billion, and the twenty-fifth, with a mere \$10 billion), five of its major holdings represent just one-third of the three-fund total. If we assume that this ratio approximates the relationship between its entire portfolio and all of the other fund and institutional accounts managed by the firm, this fund's effective size is \$105 billion, with all of the constraints that implies. And none of the funds (or managed accounts) in this complex has yet been closed to the flow of new money.

In any event, two things seem clear: (1) That funds that have created a record of remarkable returns at relatively small asset levels have a pronounced tendency to lose that edge when they get large; and (2) that highly volatile funds that have been successful tend to become far less volatile when they get large. In either event, whatever utility the fund's past record of performance may have had becomes completely irrelevant. Surely shareholders should be made aware of these facts, for they relate directly to the validity, the

viability, and the relevance of the long-term records that are presented in fund promotional material as gospel. ("Past performance does not guarantee future returns," the customary boilerplate, is but a pale recognition of this phenomenon.)

Why Is Size A Problem?

There are three major reasons, I think, why large size inhibits the achievement of superior returns: (1) The universe of stocks available for a fund's portfolio declines; (2) transaction costs increase; and (3) portfolio management becomes increasingly structured and group-oriented, and less and less reliant on savvy individuals.

The shrinking universe of investment opportunities that comes with size is quite obvious. There are legal and practical constraints on security ownership. To assure broad diversification, a manager rarely wishes to have his fund hold many investment positions in excess of 3% of fund assets. Further, since dominant ownership positions may well constrain market liquidity as shares are purchased and sold, it is the rare firm that wishes to have very many positions representing as much as 10% of a corporation's shares outstanding.

Taken together, these two limitations—on diversifying assets and maintaining liquidity—have a clearly calculable relationship to the number of major portfolio positions that can be held at a given level of fund assets. For example, assuming a 2% maximum holding and a 10% maximum ownership, a manager of a \$1 billion portfolio today would be able to choose from among 2,644 stocks (Exhibit V). But if the portfolio were \$5 billion, the number would drop by nearly two-thirds, to 994 stocks. And at \$20 billion, it would drop by another two-thirds, to 352 stocks. And if the ownership/liquidity constraint were 5% of a company's shares outstanding (probably a more realistic figure than 10%), there would be but 183 issues available—a net reduction of 93% from our original number.



To be sure, the manager of a large portfolio could try to escape some of the problems of size by having much larger numbers of holdings with much smaller concentrations (each, by definition, having less

impact on the portfolio). The largest fund, for example, owns 529 stocks. Also, the manager could "play" industry subsets (i.e., Netscape participants, modem manufacturers, circuit board makers, etc.) rather than picking a single stock. But the fundamental point remains intact: Large asset size massively reduces the number of important portfolio positions in the investable universe available to a portfolio manager.

Second, the cost of portfolio transactions increases with size. As a general rule, you could do far worse than "the larger the number of shares traded, the greater the impact on price," quickly adding "the higher percentage of a day's (or week's) volume, the greater still the price impact," followed by "the greater the urgency to complete a transaction, the greater again the impact." Thus these general conclusions follow: (1) Short-term strategies are more costly to implement than long-term; (2) momentum trades are more costly than trades based on fundamentals; (3) information-sensitive trades (based on purported market knowledge) are more costly than informationless trades (i.e., index fund transactions); and (4) aggressive trades are more costly than opportunistic ("contrarian") trades.

At this point, it becomes clear that mutual fund size, as such, is not the problem. There are no transaction costs associated with the huge long-term holdings of American Express, Disney, Gillette, and McDonald's controlled by Warren Buffett, the Oracle from Omaha, even though those positions represent fully one-half of those of the entire mutual fund industry—or in Coca-Cola, in which his 200 million shares are more than double the 90 million shares held by all funds combined. (Now we see how funds can be so under-represented in Coke!) Why? Because he doesn't buy or sell them very often. And, because the shares of Berkshire Hathaway aren't redeemable on demand, he won't need to sell them until he wishes to do so—at his price (i.e., opportunistically). To be sure, if he wants out in a rush, he would doubtless have to accept a considerable price sacrifice. But that is hardly his style. Mr. Buffett hits the proverbial nail on the head in his 1996 Annual Report, saying: "Inactivity strikes us as intelligent behavior. We wouldn't dream of feverishly trading (stocks in) highly profitable (companies) because some Wall Street pundit had reversed his view of the market."

