

The Mutual Fund Industry in 2003: Back to the Future

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Before the Harvard Club of Boston,
the Harvard Business School Association of Boston,
and the Boston Security Analysts Society
Boston, Massachusetts
January 14, 2003**

It was just over 53 years ago when my career was determined by a fortuitous but life-altering moment in Princeton University's Firestone Library. Ever the contrarian, I was eager to find a topic that had not previously been the subject of a Princeton thesis when, in the December 1949 issue of *Fortune* magazine, I stumbled upon an article describing the mutual fund industry.

The title of the article was "Big Money in Boston." It featured the nation's oldest and largest mutual fund, Massachusetts Investors Trust (M.I.T.). The story described it as "the leader of a rapidly expanding and somewhat contentious industry of great potential significance to U.S. business." I immediately realized that I had found my topic.

The extensive study of the industry that followed led me to four conclusions: One, that mutual funds should be managed "in the most efficient, honest, and economical way possible," and that fund sales charges and management should be reduced. Two, mutual funds should not lead the public to the "expectation of miracles from management," since funds could "make no claim to superiority over the (unmanaged) market averages." Three, that "the principal function (of funds) is the management of their investment portfolios"-the trusteeship of investor assets-focusing "on the performance of the corporation . . . (not on) the short-term public appraisal of the value of a share (of stock)." And four,

that "the prime responsibility" of funds "must be to their shareholders," to *serve* the individual investor and the institutional investor alike.

When I graduated in 1951 my work was rewarded with a job at Wellington Management Company, one of the industry pioneers, then with some \$140 million of our assets under management. I became head of Wellington in 1965, and in 1967 merged it with a then-small Boston manager named Thorndike, Doran, Paine, and Lewis. In January 1974, I was fired for my efforts. (It's a long story!) Painful as it was for me, I pulled myself together and by September of that year had founded Vanguard. As they say, "the rest is history". In short; no thesis, no career in the mutual fund industry; no firing, no Vanguard. There's a lot of luck in life! (Although I'm not sure our competitors would consider it *good* luck!)

In retrospect, that seminal *Fortune* article that inspired my thesis described an industry that is barely recognizable today. Not just in size, for, as I predicted, an era of growth lay ahead for this industry. If "Big Money" described a *tiny* industry, I'm not sure what adjective would be adequate to describe today's giant. And while more than one-half of fund assets were managed "in Boston" then, that share is now down to one-sixth. The mutual fund industry today is international in scope.

The vast changes in the size of this industry and in the types of funds we offer today—the difference between funds *past* and funds *present*—are but one reflection of the radical change in the very character of this industry. What *Fortune* described a half-century ago was an industry in which the idea was to sell what we made: *Funds that offer the small investor peace of mind*, an industry that focused primarily on stewardship. By contrast, the industry we see today is one focused primarily on salesmanship, an industry in which marketing calls the tune in which we make what will sell, and in which short-term performance is the name of the game.

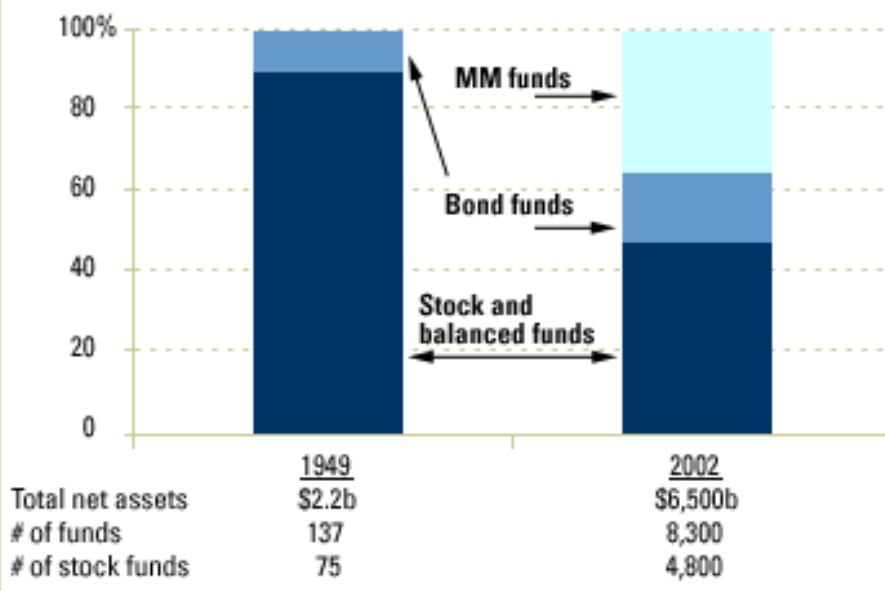
This change in character is not an illusion. Since that *Fortune* article was published slightly over a half-century ago, there are specific, quantifiable ways in which this industry has changed. Today I'll examine nine of them, and then conclude with an appraisal their impact on the

effectiveness with which mutual funds serve their shareholders: *Have these changes been good for our investors or not?* I'll be using industry averages to measure these changes. Of course some fund firms—but not nearly enough, in my view—have strived to retain their original character. But overall, the mutual fund industry has changed radically. Let me count the ways:

1. Funds are Far Bigger, More Varied, and More Numerous

The mutual fund industry has become a giant. From its 1949 base of \$2 *billion*, fund assets soared to \$6.5 *trillion* at the outset of 2003, a compound growth rate of 16%. If we'd grown at the 7% nominal growth rate of our economy, assets would be just \$72 *billion* today. (Such is the magic of compounding!). Then, 90% of industry assets were represented by stock funds and stock-oriented balanced funds. Today such funds compose only about half of industry assets. Bond funds now represent one-sixth of assets, and money market funds—dating back only to 1970—constitute the remaining one-third. Once an equity fund industry, we now span the universe of major financial instruments—stocks, bonds, and savings reserves—a change that has been a boon not only to fund managers, but to fund investors as well.

