MUTUAL FUNDS **forum**

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The Future of Mutual Funds

by John C. Bogle

I propose to deal with the subject of my talk, "The Future of Mutual Funds," as a strong advocate for the mutual fund concept. I will do so at the risk of engendering controversy—or perhaps more accurately, of responding to controversy that already exists. My thesis is that the mutual fund is a financial service of demonstrated excellence, and in this very excellence lies our opportunity to reassert the marketing thrust which made our industry the fastest growing financial institution of the Post-World War II era, when we enjoyed, through 1968, an 18% compound growth rate in industry assets.

In this context, there is no point in mincing words: we must re-establish the confidence of the shareholder, the public, the press, and the regulators, in the mutual fund's excellence as a product, and our viability as an industry. That it has come into doubt is well evidenced by these two examples:

(1) At the SEC mutual fund distribution hearings, an SEC staff member made so bold as to ask Robert L. Augenblick, head of our Institute, this sharply-worded but direct query: "Aren't you riding a dead horse?"

(2) Several days later, a query of equally prejudicial character was asked of me by Joseph A. Livingston, the *Philadelphia Inquirer* columnist: "What arguments can you give me that mutual funds are not over the hill?"

It seems likely that these two types of persons—the regulator and the journalist—reflect, and to some extent perhaps have helped to create, the atmosphere of negativism surrounding the words "mutual fund" today. In any event, that this atmosphere also exists in the perceptions of our shareholders and the public is reflected by the fact that 1972 was the first year in the entire 49-year history of the industry in which investor purchases of mutual fund shares were exceeded by share liquidations: $4.9 billion of sales—representing "Zero Sales Growth" since 1966-67 vs. $6.6 billion of liquidations.

What explains this "pause"—to put the best possible cast upon it—in the growth of our industry? Some of the reasons are too obvious to bear more than passing reference here:

- The go-go era that went up in smoke in 1969-70, along with the demise of its idols and of much of the invested capital of those who idolized them. While only a small minority of industry assets was engulfed by the go-go era, it was regrettably a very visible minority.

- A seven-year stagnation in stock prices generally, with the Dow-Jones Industrial Average still flirting with 1,000, about where it was early in 1966.

- The sharp rise in interest rates. Today's 7½% bonds simply offer more competition for the savings

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Mr. Bogle, President of Wellington Management Company and a former Chairman of the Institute's Board of Governors, gave this speech to the recent ICI General Membership Meeting. Because of an unprecedented volume of requests for copies, the FORUM is printing the speech in its entirety.

dollar than did the 4½% coupons available in the 1950's and most of the 1960's.

But the crucial reasons for our industry's problems are, in my view, less obvious. They relate first, to investor impressions about the performance records of mutual funds in general, and second, to the marketing system through which mutual funds are distributed. Let us spend a little time on each.

Perspective on Performance

With respect to performance, I do not see how the mutual fund industry's long-term record of performance could be very much better, even when we factor into the industry totals the dismal records achieved by some of the idols with feet of clay I referred to a moment ago. This claim may appear extreme or even self-serving. But, let me try to back it up with a few statistics.

My starting point is a record that is the most important of all: the absolute investment accomplishment of the average mutual fund over the long-term. This record, of course, is illustrated in the ICI advertisement, showing that $10,000 invested in the average mutual fund 23 years ago, with income compounded, would have grown to about $104,000 at the end of 1972. It may surprise you to know that the performance figures in the ad are, in fact, unfairly *negative*. For the industry's average was heavily weighted by conservative funds in the early years (when it paid handsomely to speculate) and by aggressive funds in 1969-1970 (when it paid handsomely to be conservative). Despite its obvious statistical limitations, then, the advertisement understates the industry's record. If the table had been limited to equity funds in business throughout the entire period, we estimate the final value would have approximated $120,000. In this sense, the over-all annual return of 10.7% reflected in the advertisement is not only wholly creditable, but wholly credible as well.

"Compared to What?"

Now, we live in a world in which no matter how valid the "absolute," one has to measure up to certain "relative" standards. Indeed, our critics look at our record of accomplishment and say "compared to what?" And, too frequently, the selection of a comparative standard is some combination of unfair, unsuitable, and unsupportable. And as a result, we come in for some tough criticism. The *Kiplinger Letter*, in a two-line "analysis" of our industry a few weeks ago said "most (mutual funds) are only so-so performers, or worse." Earlier in the year the *New York Times* accused us of "mediocrity." *Business Week* referred to "a sorry record . . . few fund managers recently have been able to . . . outperform the market."

