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Putting the Shareholder First, A Lifetime Ideal: A Conversation with John Bogle

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Over the course of his fifty-five-year career in the investment industry, John C. Bogle, founder and former chairman of The Vanguard Group, redefined investing for the individual investor and became known as the conscience of the mutual fund industry. Concerned since his undergraduate days at Princeton University about the impact of costs on the returns that investors receive, Mr. Bogle turned a career setback in the mid-1970s into an opportunity to put his early beliefs into action. Within the space of three years, he had established Vanguard, the first mutual fund company to be owned by its fund-shareholder clients; created the first index mutual fund; and pioneered the concept of the modern no-load mutual fund. From its beginnings in 1974 with 350,000 shareholder accounts and $1.8 billion in mutual fund assets, Vanguard grew to become the world's largest no-load mutual fund company, with 19 million accounts representing more than $900 billion in assets. That first index mutual fund, now known as the Vanguard 500 Index Fund, became the world's largest mutual fund. In 1999, Mr. Bogle was named one of the investment industry's four "Giants of the 20th Century" by *Fortune* magazine. Since stepping down as senior chairman of Vanguard in 2000, he has continued to keep an eye on investors' interests through his work at the Bogle Financial Markets Research Center.

Among the books Mr. Bogle has authored on the investment industry are *Bogle on Mutual Funds: New Perspectives for the Intelligent Investor* (1993) and *John Bogle on Investing: The First 50 Years* (2000). In his latest book, *The Battle for the Soul of Capitalism* (2005), he takes on the problem of corporate excesses and provides recommendations on ways that investors can better exercise their corporate responsibility and fiduciaries can better serve the interests of their clients in this area.

In April 2006, Mr. Bogle talked with members of the *Journal of Investment Consulting* Editorial Advisory Board about the experiences that shaped his philosophy, his views on the costs of financial intermediation, and his recommendations for improving corporate governance. Taking part in the discussion were Edward Baker III, the *Journal*'s editor-in-chief, of Alliance Bernstein Ltd., London and San Francisco; Mark Anson of Hermes Pensions Management Ltd., London; Ronald Kahn of Barclays Global Investors, San Francisco; and Meir Statman of Santa Clara University, California. This interview is the fifth in the *Journal*'s Masters Series, which presents topical discussions with leading experts and visionaries in finance, economics, and investments.

PUTTING THE SHAREHOLDER FIRST: A LIFETIME IDEAL

A CONVERSATION WITH JOHN BOGLE

Ed Baker: Thank you for joining us today. We're very interested in hearing your perspectives on the investment industry, especially the mutual fund industry. Perhaps you could start by giving us some background on the major factors that shaped your views and brought you to where you are at this point in your career?

John Bogle: First of all, the mutual fund industry that I wrote about somewhat critically in my Princeton thesis way back in 1951 unarguably was a better industry than the one we have today. An article I wrote last year for the *Financial Analysts Journal* spelled this out in some detail. Costs were lower, investment thinking was

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longer-term, and the funds were sounder for investors because they were mostly middle-of-the-road, highly diversified stock funds that basically came very close to owning the market, plus some balanced funds such as the Wellington Fund and a few bond funds that later disappeared. During my first twenty years in this business, portfolio turnover averaged 16 percent per year, give or take a percentage point. Expense ratios were low, and getting lower, running about 70 basis points on average early on and then dropping to 55 basis points ten years later, as the industry grew and we could deliver some economies of scale. The business then was to sell what we made. Today, as everybody knows, it's a business of making what will sell, a very faddish business that has become very expensive for investors. So, it was a much simpler, cheaper industry back then, with the main thrust being very diversified funds with a long-term focus. By and large, in those days, one could hold those funds for a lifetime.

My 1951 thesis was very idealistic; it was all about putting the shareholder first. I called for investment managers to subordinate their interests to those of the shareholders and for mutual funds to be managed in "the most efficient, honest, and economical way possible." Today, in the industry as a whole, we've lost that efficiency, we've lost that economy, and—as we see from recent scandals—we've lost a great deal of that honesty. So that's the ancient background, reflecting the deep-seated idealistic bias that probably any college junior or senior has, followed by—and this is an expression of Justice Brandeis I use increasingly—"the relentless rules of humble arithmetic."[1] In other words, gross return in the market minus the cost of financial intermediation is the net return investors receive. That was the major concept that shaped my thinking beyond that initial idealism and gave me a sense of the appropriateness of running the industry for investors, rather than managers.

If investors and analysts would just stand back and think about how the financial markets work, they would have to conclude that indexing is the winning strategy. However, the strategy for success in the investment business is basically, "Don't just stand there—do something." Trade three billion shares every day. If Alan Greenspan—or now Ben Bernanke—speaks, do something. If General Motors or Adelphia is going bankrupt, do something. If Microsoft isn't getting its new product out on time, do something. Yet we all know that the best rule for investors—the clients of the investment business—is, "Don't just do something—stand there." That diametrical opposition between the interest of the business side and the investors who are its clients gives rise to the great flaws in this industry. I keep trying to think of better ways to say what I'm trying to get across, so I've added one thing to this. The mutual fund industry—and for that matter investing generally—is a field where you not only don't get what you pay for, but you get precisely what you don't pay for. Gross return minus costs equals net return. So the corollary to getting precisely what you don't pay for is this: If you pay for nothing, you get everything!

Meir Statman: Before we pursue those ideas, let's go back for a minute. When you started The Vanguard Group in 1974, it was with a different organizational structure from the conventional industry firm; that is, it was formally owned by the shareholders. Was that a new idea at the time?

John Bogle: That was a brand new way of running a mutual fund complex.

Meir Statman: So the industry of the 1950s that you were talking about was not as good as it could have been because, with the introduction of this structure, you improved upon it. Would you agree?

John Bogle: We improved upon it on two levels. First, if you believe we are fiduciaries, the shareholder/owner structure gives us the best possible chance of fulfilling that fiduciary duty. The shareholder/owner approach is not a perfect structure; there's always room for too much greed in any structure, but it's a better structure because philosophically it says, "Our owners are the shareholders, and they demand that the investment managers run the funds in the interests of the shareholders, rather than those of the managers." That's a big step forward in philosophy and, I believe, the correct fiduciary philosophy in an industry where, when I read about it in *Fortune*[2] all those years ago, the words "trust" and "trustee" kept appearing. I think we've lost that notion today.