So too has the number of funds exploded. Those 137(!) mutual funds of yesteryear have soared to today's total of 8,300. More relevantly, the total number of common stock funds has risen from just 75 to 4,800, although it is not at all clear that the *nature* of this increase has created investor benefits, for, in retrospect, "choice" has done investors more harm than good.

The industry:**Bigger and more varied, with lots more funds**

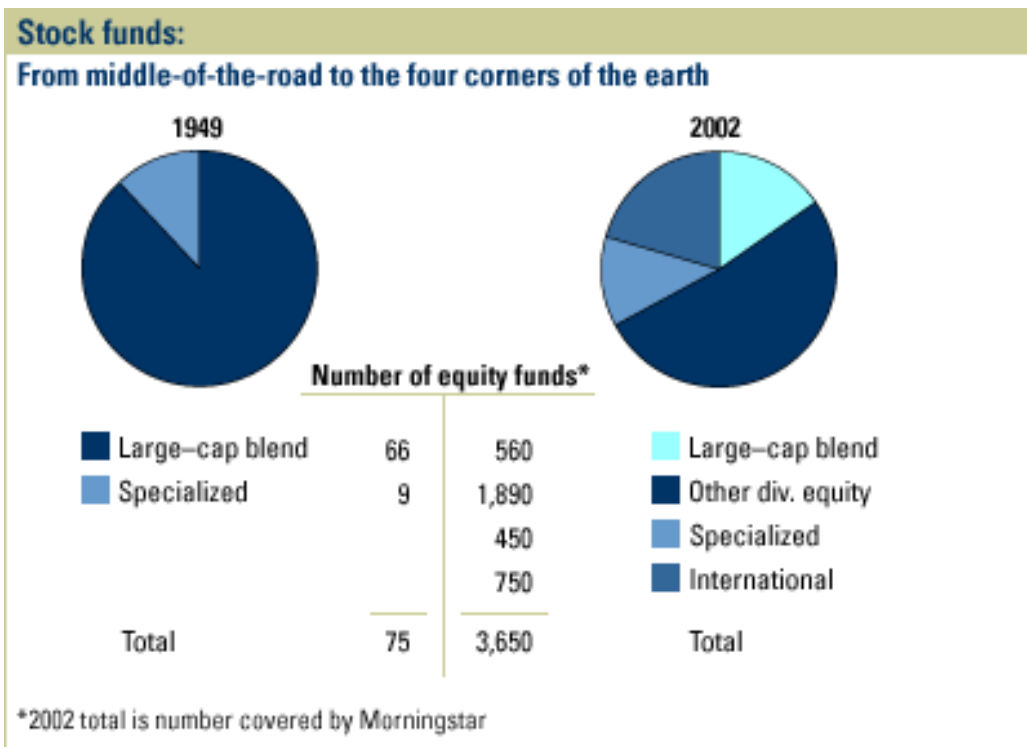
2. Stock Funds: From the Middle-of-the-Road to the Four Corners of the Earth

For as the number of stock funds soared, so did the variety of objectives and policies they follow. In 1950, the stock fund sector was dominated by funds that invested largely in highly-diversified portfolios of U.S. corporations with large market capitalizations, with volatility roughly commensurate with that of the Standard & Poor's 500 Stock Index. Today such middle-of-the-road funds represent a distinct minority of the total, and most other categories entail higher risks. Only 560 of the 3,650 stock funds measured by Morningstar now closely resemble their blue-chip ancestors.¹

What's more, we now have 450 specialized funds focused on narrow industry segments, from technology to telecommunications (particular favorites during the late bubble), and 750 international funds, running the gamut from diversified funds owning shares of companies all over the globe to highly specialized funds focusing on particular nations, from China to Russia to Israel. Among our 4,800 stock funds, there must now be one for every purpose under heaven.

A half-century ago, investors could have thrown a dart at a list of stock funds and had nine chances out of ten to pick a fund whose return was

apt to parallel that of the market averages. Today, they have just one chance out of eight! When that old *Fortune* article noted that most funds did no more than give investors "a piece of the Dow Jones Average," it presciently added, "the average is not a bad thing to own." But today, for better or worse—probably worse—selecting mutual funds has become an art form.



3. From Investment Committee to Broadway Stardom

These vast changes in fund objectives have led to equally vast changes in how mutual funds are managed. In 1950, 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. First, the "Go-Go" era of the mid-1960s and then the recent bubble brought us hundreds of more aggressive "performance funds," and the new game seemed to call for free-wheeling individual talent. The term "investment committee" vanished, and "portfolio manager" gradually became the industry standard, now the model for some 3,200 funds of the 3,650 stock funds listed in Morningstar. ("Management teams" run the other 450 funds.)

The coming of the age of portfolio managers whose tenure lasted only

as long as they produced performance moved fund management from the stodgy old consensus-oriented investment committee to a more entrepreneurial, free-form, and far less risk-averse approach. Before long, moreover, the managers with the hottest short-term records had been transformed by their employers' vigorous public relations efforts and the enthusiastic cooperation of the media, into "stars," and a full-fledged star-system gradually came to pass. A few portfolio managers actually *were* stars—Fidelity'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 a moment in time before they flamed out. Even after the devastation of the recent bear market, and the stunning fact that the tenure of the average portfolio manager is just five years, the system remains largely intact.