These negative comments are based principally on a comparison of the Standard & Poor's 500 Stock Index with the Lipper average of 530 mutual funds. They wholly ignore the critical fact that the market index is weighted by the value of each company's common stock, and the fund average is not. On the one hand, 25 giant "blue chips" account for about one-half of the weight of the Index, with the 475 remaining securities accounting for the other half. In the fund figures, the situation is reversed. While 52% of industry assets are represented by the 25 largest funds, they have a weighting of only 2% in the Lipper average. Contrarily, 209 small growth funds (generally highly volatile) account for 40% of the weight of the average, but only 2½% of industry assets.

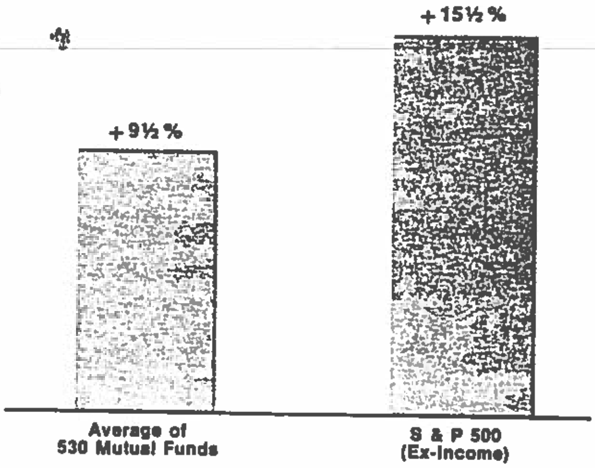
Does it matter? Of course it does. For, while it purports to compare "the market" (whatever that is) with "the fund industry" (whatever that is), it is really, to use a trite phrase, comparing "apples and oranges." Thus, in a year like 1972, when large companies are the best market performers, and small funds are the worst industry performers, we have a comparison showing a 15½% gain for "the market" (the Standard & Poor's 500) and only 9½% for "the industry" (the Lipper 530). And on the basis of that comparison (despite its obvious unfairness) a theory has gained credence in the press that might be described as the "idiot theory of performance"—if fund managers fall *that* far short of the market, they must be idiots.

MUTUAL FUND PERFORMANCE

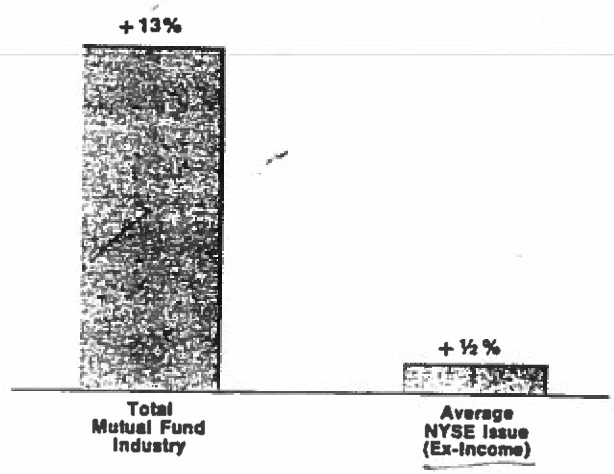
ICI AD (through 1971)	$94,008
ADJUST FOR 1972 (+10.5%)	$103,898
COMPOUND RETURN (23 years)	10.7%

"If market 'apples' can be compared with fund 'oranges,' so can market 'oranges' be compared with fund 'apples.'"

