Part I
The Story of Vanguard

Chapter 1

1974

The Prophecy

In July 1974, I was in Los Angeles at the headquarters of the American Funds, meeting with friends that I had made as a governor and two-term chairman of the Investment Company Institute. Jon Lovelace, then the head of American Funds and son of the firm's founder, Jonathan Bell Lovelace, came into the meeting and said that there was an urgent matter that he needed to discuss with me. Jon had a reputation for integrity, independence, and wisdom, so I was eager to speak with him.

Following my visit to his firm, however, I had a scheduled dinner meeting before flying back to Philadelphia on the 7:30 flight the next morning. "That's fine," Jon said, "I'll meet you at the LAX breakfast room counter at 6 a.m."

Jon was already seated at the counter when I arrived. After a few pleasantries, he got right to his point: "I understand that you're planning to create a new mutual fund complex that will actually be *mutual*, owned by the fund shareholders." Yes, I responded, I hoped to build such a firm. To put it mildly, Jon was not amused. I still remember his exact words, "If you create a mutual structure," he said sternly, "you will destroy this industry."

More than four decades later, it is clear that Jon Lovelace was on to something. If he had amended his dire prediction to say, "you will destroy this industry *as we now know it*," today we could credit him with almost perfect foresight.

Structure and Strategy

Then again, nobody in 1974 really could have predicted that an upstart firm, founded at the bottom of a vicious bear market, would overcome all odds and not merely survive, but ultimately dominate the mutual fund industry. The firm's mutual structure – owned by its fund shareholders and operated on an "at-cost" basis – had never been tried before.

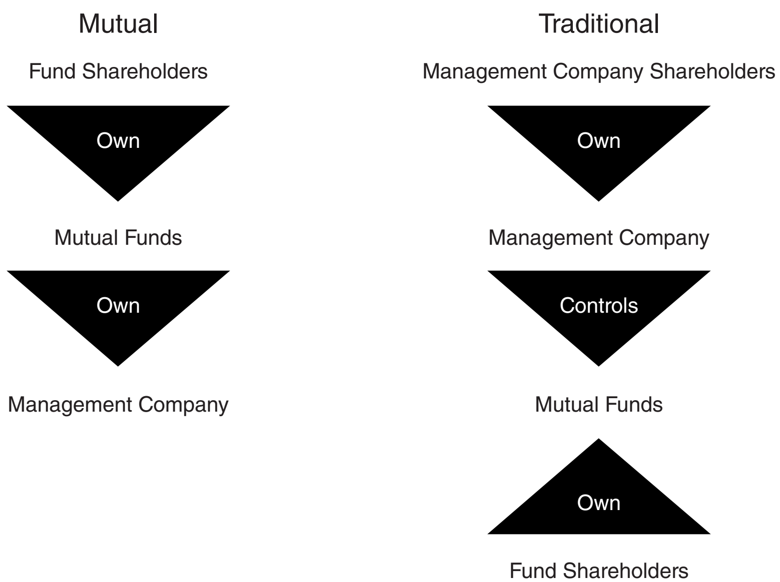
We were compelled by our own directors to retain an external investment adviser with a previous record of failure. Our role was initially limited to fund administration, for we were barred from portfolio management or share distribution. And we would soon stake our future on an unprecedented strategy: a stock portfolio that would not rely on an investment adviser.

If those liabilities were not burdensome enough, the firm had a brand-new name: **Vanguard**.

The new organization would be the first – and to this day, the only – *mutual* mutual fund organization, run on an "at-cost" basis, not by an external management company seeking to earn high profits for its own shareholders, but by the funds themselves, and ultimately by the funds' shareholders. We called it "The Vanguard Experiment" in mutual fund governance.

It may be useful to see how the Vanguard mutual structure differs from the conventional industry structure followed by (literally) all of our peers. (See Exhibit 1.1.)

