

Introduction

Conference on the Bogle Critique of the Mutual Fund Industry

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This is the ninth conference we have sponsored under the general rubric “Is there a better way to regulate mutual funds?”

Our guest and principal speaker today is Jack Bogle, a pioneer in the mutual fund industry, and the founder of the very successful and innovative Vanguard group. I won’t go into detail concerning Mr. Bogle’s extraordinary career—that’s outlined in the biography included in your materials—but suffice it to say that he began looking at the benefits and costs of the mutual fund industry with his senior thesis as a Princeton undergraduate, and essentially never stopped. His work as both an innovator and then a critic of the mutual fund industry has earned him, in 2004, *Time Magazine’s* listing as one of the 100 Most Influential People in the World.

We were eager to bring Jack Bogle to this podium because his critique of the mutual fund industry has received wide circulation—not just through his own books, but through his remarkable speaking schedule. As the *Washington Post* once said, he has “the mind of an economist and the personality of a preacher.”

Any study of mutual fund regulation and the structure of the industry must take into account the Bogle critique, and particularly his recommendations for change. And certainly we will.

In his latest book, *The Battle for the Soul of Capitalism*, which is on sale in the lobby, Mr. Bogle outlines his prescription for reform. He cites four elements in his reform agenda:

1. No more than one management company director on the fund board.
2. An independent chairman.
3. A fund staff reporting to the independent chairman, with responsibility for evaluating “the investment performance and marketing results of the manager, the reasonableness of fees paid, and other relevant information.”
4. A federal statute of fiduciary duty for fund directors.

We are eager to hear Mr. Bogle’s arguments in favor of these reforms, for several reasons.

First, the SEC’s 2004 regulation that would have required the chair and at least 75 percent of the board of directors of every fund to be independent of the investment adviser was recently struck down by the DC Circuit Court of Appeals because the SEC failed to consider the effect of its rule on “efficiency” and “competition” in the mutual fund industry. In the National Securities Market Improvement Act of 1996 (NSMIA), Congress required the SEC to consider these factors in connection with its rule-making, and we would like to hear Mr. Bogle’s view of whether and how the

independent chair and the supermajority of directors will contribute to efficiency and competition in the mutual fund industry.

Second, the only significant scandals in the mutual fund industry's 66 year history were the recent market-timing and late-trading scandals. Both were discussed extensively in Mr. Bogle's newest book. The SEC proposed its requirement for an independent chair and an independent supermajority on the board largely as a response to these scandals, and thus implemented two of Mr. Bogle's four reforms. I have been trying to figure out how this reform—had it been in effect—would have prevented these scandals. The SEC has never charged any directors—-independent or otherwise—with dereliction in connection with these clearly wrongful acts by the funds' advisers, and has never suggested that the directors could have or should have discovered the wrongdoing. So I have never been able to determine how increasing the number of independent directors—from a majority to a super-majority—or making the chair independent of the investment manager, would have been a remedy for the one serious scandal that has ever afflicted this industry. Since it is an important part of his prescription for reform, I am hoping that Mr. Bogle will draw the connection between the reform and the wrongdoing.

Third, in his book Mr. Bogle argues that expenses imposed by investment managers have eaten up very large percentages of the returns investors might have expected from the growth in the value of common stocks. Yet he recommends that the funds themselves have a paid staff to evaluate the work of the investment adviser. Presumably, that would add even more to the costs that ultimately reduce the yield that an investor receives from appreciation in the value of the fund's portfolio. Mr. Bogle does not estimate what these costs would be, but if we were to adopt this idea I'd like to get some sense of what he thinks these costs might be, and how they would increase the returns for mutual fund investors.

More generally, like Jack Bogle, Bob Litan and I are focusing our study on what reforms will improve the returns that investors will get from their mutual fund investments. In looking at mutual funds today, we see an industry with nearly \$9 trillion in assets under management, heavily regulated by the SEC, and largely under the control at the board level of majorities of independent directors. From this arrangement, investors obtain the diversification that protects their nest eggs against the kinds of losses suffered by the non-diversified shareholders of Enron and WorldCom.

Far from being dissatisfied with what this arrangement is costing them, there are indications that investors are willing to pay even more for investment advice. If I understand the figures correctly, almost 60 percent of mutual fund investors are introduced to mutual funds by financial advisers—most of whom are paid in whole or in part by the investors themselves or through 12b-1 fees that are in effect paid by fund shareholders. And how else can one explain the growth of separately managed accounts, in which investors pay advisers to set up special customized diversified portfolios?

One of the alternatives we might consider in our study is the adoption of the reforms that Jack Bogle recommends, but in order to do so we'd have to see how these reforms will cure the problems Mr. Bogle cites or give investors more of what they seem to want.

We look forward to Mr. Bogle's remarks