Committees, stars, and comets

Management Mode

1950: Almost Entirely Investment Committees

2002*: Investment Committee -	0 (?)
Single Portfolio Manager -	1,600
Multiple Port. Managers -	1,550
Management Team -	450

*Source: Morningstar. No manager listed for 50 funds.

4. Turnover Goes Through the Roof

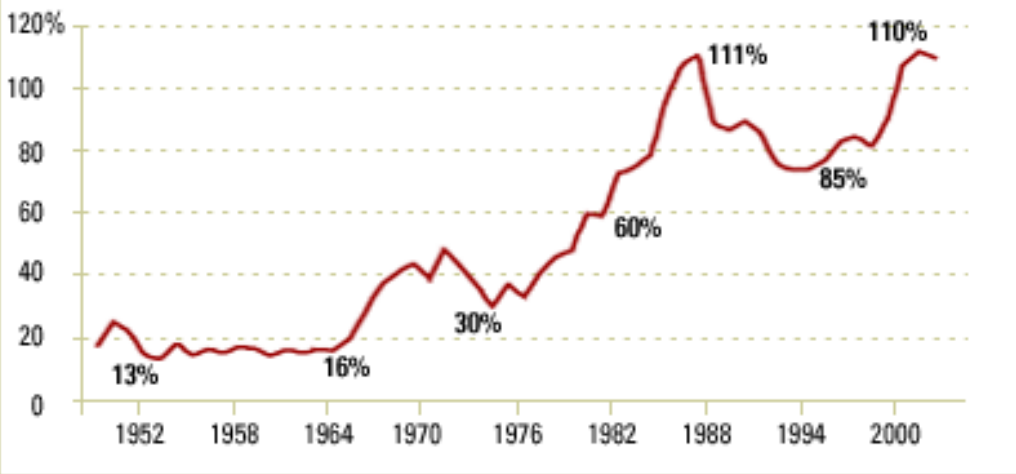
Together, the coming of more aggressive funds, the burgeoning emphasis on short-term performance, and the move from investment committees to portfolio managers had a profound impact on mutual fund investment strategies—most obviously in soaring portfolio turnover. M.I.T. and the other funds described in that *Fortune* article didn't even *talk* about long-term investing. They just *did* it, simply because that's what trusteeship is all about. But over the next half-century that basic tenet was turned on its head, and short-term speculation became the order of the day.

Not that the long-term focus didn't resist change. Indeed, between

1950 and 1965, it was a rare year when fund portfolio turnover much exceeded 16%, meaning that the average fund held its average stock for an average of about six years. But turnover then rose steadily and surely and fund managers now turn their portfolios over at an astonishing average annual rate of 110%(!). Result: Compared to that earlier six-year standard that prevailed for so long, the average stock is now held for just eleven months.

The contrast is stunning. At 16% turnover, a \$1 billion fund sells \$160 million of stocks in a given year and then reinvests the \$160 million in other stocks, \$320 million in all. At 110%, a \$1 billion fund sells and then buys a total of \$2.2 billion of stocks each year—nearly seven *times* as much. Even with lower *unit* transaction costs, it's hard to imagine that such turnover levels aren't a major drain on shareholder assets.

Let me be clear: If a six-year holding period can be characterized as long-term investment and if an eleven-month holding period can be characterized as short-term speculation, mutual fund managers today are not investors. We are speculators. When I say that this industry has moved from investment to speculation, I do not use the word "speculation" lightly. Indeed, in my thesis I used Lord Keynes' terminology, contrasting *speculation* ("forecasting the psychology of the market") with *enterprise* ("forecasting the prospective yield of an asset"). I concluded that as funds grew they would move away from speculation and toward enterprise (which I called "investment"), focusing, not on the price of the share, but on the 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 was dead wrong. We are no longer stock *owners*. We are stock *traders*, as far away as we can possibly be from investing for investment icon Warren Buffett's favorite holding period: *Forever*.

Turnover goes through the roof

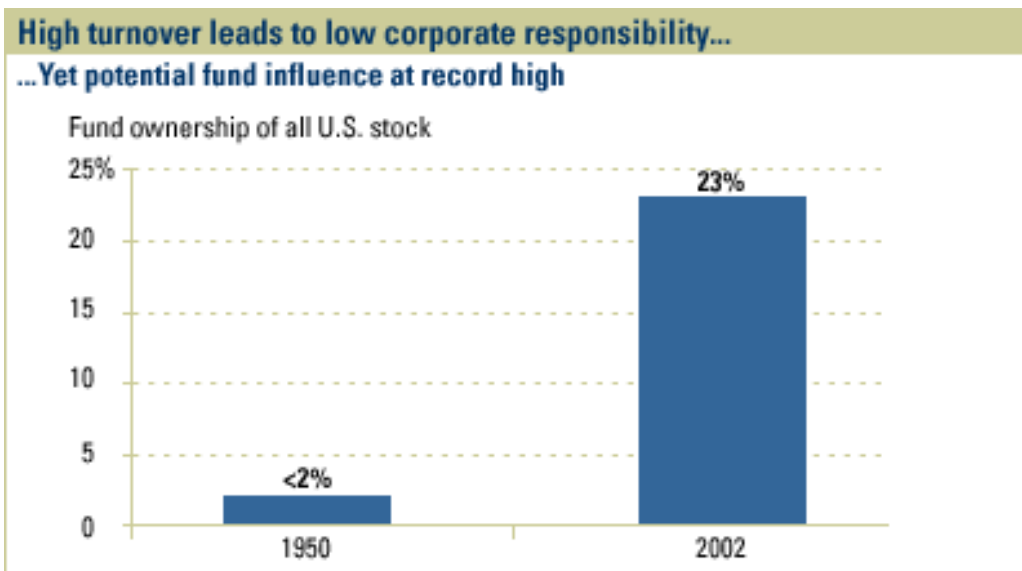
5. High Stock Turnover Leads to Low Corporate Responsibility

