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The $7 Trillion Question: Mutual Funds & Investor Welfare - Reflections on the Evolution of Mutual Fund Governance

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REFLECTIONS ON THE EVOLUTION OF MUTUAL FUND GOVERNANCE

HENRY HOPKINS: I have a job here today to introduce an old friend of mine. I started working at T. Rowe Price in 1972, and Jack was already a living legend at that point. There was an article in the *Wall Street Journal* back on January 7th of this year titled *Bogle: The Man Who Told You So.*[1] It says, "Vanguard founder John Bogle has dished out criticism of his industry for years—well before everyone else started doing so."[2] Jack has always been in the vanguard, regardless of whether that term aptly describes whether his model has become the norm.

My father always said there is a key to success. Looking at Jack reminds me of that message, which is expressed in a quote from Calvin Coolidge, "Nothing in the World can take the place of persistence. Talent will not; nothing is more common than unsuccessful men with talent. Genius will not; unrewarded genius is almost a proverb. Education will not; the world is full of educational derelicts. Persistence and determination are omnipotent."[3] I would like to introduce an omnipotent person, Jack Bogle.

JOHN BOGLE: Thank you so much, Henry. I thank all of you for coming. At last it is a great day for me: I have found the perfect forum. [laughter] Thank you, [Dean] Karen [Rothenberg] and Rich [Booth], for putting on this conference, and Jim [Hanks], our moderator for this morning's panel, for giving me the opportunity to express my deeply and profoundly held views. When they say that I am giving the mutual fund industry hell, I am reminded of the story about Harry Truman on the whistle-stop tour during his 1948 presidential campaign. The crowds used to yell, "Give them hell, Harry. Give them hell, Harry." To which the President responded, "I'm not giving them hell; I'm just telling them the truth and they think it's hell."[4] [laughter] My only objective is to make this a better industry; any industry can improve from there.

1. Karen Damato, *Bogle: The Man Who Told You So*, WALL ST. J., Jan. 7, 2004, at C1.
2. *Id.*
3. Attributed to Calvin Coolidge, 1948; printed on the cover of his memorial service program, 1933. NIGEL REES, CASSELL COMPANION TO QUOTATIONS 183 (1997).
4. The exact quote attributed to President Harry S. Truman is "I never give them hell. I just tell the truth and they think it is hell." THE GREAT THOUGHTS 423 (George Seldes ed. 1985).

I was asked to make a few remarks on some of the issues that are perhaps less recognized. In the course of these remarks I will discuss corporate governance, one of the least recognized and most deeply troublesome issues of the day, as it affects the financial services business generally and mutual funds in particular. I have studied issues regarding mutual funds and corporate governance for a long time and have developed a very deeply held set of values and biases.

Sixty years ago, funds owned only slightly more than one percent of the shares of all U.S. corporations. Today, we own more than twenty-three percent. We could wield a very "big stick." With few exceptions, we have failed to do so. As a result of our long record of passivity and lassitude on corporate-governance issues, fund managers must accept a large share of the responsibility for the ethical failures in corporate governance and accounting oversight that were among the major forces behind the recent stock market bubble and subsequent bear market.

Yet it was not always that way. In the old days, mutual funds were responsible owners. The 1949 *Fortune* article that inspired my ancient Princeton senior thesis described them as "the ideal champion of . . . the small stockholder, in controversies with government, labor, or indeed with corporate management itself. M.I.T. [Massachusetts Investors Trust] has needled Chrysler and other corporations on dividend policies, it has blocked at least one corporate merger it did not like, and it has pitched in on several proxy fights. . . ."[5] Indeed, I also quoted a 1940 report by the SEC, which called on mutual funds to serve in "the useful role of representatives of the great number of inarticulate and ineffective individual investors in industrial corporations in which investment companies are also interested."[6]

It was not to be. Once an own-a-stock industry, funds became a rent-a-stock industry, and the industry's move from investment toward speculation can hardly be unrelated to its failure to observe the responsibilities of corporate citizenship. A fund that acts as a trader, focusing on the price of a share and holding a stock for but eleven months, may not even own a company's shares when the time comes to vote them at the corporation's next annual meeting. By contrast, a fund that acts as an owner, focusing on the long-term value of the enterprise, has little choice but to regard the governance of the corporation as of surpassing importance.