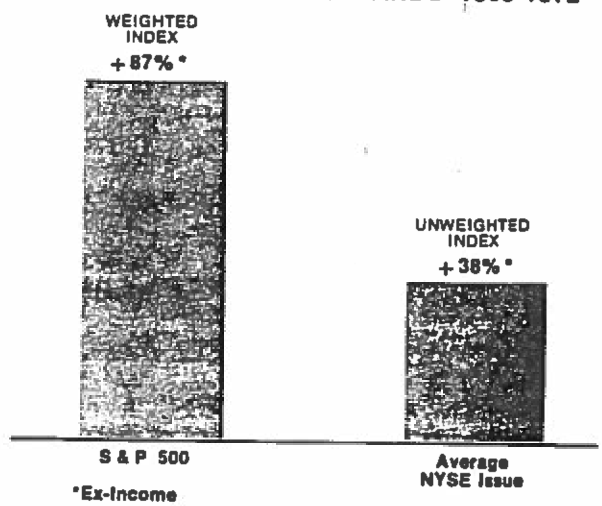
THE "IDIOT THEORY" OF 1972 PERFORMANCE



THE "GENIUS THEORY" OF 1972 PERFORMANCE



TWO DIFFERENT STANDARDS 1963-1972



But if market "apples" can be compared with fund "oranges," so can market "oranges" be compared with fund "apples." And it may not surprise you to learn that this leads us to what we can describe as the "genius theory of performance." Looking again at 1972, it turns the tables on our detractors, and gives us claim to a brilliance that is truly remarkable. Last year, the average stock on the New York Stock Exchange (unweighted by capitalization) rose by just ½ of 1%. The mutual fund industry, taking into account all of its assets (i.e., weighting each fund's performance by its assets) rose by 13%—a gain just 26 times as large. Relying on this comparison, one could properly acclaim us as geniuses. For some reason, however, this comparison—which is admittedly difficult to compute—did not find its way into the press.

The long-run implications of the selection of an appropriate comparative standard are equally great. Over the past decade (1963-72), the weighted market index (Standard & Poor's 500) rose by 87% (excluding income), more than two and one-third times the 38% increase in the unweighted average of New York Stock Exchange issues. To say "there is a difference," depending upon which relative standard one uses to evaluate the performance of the mutual fund industry, would seem an understatement. And the truth of what "the real market" did is likely to be somewhere between the two indices. Indeed, the redoubtable Dr. Irwin Friend, in his Twentieth Century Fund Study, concluded that "some average of the two (weighted and unweighted) measures of . . . performance" is "an even more appropriate basis for comparison" than the weighted index.

A Challenge: The Verification of Competence

Now, I assume that all of you would agree that we are not idiots, and most of you would concede that neither are we geniuses. Our problem is to raise the public's perception of us from something that seems far too close to the former into something that, if it does not necessarily approach the latter, is at least a verification of our professional competence. I do not know how to accomplish this job, but I do know where to begin:

1) We must work with professional performance analysts to develop far better indices of industry accomplishment;

". . . the public perception of mutual fund performance can change if we work toward better indices and averages. . ."

2) We must work with present index-makers (Standard & Poor's, Dow-Jones, the New York Stock Exchange) to develop alternative indices of "the market" (an unweighted Standard & Poor's 500 would be a small but easy start); and

3) We must play a leadership role in the communication of this data to the press and to the public.

I take this opportunity to urge that this work begin and begin now, under the aegis of this Institute.

A more subtle, and thus more difficult, job is to emphasize that even the best relative standards have their limitations. *Any* market average operates in a theoretical, frictionless atmosphere that has about as much validity as a perpetual motion machine. It has no employees and no overhead, meets no regulations, pays no taxes, has neither accountants, auditors, nor custodians, needs no cash to conduct its business, and never pays a brokerage commission nor assumes a transaction cost. It would seem a minimal assumption that such costs in the aggregate would impact on the performance of an index by something like 1% per year. Lest this seem inconsequential to you, let me note the impact of this 1% cost factor on the 9% total compound return generally agreed upon as the best single reflection of the past performance of equity securities. Such an adjustment would reduce the final capital value of a $10,000 initial investment over a 25-year period from $86,200 (at 9%) to $68,500 (at 8%)—a reduction equivalent to 177% of the initial capital invested.

By the same token, of course, any fund average has *its* limitations, albeit of a different stripe. It is hard to see the validity of including bond funds, income funds, balanced funds and specialty funds in an average purporting to reflect the results of an equity investment program. And even the stock funds differ in terms of their relative emphasis on income, growth, and stability (and thus must be "risk-adjusted"), so the job is not an easy one.

Nonetheless, the public perception of mutual fund performance *can* change if we work toward better indices and averages, better adjusted to the realities of investing and the costs of doing business—in short, better standards of performance. For the ultimate justification of the mutual fund, as we all know, lies in doing a better job for the investor than he can do himself. The issue is how we measure this accomplishment, and how we communicate it.

