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Q&A with John C. Bogle

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By Donald W. Nicholson, Sr.

Q&A
John C. Bogle
The outlook for fiduciary standards

John Bogle is the founder and former CEO and chairman of The Vanguard Group and is nationally known for his decades of insistence that index funds are better for most investors than active mutual funds. His forthcoming article, "Putting investors first," sums up the core principles of NAPFA's campaign to establish a federal standard of fiduciary duty.

The following "kitchen table" discussion took place Oct. 19 between John Bogle and Donald Nicholson, Sr., a NAPFA member from Wilmington, DE. They covered a range of topics, focusing on the outlook for the fiduciary standard that is under consideration at the U.S. Department of Labor.

Donald Nicholson: I appreciate your time. A recent article in the 401K Specialist magazine referenced you as the "conscience of the industry"…and you are! I'll leave it at that.

John Bogle: *(laughs)*

My first question is in reference to what the fiduciary standard has been for some time. Do you see any differences between the fiduciary standard as it was administered under the Investment Advisers Act of 1940 and how it's applied under the Employee Retirement Income Security Act of 1974 (ERISA) now?

Bogle: It's under the 1940 Act—which very few people realize—in the statement of objectives and purposes, that investments are affected by the national public interest and the interest of investors. It says that the investment companies (mutual funds) must be organized to operate and then be managed in the interest of their shareholders, and not in the interest of officers, directors, investment advisors, and distributors. That's all I want!

The 1940 Act was written 75 years ago, and nothing has happened. Why is that? Well, first it's a statement of general objectives of the Act—I would say an inspiring statement of the objectives of the Act, but they put no meat on those very sound bones. So, I think after 75 years, it's probably high time to come to grips with that. It ought to be incorporated into either legislation, which is not particularly easy to get done in our nation's capital, or by regulation, which we're trying to do.

Is it going to happen?

Now Congress is, I think, overreacting to [the Department of Labor's proposed fiduciary standard], and they're going to try to have legislation that says the Department of Labor can't do what the Department of Labor is obviously obliged to do under the existing state of the law!

I should say, in the interest of full disclosure, that going back to last December or January, I have done a lot of work with the White House staff—a very well qualified, mostly young, but extremely smart bunch of people. We've had three or four phone meetings, and then the Department of Labor came into the picture and I spent a fair amount of time with them on these issues. In the morass created out of this, there are thousands and thousands of pages of commentary.

Where do we go from here?

In general, the industry's position, as far as I can tell, is that we totally believe in the fiduciary standard, but we don't like the DOL proposal. It's detailed. It tries to deal with things that are, I think, very, very difficult to deal with from a regulatory

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standpoint. What is the responsibility of the broker? Brokers in this country, traditionally—although it's changing a little bit now—have been salesmen.

It's a business with a bias toward motion, and motion is expensive. Clients do not win with motion—brokers do. I mean, it must be obvious to anybody that all this trading is sometimes good for sellers and sometimes good for buyers! But before costs are taken out, they're average as a group. This is not complicated. It's the whole simple theory behind indexing: get the transactions out, get the management costs out, get the marketing costs out, get the tax costs out of the equation.

I'm not sure I've seen the phrase used in a dialogue about the fiduciary standard, but it's a kind of a "carve out," which is probably what they're doing right now in the existing regulation, for stockbrokers. That's going to be very difficult to do, but it's doable in a broad sense. I think the creation and the amount of recordkeeping is too much, with all due respect, from lawyers, and not enough from people in the policymaking role and the investment world.

So, yes, it is coming. And if this doesn't go through now, it's coming anyway. I mean it's a little bit like King Canute trying to hold off the flood! It is here. These are the times for it. It's been a long time coming, but you've got to have a certain amount of acceleration, motion or acceptance. All you have to do is look at the index fund, which is the essence of taking costs out of the equation. Index funds have minimal internal fund costs, and minimal external fund costs—the costs to acquire mutual funds—and the costs that the mutual funds pay is netted into the performance. That's another drag on performance.

What elements do you feel are most important in new regulations?