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The second level, which reinforces this structure as an idea whose time has come, is that it produces those very low costs that we now know are essential to delivering to our investors their fair share of whatever returns the markets are generous enough to give us. You could say that the creation of Vanguard was my attempt to "walk the walk" that would justify the "talk the talk" words in my thesis all those years earlier. It was action that reinforced those initial words. This retrospective view of the situation might be a slightly romanticized version, but it's a view that's not without a lot of support. Nothing is quite that pristine, I'm the first to confess.

RON KAHN: It's interesting that you look back on the industry in the early 1950s as being so much better than today. That predates Harry Markowitz, William Sharpe, the capital asset pricing model (CAPM), and all the work of academics since then. What do you think academics have added? Have they added anything beyond CAPM?

JOHN BOGLE: First, academics can't create a different market return, so the age-old problem is always with us. That is, all of that research, all that theory, even when it's implemented, is not going to give *all* investors above-average returns. Investors, all of us together, are destined to average the market return before costs and then lose to the markets after costs. On the other hand, you could credit academics with the creation of this intermediation—or agency—society that we have today, which I describe, however, as a failed agency society. When I wrote my thesis, individual investors owned 92 percent of all stocks, with the other 8 percent owned by institutions. One assumes that, among them, individual investors would have had great spreads in their returns from one to another, but still averaged the market return before intermediation costs. If we look at the idea of diversification—the fundamental Markowitz theory—and add in Sharpe's theories on the level of risk that you decide to accept in your investment program, all of this leads to investors requiring an intermediator. So investors, with the help of modern portfolio theory or the efficient market hypothesis, began to move to diversified programs instead of trying to do it themselves. I think that's a plus. But can we say that academic research has enabled investors as a group to do better than the market itself? I don't think that's possible.

MEIR STATMAN: In 1960, you wrote "The Case for Mutual Fund Management," the core of which was not passive investing and low costs, but an advocacy of an active, beat-the-market kind of investing that you have since repudiated. What is your view of active management now? If that stands as the contrast to index funds, how do you reconcile the two?

JOHN BOGLE: I still would defend "The Case for Mutual Fund Management" today. It's actually a thorough article; I'm surprised that I was capable of a job that good back then, when I was barely thirty years old and fairly inexperienced. It basically said that in a good mutual fund industry, there wasn't a lot of point to having a mutual fund that tracked a broad market index, in that case the Dow Jones Industrial Average. What led up to the introduction of the first index fund—the First Index Investment Trust, known today as the Vanguard 500 Index Fund—is a story worth telling. The Vanguard Group was incorporated in September 1974 and started operations in May 1975. The understanding was that Vanguard was to limit itself to administration and not get into investment management or distribution; those were to stay with Wellington Management Company. However, for strategic reasons, I decided we needed to be in the management business. I was interested in building Vanguard as a company where we would control the kinds of funds we ran, how they were run, who would run them, to whom our shares would be distributed, and through whom our shares would be distributed.

I thought about the index fund that I had hinted at in my thesis so many years before, which would be essentially unmanaged and so provide a way for me to get back into the investment business. I got out these old Wiesenberger books[3] and calculated the average return of the fifty or sixty equity mutual funds that were in business then over the previous thirty years. When I compared the result with that of the Standard & Poor's 500 Stock Composite Index, the difference was approximately 1.5 percentage points per year in favor of the index, without taking into account index costs. I did calculate mutual fund returns net of expense ratios and

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turnover costs (but ignored sales charges), which were significantly lower in 1945–1975 than they are today. Then I calculated the two returns—9.6 percent for the funds and 11.1 percent for the index, or market—and compounded them over the thirty-year period.[4] Because I had to persuade the directors that this index mutual fund was a good idea to pursue, I wanted the results to look impressive. So instead of an initial investment of $10,000, I used $1 million and came up with $16 million of final value for the funds, compared with $25 million for the market over that period. The directors thought I was overstepping my mandate by starting such a mutual fund, reminding me that I was not allowed to get into management. I told them that the fund wasn't managed, and—believe it or not—they bought that.

Shortly after the fund was introduced, Paul Samuelson wrote about it in *Newsweek*, saying that his prayers for an index fund had been answered but that "a professor's prayers are rarely answered in full," citing the fund's sales commission. However, it quickly became clear—not only for indexing, but for Vanguard, which was striving to be the low-cost provider—that it didn't do any good to have an expense ratio of 0.25 percent or 0.5 percent if an investor had to pay 8 percent to buy the fund. In less than six months after the offering of the index fund in August 1976, we had moved to a no-load distribution system. When the directors reminded me that I could not take over distribution, I told them that I was not taking it over, I was eliminating it. That was not without a grain of truth, but probably could be considered a bit disingenuous. By February 1977, we were where we wanted to be: a full-line mutual fund complex providing administrative, investment management, and distribution services on the way to building Vanguard as the industry's low-cost provider, with the elimination of sales charges and the index fund as the obvious manifestation of those benefits.

MEIR STATMAN: That still leaves out the active part, and Vanguard of course has active funds, including funds that used to be managed by John Neff. In fact, I believe you personally owned those funds. How does active management, which is more expensive, live side-by-side with indexing?

JOHN BOGLE: It's not all that complicated. When we had the underwriting of the index fund, Vanguard's assets were approximately $2 billion, of which $11 million was in the index fund. We could, I suppose, have done away with the other funds and been left with an $11 million fund that couldn't possibly operate efficiently. But the other mutual funds already were here, part of our resource base, so my idea was to see how closely we could get them to look like index funds. That meant hiring experienced managers with a special mandate and a long-term time horizon and getting fees as low as we could. We negotiated aggressively with Wellington and made staggering fee reductions that didn't hurt them very much because they were all prospective. If you look at the actively managed Vanguard funds as having no sales charges, expense ratios of around 35 basis points—an 80-point advantage over their comparable competition—and pick up another 50 to 60 basis points through reduced turnover costs, you've got an annual advantage of about 135 basis points. And even more if you count the impact of their sales charges. Even if the active managers are only average in performance, you win, simply by using the very concepts that account for the success of the index fund.