Whatever the consequences of this high portfolio turnover are for the shareholders of the funds, it has had dire consequences for the governance of our nation's corporations. In 1949, *Fortune* wrote, "one of the pet ideas (of M.I.T.'s Griswold) is that the mutual fund is 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." And in my ancient thesis that examined the economic role of mutual funds, I devoted a full chapter to their role "as an influence on corporate management." Mr. Griswold was not alone in his activism, and I noted with approval the SEC's 1940 call 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."

It was not to be. Just as the early hope I expressed that funds would continue to invest for the long term went aborning, so did my hope that funds would observe their responsibilities of corporate citizenship. Of course the two are hardly unrelated: A fund that acts as a trader, focusing on the price of a share and holding a stock for but eleven months, may not even own the shares when the time comes to vote them at the corporation's next annual meeting. By 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.

While funds owned but two percent of the shares of all U.S. corporations a half-century ago, today, they own 23 percent. They could wield a potent "big stick," but, with few exceptions, they have failed to do so. As a result of their long passivity and lassitude on corporate governance issues, we fund managers bear no small 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. It is hard to see anything but good arising when this industry at last returns to its roots and assumes its responsibilities of corporate citizenship.



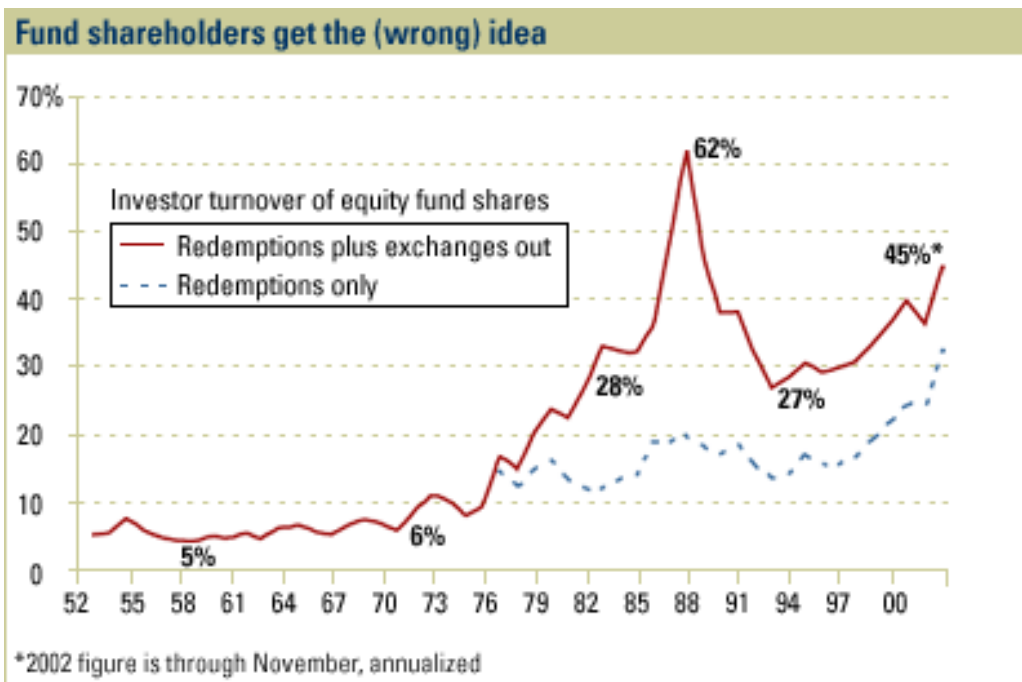
6. The Fund Shareholder Gets the (Wrong) Idea

The change in this industry's character has radically affected the behavior of the mutual fund shareholder. In the industry described in the *Fortune* article as having "tastes in common stocks that run to the seasoned issues of blue-chip corporations," shareholders bought fund shares and held them. In the 1950s, and for a dozen years thereafter, fund redemptions (liquidations of fund shares) averaged 6% of assets annually, suggesting that the average fund investor held his or her shares for 16 years. Like the managers of the funds they held, fund owners were investing for the long pull.

But as the industry brought out 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. Up, up, up went the redemption rate. Last year it reached 45% of assets, an average holding period of slightly more than two years. The time horizon for the typical fund investor had tumbled by fully 90%.

As "buy and hold" turned to "pick and choose," the average fund owner who once held a single equity fund came to hold four. *Freedom of choice* became the industry watchword, and "fund supermarkets," with their "open architecture," made it easy to quickly move money around in no-load funds. Trading costs are hidden in the form of access fees for the shelf-space offered by these supermarkets, paid for by the funds themselves, so that swapping funds seemed to be "free," tacitly encouraging fund shareholders to trade from one to another. But while picking tomorrow's winners based on yesterday's performance is theoretically attractive, in practice it is a strategy that is doomed to failure.