I have heard of but one manager in the mutual fund industry who has both examined the impact of trading costs—commissions, bid-asked spread, market impact, opportunity cost—in his own firm, and has had the courage to make the results public. He is John C. Bogle Jr. (my oldest son), portfolio manager for the three mutual funds of Numeric Investors, all quantitatively run, high-turnover accounts. After examining more than 20,000 trades, he reports that his value trades cost 0.6% of the dollar amount of the trade; trades in small growth stocks 1.8%; trades where shares represent one-eighth of daily volume, 0.5% of the trade; shares representing two days volume, 2.3%. He concludes that the hidden drag of transaction costs rises as the size of purchases and sales become a larger fraction of market volume, an effect that, he states, "exists for every style, for every size, and for every manager." (He recently closed two of his three funds at asset levels of \$100 million each. That is called discipline.)

More universally, typical total trading costs for an investment manager are estimated by the Plexus Group at about 0.8% of the amount of transaction value. If a fund has a turnover of 50% per year, purchases and sales together would be equal to the fund's average assets. Thus the fund's annual return would have been reduced by 0.8% (or 8% of a 10% return). At 100% turnover, the annual performance penalty—other factors held constant—would be 1.6%. Then, a fund's transaction costs would roughly double the expense ratio cost of 1.5% for the average equity fund, creating an aggregate "fiscal drag" of about 3%. Smart managers—and most fund managers are smart—have to add some sort of value larger than that amount through their stock picking skills or else fall short of the cost-free returns earned on unmanaged market indexes composed of securities similar to those represented by the fund's style.

It is fiscal drag—the frictional costs of investing that encompass both expense ratios and transaction costs—that accounts for the inability of most managers to beat an appropriate market index. For what it's worth, some 353 of the 439 actively managed mutual funds with ten-year records—80% of the total—provided returns during the past decade that fell short of the return of the S&P 500 Index. This was,

admittedly, a particularly favorable period for the large-cap, blue-chip stocks that dominate the Index. Over the longer term, I would expect about 75% of all funds to underperform.

The third reason that large size impairs outstanding returns is less obvious, but no less real: organizational impact. As an organization grows large, the impact of an institutionalized investment process waxes, and the impact of an individual portfolio manager wanes. No longer are there a few portfolio managers with messy desks, bright ideas, and decisive minds, supported by a handful of analysts and traders, and modest administrative support. Now, there are multiple funds (as many as 100 or more), an organization chart, an investment process, committees to approve transactions and to appraise them, meetings, filings, red tape, and a focus not on "what should we own today," but on "who's in charge here anyway?"

Wall Street Journal columnist Roger Lowenstein is one of the few journalists who has recognized this problem. He recently wrote, "Picking stocks, like writing stories, is a one-at-a-time endeavor. It is done best by individuals or small groups of people sharing their ideas and buying only the very best. A small fund family managing selective portfolios . . . can succeed as a group, but no large institution . . . can order dozens of managers to outperform. The image can be branded, but not the talent. The people matter more than the name."

Who Benefits From Size? Shareholders Versus Managers

So, my hypothesis that "nothing fails like success" has been laid out before you. I've presented, I think, a compelling case showing why it must be so—based on statistics as well as elementary logic. It is hardly a counterintuitive case. Given the industry's present size (which seems rather unlikely to shrink back to where it was ten, or even five, years ago), it is a situation that is far more likely to intensify than abate as we approach the new century. It is not without significance that no one—so far as I know—has ever seriously presented the converse case. There is no financial journal paper entitled "The Benefits of Asset Size to Mutual Fund Investors," nor—even in *Worth* magazine—an article headlined "For Truly Superior Performance: Go with the Giants." Or even a defense that

meets a lower standard: "Large Funds: The Easiest Way to Beat the Indexes in the Future." Probably the most favorable comment the manager of any large portfolio would dare make on the subject is "size doesn't significantly impair my ability to do my job." And I'm not sure that it would be said with either enthusiasm or conviction. In short, the case that asset size is the enemy of performance excellence, it seems to me, is so obvious as to defy serious debate.

So why do funds allow size to get out of hand? Because, for advisers, "nothing does succeed like success." The management company loves large size, because the dollar amount of advisory fees it receives rises on an almost linear basis with fund assets. The larger the assets, the larger the fees. And its profits grow at a still higher rate. Why? Because of the leverage of economies of scale, arrogated by advisers to their own benefit rather than to the benefit of the fund shareholders they serve, a system that is accepted by fund independent directors, even as they are pledged under the law to place the interests of fund shareholders ahead of the interest of fund advisers.

To be sure, the industry is growing apace, largely because the American public, excited by the continuing bull market, has an appetite for mutual funds that seems virtually insatiable. And individual fund complexes too are growing apace. But that growth is not only accepted, but is being accelerated, at the expense of the investors who own the fund. It is being accelerated by fund advisers who have everything to gain, financially speaking, and nothing to lose by building funds to a size where past performance is irrelevant and future performance is destined for mediocrity: the return of the market, reduced by the fund's management fees and transaction costs.

