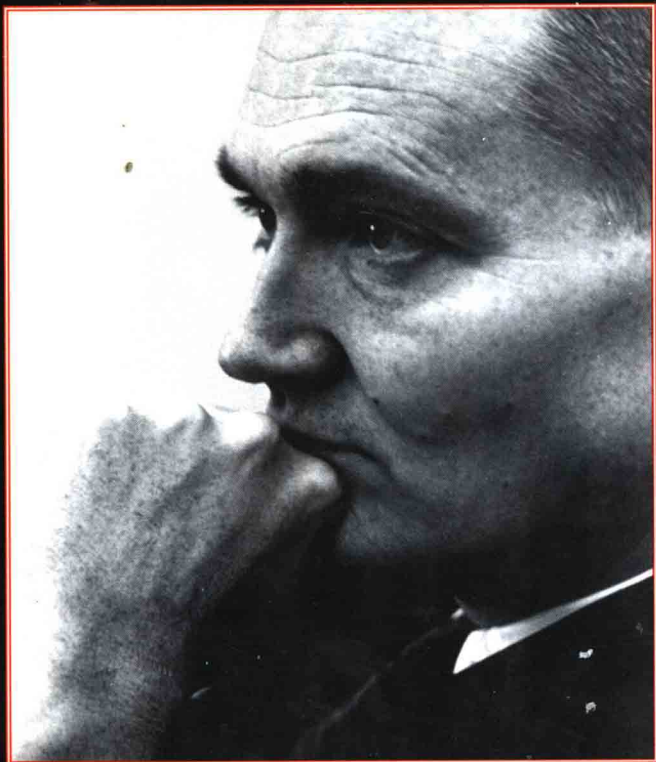


John Bogle and the Vanguard Experiment

One Man's
Quest to
Transform
the Mutual
Fund
Industry



ROBERT SLATER

**JOHN BOGLE
AND THE VANGUARD
EXPERIMENT**

**One Man's Quest to Transform
the Mutual Fund Industry**

Robert Slater

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Acknowledgments

THE IDEA for *John Bogle and the Vanguard Experiment: One Man's Quest to Transform the Mutual Fund Industry* came from John C. (Jack) Bogle, the founder of the Vanguard Group of Investment Companies. He favored such a project as a way of pulling together the corporate history of this remarkable enterprise and providing an orderly road map of his own philosophy and values for future generations. Bogle relishes his role as “conscience of the mutual fund industry” and prides himself on founding Vanguard and developing it into one of the nation’s most remarkable business enterprises. As he neared retirement, he was ready to cooperate with a book that would delve into the unique, compelling, and controversial world of Vanguard. Bogle put the idea to the publisher of his mutual fund guide, *Bogle on Mutual Funds*, Irwin Professional Publishing, which happened to be my publisher as well. Happily for me, Irwin asked me to take on the assignment.

I was pleased to immerse myself in this subject for a number of reasons.

While working on previous business book projects, I had come to appreciate the fact that during the 1980s and 90s millions of Americans had become “players,” however large or small, in the mutual fund industry. And yet while the industry was the fastest-growing segment of American business, it was also one of the least scrutinized. Investors had a pretty good idea of the various kinds of mutual funds, but few had much insight into the large mutual fund companies, how they operate, what challenges they face, and what their philosophies and strategies are.

The more that Americans began to put their trust in mutual fund companies, the more crucial it became to take a close look at their operations.

A book on Jack Bogle and Vanguard, therefore, made a lot of sense to me. That few others had written about mutual fund personalities struck me as one more reason to write *John Bogle and the Vanguard Experiment*. Books on the mutual fund field exist, of course, but they have focused almost exclusively on the advice-giving side, explaining what mutual funds are and giving suggestions about the best strategies when investing in mutual funds. What sets this book apart is that it is the first authorized inside look at a major mutual fund company.