"We Have Met the Enemy and They Are Ours"

No matter what we do, however, it will be a while before the press and public will accept a comparison other than the Standard & Poor's 500 vs. the average mutual fund. But we have, as an industry, met this standard (and then some) based on the most demanding and sophisticated series of performance calculations most of us in this room have yet confronted. I refer to the SEC *Institutional Investor Study*, which found that the average return on mutual funds over the 1961-1970 decade was 8.8% per year (risk-adjusted), compared to a 7.6% figure for the Standard & Poor's 500. "We have met the enemy, and they are ours."

And as the mutual fund industry has met and "captured" this tough standard, many other institional investors are struggling to catch up with it. At the Rodney White Seminar at the Wharton School a few months ago, for example, two executives of American Telephone and Telegraph Company noted that its $10 billion group of pension funds—now run by 57 banks and 17 private counsel firms—had a five year (1967-1971) total performance of +41%, compared with +49% for the Standard & Poor's 500 and +48% for a selected list of mutual funds. One questioner asked if, with all these managers, they were not "doomed to average performance." They answered: "If we could only achieve average performance, we would settle for it!" You might be interested in how the press interpreted the Telephone pension results. The *Philadelphia Evening Bulletin* headlined the story:

Banks Fare Poorly As Investment 'Pros'

The next day the *New York Times* headlined:

STUDY SUPPORTS BANKS' EXPERTISE

Hoping for enlightenment as between these two positions, I sought out the *Philadelphia Inquirer*, but found only that it had occupied the middle ground:

Bell System Believes in Diversifying Its Billions Invested in Pension Funds

It seems clear that, in the mutual fund field, our present negative sales/redemption mix is based importantly on the wholly invalid premise that mutual funds have failed to meet the test of performance. Yet we see management companies gaining literally hundreds of millions of dollars of positive cash *inflow* in their private counseling activities, while experiencing comparable cash *outflow* in their mutual funds. This is happening despite the fact that the same organizations frequently manage both classes of money—counseling and fund—and achieve performance for the two classes that is, in my perception, not significantly different over time.

"To get this story across effectively, however, we must have new tools of communication."

Mutual Funds: The Performance Edge

Indeed, as we look at comprehensive industry-wide figures, the conclusion is clear that, if there is a performance edge, it lies with the mutual funds, and not with the pension accounts (which are predominantly bank-managed). A study in *Pensions* magazine by William A. Dreher showed a compound return (1965-1971) of 6.8% for equity mutual funds, compared to 6.4% for bank-managed pension funds, 6.2% for insurance-managed pension funds, and 6.1% for the Standard & Poor's 500. Further, the comprehensive A. G. Becker study, accounting for 95% of all U. S. pension fund assets, has just recently been updated. In the 1963-1972 decade, it shows a 9.5% compound return for the stock portion of institutionally-managed pension accounts, compared with 10.0% for the Standard & Poor's 500. Stock mutual funds in the same period compounded at 10.7%, according to figures prepared by our Company. (It is interesting, if only coincidental, that this 10-year annual rate of return is the same as shown in the ICI ad, both for the 23-year period, and for the year 1972.) And at the risk of belaboring the point, let me illustrate the impact of what you might consider small annual performance differences over the past decade for a $100,000 dollar account:

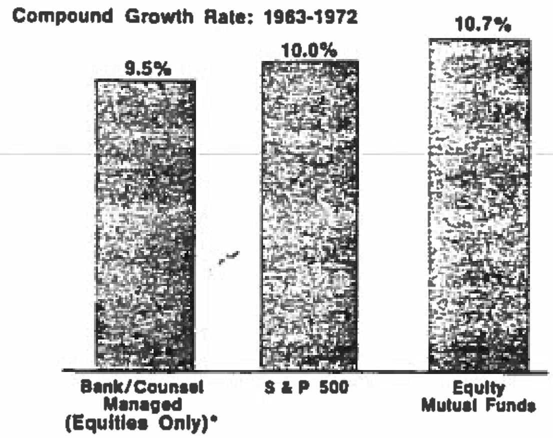
	Compound Return	Final Value
Mutual Funds	10.7%	$276,300
Standard & Poor's 500 ..	10.0	259,400
Pension Funds..........	9.5	247,800

N. B. Excludes consideration of sales charges, if any. Pension fund figures are not adjusted for management and custodian fees; mutual fund figures are net of all operating expenses.