ED BAKER: So do you believe that, in principle, active managers aren't really able to add value, that it's just a wasted effort?

JOHN BOGLE: As a group, active managers are average before costs and losers to the market after costs. It's less a wasted effort than an inability to know what is real—actual net returns earned—and what is illusion—the market returns themselves—what is luck and what is skill, and—equally importantly—what are taxes and what are not taxes. In terms of tax efficiency alone, active managers lose to the index by about 120 basis points a year. That active manager has to be very, very good to overcome the costs of the expense ratios, turnover, sales commissions, and other expenses, such as marketing costs. Even if his performance is good, you don't know that he will be able to repeat it. I believe you can invest in the index in a very satisfactory way for an investment lifetime, that is, for sixty-five years, figuring you're investing from age twenty to age sixty-five and then have

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another twenty years of life expectancy. You can buy an index fund, forget about it, and get the market return for the entire period, if you're using the Dow Jones Wilshire 5000 Total Market Index or the S&P 500.

To make matters worse on the active side, managers come and go. You mentioned John Neff; he hasn't run the Windsor Fund for the past ten years or so. In the fund industry, the average manager lasts five years, and the average investor owns four funds, so that's four managers in the first five years, eight managers after ten years, sixteen after twenty years, and fifty-two over the entire sixty-five years. What is the possibility that fifty-two managers, coming and going, cleaning out their portfolios time after time, could with remote conceivability do as well as the index? The return you get from holding the market portfolio over sixty-five years—even a modest return—demonstrates the "miracle of compounding returns," and the tremendous impact the cost of active management makes is "the tyranny of compounding costs." The way mathematics works, this tyranny absolutely overwhelms the miracle of compounding returns; to wit, over an investment lifetime the active equity fund investor captures about 20 percent of the return available simply by holding an all-market index fund.

Meir Statman: You convinced me about index funds many years ago, and I've invested in the Vanguard fund. Academics generally seem to favor index funds, but I think we are in the minority. Only about 15 percent of the money in mutual funds is in index funds. So why is it that you and I and others who have been propagating an idea that is so compelling logically have not been more successful? Why are we failing to get the message across?

John Bogle: Well, our livelihood doesn't depend upon our selling index funds to people, but the brokerage business is a giant marketing business, and increasingly so. An enormous sales force is arrayed out there, and they—the brokerage salesmen and, for that matter, financial advisers who choose to do this—have a wonderful ability to find, in any period, a fund that has beaten the index. In fact, they can probably find twenty-five funds that have beaten the index handily over, say, five years.

So we have a couple of problems: first, an information problem, that is, the imbalance between the information the buyer has and the information the seller has; it's called information asymmetry. Then we have human nature—we all think we're above-average drivers, above-average lovers, above-average investors, and if we don't think we're above average, we'll hire an expert. The mathematics that assure the superiority of index funds is overwhelming. So I keep asking, "Where's the tipping point?" I thought it would have arrived a long time ago. You have Warren Buffett saying exactly the same thing as I'm saying; Jack Meyer, one of the best investment managers in the country who tripled the Harvard Endowment Fund from $8 billion to $27 billion, saying that the investment business is a giant scam, and that investors should buy an index fund and hold it forever; David Swensen at Yale who not only says buy an index fund, but don't buy any fund from a company in business to make a profit. The investment business has really done itself a big disservice—and its clients a greater disservice—by somehow permitting the takeover of the business by financial conglomerates. These giant conglomerates are in business to earn a return on *their* capital, and not a return on *your* capital and my capital as fund investors. Their objective is in direct opposition to ours.

Ed Baker: So you're saying that, in theory, those objectives should be aligned, but they're not? If they were aligned, wouldn't that suggest the existence of a viable business?

John Bogle: You could argue, and I would argue, that Vanguard's claim to fame in a business that is known for "taking" rather than "making" is that we take less than anybody else. The less that is taken out, the more of the market return investors receive. Vanguard tries to provide index funds at the lowest possible cost, and to provide managed funds at such low cost that the investors who prefer them have at least a fighting chance of winning. As to why Vanguard has actively managed funds, it's a fairly obvious answer: If investors want an index fund, they'll buy one. You can't force someone to switch from a managed fund to an index fund; we would do that at our peril. If your preference is for managed funds, you want a managed fund that, one might put it,

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is like a sailboat fighting not a typhoon of costs but only a breeze.

Meir Statman: Are you suggesting that if you try to feed all investors index funds all of the time, they will simply defect and go elsewhere, and so you give them actively managed funds that will do the least damage?

John Bogle: In a Duke University study (Reinker and Tower 2004) that covered January 1977 through January 2004, Vanguard's managed equity funds were shown to have actually performed a hair better, with a little less volatility, than the Wilshire 5000 and the S&P 500. The study didn't take into account taxes, which would have changed the conclusion, and of course choosing a different time period would have produced different results. However, I think it's reasonable to make the case that Vanguard's actively managed funds have been among the better choices because of low costs, low turnover, and discrete investment universes, which also are the key characteristics of the index fund.

Ed Baker: Do you think there may be more need for active management when you move away from the purely domestic marketplace, e.g., global market strategies or emerging markets or other strategies where market inefficiencies may exist?

John Bogle: Well, in a word, the answer is no. The same is true of small cap, which is often put into that same category. The reality of investing is that as soon as you have a discrete universe of securities that you can index—let's say, all international stocks—that market has a return that's measurable, and it's measurable by a soundly constructed index. It doesn't matter whether the market is efficient or not. I've often said that the efficient market hypothesis, or EMH, has a lot of truth to it, but the CMH—or "cost matters hypothesis"—is eternally truthful to the last penny. That goes back to our old friend: Gross return in the financial markets, minus the costs of financial intermediation, equals the net return earned by investors as a group. Once you get that discrete group of stocks in the international market—or in the emerging markets subset—and calculate their total capitalization, it will produce a return of *x* before costs and a return of *y* after costs. From an intellectual standpoint, I'm inclined to say that in inefficient markets, there may well be greater opportunities for a group of active managers to outperform. However, the reality is that if a small group of managers—say, 10 percent—can outperform by 4 percent per year before costs, there has to be a similar percentage that underperform by 4 percent per year. There's no way around the math.