When I met Jack Bogle for the first time in his office at Vanguard's headquarters in Malvern, Pennsylvania, we agreed that the project would be mine, and not Vanguard's; that is to say, that I would enjoy a free hand in writing whatever I saw fit to write, by including whatever material I deemed important and omitting whatever I thought irrelevant or uninteresting. As if to underline the independence I would enjoy in researching the book, Bogle permitted me to peruse a box-load of confidential documents dating back to the founding of the company in 1975, documents that portrayed a whole array of Vanguard personalities, including Bogle, sometimes in a negative light. I was also able to interview Bogle at length about the most unpleasant period of his career, his dismissal as head of Wellington Management Company in early 1974, an event he has never spoken about in public until now. I was able to interview other participants in that event as well. In allowing me full rein, Bogle arranged for me to interview the heart specialist, Dr. Bernard Lown, who treated his heart ailment for a number of years. Lown's candor in discussing the precise details of Bogle's heart condition helped me to report on one of the most private parts of Bogle's life.

Most important, Jack Bogle promised that I would have access to him. We did not discuss at our first meeting how much time he would give me; as it turned out, I conducted 30 hours of interviews with him spread over a nine-month period (February to November 1995). In addition, Bogle made sure that I had access to as many of Vanguard's employees as I wished to interview, including his top executives. I was also able to talk to Vanguard board members, past and present. And, to gauge Vanguard's reputation within the mutual fund industry, I spoke with a number of industry leaders as well as academic experts.



I am indebted to a number of people, both at Vanguard and elsewhere, for giving of their time generously for the research of this book.

First and foremost, to Jack Bogle. We met in different places, sometimes at his office at Vanguard headquarters; sometimes at his summer home in Lake Placid, New York. We had long phone conversations as well, some of them while he was in a Philadelphia hospital awaiting a heart transplant.

My research spanned one of the busiest and most challenging periods for Bogle—including the announcement of his retirement in May 1995, turning over the leadership to Jack Brennan, and subsequently, Bogle's stay in a heart transplant ward. Though Bogle's time was limited, he treated this book as a top priority. In my previous book projects, I have rarely been able to sense how important my project was to the person about whom I was writing; in the case of this book, I could feel and see how large a priority it was for Bogle. That knowledge gave me an even greater sense of responsibility to do the best job possible.

I want to give special thanks to Jack Brennan, who in early 1996 became Vanguard's new chief executive officer. For a number of years Bogle's heir-apparent, Brennan granted me a number of lengthy interviews; his insights have been particularly useful to me and have helped to shape this book in many ways. And I want to express my gratitude to Walter L. Morgan, who founded the Wellington organization, Vanguard's forerunner, in the late 1920s, and who continues to work at his office at Vanguard headquarters at the age of 97. I met with Morgan on a number of occasions and learned a good deal about the early days of Wellington as well as of the entire mutual fund industry.

Jim Norris, Jack Bogle's assistant, played an important role in this book, adding to my understanding of Vanguard considerably and providing me with a continuing stream of facts and figures. I am very grateful to him.

I also want to express my gratitude to the other people I interviewed both inside and outside of Vanguard. They are: Peter Bernstein, John C. Bogle, Jr., Mike Brascetta, Robert W. Doran, Jeremy G. Duffield, Matthew Fink, Richard Fentin, Philip J. Fina, Jon S. Fossel, James French, James H. Gately, Nick Giangulio, T. Chandler Hardwick, Barbara B. Hauptfuher, John T. Jackson, Raymond J. Klapinsky, A. Michael Lipper, Deborah Lockwood, Bernard Lown, Peter Lynch, Ian A. MacKinnon, Burton G. Malkiel, Kenneth G. Martin, Brian S. Mattes, F. William McNabb III, Duncan M. McFarland, Daniel C. Maclean, Sid Mendelsohn, Paul F. Miller, Jr., John B. Neff, George Putnam, James S. Riepe, Charles D. Root, Jr., Paul Samuelson, George U. "Gus" Sauter, Barbara Scudder,

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Various friends and family members provided me with moral and other support during the writing of this book. They are: Jack and Bea Slater, Roslyn and Judd Winick, Michael and Bobbi Winick, Mitchell Slater and Leslie Dickstein, Mel and Anat Laytner, and Jean Max. A warm thank you.