Indeed, my thesis, titled "The Economic Role of the Investment Company," includes an entire chapter devoted to the responsibility of funds. That chapter, "As an Influence on Corporate Management," approvingly quotes Merrill Griswold, long-time head of Massachusetts Investors Trust (the oldest and, for its first forty-five years, by far the largest and lowest-cost fund in our industry):

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5. *Big Money in Boston*, FORTUNE, Dec. 1949, at 118.

6. *See* JOHN C. BOGLE, JOHN BOGLE ON INVESTING: THE FIRST 50 YEARS 419 (McGraw-Hill 2001) (quoting 1940 SEC ANN. REP. at 371).

> *Investment companies are . . . in a position to work intelligently with corporate managements on plans for mergers, recapitalizations, and other corporate changes. They can point out objections to such plans and suggest changes necessary to assure fair treatment of all stockholders. As intelligent and unbiased stockholders, investment companies can also come to the defense of business organizations and their managements against unwarranted attacks by others.*[7]

What makes the problem so complex is that we have become a rent-a-stock industry. Thus, we do not, and perhaps should not, have any interest in the kind of corporate governance that an own-a-stock industry would almost have to demand. Today's 110% annual portfolio turnover reflects a profound change in our investment focus and is in stark contrast with the fifteen-percent turnover that regularly characterized the fund industry from the 1940s to the mid-1960s. That change, in turn, has radically altered our view of corporate governance.

I dealt with the change in investment focus in my thesis as well, discussing Lord Keynes's worry that our society would be harmed when "the conventional valuation of stocks is established [by] the mass psychology of a large number of ignorant individuals,"[8] leading to "violent changes in prices, a trend intensified as even expert professionals, who, one might have supposed, would correct these vagaries, follow the mass psychology, and try to foresee changes in the public valuation."[9] As a result, he described the stock market as "a battle of wits to anticipate the basis of conventional values a few months hence rather than the prospective yield of an investment over a long term of years."[10]

After I cited those words way back in 1951, I had the temerity to disagree with the great Keynes. Portfolio managers in a far larger mutual fund industry, I suggested, would "supply the market with a demand for securities that is *steady, sophisticated, enlightened,* and *analytic,* a demand that is based essentially on the [intrinsic] performance of a corporation rather than the public appraisal of the value of a share, that is, its price."[11] Well, fifty-three years after writing those words, it is fair to say that the worldly-wise Keynes has won, and that the callowly idealistic Bogle has lost. The contest wasn't even close!

This focus on short-term speculation has led to a counterintuitive and counterproductive switch from being responsible corporate citizens to virtually passive participants in the corporate-governance arena. Funds are not only not demanding

7. William D. Carter, *Mutual Investment Funds*, 27 HARV. BUS. REV. 715, 740 (1949) (quoting Merrill Griswold, Trustee, Massachusetts Investors Trust, INVESTMENT DEALERS' DIGEST, Aug. 22, 1949).

8. JOHN M. KEYNES, GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY 154–55 (Macmillan and Co. 1936).

9. John C. Bogle, Founder and Former CEO, The Vanguard Group, Keynote Address at the Center for Economic Policy Studies: The Perils of Numeracy (Oct. 18, 2002), http://www.vanguard.com/bogle_site/sp2002 1018.html.

10. KEYNES, *supra* note 8, at 155.

11. BOGLE, *supra* note 6, at 432 (emphasis added).

shareholder democracy, they are fighting against it. It is no secret that most funds have been reluctant participants in the proxy process. TIAA-CREF [Teachers Insurance and Annuity Association-College Retirement Equities Fund Individual and Institutional Services, LLC] has been a notable and noble exception. When we had the opportunity to place the interest of the principals ("them," our shareowners) ahead of the interest of the agents ("us," the fund-management companies), we did the opposite. We defied the basic principle of agency relationship: *The role of the agent is to represent his principal.*

When the SEC proposed that mutual funds disclose their proxy votes,[12] the Investment Company Institute offered its support for almost everything *except* the requirement that we disclose how each proxy is voted. Even the heads of longtime rivals Fidelity and Vanguard joined in a *Wall Street Journal* op-ed essay decrying the proposal and warning that adopting the proposal, "will distract [fund shareholders] from more critical issues in judging funds—like investment objectives, long-term performance, and risk."[13] The op-ed also asserts that the proposal "could undermine the best interests of 95 million mutual-fund shareholders in the U.S."[14] Indeed, the two executives claimed that it was their "fiduciary duty" that brought them together to oppose the SEC's disclosure proposal.[15] "Politics makes strange bedfellows."[16] But the SEC proposal has now gone into effect, our proxy votes were disclosed in August, and the sky has not fallen.