The message of this statistical exercise is simply this: intelligent, experienced, fact-oriented, sharp-pencil, earnings-conscious corporate financial executives are putting billions of dollars annually into equity-oriented accounts and getting relative performance that is slightly below-average ("below-index" is more accurate). On the other hand, the average individual is getting "above-index" results in mutual funds, but withdrawing his dollars in larger-than-normal amounts. This despite the fact that the individual—unlike the corporation—has no practical alternative way to receive the same kind of management, diversification and administrative services.

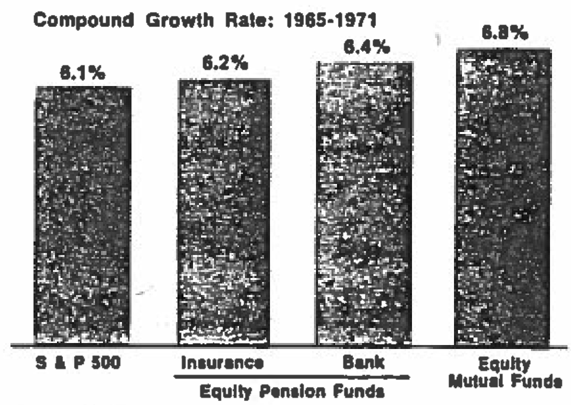
To sum up, I believe the record is clear that the value of the mutual fund product—in terms of measured actual performance—is there. Not always, or for all funds, to be sure. But most of the time, for most funds. In total, our industry's long-term performance record is, on an absolute basis, excellent; and, on a relative basis, superior to the toughest market index, the typical institutionally-managed corporate pension account, and, of course, any alternative fixed-dollar medium.

INSTITUTIONAL INVESTMENT PERFORMANCE



* Source: A. G. Becker Survey

INSTITUTIONAL INVESTMENT PERFORMANCE



Source: Wm. A. Dreher Study, Pensions magazine

Compound Return: A New Communication Tool

To get this story across effectively, however, we must have new tools of communication. I am not overstating the fact when I say that not a single one of the "compound annual return" numbers I have used in my remarks this morning comply with the provisions of the SEC's Statement of Policy, which governs sales materials used with the public. They are "average returns" and not annual totals; they are "total returns," combining income dividends with capital gains and losses. And, they probably violate several other principles of the Statement of Policy as well. Had I used them in the offering of a specific fund to a specific investor, I would be in serious legal trouble.

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The Future of Mutual Funds

(continued from page 5)

But we must have the right to use these compound return figures, provided only that they meet the standard of complete fairness, and that a full disclosure of other material information accompanies them. For it we are to communicate with an average investor of reasonable intelligence, we have to be able to give him numbers that facilitate comparisons of fund results with other savings and investment media. This seems perfectly proper so long as variations in return (risks, if you will) are disclosed. Such figures, further, are what we use within our industry, and what are used by all financial institutions in their own evaluation process. It is hard to conceive that the public is not entitled to the same information. **I therefore take this opportunity to urge the SEC to move forward with long-needed and long-awaited changes in the Statement of Policy to allow the use of compound return figures in our fund sales literature. We need this ability to concisely state our record, if we are to change the perceptions of the public from inaccuracy to accuracy.**

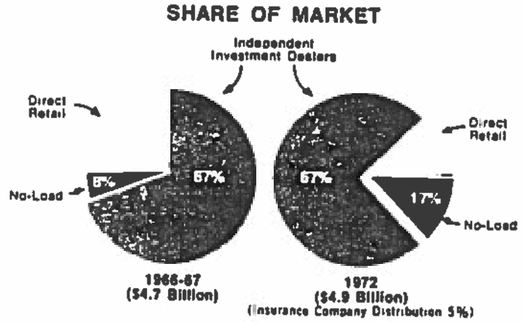
Perspective on the Marketing System

Let me now turn to the second major area I noted at the outset: our marketing system. Sooner or later, if you agree with the theory of "the better mousetrap," our record, described understandably, will reassert itself in the savings marketplace. But when it does, will our industry's marketing effort reassert itself? Let's first look at each of the marketing segments that exist in our industry today, and see how they have done in the period since 1966-1967. As I noted earlier, total industry sales then were just short of $5 billion a year, or approximately the same as in 1972.