7. The Modern Mutual Fund . . . Made to be Sold

It is easy to lay the responsibility for this astonishing telescoping of holding periods on gullible, flighty, and emotional fund investors, or on

the change in the character of our financial markets, especially in the boom and bust in the stock market bubble of 1997-2002. It was clearly a mania driven by the madness of crowds. But by departing from our time-honored tenet, "we sell what we make," and jumping on the "we make what will sell" bandwagon, creating new funds to match the market mania of the moment, this industry was a major contributor to that bubble. As technology and telecom stocks led the way, we formed 494 new technology, telecom, and internet funds, and aggressive growth funds favoring these sectors. In all, the number of stock funds, which grew by 80% in the 1950s and 48% in the 1970s, burgeoned almost 600% in the 1990s.

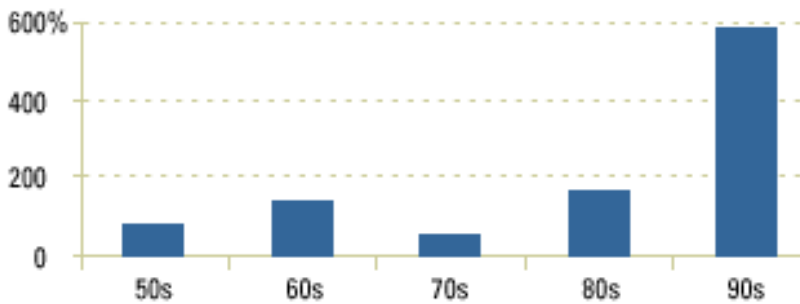
Not only did we form these funds, we marketed them with vigor and enthusiasm, through stock brokers and through advertising. Case-in-point: Right at the market peak, 44 mutual funds advertised their performance in the March 2000 issue of *Money*. *Their average return over the previous twelve exuberant months came to +85.6%! Small wonder that this industry took in \$555 billion of new money—more than a half-trillion dollars—during 1998-2000, overwhelmingly invested in the new breed of speculative high-performance funds. Most of the money, of course, poured into those winners of yesteryear after they led the market upward. So their assets were huge when they led the market on the way down, the investors' money gone up in smoke. First the cash flow stopped, and then it turned negative—an \$18 billion outflow in the year just ended. Today, it is not irrational exuberance but rational disenchantment that permeates the community of fund owners, many of whom, unaware that the great party was almost over and that a sobering hangover lay ahead, imbibed far too heavily at the punch bowl.*

It was not long until this flagrant formation of opportunistic new funds soon began to unwind. Fund deaths began to match, and will surely soon exceed, fund births. But it is not the old middle-of-the-road funds that are dying; it is largely the new breed of funds—those that sought out the exciting stocks of the new economy and hyped their records. While those conservative early funds were, as the saying goes, "built to last," their aggressive new cousins seemed "born to die." The fund failure rate soared. While only 10% of the funds in the 1950s were no

longer in business at the end of that decade, more than half of the funds that existed during the past decade are in not business today. And this trend shows no signs of slowing, with nearly 900 funds giving up the ghost in the past three years alone, a rate that, if it continues, will produce another decade in which more than half of all equity funds cease to exist.

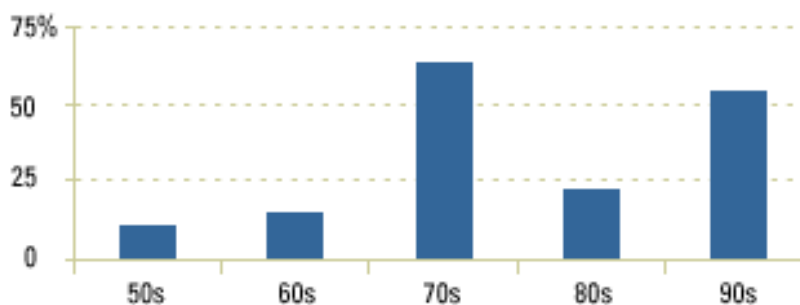
Mutual funds: Made to be sold?

Equity funds created each decade, as % of equity funds in existence



Mutual funds: Born to die?

Equity fund failure rate



8. The Costs of Fund Ownership Have Soared

When "Big Money in Boston" featured Massachusetts Investors Trust, it was not only the oldest and largest mutual fund, but the least costly. The *Fortune* article reported that its annual management and operating expenses, paid at the rate of just 3.20% of its investment income, amounted to just \$827,000. In 1951, its expenses come to just 0.29% of its assets. The average expense ratio for the 25 largest funds, with aggregate assets of but \$2.2 billion, was only 0.64%.

What a difference five decades makes! In 2001, M.I.T.'s expense ratio had risen to 1.20%, and its \$141 million of expenses consumed 87%(!) of its investment income. The average expense ratio for the equity funds managed by the 25 largest fund complexes has risen 134% to

1.5%, despite the fact that their assets have soared 845-fold, to \$1.86 *trillion*. The dollar amount of direct fund expenses borne by shareholders of *all* equity funds has risen from an estimated \$15 *million* in 1950 to something like \$35 *billion* in 2002. Despite the truly staggering economies of scale in mutual fund management, fund investors have not only *not* shared in these economies. They have been victims of far higher costs.