To make matters worse, a rather frightening paradox emerges: Fund expenses are high in part because massive amounts of shareholder assets are used to finance huge marketing programs. Shareholders are clearly penalized by large size, even as advisers are enriched by ever-rising fees. Profitability—of the advisers—has risen to unprecedented levels, bringing about a merger boom among advisers, further accelerated as fund managers sell their companies to their competitors, to banks, and to financial corporations, domestic

and foreign. The idea, in this age of marketing, is to build a nationally recognizable name—a "franchise." Simply put, marketing, not management, has become the industry watchword. The message has become the medium.

To Dream The Impossible Dream

Now, if fund directors and managers were somehow to agree with the case I've presented here, what steps might they take? It may be an impossible dream, but let me offer some decidedly real world solutions.

1. Change fund strategy—but not objective. Whatever happened to long-term strategy? The increase in fund portfolio turnover to nearly 90% from 30% in the "good old days," whatever else it may have accomplished, has not improved fund returns relative to the market. In fact, fund relative returns have arguably deteriorated. So why don't the leopards of the mutual fund industry change their spots and go back to those good old days? (Maybe 20% turnover would be even better.) I imagine the answer is: Most managers would rather be short-term traders (today's average holding period is roughly one year) than long-term investors (if an average holding period of even five years—i.e., 20% turnover—truly qualifies for that description). The present situation is likely to persist, I think, for two major reasons. The "new breed" of portfolio managers simply likes turnover. Perhaps these managers are aggressive by temperament. Surely they're highly intelligent and well-educated and want to apply their talents actively and often. Further, and perhaps even more important, the big money for managers in this industry is made by flashy short-term fund performance and rarely achieved very quickly by a steady-as-you-go, buy-and-hold portfolio. The way to garner assets for a new fund is to build a record the press will write about. The money flows in, leading to soaring advisory fees and strong profits for the managers. No need to worry much about how the fund must change when it grows large. That's for tomorrow.
2. Close the fund to new investors. When a fund reaches a size at which it can no longer implement its strategy because of a constricting number of stocks in its universe, or because of the

increasing difficulty of buying and selling without significantly influencing price, why not close the fund? But as the problems of dealing with size became imminent, only about two out of every hundred funds have closed, including a few that have done so at far higher asset levels than would seem appropriate. But most funds seem to ignore the problem and so face deteriorating relative returns and reduced opportunities to distinguish themselves, to the potential benefit of the very shareholders that purchased their shares because the fund had distinguished itself in the past. In other words, as John Bogle Jr. has said, "Managers and trustees have turned a blind eye towards the interest of the shareholder, in favor of their own interests in the ever-growing stream of revenues." Again, sad to say, the status quo too seems likely to persist, simply because the profitability of a fund "franchise" to the manager is linear: the larger the fund, the larger the return to the adviser. This incentive seems clearly to supersede any interest in providing the optimal return to the shareholder. Only if fund shareholders, financial advisers, and—most of all—fund directors would raise these issues, and if the financial press would give them the attention they deserve, will fund managements finally be forced to act.

3. Let the fund grow, but add new managers. One obvious solution to the problem created when a fund reaches optimal size is to bring in a new portfolio manager and allocate part of the existing portfolio and future cash inflow to the new firm. (I say "new firm" simply because bringing in a new manager from the existing firm will not solve the liquidity problem.) A very few large fund groups have done so, using an external manager for a new fund, or using multi-manager structures with two to four external managers for an existing fund. Given the arm's-length negotiations implicit under these circumstances, advisory fees are apt to be far below industry norms. (This situation presents the paradox of why the "in-house" adviser for a given fund receives a high fee, but a fund managed by an external adviser receives a fee a fraction as large. The fund directors should raise that question! I'd love to hear the answer.) The external manager solution clearly comes to grips with this issue by allowing a fund to grow without the loss—and perhaps even an increase—of investment efficiency. However, the solution also

creates a new problem. How likely is it that the portfolio run by the new adviser will add value? Won't two managers simply offset each other with inevitably alternating periods of good and bad returns? What about four managers? Or six? There is clearly a law of diminishing returns, and it may begin to come into play with the addition of the first manager. In any event, rare indeed is the use of this strategy.