More recently, the SEC offered the most modest possible proposal to give investors "access" to proxy statements—putting forth a tenuous, pallid, time-delayed program in which a "triggering event" would be required before even a single director (or for large boards, two directors) could be nominated.[17] The proposed rule did not even approach the U.K. rule that any director for whom a majority of votes was withheld would not be elected to the board. "How daringly democratic," the *Economist* observed.[18]

The industry, rather than seeking greater access, seemed to seek even less. Most commentators sought to make a weak access proposal even weaker, raising ownership thresholds to even higher levels. Nowhere did I see a hue and cry to let us behave as active owners. Interestingly, as far as I could determine, the industry's

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12. Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 67 Fed. Reg. 60,828 (proposed Sept. 20, 2002) (to be codified at 17 C.F.R. pts. 239, 249, 274).

13. John J. Brennan & Edward C. Johnson III, Op-Ed, *No Disclosure: The Feeling Is Mutual*, WALL ST. J., Jan. 14, 2003, at A4.

14. *Id.*

15. *Id.*

16. Attributed to Charles Dudley Warner in his essay "Fifteenth Week" in his collection of essays, *My Summer in a Garden* (1870) (possibly paraphrasing Shakespeare's "Misery acquaints a man with strange bedfellows." WILLIAM SHAKESPEARE, THE TEMPEST act 2, sc. 2). AMERICAN HERITAGE DICTIONARY OF AMERICAN QUOTATIONS 390 (1997).

17. Security Holder Director Nominations, 68 Fed. Reg. 60,784 (proposed Oct. 14, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 274).

18. *No Democracy Please, We're Shareholders*, THE ECONOMIST, May 1, 2004, at 13–14.

biggest guns did not even respond. I found nothing in the way of comment from Fidelity or Putnam or Janus or MFS or Vanguard or Dreyfus. Neither did Citibank, Merrill Lynch, or Morgan Stanley respond, though they control giant fund empires. Other institutions, all with large institutional investment and mutual fund units, actually *opposed* the SEC's modest thrust toward corporate democracy, including Schwab, Prudential, Northern Trust, and J.P. Morgan Chase.

That brings me to my final point. Beyond our short-term investment focus, is there something else, something ominous, going on beneath the surface that explains our failure to act as owners? There seems to be more than short-termism that accounts for the absence of funds from the governance scene. Consider that index funds (and other funds that follow essentially static buy-and-hold strategies) make up some twenty-five percent of the assets of the Institutional 100. Yet the voices of these consummate long-term investors have been, if not totally silent, at least seriously muted. Even active managers who engage in what passes for low turnover in the current environment (say, below thirty-five percent) have generally refrained from intrusion into the affairs of the corporations in which they invest. One obvious reason for this passivity is the desire to avoid controversy. In the asset-gathering business that the money management profession has become, a high profile on a divisive issue is more of a liability than an asset.

Another reason for such forbearance is conflict of interest. Such conflicts are regularly denied. But it is easy to imagine that private institutional managers would hesitate to vote against the entrenched corporate management that has hired them to manage most of the more than $2 trillion of equities in their pension plans and 401(k) thrift plans.

That is only the beginning of the problem. Although the votes of the mutual funds in a company's thrift plan presumably must be voted as a whole, the corporation itself could direct its pension managers to vote the shares of the corporations held in its pension plan in any way it wished. It does not take a lot of imagination to realize that corporations, too, are unlikely candidates for aggressively voting the shares their pension plans hold in other corporations. Why be known as a troublemaker among your Business Council colleagues? Whether tacit or explicit, a system has emerged in which "Let him who is without sin cast the first stone"[19] has become the watchword of behavior for corporations that control trillions of dollars' worth of shares of other corporations, almost an American *keiretsu*.[20]

Further, passivity in governance may pay. Let others undertake the hard work and costs of activism. If their efforts are successful, the "passive-ists" (who hold the remaining ninety-five percent to ninety-nine percent of shares) will not only reap

19. *John* 8:7 (King James).

20. The term *keiretsu* refers to a group of connected businesses in various industry sectors that were horizontally and vertically linked through various banks and trading organizations in Japan after the Second World War. *See* JOHN J. CAPELA AND STEPHEN W. HARTMAN, DICTIONARY OF INTERNATIONAL BUSINESS TERMS 298 (2001).

the rewards without spending a penny, they will also increase their chances of getting the pension and thrift business of the activists. Thus, the decision to remain silent becomes what is called a win-win decision (I do not much care for the expression).