Inefficiency doesn't make it easier for *all* investors to beat the market. That can't be, because smart investors are trading with dumb ones, and the spread between dumb and smart will grow. When you think about it in those terms, it should mean that indexing works *better* in international markets than in the U.S. market. The reason for this is that international transaction costs are higher, tax costs are higher, and nearly all international funds have higher expense ratios, and indexing should work better in markets where the costs of active management are higher. Not that the brightest managers don't have a chance to do better in those markets. I freely concede that they do, although I personally think they're overrated. The record is clear that there is little correlation between past success and future returns. Yes, measuring the returns of all investors in international markets is a fly-by-night, spasmodic thing because the data are hard to come by. But I've been known to say that if the data don't prove my analysis is right, then, well, the data are wrong.

Ed Baker: Let's switch gears slightly and ask you to tell us about your biggest mistake or biggest disappointment, if you can pinpoint one, over the course of your career.

John Bogle: That's a great question, because I've made a lot of mistakes. One of my life principles is that the only way you can live life is by dealing with what is, and not with what might have been. So that's the way I've tried to deal with setbacks. I'm a rather thick-skinned guy, and I don't lie awake at night worrying about my mistakes—never have, never will. The curious thing is that certainly my biggest business mistake, or strategic mistake if you will, was my utter stupidity, callowness, and unwillingness to learn from the very lessons of history that I was teaching when I engineered the Wellington merger with the Ivest Fund group in 1966. The Ivest managers

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were what I call "go-go" managers, that is, very aggressive, and I should have known they wouldn't be durable. When Wellington, where I was in charge, announced the merger, I got a call from Bernard Cornfeld,[5] who owned stock in both Wellington Management Company and Ivest Fund, saying that if we let the merger go through, he would sue to stop it. My job was to go to his headquarters in Geneva, Switzerland, and try to persuade him that he was wrong. I was just a kid then, thirty-six or so. He did finally back down and decide not to sue Wellington, but he told me, "Jack, let me give you a piece of advice. These Ivest guys aren't very smart. You'll find that out, and when you find that out, you won't fire them—they'll fire you." And so they did.

The Ivest merger was a bad mistake on my part, not only in and of itself, but also because I let that aggressive thinking creep into the Wellington Fund, which had the worst decade in its history while that merger was in effect. Relative to its competitors, the Wellington Fund was the second-worst performing of all balanced funds; we'd never been in such a position before. It was very close to a disaster. So I'd put that down as my biggest strategic mistake. Yet, a funny thing happened: If I hadn't been fired in January 1974, I would not have had the opportunity to start Vanguard in September 1974. While it was a difficult way to get back on the right track and solidify the things that I knew but failed to acknowledge, my biggest failure led to what was arguably my biggest success.

Meir Statman: The kinds of issues that you just described—dealing with people in the real world and so on—are issues that financial advisers have to face. Market efficiency and costs are, of course, extremely important, but advisers have to deal with people who come to them wanting to invest in "go-go" funds or who have ideas that the adviser knows are not wise for them. How can you guide them without having them bolt away and do something really stupid? You might also speak to the question of how advisers get compensated, because I think one of the problems advisers face is that investors see their value in beating the market, but not in the advice and the hand-holding that are the real services of advisers. How can financial advisers make a living and still do the right thing?

John Bogle: Of course, financial advisers are part of this colossal system of financial intermediation, which by my count takes about $400 billion out of the pockets of investors. If you figure that the financial statements of stock brokers filed with the SEC show $250 billion, mutual funds $90 to $100 billion, hedge funds probably another $30 billion, financial advisers $10 billion, and variable annuities $20 billion, you can get to $400 billion without trying very hard. When I wrote "Relentless Rules of Humble Arithmetic," I made a point that ought to be obvious to everybody: Our industry is based on seeking a comparative or competitive advantage, that is, beating the market or coming up with a new strategy or picking the best stocks and outperforming others. Yet all of that work to improve performance—by all the participants, all the advisers, all the analysts—is not going to do one single thing to help the performance of investors *as a group*. In fact, it harms investors. As each manager seeks a competitive advantage, the cost of seeking that advantage is a big negative, a massive reduction in the returns investors actually earn. It therefore follows that if we could ever get enough wisdom to try to seek a *community* advantage, instead of a *competitive* advantage, we would slash the costs in the system. Since none of us can do anything about whatever returns the markets are generous enough to give us, the only way to enhance our investors' share of those returns is either a) to have all managers get smarter at once, which is an impossibility, or b) to take hundreds of billions of dollars of costs out of the system.

Meir Statman: But even if costs are at their lowest and markets at their most efficient, investors can still do stupid things, such as make the wrong asset allocation decision. Who is going to help them, and how is that person going to be compensated for steering investors in the right direction? That is not really going to be done by the marketplace alone.

Ron Kahn: And, Meir, I would add to that, in deciding asset allocation, the same answer doesn't apply to everyone. Individuals are saving for different reasons—to finance retirement, to send children to college—and everyone has different timing needs and different cir-

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cumstances. There's a need for help in connecting financial products to the individual's particular circumstances.

MEIR STATMAN: Aren't you a bit hard on some of those intermediaries, Jack? I can see that some of them could be taken out of the system without much damage, but don't you devalue some services that investors desperately need?

JOHN BOGLE: Let me take that in a couple of units. Think about this from an investment allocation standpoint. You can help individual investors have an allocation more appropriate to their age, or their wealth, or their risk tolerance. However, the allocation of all investors is fixed at any point in time. If everyone were to get out of stocks and into bonds, to whom would you sell your stocks? From whom would you buy your bonds?

MEIR STATMAN: But we're not talking about the aggregate. The fact that, in the aggregate, it's a zero sum game is all very nice. However, the question should be about Joe Schmoe from Kansas City, who is seventy-eight and has all his money in equities, even if it's fully diversified, which might make sense in some cases and not in other cases. Who's going to provide Joe with that advice? I don't think you can even get that advice from your books, Jack.