The fund industry reports that the costs of fund ownership have steadily declined, but it is difficult to take that allegation seriously. The decline, if such it be, arises from investors increasingly choosing no-load funds and low cost funds, *not* from substantial management fee reductions. But even accepting the industry data at face value, the cost of mutual fund ownership is vastly understated. Why? *Because management fees, operating expenses and sales charges constitute only a fraction of fund costs.* Portfolio transaction costs—an inseparable part of owning most funds—are ignored. Out-of-pocket costs paid by fund investors are ignored. Fees paid to financial advisers to select funds (partly replacing those front-end loads) are ignored. Put them all together and it's fair to estimate that the all-in annual costs of mutual fund ownership now runs in the range of 2½% to 3% of assets.

What does that mean? While 2½% may look like small potatoes compared to the value of a typical fund investment, such a cost could cut deeply into the so-called "equity-premium" by which investors expect stock returns to exceed bond returns, giving the average equity fund investor a return little more than a bondholder, despite the extra risk. Looked at another way, 2½% would consume 25% of an annual stock market return of 10%. Over the long-term, \$1 compounded in a 10% stock market would grow to \$17.50 over 30 years; compounded at 7½%—a typical fund's return *after* such costs—would reduce that value by exactly one-half, to \$8.75. *Costs matter!* Yet costs rise and sharply, one more indication that the fund industry has veered from its roots as an investment *profession*, moving ever closer to being just another consumer products business.

The costs of fund ownership

	<u>1951: top 25 equity funds</u>	<u>2002: top 25 fund mgrs.</u>	<u>Change</u>
Total assets (bil)	\$2.2	\$1,860	845x
Average exp. ratio	0.64%	1.50%	+134%
		<u>Total equity funds</u>	
Fees and op. expenses (e)	\$15 mil.	\$35 bil.	2,300x

9. The March of the Entrepreneur

The industry that *Fortune* described all those years ago clearly placed the emphasis on fund management as a profession—the trusteeship of other people's money. The article is peppered with the words "trust" and "trustee," and frequently refers to the "investment-trust industry." Today, it seems clear that salesmanship has superseded trusteeship as our industry's prime focus. What was it that caused this sea change? Perhaps it's that trusteeship was essential for an industry whose birth in 1924 was quickly followed by tough times—the Depression, and then World War II. Perhaps it's that salesmanship became the winning strategy in the easy times thereafter, an era of almost unremitting economic prosperity. But I believe that 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.*

The fact is that, only a few years after "Big Money in Boston" appeared, the whole dynamic of entrepreneurship in the fund industry changed. Up until 1958, 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 SEC held that the sale of a management company represented the payment for the sale of a fiduciary office, an illegal appropriation of fund assets. If such sales were allowed, the SEC feared, it would lend to "trafficking" in advisory contracts, leading to a gross abuse of the trust of fund shareholders.

But a California management company challenged the SEC's position.

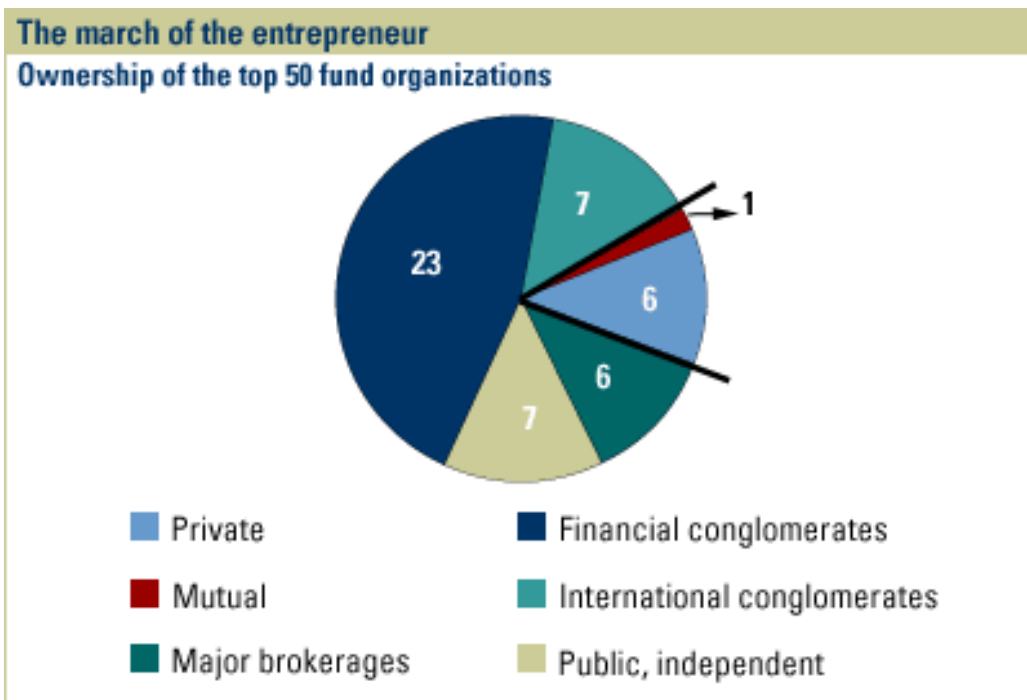
The SEC went to court, and lost. As 1958 ended, the gates that had prevented public ownership since the industry began 34 years earlier came tumbling down. *Après moi, le deluge!* A rush of initial public offerings began with the shares of a dozen management companies quickly brought to market. Investors bought management company shares for the same reasons that they bought Microsoft and I.B.M. and, for that matter, Enron: Because they thought their earnings would grow and their stock prices would rise accordingly.