My own attitude toward this regulation is to try to move away from so much detail and recordkeeping. Everything is ultimately going to have to require trust, no matter how many records you keep, and maybe move, as you suggested in the article you wrote, Don, to a more of a "principles-based" system.

Now, that is lot more easily said than done. Try and write down the principles. I was on an international committee once, and we talked about a principles-based system and found that it is as easy to say as it is hard to deliver.

You need a principles-based system with some kind of a background, suggestions, and best practices. It will move fiduciary duty along an upward arc. And that's the most important thing to me. It involves a lot of compromises to get it done—I'm not saying it will or won't, but I think it probably will involve some compromises. But do it anyway! Get the standard in, and let's see what happens from there.

You mentioned about the mutual fund companies, and I realize that American funds today run about 55 percent of the world's assets under management. And not just nationally—it's also international.

Bogle: Yes, I am unable to deal with international. Beginning with Canada, as you move away from the United States, fund expense ratios go up and up and up. It is relatively cheap for investors to buy mutual funds in the United States, but it's just too expensive anyway, if you can handle that paradox.

Some of these countries have cut out their commissions now and are using Fee-Only.

Bogle: When a new idea or a new industry begins, it does not sell itself. It requires salesmen. Forget the word "marketing"—I'm talking about people knocking on doors. This industry got a lot of strength in growth in the 1930s with contractual plans, like life insurance contracts. You put money in regularly. You sign the contract.

You can always walk out on the contract, but half of your first years' payments went to the salesmen, and then it equalized out over time so that it gave you the same 8 percent sales charge. But, of course, the most valuable money is the earliest money. Contractual plans probably represented about 30 percent of industry assets during the 1930s.

Does it make sense for Congress to eventually harmonize the market conduct standard for investment advice, regardless of whether it involves a 401(k) plan, a retail brokerage account, or an IRA?

Bogle: Of course you're right, and there's a little bit of internecine—if you want to call it that—jealousy that the surge of interest in fiduciary duty is applied only to retirement plans, and only from the Department of Labor. The SEC simply has to understand that there is no point in having two different standards. You know, for example, the money I inherited, which happened to be nothing, is entitled to the same fiduciary duty as the money that somebody else accumulates by putting it away regularly.

The SEC is going to have to have a similar standard. With Washington being Washington, I suppose it's highly unlikely that the SEC would join forces with the Labor Department at this stage of the game. I think it funny that the Labor Department has put this proposal out, which was the right thing for them to do, and the SEC, in its role of "protector of the investor," comes up behind. But that's the way it is. I was at the 75th anniversary of the Investment Company Act of 1940 in Washington on the first panel. I gave them a little piece of my mind. You can look it up on their website.

Yes, I had about heard that. Thank you.

Bogle: Chair Mary Jo White is in favor of a principles-based rule. A principles-based rule is fine—it's a great idea, but as I've often said around here, ideas are a dime a dozen and implementation is everything.

Does the rapid growth of new types of investments, such as ETFs, make any difference in the need for new regulation?

Bogle: The stock market is heavily driven by speculation. We like to think of the stock market—the financial system—as being "the grease that oils the wheels of capitalism." We raise money for new in-

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novation—additional assets for companies that want to make new investments—to bring out new IPOs with great promise, and yet the market trades approximately $40 trillion a year, and the amount of money raised in the way of new capital is around $300 billion.

About 0.8 percent of what Wall Street does is its basic, agreed-upon function, which is raising capital for new business or the growth of an existing business. The other 99.2 percent is people trading stocks with one another. This is all going to change, and indexing is going to make it change. Or is it?

We now have exchange-traded index funds, which trade almost as much as stocks every day. The largest 100 stocks trade around $18 trillion or $19 trillion per year, and the largest 100 index funds trade around $16 trillion or $17 trillion. Yet the largest ETFs are trading out on a base of $1 trillion, while the largest stocks are trading on a base of $11 trillion!

The turnover of stocks is less than 200 percent a year, and the turnover of ETFs is around 1,400 percent a year. So there's a big difference between the old traditional index fund (TIF) and the ETF.