- The no-load funds, with the impact of greater investor knowledge in a climate of consumerism, have enjoyed a 100% sales increase, and now account for 17% of industry sales.

- The controlled retail (or "captive") sales organizations have turned from mutual funds to insurance, oil and real estate. They have suffered a 40% decline in fund sales, and now do 16% of industry volume.

SHARE OF MARKET



- The member firms and independent investment dealers—aided in no uncertain terms by the entry of a small concern which, as I understand it, is "bullish on America"—have shown a 5% sales gain, and maintained their market share at about two-thirds of industry volume.

(A more than incidental note about these market share patterns: one of the most overlooked statistics in our ICI data is the slow, but very sure, growth of insurance company distribution of mutual fund shares, included in the above totals. From a zero base in 1966-1967, it has risen year after year to 5% in 1972. A real credit to the life insurance industry, this trend carries a message for us all.)

Future Sales Patterns

It is easy to describe past patterns. Future sales patterns are less easy to deal with, but much more interesting, so let me speculate a bit. Likely, the no-loads will continue their high-growth rate—but, I would suggest, only so long as they have a performance champion. In the past decade, this "championship" has been characterized by significant rotation—passing from one fund to another as market emphasis has changed. An inspection of the record of no-load cash flows on a fund-by-fund basis, however, would suggest this conclusion: the no-load appeal has been based at least as much on high performance as on low cost. And to the extent performance falls short, relative cost is likely to carry little marketing weight.

Turning to the captive organizations, I do not foresee a full recovery of the lost "share of market" noted earlier. More important than my opinion, however, is that their own marketing experts (as indicated in the excellent statement Investors Diversified Services presented at the SEC hearings on mutual fund distribution) suggest a similar conclusion. This statement notes that their salesmen's commissions from fund sales have declined from 76% of total compensation to 48% since 1967, as mutual funds have been increasingly supplanted by insurance, annuities, tax shelters and face amount certificates, reflecting a commission structure that is, in general, substantially higher than that on mutual fund shares.

Whether or not you grant these assumptions about no-load funds and the captive organizations, the prime future thrust in mutual fund sales almost has to come from the independent member firm and broker-dealer—the traditional backbone of the industry's distribution system. For it is hard, as a practical matter, to see any major near-term resurgence in industry sales without the resurgence of the segment that now accounts for two-thirds of total volume. Further, these independent firms have much going for them. They have the facilities to select funds with the right objectives and the right managements for the needs of their clients. Their representatives know the mutual

". . . our competitive environment will get more intense in the year ahead."

fund story. They deal with substantial clients. But they are not doing the amount of volume they could be doing in mutual funds. In short, the independent firm is, to our regret as an industry, clearly demonstrating its independence today.

To a major extent, they have replaced their mutual fund volume with other financial products—closed-end bond funds ($1.2 billion last year and a similar amount already in the first four months of this year), real estate investment trusts ($1.1 billion last year) municipal trusts ($900 million), oil drilling programs ($600 million). And when their salesman offers these products, he avoids the negative "mutual fund" reactions: "What about the sales charge?" "Performance hasn't been good." "Isn't the industry in net redemption?" "What about these SEC hearings?" "I hear the Justice Department is suing the industry." And a few others, too.

These negative factors are not easy to overcome. Indeed, to return to the two questioners I mentioned at the outset, as least one regulator and one journalist seem to believe that they are impossible to overcome. But I choose to believe that mutual fund performance effectiveness will tell in our marketing efforts, sooner or later, if only we can get our story across to the investor, simply and effectively. In short, I believe our industry's marketing problem is less involved with the economics of the marketing system (though the economics today are incredibly challenging) than with the fact that mutual funds today are "harder to sell" for the reasons I have earlier indicated. We should not be discouraged by the economic pressure on our marketing efforts, for it indicates, at a bare minimum, that neither compensation of salesmen, nor profitability of broker-dealers and underwriters is excessive. I think we could all agree on that quite readily. This is the standard set by the law, and we clearly meet it.

In the marketing of our financial service, then, we have maintained a "delicate balance" between minimum cost (and hence maximum performance) for the consumer, and distribution expenses adequate to give the seller a fair incentive to offer the product. This will pay off in the era of consumerism that is here today and will hardly be gone tomorrow.

"Yesterday's Product" vs. "Tomorrow's"?