Exhibit 1.1 Mutual Ownership Structure versus Traditional Corporate Structure



2018: The Prophecy Fulfilled

Yet during the decades that followed, the name Vanguard – along with its unique structure and an unprecedented strategy built around the creation of the world's first index mutual fund – would unquestionably change the nature of the mutual fund industry as we then knew it.

Call it creative destruction. Call it disruptive innovation. Call it luck. Call it, as some have, my attempt to salvage my career. (There's some truth in that.) But more than anything else, call it good karma, along with a healthy dollop of good timing. For surely the passage of time would have eventually awakened the investment world to this fundamental truth: before costs are deducted, the returns earned by investors as a group precisely equal the returns of the market itself.

After those costs, therefore, investors earn lower-than-market returns. The irrefutable fact: the only way for the 100 million families whom the mutual fund industry serves to maximize their share of the financial-market returns they earn as a group is by minimizing their costs. Paraphrasing the words of our nation's Declaration of Independence in 1776, "We hold this truth to be self-evident." Vanguard took the leadership role in bringing down the costs of investing, ultimately becoming the world's lowest-cost provider of mutual funds.

Vanguard: Lowering Costs for Investors

Since our founding in 1974, Vanguard has been focused on lowering the costs of investing. As a result, the Vanguard that we know today is a colossus. Worldwide, we manage more than $5 trillion on behalf of some 20 million clients – more than our two largest competitors *combined*. Our near-25% share of long-term mutual fund assets is almost double the previous high of 15%, reached earlier by three different firms, and our 65% share of the industry's entire net cash flow during the past five years is also without historical precedent.

In recent years, investors have entrusted an average of some $1 billion each business day to Vanguard's care, an amazing endorsement by the investing public, also without precedent in our industry.

Index Strategy Follows Mutual Structure

What accounts for Vanguard's acceptance in the marketplace? Surely our growth is rooted in that mutual structure that so concerned Jon Lovelace, and the strategy that it entailed. Thanks largely to the rock-bottom costs generated by our mutual structure, the long-term returns earned by the Vanguard funds for their investor/owners frequently rank among the highest in the industry. Such acceptance would not have been imaginable during the stormy and uncertain years following our founding. Indeed, at the outset we experienced 83 consecutive months of net cash *outflows* from our funds.

Nor would it have been imaginable that such a structure would almost compel the design of a strategy focused on index funds, which were not even a blip on the horizon when Vanguard began. But it took no genius to realize that "strategy follows structure," and within a year of Vanguard's founding, we created the world's first index mutual fund.

"The Emperor's Clothes"

Almost a century has passed since the first U.S. mutual fund was incorporated in 1924, yet only during the past two decades have investors come to fully embrace the truth that Vanguard holds self-evident. Rather than wearing the clothes of market-beating "professional management," the mutual fund emperor was wearing no clothes at all. In fact, it wasn't only the mutual fund emperor who was naked, it was the entire mutual fund empire, an industry unable to deliver on its prime, if tacit, promise: that professional money managers as a group would enhance the returns earned by fund investors.

The concept that fund managers could not add value to their clients' wealth, once considered nearly heretical, is now broadly accepted. It has led to a disruptive revolution in the mutual fund industry, largely driven by the rise of index funds. The index revolution, in turn, has been led by Vanguard.

The odds against Vanguard's ever coming into existence, let alone surviving that first decade, were staggering. To paraphrase a line from the hit musical *Miss Saigon*, Vanguard was "conceived in Hell and born in strife." Its creation was the result of an unsatisfactory compromise that ended an ugly fight for control of Wellington Management Company, a fight that cost me my job as CEO and made it appear for a time that my career in the industry I loved was over. But, by a series of unlikely but happy events, even coincidences, I made a comeback. Result: Vanguard oversees $5 trillion of assets in mid-2018, has become the world's largest mutual fund firm, broadly respected for its low-costs, its investment returns, and its ethical values.

How did that turnabout come to pass? Let's begin at the beginning.