I was blessed with a wonderful editor for this book: Amy Gaber, the Executive Editor at Irwin Professional Publishing. She not only brought her considerable knowledge of Vanguard and the mutual fund industry to our project, but also engaged in an ongoing dialogue with me about the subject matter as part of the process of improving the manuscript. Her editing talents are in great evidence throughout the book and I thank her very much. I also want to thank Jeffrey Krames, Editor-in-Chief at Irwin Professional Publishing, who urged to me write this book and who made it possible.

To my family, a very warm thank you. To my wife Elinor, my children Miriam, Shimi, Adam, and Rachel; and to my grandson Edo, I am grateful for all the help and support I received while writing this book.

Robert Slater

Introduction

JOHAN C. BOGLE, a lover of military, naval, and aviation history, has taken part in many battles of his own throughout his life. Some have been personal, particularly a series of debilitating heart attacks; others have been on the field of business, including the ill-fated merger he engineered between his mutual fund firm, Wellington Management Company—which Bogle had been selected to lead by its founder, Walter L. Morgan—and a high-achieving Boston investment-counseling firm, whose partners eventually would mount a successful campaign to fire him from his post as Wellington’s president and CEO.

For Jack Bogle, the battles in which he has engaged have, more often than not, ended triumphantly. Despite the gloomy prognoses of the many cardiologists who treated him throughout his life, Bogle was still thriving 35 years after his first heart failure. Following his ouster from Wellington Management Company, Bogle moved on to found The Vanguard Group of Investment Companies and build it into a powerhouse with few equals in the mutual fund industry. Most important of all, Bogle led numerous efforts, many of them successful, to end what he saw as the overall greed of the mutual fund industry, its excessive claims of investment management success, and its lack of candor in advertising and marketing.

On May 8, 1995, when Bogle turned 66, he decided it was time to turn Vanguard’s reins over to the next generation. Medically speaking, Bogle was a walking miracle. When he suffered his first heart attack at the age of 31, his cardiologists believed he would not live to see 40; Bogle, a bit more optimistic, told friends that he doubted he would make 50. Not surprisingly, at least to those who know him, he defied the odds, blessed by what doctors called the Jack Bogle Factor—an incredibly strong will

to survive. Nonetheless, Bogle had long considered the day when his business career would end and he would no longer report to the office to command the crew, as he liked to call Vanguard's employees. At the same time, it saddened him to think that he would no longer be able to challenge his colleagues at other mutual fund companies so fervently in his quest to transform the mutual fund industry.

As Bogle considered his decision over the next few days, he knew he wanted to assume a greatly diminished role in Vanguard's leadership only when Vanguard was in as strong a position as possible, and the time was right. As Vanguard approached its 20th anniversary, it was enjoying its best year ever. Assets under management—a mere \$1.4 billion at the firm's inception—surpassed \$150 billion on May 16, 1995, making Vanguard the second largest mutual fund company in the United States, behind Fidelity Investments. Index funds, long scorned by the industry, had finally begun to gain acceptance, and the media were praising Bogle for introducing index funds into the industry and championing their cause. Finally, the company's conservative investment strategies, as well as its mutual funds, were being applauded for their high performance rankings, and the firm was winning legions of new clients, now some 5 million in all.

For the past two decades, Bogle had been the dominant influence in building one of the largest and most successful mutual fund companies in the world. He was an intimidating presence in the company, and while he sought counsel and listened to the advice of his associates, the company was no democracy. In the end, it was usually his vote that counted. If he seemed difficult to work for and if his ego made him seem self-righteous, his crew members gave him their full support—not simply out of loyalty, but because he was right about so many things so much of the time. And being right, in a climate of unprecedented bull markets in stocks and bonds, he presided over a long period of prosperity at Vanguard. While all of the mutual fund leaders in the industry made strident declarations about caring for their shareholders and employees, none was as zealous as Bogle.