Wall Street wanted to stamp out index funds back in the early years. Wall Street hated the index fund. But now they love the index fund. As I said in one of my talks, if you want to understand why Wall Street has gone from hating to loving the index fund, follow the money. Indexing is now hugely profitable! ETFs are largely trading vehicles, and Wall Street loves them.

Do you see any key differences between the fiduciary standard as it is administered under ERISA and under the Investment Advisers Act, or should those two be separated?

Bogle: I don't see why there's any difference. The client deserves to be put first, whether it is a retirement plan or anywhere else. We got a little bit lost in the fact that we got the Advisers Act, which has established what is called a clear standard of fiduciary duty for RIAs, but if you read the Capital Gains Research case [Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 1963], which said there is a fiduciary duty there, it's the most convoluted reasoning you've ever seen in your life. But it's the law, so that's fine.

We have not had such a case in the fund area. There have been a lot of fee cases, most of which were settled or even lost, but I took some heart from Tibble vs. Edison International [2015], the corporate 401(k) retirement case. The colloquy that took place between the lawyers for the defendants who lost—regarding the fees they had inflicted on their company 401(k) participants—and the justice, went something like this: the lawyers said, "You can't be saying we have to constantly look at the fees we're paying and make sure we have the lowest fees that are available," and Justice Kennedy said, "You're darned right you do. You have to do that."

Interesting that we keep coming back to fees...

It's a very important case because that dialogue was all about fees, and fees are a vital part of it. Because if you just think—and nobody wants to think in this business (this is a real problem)—there are two groups of retirement plan holders. And let me suggest that you won't be too far off if you say that half of them are invested in "X" funds and half of them are invested in "Y" funds. It is such a vast amount of money, counting retirement plans and IRAs and 401(k)s—it's probably $14 trillion.

Even if it's $7 trillion and $7 trillion, just to make the math easy, that's $7 trillion divided up between Merrill Lynch, Fidelity, Capital Group, and others. Well, who owns the market? There's too much money there for these supposedly actively managed funds not to own the market. If one fund is, as they say, "overweight in Apple," then another fund must be "underweight in Apple." Together, they're going to own the "market weight" of Apple.

There's a group of investors who own the entire stock market and trade back and forth with one another (active investors), and there's group of investors who simply holds the entire market and do not trade (index investors). Who do you think is going to win? I don't have to tell you. The index fund wins.

Investment research certainly doesn't encourage active management, even by expert managers.

French and Fama say there's about a 3-percent chance that a money manager can win over 50 years. I'm not sure how they get to that, but I think the number must be more like a half of 1 percent, because first of all, name me a manager who has been managing for 50 years. The average fund manager lasts eight years, and 50 percent of equity funds go out of business every 10 years.

If you own a selection of funds—many of which are going to go out of business and many or all of which are going to change managers—your chances of keeping up with the market are pretty close to zero.

Think about it. Why does a fund change managers? Often, the reason is that the previous manager failed. By definition, if you've got a lot of management changes, you've got a lot of failures. I find the system complicated beyond necessity. The simple solution works: get the costs out of the equation.

Now, another big part of the problem is that when someone retires from a company, they have a substantial nest egg that they've accumulated over their career, and salesmen from all over the industry descend on them. Merrill Lynch and Columbia (formerly IDS and Ameriprise) and the like all have salesman, and they've got to sell something in order to make a living. So they're going to charge commissions, and that's murder for the investor over the long term. If you give up 5 percent, 6 percent, or 7 percent of your money—and some of these advisors are much more expensive than that—investors are likely to fall far short of the stock market's return. Over a long period of time, the chances of winning decline precipitously.

Isn't that why they were trying to make a fiduciary standard out there? So that everybody is responsible?

Bogle: It's going to be difficult to do, but it has to be done. We have to try. The edge for brokers and salesmen is built on vigorous salesmanship, and vigorous salesmanship comes with the desire to make

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a living. I think these are, by-and-large, honest, God-fearing people, but they have a job to do. They must sell something in order to get paid.