JOHN BOGLE: First of all, I agree with you. However, it's not a trivial point that all investors as a group have a fixed asset allocation. If Joe in Kansas City increases his bond allocation, an investor in Peoria reduces his, or all the other investors in the market do, however you want to look at it. It's still an important point in the minutiae of investing. You can put actively managed funds in your tax-deferred account and index funds in your taxable account or municipal bonds in your taxable account. It's disgraceful that some people still put municipal bonds or even variable annuities in their retirement plan accounts, and it probably calls for a financial adviser to help them avoid that kind of thing. I still come down to the fact that advisers take about 1 percent—I believe that is the generally conceded norm—out of the returns that investors receive, a huge cost if the *real* (adjusted for perhaps 2.5 percent inflation) return on a balanced fund is, say, 4 percent *before* fund costs, and 2 percent or less *after* those costs are deducted.

Let's take advisers in two classes: First, the stock broker. I think a business where you make your living by getting people to act—"Don't just stand there, do something"—is a business that simply doesn't work for investors in the long run. I would add that it seemed to work fine when we had twenty years of returns in the double-digits. However, I believe we will have to be content with much lower returns in the years ahead—that 6.5 percent nominal return I mentioned for a balanced portfolio seems a decent estimate. Investors could do a lot worse than using a rule-of-thumb calling for their bond percentage to equal their age.

In my opinion, we've made asset allocation a little too confusing, but still, making that allocation decision is not nearly as important as making sure you do everything you can at low cost. If you can get a percentage point or two of costs out of the system with simplicity—by buying lower-cost funds or index funds—an investor with 80 percent bonds/20 percent stocks who's in index funds, for example, would have a higher net return than an investor with 60 percent bonds/40 percent stocks and costs of 2.5 percent. (Here, I'm estimating future nominal market returns, in very round numbers, of 5 percent for bonds and 6–8 percent for stocks.) Now think about the equity premium—3 percent or probably closer to 2.5 percent—in a Treasury bond that has zero cost for acquisition and holding and an actively managed mutual fund that has a 2.5-percent cost of holding, so that's an equity premium of zero for a lot of investors in the environment ahead. This just shows how important it is to get costs out of the system. A trading—or brokerage—mentality is not going to do it.

Now let's look at the independent financial adviser. I think many financial advisers are worthy of hire. They're responsible, and they're charging reasonable amounts of money by today's standards, although in the aggregate over an investment lifetime, the charges are quite large. In my opinion, we should be considering a somewhat different system in which the financial adviser takes into account the known economics of investing, or the relentless rules of humble arithmetic, and is paid on a fee basis—as lawyers and consultants are paid—

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rather than with a percentage of assets. If the client needs a lot of service, he pays for it, and if he doesn't need a lot of service, he doesn't pay for it. Then the adviser and client need to work on those marginal decisions that are so important—evaluating taxable account versus nontaxable account versus tax-deferred account and where tax-managed funds fit into the picture. We have complicated the business so that not enough people have the confidence to say, "I'm going to own the market in whatever proportion my risk tolerance tells me; my bond position's going to equal my age; I'm going to capture almost all of the returns on both markets through index funds; I'm going to invest in low-cost municipal bond funds when I'm in a higher tax bracket; and then I'm going to look at the nuances, for example, a municipal bond fund that's exempt from state taxes if I live in a high-tax state like California and New York." There are many decisions that can make differences at the margin, and I think financial advisers can help investors with that. However, I think that a fee of 1 percent may well be more than advisers can justify in the world I see, and that a cost-of-service-based system is going to be a better approach.

MARK ANSON: Do you see exchange-traded funds (ETFs) as an extension of index management or as a competitor to index management?

JOHN BOGLE: I look at ETFs and feel like humming a few bars of that old song, "Look what they've done to my song, Ma, look what they've done to my song—well, they tied it up in a plastic bag and turned it upside down." I don't see ETFs as an extension or a competitor—I see them as a contradiction.

MARK ANSON: That's an interesting take.

JOHN BOGLE: ETFs *are* index funds, let's start with that. Many people don't seem to realize that fact. In describing ETFs, I use a little box divided into four squares. The top half of the box is long-term holders, and the bottom half is short-term holders. The left side of the box is total market funds, and the right side is sector funds. Indexing is in the SPDR [S&P Depositary Receipts] or VIPER [Vanguard Index Participation Equity Receipts] box on the upper left—or long-term investments in the total U.S. stock market. (International investors could appropriately put an international index fund there for that portion of their returns.) The box at the top right—long-term holders of sector funds—is empty because investors are buying and trading those; I can't imagine that anyone is holding, say, the technology sector or the Korean market for an investment lifetime. The lower half of both boxes is the short-term sector, and the turnover of Qubes and SPDRs runs to something like 5,000 percent a year. It's difficult to tell what percentage of turnover is accounted for by individual investors. How much of that is brokers' positioning, I don't know, but I'd be very surprised if SPDRs are held to any material extent by investors for long holding periods.

MARK ANSON: So the contradiction you see is the fact that you have a passive index that is actively traded?

JOHN BOGLE: Yes, I call it convergence. How is it possible that just as active management is becoming more and more like indexing—e.g., managers measuring themselves against the index, looking at every stock in the portfolio and comparing their weighting with the index weighting—indexing is getting closer and closer to active management? And that's what we see in the ETF market. These are funds designed for speculation, and they're even promoted that way. The State Street ad for SPDRs says, "Now you can own the S&P 500 index in real time, and trade it all day long."

MARK ANSON: In other words, you have an oxymoron: passive speculation.

JOHN BOGLE: Yes. Who in their right mind would do that? Everyone knows that the advantage of indexing is in low cost. Even if ETF commission rates are fairly modest, there's a high rate of trading going on, so aggregate costs are steep. If even 10 percent of ETFs were long-term holdings, I would be surprised. I'm the first to concede that ETFs are probably a more intelligent way to speculate than individual stocks—these sector index funds or timing the total market index—but I don't believe in speculation. Speculation is a loser's game. Because of the costs, it has to be a loser's game.

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MARK ANSON: On the other hand, if you are a long-term investor, ETFs seem to offer a reasonable way to go because they are more tax-efficient.

JOHN BOGLE: Let's say they *may be* more tax-efficient. I'm not sure that they are. Vanguard's tax-managed (index-based) funds ought to be able to go up against them, blow for blow. Certainly ETFs theoretically have the potential to be more tax-efficient, but both ETFs and tax-managed funds should be highly tax-efficient.