Thus, as Bogle prepared to leave the arena he loved so much, the moment was bittersweet. Eleven days after his 66th birthday, he walked into the boardroom at Vanguard's new headquarters in Malvern, Pennsylvania, and announced to the company's nine other board members that he wished to step down as chief executive officer effective January 31, 1996, but with the board's consent would like to remain as chairman. Bogle further announced that he planned to nominate his heir apparent, John J. Brennan, to succeed him as CEO. It obviously gave him no pleasure

to give up the command of Vanguard, and he insisted that he would “still be around as chairman, watching over the interests of shareholders and the crew, remaining involved in investment policy, writing annual reports, and speaking out in public on shareholder issues.”

When Bogle founded Vanguard in 1974, he often referred to it as the Vanguard experiment. His goal was to establish a mutual fund company that was like no other in the industry. Until Bogle came along, the conventional mutual fund company employed a management company to direct the activities of its mutual funds, including administration, distribution, and investment counseling services. Bogle, on the other hand, came to believe that shareholders were being shortchanged under such a system, and that they would be treated fairly only if power were taken from the management company and placed directly in the hands of the independent directors and shareholders of the funds.

By seeking to have Wellington Management Company—Vanguard’s predecessor—relinquish its near-total control over its mutual funds, Bogle embarked on an experiment that at first seemed to have little chance of success. He got his chance to put his plan into action when Wellington fired him in 1974. In the wake of the skirmishes and bad blood that surrounded his dismissal from Wellington Management Company, Bogle built a new mutual fund company based on his unconventional model. It would be the first time anyone in charge of a mutual fund company had challenged the status quo, that is, the belief that management companies deserved to reap enormous profits at the expense of their fund investors. But controversial as it was, Bogle’s conception of the perfect mutual fund company became a reality.

As he prepared to step down as chief executive officer of Vanguard, Bogle was proud that the Vanguard experiment had come so far: Vanguard was the largest pure no-load mutual fund organization in the world and a dominant player in what had become a \$2.8 trillion industry. Quite literally, mutual funds had revolutionized the way many Americans provided for their future and the way in which they thought about investing and the financial markets. Bogle, however, felt a lingering sense of disappointment and frustration that his larger dream—to transform the mutual fund industry into Vanguard’s image—had yet to be realized.

While the industry had changed somewhat as a result of his preachings—becoming aware of cost competition, considering some sharing with fund shareholders of the economies of scale that were generating enormous profits for fund management companies, and beginning to exhibit a new sense of candor and responsibility—Bogle still was not satisfied.

After all, Vanguard remained, for the most part, a leader without followers. Bogle believed that only when mutual fund companies liberated themselves from their management companies would the interests of all mutual fund shareholders truly come first. He optimistically predicted that this restructuring would occur within the next 25 years.

Had Bogle been a minor player in the industry, his colleagues at other firms, who were earning huge profits from the status quo, could have dismissed his jeremiads. To their regret, however, Vanguard was too much of a presence in the industry for Bogle to be easily dismissed. His company had become a benchmark, an industry standard on many different levels, from its minuscule expense ratios, to the candor of the descriptions of its funds' returns and risks in annual reports, to the investment accomplishments of its mutual funds. Indeed, in mid-1995, Vanguard was increasingly regarded as the number one mutual fund family in the industry. In short, Bogle's quest to remake the mutual fund industry was showing signs of success, but only when the first Vanguard clones appeared would Bogle acknowledge that the Vanguard experiment had truly succeeded.

This book is the story of Jack Bogle—a man both revered and reviled—and the Vanguard experiment, his quest to transform the mutual fund industry.