There may well be a third, even more devious reason for our unwillingness to act as owners. We are not only *owners*; we are *owned*. One major difference between the mutual fund industry today and the industry in the era during which I wrote my thesis is the change in the nature of its ownership. Then, the typical fund manager was a small, privately owned professional organization. Up until 1958, both public ownership and transferring ownership of the management company for a premium over book value were effectively precluded by SEC policy. In 1958, a Supreme Court ruling abrogated that prohibition, the floodgates opened, and public ownership moved to the fore. It was only a matter of time until large financial conglomerates began to acquire mutual fund managers. The industry today is dominated and, to some extent, controlled by these giant firms. Among the fifty largest fund managers today, only eight private firms remain (plus Vanguard, which is mutually owned by its fund shareholders). Six are independent, but publicly owned. Of the remaining thirty-five fund managers, twenty-one are owned by U.S. banks and insurance companies, seven by international conglomerates, and seven directly by brokerage firms. In all, these fund managers control $3.1 trillion of the industry's $6.9 trillion total.

It must be clear that when a corporation buys a business, whether it is a fund manager or not, it expects to earn a hurdle rate of roughly twelve percent on its capital. If the cost of acquiring a fund manager was $1 billion, the acquirer would likely defy hell and high water in order to earn at least $120 million per year. In a bull market that may be an easy goal. When the bear comes, however, we can expect some combination of the following: (i) slashing management costs; (ii) adding new types of fees (distribution fees, for example); (iii) maintaining, or even increasing, management fee rates; or even (iv) getting its capital back by selling the management company to another owner (the SEC's "trafficking" in advisory contracts writ large).

If you think about these conglomerates not only as owners but also as owned, the conflict of interest becomes obvious. When Citibank fails to take a stand on the SEC's access proposals, is it because it fears that access will harm the interests of its fund shareholders, or because it seeks to fortify the insulation of its own governance from interference? When Charles Schwab opposes those same proposals, is it doing so to protect the interests of its fund shareholders, or to protect the interests of its entrenched management?

Whatever the case, the weight of corporate influence in its own governance process is enormous. With nearly $1 trillion of U.S. equities held in its defined benefit pension funds and another $1.6 trillion in its defined contribution savings plans, corporate America holds control, or at least strong influence, over how the shares of some $2.6 trillion of equities are voted. Those shares constitute twenty percent of all shares outstanding. In addition, corporate America also has strong influence over the voting policies followed by managers of the remainder of the mutual fund and institutional assets, which are perhaps another $2 trillion. In all, although corporate America does not entirely own itself, with more than a little influence over forty-two percent of its shares, it gives it a good shot.

In a speech I gave in 1971, when Wellington Management Company (for whom I was then working) was a publicly held company, I expressed the opinion that having public owners in mutual fund management was antithetical to our fiduciary duty.[21] These issues I described are not, however, unobserved, trivial matters. If you believe it is high time for owners to assert their role in a corporate democracy over the managers, you can see how much work remains to be done. It is a very intractable problem, like many we have discussed today, but I think putting the issue on the table and debating whether or not this "conglomeratization" of the mutual fund industry is healthy for mutual fund shareholders (the people we are all sworn to serve) is a vital first step. I think we ought to be thinking long and hard about that issue.

Thank you very much, and I will be glad to take a couple of questions.

QUESTION: We heard an argument for mutualization based on management or a board controlling the cost of mutual funds. Now we hear a slightly different argument that also supports mutualization in terms of wanting funds to act as owners of assets and as responsible corporate citizens. Those two arguments are in tension with one another. If you are really a passive investor, your interest should not be in trying to spend resources of the fund aimed at improved corporate management. You should be a totally passive index-driven investor in terms of strategy. Can you reconcile the conflict there and, if not, which is the more important argument for mutualization?

JOHN BOGLE: That is a very good question. The answer is that we should expect index investors to be more involved on the governance front than anybody else because they are the ultimate long-term owners. They buy and hold forever. They cannot trade based on the price of a stock. They have to buy and hold the company and hope that the value of the corporation will grow. If the corporation is not being properly run, they have no other choice. They cannot follow what used to be called the Wall Street Rule: If you do not like the management, sell the stock. That is not an option, so they have to improve the corporation from within. They have to be very active in governance because their only resource is to improve value rather than price. That is a very powerful argument in favor of getting passive investors involved in corporate governance. TIAA-CREF for example, is a very

21. John C. Bogle, Partner, Wellington Management Company, Speech to Company Partners: Deliverance (Sept. 9, 1971) *in* BOGLE, *supra* note 6, 246, 257.

active governance investor. Most of TIAA is pretty much indexed, as they will be the first to tell you.