ED BAKER: What about from a risk management point of view? Is there a role for products like ETFs to play when you want to hedge your market exposure for one reason or another?

JOHN BOGLE: There again, I'm the kind of person who knows that I can't do it. I think the idea of timing or hedging is a very difficult thing for investors to pull off. It is in the nature of the human psyche, we are much more likely—this is a behaviorialist kind of argument—to make the wrong choices at the wrong time. We've compared returns earned by mutual fund investors—dollar-weighted returns—with returns earned by mutual funds themselves, or time-weighted returns, and the investors seem to lag the funds themselves by almost 3 percent per year. Fund investors put almost no money into equity funds in the late 1980s and early 1990s when stocks were cheap, and then they poured huge amounts of money into equity mutual funds between 1998 and the crash in 2000. Investors also bought the wrong kinds of funds, that is, in the three years leading up to the crash, they put nearly $500 billion into technology funds, telecommunications funds, and a whole new breed of aggressive growth funds we can describe as "new economy" funds. At the same time, they took about $100 billion out of value funds. Then, after the market crashed, they took money out of those aggressive growth funds and put it into value funds.

Overall, investors seem to have an innate sense of bad timing. You can actually measure this. One of the great things about the mutual fund system, unlike the rest of this business of investing, is that every buyer isn't matched by a seller, and that makes it an excellent laboratory for research. When you read in the paper that investors today poured money into bank stocks and pulled out of technology stocks, how did that happen? When they bought their bank stocks, didn't somebody sell those stocks to them? When they sold their technology stocks, wasn't somebody buying those stocks from them? By my standards, the market is essentially a closed system. However, the mutual fund industry is not a closed system. We actually can see and indeed measure how badly investors do at timing. They're their own worst enemy. As Warren Buffett says, the two greatest enemies of equity investors are expenses and emotions. You can see the expenses in the gap between the market return and fund returns, and the emotions in the gap between fund returns and investor returns. When you look at data on the origin of these shortfalls, it is staggeringly loaded toward the degree of fund specialization; in other words, the biggest gap between fund time-weighted returns and fund investor dollar-weighted returns is found in technology funds, telecommunications funds, aggressive growth funds. We did a study that covered six years, i.e., the last three years of the up market and the first three years of the down market. With the ups and downs taken together, the twenty-five largest sector funds actually returned about 5.5 percent per year, versus 3.7 percent for the twenty-five largest diversified funds. However, while the typical investor in the diversified mutual funds ran about 2 percent behind the funds themselves, the investors in these specialty funds fell short of the fund returns by about 14 percent

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a year, which, when compounded over six years, is a staggering shortfall of 59 percent.

Meir Statman: You've talked about expenses and emotions. What about investors' preferences or tastes? What if an investor has a preference for socially responsible stocks, for example? Is that a legitimate choice, or do you consider that wasteful or impractical?

John Bogle: The record is so clear to me that owning the market at minimal cost gives you the market return, or very close to it, allowing for taxes unless you're in a tax-deferred plan. That's the ultimate strategy, the gold standard.

Meir Statman: What about people who cannot sleep at night because their index fund holds tobacco stocks? Should they choose to exclude tobacco stocks and anything else that gives them problems? In the Ave Maria Funds, for example, it's companies that don't comply with the teachings of the Catholic Church, such as those that allow gay partners to have benefits. There are many types of social responsibility, and many kinds of tastes. What it comes down to is that people get more out of investing than just risk and expected return.

John Bogle: I know that you, Meir, have argued in the past that it's clear people like to gamble, and so let them gamble a little bit in investing. So, a couple of things: One, there's serious money—the money you need for your children's education or a new house or your retirement—and there's funny money—what you need to satisfy your indulgence in your wish to gamble, or your wish to honor your social responsibilities. I say fine, do it, but please, just for me, don't put one penny more than 5 percent of your account in funny money, so it won't hurt you too badly. Then check every few years and see how that account is performing compared with the serious money account. I obviously expect that it will be doing worse, but for some people, it will perform well. Nonetheless I have to say that, if you're not sleeping at night, please do whatever is necessary to get some sleep. Make whatever sacrifice in long-term returns you want, because life is short. Before my heart transplant, I couldn't sleep at night at all. When your heart starts to break down, your legs start to shake, and it's miserable. I wouldn't impose sleepless nights on anybody, so they should accept what I believe will be suboptimal returns and live according to their values.

Second, I think we need to be careful when we get into something as vague as social responsibility. One person's social responsibility may be very different from another's, or different from the fund manager's. I remember many years ago, when an investor decided that if a certain Vanguard fund didn't get rid of tobacco stocks—which we wouldn't—he would go to a socially responsible fund. Before I answered the investor's letter, I looked up the portfolio of the socially responsible fund he had chosen, and the largest investment by far was Caesar's World. Now that isn't my idea of socially responsible, but I guess my idea didn't particularly count.

So I'm just skeptical. I'm deeply, profoundly troubled by things like the tobacco industry, but I think that's a war that has to be fought on a different battlefield. It's not going to be fought on the investment battlefield. As a wise man once said, "A stock doesn't know whether you own it or not." We did have index funds in the institutional market that excluded companies doing business in South Africa, and for a time that was a moderately viable strategy in that market. If excluding stocks is not a good idea from an investment standpoint—and I don't believe it is because I believe you should own the entire market—I would not recommend it. Sooner or later, each investor has to decide where his priorities lie, and if an investor insists on a socially responsible fund, I would tell him to invest at the minimum. I still think it's important to stick to the straight and narrow here, which is capturing the market return. I know I sound like "Johnny One-Note," and it goes back a long way. But it works. And as a wise man once said, "That's important, too."

Ed Baker: Let's shift over to talking about your new book on corporate governance, *The Battle for the Soul of Capitalism*. I've started reading it, and it certainly makes a very compelling argument that corporate America needs a radical overhaul. However, in the end, I didn't find much that was prescriptive in the book.

John Bogle: Someone wrote to me with that comment, and so we counted the recommendations in the book and came up with 59 "prescriptions," if you want to call them

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that. The overriding prescription is for a form of governmental participation, or some would say interference, in the system. I believe the root of the problems with our financial system—and leading over into the corporate system—is the loss of the ownership society. President Bush can say that we're trying to bring the ownership society back, but it's never going to happen. We had such a society fifty years ago, when 92 percent of all stocks were owned by individuals. Now it's 32 percent, with the other 68 percent held by large financial institutions, just twenty-five of which own close to 40 percent of the total. So now we not only have institutional ownership, but very concentrated institutional ownership.