But the IPOs were just the beginning. Even *privately-held* management companies were acquired by giant banks and insurance companies, taking the newly-found opportunity to buy into the burgeoning fund business at a healthy premium—averaging 10 times book value or more. "Trafficking" wasn't far off the mark; there have been at least 40 such acquisitions during the past decade, and the ownership of some firms has been transferred several times. Today, among the 50 largest fund managers, only six(!) are privately-held, plus mutually-owned Vanguard. 23 managers are owned by giant U.S. financial conglomerates, six are owned by major brokerage firms, and seven by giant foreign financial firms. (In 1982, even the executives of M.I.T. and its associated funds sold their management company to Sun Life of Canada.) The seven remaining firms are publicly-held.

It must be clear that when a corporation buys a business—whether a fund manager or not—it expects to earn a hurdle rate of, say, 12% on its capital. So if the acquisition cost were \$1 billion, the acquirer would likely defy hell and high water in order to earn at least \$120 million per year. In a bull market, that may be an easy goal. But when the bear comes, we can expect some combination of (1) slashing management costs; (2) adding new types of fees (distribution fees, for example); (3) maintaining, or even increasing, management fee rates; or even (4) getting its capital back by selling the management company to another owner. (The SEC's "trafficking" in advisory contracts writ large!)

It's not possible to assess with precision the impact of this shift in control of the mutual fund industry from private to public hands, largely those of giant financial conglomerates, but it surely accelerated the industry to change from profession to business. Such a staggering

aggregation of managed assets—often hundreds of billions of dollars—under a single roof, much as it may serve to enhance, to whatever avail, the marketing of a fund complex's "brand name" in the consumer goods market, it seems unlikely to make the money management process more effective, nor to drive investor costs down, nor to enhance this industry's original notion of stewardship and service.



Summing Up the Half-Century: For Better or Worse?

In short, this industry is a long, long way from the industry described in "Big Money in Boston" all those years ago. While my characterization of the changes that have taken place may be subjective, the factual situation I've described is beyond challenge. This *is* an infinitely larger industry. The variety of funds *has* raised the industry's risk profile. The management mode *was* largely by committee but *is* overwhelmingly by portfolio manager. Fund turnover *has* taken a great upward leap. Fund investors *do* hold their shares for far shorter periods. Marketing *is* a much more important portion of fund activities. Fund costs, by any measure, *have* increased, and sharply. And those closely-held private companies that *were* once the industry's sole modus operandi *are* an endangered species.

All this change has clearly been great for fund managers. The aggregate market capitalization of all fund managers 50 years ago could be fairly estimated at \$40 *million*. Today, \$240 *billion* would be more like it. Way back in 1967, Nobel Laureate Paul Samuelson was smarter than he imagined when he said, "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."

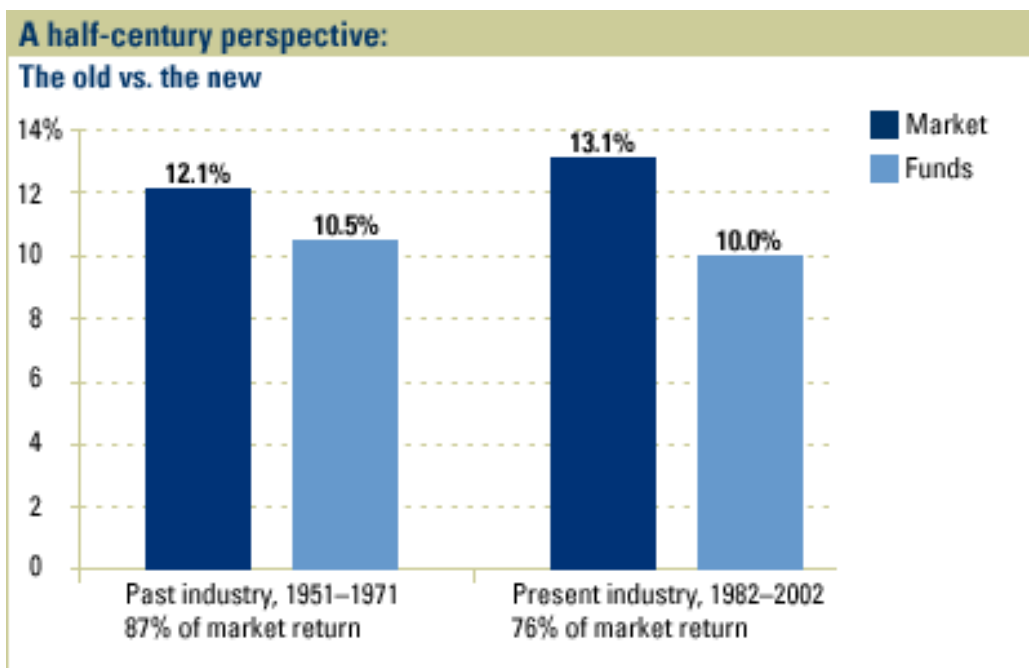
But our charge is to answer the question posed at the start of this speech. Have these nine changes served the interest of the mutual fund investor? The answer is a resounding no. It's a simple statistical matter to determine how well those on the other side of the bar in that saloon, using Dr. Samuelson's formulation, have been served, first by the old industry, then by the new.

- During the first two decades of the period I've covered today (1950-1970), the annual rate of return of the average equity fund was 10.5%, compared to 12.1% for Standard & Poor's 500 Stock Corporate Index, a shortfall of 1.6 percentage points, doubtless largely accounted for by the then-moderate costs of fund ownership. The average fund delivered 87% of the market's annual return.
- During the past 20 years (1982-2002), the annual rate of return of the average equity fund was 10.0%, compared to 13.1% for the S&P 500 Index, a shortfall of 3.1 percentage points, largely accounted for by the now-far-higher levels of fund operating and transaction costs. The average fund delivered just 76% of the market's annual return.