4. Lower the basic advisory fee, but add an incentive fee. If the idea is to maintain generous incentives for the manager without jeopardizing the relative returns to the investor, why not cut the regular fee and add an incentive that is paid only to the extent that the fund's returns exceed the returns of an appropriate market index. By way of simple example, cut the fee from 1.00% to 0.75%, and add an incentive of 0.25%. The problem for the manager is that the incentive must be "symmetrical"; that is, a fee penalty of 0.25% be imposed if the fund falls short, in which case the total fee would tumble to 0.50%. But "fair is fair." Do the job and get paid; fail and take the consequences. (That's what life should be about.) Fairer yet, make the standard not the index return, but the index return plus the margin of excess return over the index that the fund had achieved in, say, the prior five years—i.e., the performance the shareholder is all too likely expecting. The mutual equity of such a structure seems quite obvious. Alas, again, these two types of incentive fee solutions (especially the second!) seem unlikely to be adopted, at least so long as fund shareholders (through their fund independent directors) don't demand it. Basic incentive fees, a rarity in this business today, are becoming increasingly rare; managers would rather receive something (a high fee) for nothing (a fee that is paid whether performance is good or bad). And fund directors seem ill-prepared to challenge the existing fee culture of the industry.
5. Offer a mutual fund that is "size proof," with minimal turnover and a nominal fee. Given the clear evidence at hand on the importance of transaction costs and management fees in shaping past returns—along with the fact that the huge present size of the industry may well make the attainment of even this standard of mediocrity more difficult in the future—wouldn't such a fund provide a solid alternative for mutual fund investors? I believe

that a great opportunity for cost-effective, low-turnover, tax-efficient mutual funds lies at hand today. Indeed the closest approximation of such a fund, the basic market index fund, has existed for more than 20 years, and has recently gained considerable market acceptance. Alas, too much of that acceptance is based on the outstanding relative performance of the S&P 500 Index (not the best, nor even the lowest turnover, form of index fund) over the past 15 years—and especially the past three years—at margins that are highly unlikely to persist. Further, it is difficult for a fund complex relying on active professional managers to accept low-cost, passively managed index funds or quasi-index funds with much enthusiasm, or to make money on them (as distinct from making money for its fund shareholders) since an index fund is a generic investment, meaning that (in an efficient market) cost must be at the rock-bottom level in order to compete. A one- or two-basis-point profit margin for the manager is about all that traffic will bear. With manager profit margins now in the 50% (to 80%!) range, the supply of index-oriented funds seems unlikely to increase markedly very soon. If that fact suggests that the interest in optimal adviser profits outweighs the interest in optimal shareholder profits, so be it. But there is a point at which investors will demand that their interests be served.

Well, I've offered five suggestions that only a few fund organizations have taken very seriously—so far. Portfolio turnover is high and shows no sign of diminishing, and some fragile evidence exists that unit transaction costs are rising. Few funds have closed, and many of those that have closed have done so far later than their growth demanded. External manager structures are as rare as 20-carat diamonds. Expense ratios are rising, especially for the horde of new funds being formed. Incentive fees not only remain conspicuous by their rarity, but are indeed being abandoned. Fund innovation—in other areas, clever to a fault—has ignored the opportunity to create funds that are more cost-efficient, to say nothing of far more tax-efficient. (It's fair to say that this industry substantially ignores the needs of its 15 million taxable shareholders.) And, the best existing proxy for dealing with the challenges of large size—the index fund—is a pariah that is accepted largely because trustees of institutional

savings plans (which, paradoxically, gain no performance advantage from tax efficiency) are demanding it for corporate employees. At any rate, the 30 million Davids—fund investors—out there seem unable to find the rock that will get the attention of the Goliath fund management companies and stun them into recognizing the problems of asset size.

Conclusion

To return full circle, we have a different mutual fund industry today, different in the aggregate, different in its very power in the financial markets, different in its investment limitations, different in its costs and market impact, different in the way its investment decisions are made and implemented. And that means that any reliance on history as a guide to the future is tenuous at best.

A new century lies before us. For the firms that manage mutual funds, to control perhaps four-tenths of all U.S. equities when the 21st century arrives on January 1, 2001, the traditional ground rules are changing. In this environment, I simply ask: Why can't this industry be more forthright about the issue of size? Why can't we face up to the fact that our burgeoning asset growth has changed the character of most giant funds and indeed, of the industry in the aggregate? And that liquidity matters. And that cost matters. And that taxes matter. And that size can kill. The challenge of performance excellence is becoming more formidable, more impregnable than ever from attack, even by skilled professional portfolio managers.

It may well be that, despite our industry's fabulous success, living proof that "nothing succeeds like success," is sowing the seeds of its own antithesis. We'd best not forget, then, the converse axiom that "nothing fails like success," and consider the full range of implications of investment size for the colossus we have created. No firm—I repeat, no firm—is exempt from these issues. And any firm that has lacked the courage to face this disturbing music should remember that the success it has had the opportunity to enjoy in these halcyon bull market days will fade away if it doesn't resist the temptation to forget its old, vintage disciplines. For, even as we bask in the success of our past, we may be sowing the seeds of failure and forfeiting the

success that could otherwise lie before us.

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