I would also add that I have struggled, with complete failure to this point, to try to form a federation of long-term investors to get together and start talking about voting responsibilities. The intention is not to get the investors to agree on how to vote, but rather to agree on what the issues are. We have had only one meeting in New York with mostly passive managers. Some very, very good active managers, by the way, were at the meeting, but not managers from these great big mutual fund financial conglomerates. Rather, they were from the smaller firms. Bill Miller, for instance, was there.[22] Bill is much more interested in governance issues than most active managers because he is not part of a great big conglomerate dedicated to gathering fund assets. Of course, most participants did not want their attendance to be publicized. I think they all came in anonymously, probably wearing red wigs or something. The highlight of the meeting was when, after we talked for an hour, a representative of one of the large index firms looked at me and said, "You know, Jack, I don't think it's our responsibility as long-term index holders to take this on. Why don't we just leave it to Adam Smith's invisible hand?" And I said "Don't you understand that *we* are Adam Smith's invisible hand?"[23]

We have to stand up and do something, but there are obstacles to doing just that. By and large, firms do not want to be known for being big corporate-governance advocates. They would much prefer that all of this take place behind the scenes. I do not say that to derogate their motives at all. The reality is that it is not good for business to be known as a troublemaker. As a result, trying to get any kind of an organization or a group of owners to be out in front on these issues is, for the reasons that I touched on in my remarks, very difficult to do.

As far as index funds are concerned, I am absolutely convinced that they should be involved. Passive investment policies mean buying and holding; the only way you can improve your return is to improve the intrinsic value of the corporation. If the management is not doing it or the directors are not doing it, get new directors and get new management.

QUESTION: John, you have not really said much today about closed-end funds. I wondered what you think of closed-end funds as an investment model. I would also like to know what your view is on closed-end funds' taking various measures to protect themselves against hostile activity directed at our realizing discount, even at the cost of destroying the vehicle with liquidation or appending or otherwise.

JOHN BOGLE: I think the answer is that closed-end funds are a kind of mysterious business because, as everybody knows, only a lunatic buys a closed-end fund on its

22. Bill Miller served in many positions since joining Legg Mason in 1981. He currently runs Legg Mason's Opportunity Trust and Value Trust mutual funds. Legg Mason Funds, Investment Managers, http://www.leggmason.com/funds/ourfunds/managers/lmfm.asp#Bill%20Miller,%20CFA (last visited Apr. 10, 2006).

23. *See* ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 477 Vol. I (Edwin Cannan ed. 1976).

initial public offering. I am talking about equity funds now, although this probably pertains to fixed-income funds, too. On the fund's initial offering you pay a premium. You know that once the fund starts trading, it is going to trade at a discount, so you are hit with a double whammy if you are one of the initial investors. If nobody wants to buy a closed-end fund when it launches, it is not a stretch to think that soon there will not be any more closed-end funds. Simple logic tells you that. What do you do when they are trading at a discount? I do not think they should have any protection against someone coming in to make a shareholder's resolution to open it up and have the shares redeemable at that asset value. I am not sure what the argument against that would be, other than the fact that, of course, the fund would presumably go out of business. That is not a gain or a loss for the financial system, although it is certainly a loss for those who are managing it, as is the case in all those systems.

My answer is somewhat dictated by a very frustrating experience I had about twelve or fifteen years ago. There was a fund called Liberty All-Star Equity Fund, which is still around, and it sold at a discount. We wanted to merge the fund into a Vanguard fund at its asset value, so I tried to start my own little proxy fight. My motto was, "Give me liberty or give me death."[24] It turned out that they did not give me liberty, but they are still alive anyway. I do not see that management is entitled to protection since it is the shareholders' money. If they want to get their asset value and have no other way to get it, then it would seem to me that it is the shareholders' right to open the fund up. What you have in a lot of these cases, of course, is that by the time you get to that point, some trader comes in and buys the shares of the fund at a discount with the sole objective of taking out that discount. Well, that is the way corporate takeovers work. I am not particularly smitten with the process, but I do not see that there is a logical alternative; the shareholders want their money, and they ought to be able to get it. One man's opinion.

24. Attributed to Patrick Henry, speech, Virginia Convention, March 23, 1775. AMERICAN HERITAGE, *supra* note 16, at 199.