Contents

	Acknowledgments	v
	Introduction	ix
1	“I Thought I Was in Heaven”	1
2	The Mutual Fund Pioneer	9
3	“He Knows More about the Fund Business than We Do”	15
4	A Marriage Made in Heaven	23
5	The Storm Brews	33
6	Throwing Down the Gauntlet	45
7	Fired with Enthusiasm	55
8	Bogle Pulls a Coup	65
9	The Future Structure Study	71
10	From the Deck of HMS Vanguard	83
11	Cutting the Gordian Knot	91
12	The 18th Century Man	107
13	The Vanguard Manual	119
14	Creating Loyalty and Respect	127
15	The Crest of the Wave	139
16	No Thrills or Chills	149
17	“The Devil’s Invention”	157

- 18** The Man Who Walked on Water 169
- 19** Swiss Army to the Rescue 181
- 20** The Great Sacred Cow Sweep 191
- 21** Press on Regardless 199
- 22** The Fidelity Wars 213
- 23** A Cross between Don Quixote, Ralph Nader,
and Henry Ford 223
- 24** The Succession 233
- Epilogue 245
- Appendices 251
- Endnotes 255
- Index 263

C H A T E R

1

“I THOUGHT I WAS IN HEAVEN”

WILLIAM YATES BOGLE, JR., WAS BORN in Montclair, New Jersey, in 1896. In 1924 he married Josephine Lorraine Hipkins, born in Brooklyn also in 1896. In the early years of their marriage, the Bogles lived a well-to-do existence in a spacious home in Verona, New Jersey, a bedroom community not far from New York City. Their first son, William Yates Bogle III, was born in 1927. Then, on May 8, 1929, Josephine gave birth to twins—John Clifton (“Jack”) and David Caldwell—named after their maternal grandfather and great-grandfather.

Jack Bogle remembers his mother as a beautiful woman with a sparkling personality and her own special charm; his father, above all else, was a dashing aviator, having served as a pilot in the British Royal Flying Corps during World War I. He recounted that his father was often called the Prince of Wales by his friends, in part because of his strong physical resemblance to the prince, and in part because of his high living style. No matter what else Jack would learn about his father, his war service was enough for Jack to put him on a pedestal. Jack’s first model of a successful businessman, however, was his grandfather, William Yates Bogle, Sr., who had founded the American Brick Corporation and cofounded the American Can Company (later Primerica). When Jack’s father returned

from the war, he worked first for American Brick, then for American Can. In both of these jobs he prospered, and the family enjoyed a genteel life.

Then came the 1929 stock market crash, which had a nearly disastrous effect on the Bogles, wiping out the family's inheritance. The harsh new economic realities of the ensuing depression forced the family to sell their home. As the depression wore on, and Jack entered childhood, he came to realize that he was the son of no-longer-wealthy parents, and he developed a sense that life was precarious—especially financially.

As a result of the family's setbacks, Jack came to equate financial insecurity with weakness and having money with success. He became determined to help his family restore the Bogle legacy and to help his parents regain their financial security. All three boys held down time-consuming jobs at early ages. By age 10, Jack was delivering newspapers and magazines (*The Ladies' Home Journal*, *Collier's*, and *The Saturday Evening Post*) and working at an ice cream parlor. Although the jobs suggested only modest responsibility, Jack was relentless about them: "I wouldn't slacken. I didn't just get the job done. I was super-responsible." By the time they were 16 (and Bill had joined the U.S. Marine Corps), Jack and David were working summers in Bay Head, New Jersey, dropping mail into the U.S. Post Office's interior mailboxes for summer residents. Paid \$1.04 an hour, Jack recalled his delight at crossing his "first wage milestone: more than \$1.00 an hour!"

Like many Americans who drew lessons from the depression, Bogle had plenty of reasons to avoid recklessness with money, to resist get-rich-quick offers, and to protect whatever money he had saved. Having watched his parents and many of their friends sink into a financial abyss, he vowed that he would take the conservative path in whatever career he pursued. More important, his parents' financial losses turned him into a driven young man.



Jack and David spent their freshman and sophomore years at Manasquan High School on the New Jersey shore, as had their older brother Bill before he went on to spend a year attending Blair Academy, a prestigious boarding school located in Blairstown, New Jersey. Jack's academic record during his sophomore year was excellent: A's in English, the sciences, and math; B's in mechanical drawing, typing, and physical education. His character was described as excellent; his personality as pleasing; his industry and ability as above average.