I profoundly believe that these institutional owners, or agents, are not serving their principals. What we need to do, as I say in the book, is establish a federal standard of fiduciary duty that ensures that pension managers and mutual fund managers, in particular, have a duty spelled out in detail in the law to represent the interests of those they serve, that is, the pensioners and mutual fund owners. The problem in achieving this goal is that the institutional agents aren't even real owners any more; they trade stocks with a fury, with turnover of 100 percent a year and an average holding period of one year. It's now a rent-a-stock industry, compared with the old own-a-stock industry when turnover was 16 percent and the average holding period was six years.

MARK ANSON: I'm not sure that's true of the large concentrated owners. I think it's mainly the large index funds.

JOHN BOGLE: Well, you're correct about the index funds, but that's only 15 percent of all equity fund assets. There's an anecdote that I didn't put in the book about the time I got some of the large indexers together with a few active managers, managers I'd clearly identify as long-term investors. We went over some ideas: taking a stand on issues, establishing a research facility that would be jointly funded, and devising a plan to have these large institutions take a more active role in governing the corporations in which they own stock. At one point in the conversation, one of those in attendance said to me, "You know, Jack, I understand where you're trying to go, but why don't we just leave it to Adam Smith's invisible hand?" I said, "Don't you realize that *we* are Adam Smith's invisible hand?" And we are. We're supposed to be operating in the interests of our shareholders, but when you stand back from your governance responsibilities, you're simply not doing the job your shareholders have the right to expect you to do.

Part of the reason for that is that governance is not very high on the priority list. Think of the money we spend on marketing, trying to get investors to send us more money, compared with the money we spend on governance. Think of the profits of investment management companies compared with the money we spend on governance. It's a drop in the bucket, and probably not even that. To borrow a phrase from shareholder activist Bob Monks, "Capitalism without owners will fail." Corporations have been allowed to run amok in their accounting, in mergers, and certainly in executive compensation, correctly thinking that few of their shareholders really much care. There's an old saying in the book, "When we have strong managers, weak directors, and passive owners, don't be surprised when the looting begins." We've had some real looting, of course, with the best known cases being Enron, WorldCom, and Adelphia, as well as incidents that come close to looting, for example, the short-term focus on the price of a stock compared with the long-term intrinsic value of a company.

Another of the prescriptions in my book is a tax on short-term capital gains for taxable as well as tax-exempt investors. Although he now says it was done tongue-in-cheek, Warren Buffett suggested this a long time ago, and it was recently put up as a possibility by Lou Gerstner, former chairman of IBM. These aren't people without credentials. If you have a short-term focus, it's arguable that you shouldn't care about governance. You not only don't care; arguably you shouldn't care. What's the point if you're not going to be holding the stock a year hence?

ED BAKER: Your book clearly underscores some fundamental weaknesses in corporate governance, for example, lack of independence of the boards and lack of separation between the chief executive officer and the chairman. If you were to pinpoint the key weaknesses and improvements, what would you suggest?

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JOHN BOGLE: There are actually different sets of circumstances for corporate America—the owned—and for financial America—the owners. In corporate America, I feel very strongly about separation of powers, that is, the boss of the business should not be the boss of the board of directors. It's amazing that system hasn't been changed much more substantially. One of the problems with trying a different approach is that the first thing someone says is, "Prove it works better," and there is no proof. Prove that British corporations, which have independent chairmen, have performed better than U.S. corporations. I don't have numbers to support this, so I have to fall back on a very important idea: *Sometimes common sense tells us what statistics cannot.*

Another recommendation is to have the federal fiduciary duty standard, which I talked about earlier, apply to corporate directors. Much of this reform has to come out of changing our investment system back to the way it used to be, that is, not a system of renters who shouldn't care, but a system of owners who do. A federal standard of fiduciary duty also would require mutual fund managers and pension managers to run their companies on behalf on their investors.

On the mutual fund side, I totally agree with SEC Chairman William Donaldson's proposal, since supported by his successor Christopher Cox, that mutual funds institute three changes in governance:

- An independent chairman who is not the chairman of the management company. I can't imagine anything that would be more common sense than that.
- A board where 75 percent of the directors are independent. Deep down, however, I wonder what right the chief executive of a management company has to be on a fund board. It's a complete conflict of interest; for example, the board might want to reduce fees, while the management company executive probably wants to increase them.
- Empowerment of fund directors to allow them to have their own staffs or independent consultants to appraise the manager's results, i.e., performance, costs, marketing efforts, cash flows. That makes sense because the manager—even the most honest of managers—is going to view things through the lens of his own self-interest.

In addition to the overarching idea of a federal statute of fiduciary duty, under which agents represent shareholders, by moving past the ownership society that used to exist, beyond the agency society that's failing investors, to a new fiduciary society where investors come first. But investors also have to wake up and get a life. We need a huge investor education effort just to get across what all the experts are saying—every Nobel laureate; people like Warren Buffett and David Swensen; Andrew Lo, who wrote *A Non-Random Walk Down Wall Street* but still owns index funds himself; Paul Samuelson, who called the invention of the index fund the equivalent of the creation of the wheel and alphabet. As we said before, how can all that powerful intellectual wisdom be making such little progress? We must convince investors to look after their own interests.

ED BAKER: How active can we expect index funds to be in this corporate governance oversight role? Doesn't that introduce some relatively significant costs if the funds have to take an active role in all 500 companies in the S&P index, for example?

JOHN BOGLE: I don't think so. Right now the large funds are required to vote each issue and disclose each vote. I don't know how much more work is required. The idea is not to run the companies but simply to ensure that the directors are representing the shareholders. I'm not in favor of institutional investors stepping into the business decisions of American companies. I don't think we run our own business very well, to be honest, and until that happens, we ought to stay out of the businesses of others. So I'm not talking about institutional owners getting involved in business decisions; I'm talking about items that get approved without sufficient shareholder involvement, e.g., the nomination and election of directors; mergers and acquisitions; and executive compensation. They all ought to be the subject of shareholder voting.