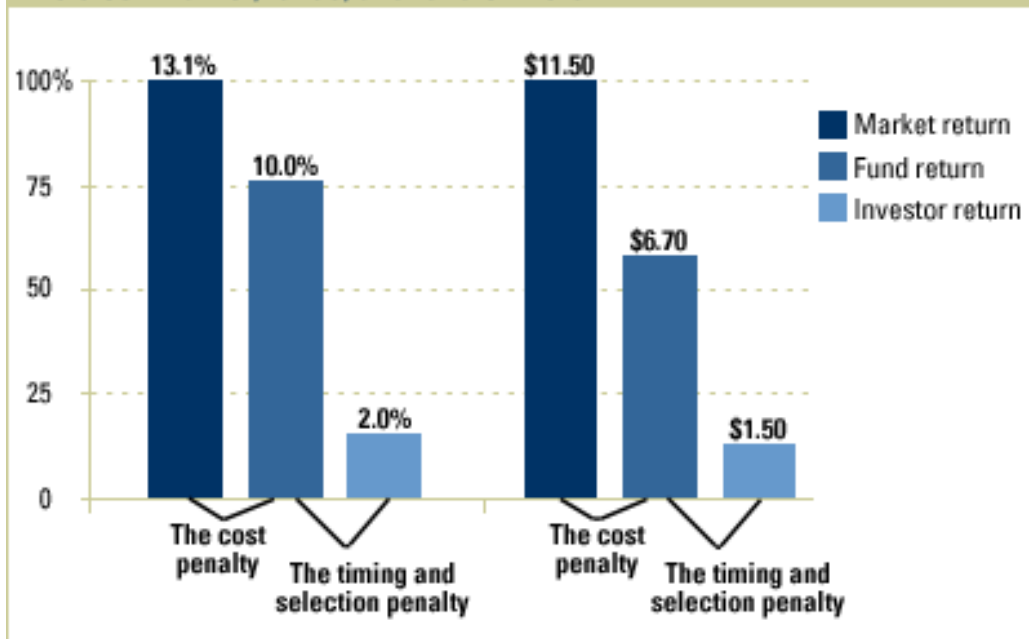
It is the increase in costs, largely alone, that has led to that substantial reduction in the share of the stock market's return that the average fund has earned. But it is the change in the industry's *character* that has caused the average fund *shareholder* to earn far less than the average *fund*. Why? First, because shareholders have paid a heavy *timing* penalty, investing 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. Second, because they have paid a *selection* penalty, pouring money into "new economy" stocks and withdrawing it from "old economy" stocks during the bubble, at what proved to be precisely the wrong moment.

The result of these two penalties: While the stock market provided an annual return of 13% during the past 20 years, and the average equity *fund* earned an annual return of 10%, the average fund *investor*, according to recent estimates, earned just 2% per year. It may not surprise you to know that, compounded over two decades, the 3% penalty of costs is huge. But the penalty of character is even larger—another 8 percentage points. *\$1 compounded at 13% grows to \$11.50; at 10%, to \$6.70; and at 2%, to just \$1.50.* A profit of just fifty cents!



The stock market, funds, and fund owners



The point of this exercise is not precision, but direction. It is impossible to argue that the totality of human beings who have entrusted their hard-earned dollars to the care of mutual fund managers has been well-served by the myriad changes that have taken place from mutual funds past to mutual funds present. What about mutual funds yet to come? My answer will not surprise you. It is time to go back to our roots; to put mutual fund shareholders back in the driver's seat, to put the interests of shareholders ahead of the interests of managers and distributors, just as the 1940 Investment Company Act demands.

This industry must return to its focus on broadly-diversified funds with sound policies, sensible strategies, long-term horizons, and minimal costs. Some of the steps we must take are relatively painless—reducing turnover costs, by bringing turnover rates down to reasonable levels, for example—and some would be very painful—reducing management fees and sales commissions, and cutting our operating costs. But such cost reductions are necessary if we are to increase the portion of the stock market's return earned by our *funds*.

To enhance the share of our *fund* returns earned by our *shareholders*, on the other hand, we need to reorder our "product line" strategies by taking our foot off the marketing pedal, and pressing our foot down firmly on the stewardship pedal, giving the investor better information

about asset allocation, fund selection, risks, potential returns, and costs, all with complete candor. After the market devastation of the past three years, I have no doubt that is what shareholders will come to demand. After all, as an article in the current issue of *Fortune* notes, "people won't act contrary to their own economic interests forever."

Fifty-plus years ago, the headline in that original *Fortune* article read: **The Future: Wide Open**. So it was then. I leave you with the same headline today. **The Future: Wide Open**. For it remains wide open, but only if we go back to the future—only if we return funds present to funds past—to our original character of stewardship and prudence. If funds come yet again to focus above all on serving our shareholders—serving them "in the most efficient, honest, and economical way possible"—the future for this industry will be not just bright, but brilliant.

1. The accepted terminology in 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. Yesteryear's middle-of-the-road funds would today find themselves in the "large-cap blend" box, constituting just 23% of the funds in the diversified U.S. fund category, and 15% of the Morningstar all-equity fund total. [Back](#)

An adaptation of this text has been published as chapter 1 in "Investing Under Fire: Winning Strategies from the Masters for Bulls, Bears, and the Bewildered" (Bloomberg Press, 2003). Available by calling (800) 869-1231 or at www.bloomberg.com/books.

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