In this context, our competitive environment will get more intense in the years ahead. For the imagination of the marketing organizations in the insurance industry, in the banking industry, and in our own industry, are bringing forth new products designed to meet the investor's needs. We have to challenge our own judgments and preconceptions by asking ourselves whether these are "tomorrow's products," and whether the mutual fund is in fact "yesterday's product"—a "dead horse" or "over the hill." While this challenge may seem harsh, let me close by briefly examining three new products that have been suggested as prime alternatives to the mutual fund—variable life insurance, closed-end bond funds, and mini-counsel accounts. To do so, however, requires that we first define our own product. Through our mutual fund, we provide a professional money management service—

—in which the *costs*, by law, must be fair to the investor (reasonable sales charges and management fees that meet fiduciary standards).

—which provides immediate *liquidity* for the investor, who is entitled to receive on demand the current value of his shares.

—which has a *structure* that centralizes management responsibility and affords broad diversification by the pooling of assets in a single account, with commensurate operating efficiencies and transactional economies.

Let us examine the extent to which the three new products I have cited can provide these services:

- On the *cost* side, under the SEC's decision to exempt variable life insurance from each and every provision of the Investment Company Act, the Federal requirement of fair costs is inapplicable. A sample variable life policy has a cost structure tilted so that, to keep up with a 3% rise in living costs during its first decade, it must grow at 23.6% per annum—in my experience, at least, an impossible performance achievement. One key reason for the SEC decision was the applicability of state insurance regulation to such contracts. In the context of certain headlines of the past month, you might want to reflect on this comment from the statement by a group of major mutual fund organizations before the SEC over a year ago:

> ". . . Variable life insurance must and will be regulated by the Federal government. The only real question in these proceedings is whether that regulation will come now, or must wait until the Bernard Cornfeld of the variable life insurance industry arises from the gaps and crevices of state regulation . . ."

- As to *liquidity*, I understand that part of the magic of a closed-end bond fund is the "underwriting urgency" calling for an immediate decision by the investor. But the lack of redeemability both curtails important services (free exchange being a good example) and may well result in large discounts when investors wish to sell their shares. (I further note that a gross portfolio yield of 8.5% must be obtained in order to meet the 7.0% return on offering price that seems to be projected by some of these funds. One can only speculate on where and how such yields are obtained in the current bond market.)

- As to *structure*, I ask these questions about the mini-counsel account: Can the administration of, say, 1,000 accounts averaging $50,000 be as efficient as managing one $50,000,000 account? Can investment decisions be made and investment transactions be implemented as effectively? And can the resultant performance not only be as good, but sufficiently superior to offset a management fee *differential* of 1% to 1¼%? The future of this growing area depends upon the answers to these questions.

You would sadly miss my point if you construed these as "sour grapes" remarks. We in this field have far too much to learn and to do in the "packaging" of mutual funds and insurance to denigrate the wholly viable concept (as distinct from the appropriate regulatory framework) of variable insurance. Our concern about whether closed-end products will ultimately fail to realize projected yields, lack valuable services, and sell at sharp discounts is valid, but perhaps we could more profitably ask ourselves why we were not earlier and better positioned to market "open-end" bond mutual funds with their greater product qualities and their appeal to an income/savings market. We were afflicted, I fear, from an attack of "marketing myopia." Finally, the apparent success of mini-counsel accounts should force us to examine just why it is that an investor would turn away from mutual funds to a service that, in the view of many observers, has less attractive structural and cost characteristics. Perhaps some of this was our own doing.

A Positive Response to Three Challenges

I hope it is obvious that my examination of these competitive products has not diminished in the slightest my enthusiasm for the mutual fund product. In fact, it has strengthened my conviction that we serve investors well. We can do so even more effectively, as we expand our markets, if we meet the three challenges I have set forth today:

- **The challenge to our Institute to develop new measures of both market and mutual fund performance.**

- **The challenge to the SEC to allow mutual funds to show compound annual rates of total return, as do other investment advisors and other savings media.**

- **Most important of all, the challenge to each of us to critically examine our own mutual fund product in the light of alternatives, and work toward its further improvement.**

If our response to these challenges is positive, as I believe it will be, the future of mutual funds—the title of my talk today—is bright. And we can maintain "that fine moment," in the words of John W. Gardner, "when an institution is responding with vigor and relevance to the needs of its day, when its morale and vitality are high, when it holds itself to unsparing standards of performance."