The economics of this business are really not very complicated. People say, "Why doesn't everybody understand that indexing works better?" Paraphrasing Upton Sinclair, "It's amazing how difficult it is for a man to understand something, if he's paid a small fortune not to understand it."

They believe they're doing the right thing when they move from fund manager X to fund manager Y. They believe they can pick managers who do better than the index fund, and that's fine—except it's not possible. I was really irritated to read The New York Times a couple of Sundays ago when even Todd Rosenbluth, who is the mutual fund performance guru at Standard & Poor's, is constantly writing about how funds perform and how the index fund wins hands down every time he does a comparison. People say, "What do I do to pick a good fund?" He says, "Look at the five-year record and the management quality and durability."

Vanguard recently did a study of fund performance over two consecutive five-year periods. If you look at the funds in the top quintile of performance over the first five years, only 14 percent of those top funds ended up in the top quintile over the next five years. Of the worst performers in the first five years—those in the bottom quintile—14 percent of them ended up in top quintile over the next five years. The best performing funds and the worst performing funds had exactly the same level of success over the subsequent five years. So what good does it do you to look at the last five years? None—it actually hurts you.

Are people catching on to the importance of indexing?

Bogle: The two big index firms in addition to Vanguard are BlackRock and State Street. In the last six years, these three firms have taken in about $1.3 trillion in net cash flow, while the rest of the industry has lost about $4.5 billion.

The index-focused firms account for the entire industry from a cash-flow standpoint. Indexing is a new force out there that has to be contended with.

Maybe consumers are getting smarter?

The idea that the consumer must ultimately take charge from a distribution standpoint is not my own. But the focus on the consumer had to grow gradually as the fund industry matured, because if you have nothing to sell a consumer—no record—where are you going to get the money to run the fund?

You start with a sales-oriented focus. Look at the automobile industry. You're seeing more and more knowledge about the cost of cars, more and more websites that you can use to check prices. It's all to appeal to the consumer.

This may seem like a "brand new" idea, but the roots of this focus on consumers run very deep: "Consumption is the sole end and purpose of all production." That is to say, the investor is the sole end and purpose of all management, and "the interest of the producer (call that 'the manager') ought to be attended to only so far as it may be necessary for promoting that of the consumer (i.e., the investor). The maxim is so perfectly self-evident that it would be absurd to attempt to prove it." Adam Smith, ["Wealth of nations"], 1776.

Wow.

Bogle: That's exactly what I'm saying, exactly what I've always been saying! He says it with a bit more style than I do, I'll give him that. But he was very focused on common sense. Some of that book is difficult to read, But I found many of these nuggets of wisdom like the one I just read to you.

And even in "Moral sentiments."

Bogle: Oh, don't even mention that. I often quote his idea of the "impartial spectator," which serves as our conscience. "The inhabitant of the breast," as he writes, makes us do things that may seem counter to our interests, but we choose to do them out of a sense of service to some greater force, community, or whatever it may be. What a great world we live in. I've used the impartial spectator a hundred times. Whether the impartial spectator is God, the community, or name and reputation, I don't know, but it's there.

I haven't read "The theory of moral sentiments" with the same care that I read "The wealth of nations," which I read while I was a student at Princeton, but I didn't really get it then. But I've just written a chapter for a book that's being published by Princeton University Press on Adam Smith. I've written one of 35 chapters called "Adam Smith and shareholder capitalism," and I quoted heavily from "The theory of moral sentiments."

I just keep working toward a universal standard of fiduciary duty. I know my efforts will not reach fruition during my lifetime, no question about that. Maybe it will take an eternity to reach fruition, but as one might say after Martin Luther King, Jr., "The arc of investing is bending toward fiduciary duty."

This is good information, especially about Adam Smith. Back to our questions, if you could rewrite the regulation, what could you do other than what you are doing?

Bogle: It depends on your approach. I would not have the capacity to rewrite this incredibly detailed, more than 100-page regulatory proposal. Thousands of pages have been written about it in comment letters from firms in the industry.