ED BAKER: I don't think the proxy voting system really involves active oversight on the part of many funds, in my experience. It's a routine check-the-box process.

JOHN BOGLE: At last it's moving a bit away from that. There's certainly more effort being put into that area by

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big institutional investors, and at fairly nominal cost, with votes reported on the Internet, so the communication cost is essentially zero. I see that moving forward slowly. The biggest problem—and here's where we need a lot of help—is the awful conflict of interest of corporate America basically owning itself. It's a circular ownership where the funds run by Citibank, for example, and the pension plan run by Citibank own 1 percent of Citibank, and so on through the list. In managing the pension plans and corporate 401(k)s, the investment managers are beholden to the corporations, and there's not a lot of money to be made in offending your clients. As I say in the book, the problem goes further, because there are two kinds of clients we don't want to offend: *actual* clients and *potential* clients. So that's everyone. It's hard for me to believe that financial institutions really feel comfortable in standing up and being counted.

Part of the problem, as we read in the press, is the analysts themselves. Those who write negative reports about a company can be cut off from information. That's another thing that has to change, and that's where the fiduciary duty standard would help.

However, make no mistake about it—these are not easy things to fix. I also talk in the book about ideas like opening up the nominating process for the board of directors on the company's nickel to, let's say, any group of investors holding 10 percent, or even 5 percent, of the company's stock over the previous two years, in order to exclude short-term holders. It's fairly obvious that dividend-paying stocks have much lower turnover than nondividend-paying stocks. So why not have a class of stock that's interchangeable with the basic class but that pays an extra 10 cents in dividends after a two-year holding period and, after ten years an extra 15 cents; that is, higher dividends for longer-term shareholders. A large part of the problem is that we're all so focused on the short-term price of the stock that we ignore the long-term value of the corporation.

Meir Statman: Unfortunately, our time is running short. Are there some final thoughts you'd like to leave us with?

John Bogle: One thing is for certain: The mutual fund industry has to change. You can't look at the cost inefficiencies, tax inefficiencies, and marketing focus—to say nothing of the cheating around the edges that we saw in the timing scandals—and think otherwise. Those scandals were all about putting the interests of the managers ahead of the interests of the shareholders. That focus on self-interest is less apparent, but financially much more important, in the other problems facing this industry, including excessive advisory fees, excessive marketing costs, excessive focus on introducing faddish funds at the peak of their popularity, all of which detract hugely from the investment returns received by fund shareholders. I'm a David Swensen guy; I think if everybody read his book *Unconventional Success* and did what he recommends—never buy a mutual fund from a company in business to make a profit—we would start to have the mutualization of the mutual fund industry. Vanguard is still waiting for its first follower. It's so clear that it has to come, simply because the economics—the relentless rules of humble arithmetic—are so compelling.

The outlook for the future of the mutual fund industry will not brighten until investors get sick and tired of it and the industry changes. At the minimum, the outlook is bad for those who are doing it wrong, and better for those who are doing it right. Sooner or later in a competitive field, the competitive norm has to be taking costs out of the system. I don't see how that can fail to happen. Some of these changes require a little help from the federal government in terms of standards, but much of it just entails investors looking after their own interests, if they were only wise enough to do so. I don't know how to get that lesson across. I'm not sure what happened to the attempt at investor education that was to be financed out of the 2002 settlement with Wall Street investment firms. We need that, even though that education will cause controversy because it will lead, finally, to investors being educated that the answer is to own the market and hold it forever. The economics of that are absolutely unarguable, and yet we seem to have a blind spot about this. Essentially, we tell investors to keep trying and if they're not doing well, hire the experts, and if they're still not doing well, hire an adviser to hire the experts. It doesn't work.

That's the line of reasoning Warren Buffett talks about in his 2006 annual shareholder letter, and he has this wonderful example of the "Gotrocks" family, as he calls them. The Gotrocks are very wealthy. They own

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every stock in America, they get earnings and dividends every year, and they're doing very nicely. Then some brokers convince the family that they can outsmart other members of the family by buying and selling certain stocks, so they hire the brokers and trade stocks back and forth. Of course, at the end of the year, the family did worse than they did the year before, because they're getting less than 100 percent of the market-return pie because of those brokerage costs.

They decide they don't know how to pick stocks, so they hire some managers, and the managers go out and vigorously swap stocks around with one another, incurring a lot of additional transaction costs and tax costs for the family. At the end of that year, the family is doing even worse. So now the Gotrocks think, "We know we can't pick stocks, and we know we can't pick managers, so let's pick a bunch of consultants to help us pick managers." And again they do even worse. Warren takes the example all the way up, finally, to using hedge funds, and of course, that strategy can't work either, for it adds costs while having no effect on market returns.

Each time the family incurs more costs, their net returns after costs and taxes decline, and they become more impoverished until they are the "Hadrocks." I see the Gotrocks as the typical American investor. At some point there has to be a realization of the way that costs are diminishing investors' share of the pie produced by the market, and of the fundamental nature of those relentless rules of humble arithmetic. That's the main thing I want to get across.

Ed Baker: Jack, we thank you very much for your time. This has been most interesting and thought-provoking. I think our readers will find a lot in this interview to both believe in and argue against.

John Bogle: I'd love that. Please let the world know that if any active manager wants to debate these issues, I'm available any hour of the day or night.

ENDNOTES

1. See Louis D. Brandeis, *Other People's Money—and How the Bankers Use It*. In this 1914 book, Brandeis described how the interlocking interests of investment America and corporate America were "trampling with impunity on laws human and divine, obsessed with the delusion that two plus two make five" (p.45). Brandeis, who became one of the most influential jurists on the U.S. Supreme Court, accurately predicted that the widespread speculation of the early twentieth century would collapse, "a victim of the relentless rules of humble arithmetic" (p.45).

2. See "Big Money in Boston," *Fortune* (December 1949): 116.

3. Wiesenberger Financial Services, the nation's first mutual fund tracking service, has provided mutual fund data for more than sixty years.

4. More accurately, the period was thirty and one-half years; Bogle took the returns through June 1975 in his presentation to the board of directors.

5. Cornfeld was a businessman later convicted of selling fraudulent investments during the 1960s.

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