Beneath the surface, though, Jack's home life was turbulent. His father had become a heavy drinker and early in the 1940s lost his job at American Can. A few years later he separated from Josephine. (Both died in 1952 at the age of 56.) At least on the surface, Jack forgave his father, whom he considered a wonderful man who had done his best to take care of his family. Josephine, however, became the dominant figure in Jack's life as she struggled to keep the family together and functioning.

Even as a teenager, Jack yearned for an environment that would allow him to create his own identity and succeed on his own merits. His mother helped to provide him with such an environment when she decided that the twins, like their older brother, should transfer to Blair Academy. Josephine's brother, investment banker Clifton Armstrong Hipkins, arranged for both Jack and David to obtain work scholarships at Blair.

Founded in 1848, Blair Academy was an all-boys school with an enrollment of 300 during Jack's junior and senior years. Although Blair was no boot camp in Jack's day, it had some of the ambience of a military school. Students rose at 6:00, attended classes, worked at part-time jobs on campus, and hurried to complete their homework before lights out at 10:00. Pampered students would have found Blair stifling, but Jack thrived in the atmosphere. Attending Blair, he said later, was the signal event of his life.

Jack must have found it a relief to get away from his tenuous life at home. At Blair, he got his first chance to show what he could do—in academics, athletics, and the jobs he took to maintain his scholarship—and he was determined to make the most of the experience. He was driven to make his mark at Blair, to attain good grades, to please his parents, and to attend college.

Both in the classroom and on the athletic field, Jack's self-confidence grew as he found that he could not only compete with his fellow students but also outshine them in many endeavors. He showed competitiveness and ambition, qualities he would exhibit throughout his life. He had to excel at anything in which he participated. Even when waiting on tables, Jack wanted to be the best, and soon became captain of the student waiters. He came to hate the idea of defeat; winning, no matter what the obstacles, became a part of his makeup.

Jack had a particular aptitude for math. Numbers fascinated him; he could look at a stack of figures and point out an error in the computation before anyone else had started to work on the problem. He could analyze mathematical problems in his head and arrive at answers long before other

students, using pencil and paper, could. His ability to use a slide rule became his trademark.

In 1947 Jack graduated from Blair *cum laude*. Although his senior classmates voted him most likely to succeed as well as best student, he failed by a fraction of a percentage point to be named class valedictorian. Jack was so determined to succeed that he regarded number two (he was named class salutatorian) as a stinging defeat. He visited several of his teachers and urged them to reconsider his grades so that he could graduate number one. None would. (Even now, he does not think number two is good enough, often citing the crossword-puzzle definition of “came in second,” which is “lost.”)

Bogle came to believe that he owed his greatest debt to Blair Academy. His success there enabled him to attend a top-ranking college, without which he may not have accomplished as much as he did in later life. As a result, repaying Blair became of great importance to him, and the bulk of his charitable contributions would be directed to Blair, eventually making him the largest single contributor in Blair’s 148-year history. In 1972 he joined the board of trustees of Blair and has served as its chairman since 1986.

Because of the family’s limited finances, only one of the Bogle boys could attend college; the two other brothers would have to work to help support the family. With little discussion, it was understood that Jack would be the one to attend college while David and Bill would help the Bogle family keep above water financially. Against this backdrop of responsibility and guilt, Jack became even more motivated, more determined that nothing should interfere with his success.

Jack’s academic achievements at Blair qualified him to apply to top colleges, including Williams College and Haverford College, but he ultimately decided on Princeton University, which offered a generous scholarship and student jobs that together would cover all of his expenses. In his determined frame of mind, he sifted through the Princeton curriculum, majoring in economics but discovering Shakespeare, English history, and, for the first time, art history. A few courses gave him trouble. Despite his aptitude for mathematics, he found calculus a challenge, and a course in international trade was no snap. (In later years, he quipped that perhaps he owed his skepticism about investing in foreign markets to the troubles he encountered in that course.)