In this complicated world, the first thing I would do is simplify. Vanguard's secret is simplicity. We have offer a really simple investment strategy—buy the market and hold it forever. Get the costs out of the equation. Diversify to the Nth degree. That's all there is to it.

When you've got complexity, you've got cost. When you've got simplicity, you've got economy.

Cheating and bad behavior will not likely be eliminated by laws and regulations—we'll still have bad behavior. The questions are: 1) how do you minimize the impact of the financial buccaneers and, worse, outright thieves; and 2) how do you bring it home to investors?

You have firms that meet the fiduciary standard and firms that don't. If investors are wise, they'll go to the firms that put their interests first. One suggestion, and I don't particularly like the idea, is that firms get a Good Housekeeping seal of approval, and all the cash flow will go to those managers.

Investors don't know very much. Fund directors don't know very much. How could they? I mean, this business requires my full attention all day, every day just to understand it, and I've been in it for almost 65 years. I should understand something by now, but I still have to work at it.

So how do you bring it down to the level of the ordinary investor? Education? A fiduciary standard would certainly help. A fiduciary standard that is something that reasonable people can understand with ease. I'm going to be very clear that I don't know how to do this—but a fiduciary standard must be guided by principles backed up by limited number of specific regulations.

There's a book by Malcolm Gladwell called "Blink." He says that decision-making is not necessarily based on knowledge or information, but really on understanding. You can get too much information, and your reaction could be clouded by that. It's hard for the consumer to see that. When it comes to stewardship, it's even harder because of all the information that's out there.

Bogle: I don't have any good answer to that at all, except to say in this flood of information we have, why don't we have much wisdom?

The sequence should go something like this: information turns into knowledge, which turns into wisdom. We're not there yet, and it's going to take a while because of this big exception—there are a lot of investors out there who have personally experienced and paid the price of poor investing. And there's nothing like personal experience to bring a lesson home.

It's too bad, but one of the more difficult things in life is learning from the experience of others. Sometimes, you just have to do it yourself. It's better to make those mistakes early in your investment lifetime rather than later. But so many of us overrate our ability to invest successfully—and overconfidence is driven by the media, by fund promoters, and by investors themselves.

On top of that, stock market returns over the past, say, six decades have been much higher than what we can expect going forward. That's going to be a big problem, because future returns will revert to the mean. Everything in this business reverts to the mean—a very important principle. Investors have to know that.

I guess what makes our industry possible in the first place is the trust, which is not gained, but earned.

Bogle: And it's a lot easier to lose it than to earn it.

Thank you for your time.

Bogle: Have I answered your questions?

And then some.

Impact of publicly owned mutual funds

There's a great deal of inertia in the investment industry that is slowing the move toward a broader and stronger fiduciary standard. John Bogle explained why mutual funds have dragged their feet on this issue.

"We badly need more people who care in this industry—people who aren't putting their own interests or the interests of their corporate or conglomerate owners ahead of the interests of their investors. One of the worst things that ever happened to this industry was in 1958, when mutual fund managers were allowed to go public.

"Today, 40 of the 50 largest mutual fund firms are owned by outside owners. That is a major factor in the industry's resistance to the fiduciary standard. I think this is an important point. I was speaking at the ICI a few years ago about how we needed a fiduciary standard—I've been talking about it forever—maybe longer.

"I said, 'We ought to have a fiduciary standard.'

"They said, 'Look, you don't understand, we are fiduciaries!'

"And I should have let him have it with this follow-up question: 'For whom are we fiduciaries?' Are we fiduciaries for the shareholders of the mutual fund? We have fiduciary duty to them, clearly. Or are we fiduciaries to the stockholders of the management company?

"We also have a fiduciary duty to earn as much money for them as we can. We have to earn a high return on their capital, which is in direct conflict with earning a high return on the mutual fund investor's capital: dollar for dollar.

"These conflicting duties remind me of a quote from the good book: "No man can serve two masters, for he will love one and hate the other." I bet you can guess which master gets the management company's love."

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