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The Tailwinds in Vanguard's Sails

By Kerry Pechter *Thu, Sep 18, 2014*

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Lots of fund companies and investment firms claim that the costs of their active funds or their advisory services are justified by their results. At one recent conference, for instance, presenters from several companies insisted that job changers should choose a rollover provider that offers *value*, not just low fees.

But, judging by the torrent of money flowing into low-cost Vanguard funds, investors don't seem to be listening to that argument. Investor behavior suggests that, like Vanguard founder Jack Bogle, they believe that low costs *are* value.

"Vanguard has been absolutely dominant in the flows. No one is a close second," Morningstar analyst Michael Rawson told *RIJ* recently. "It's almost scary. It *would* be scary if Morningstar didn't have such a high opinion of Vanguard. The trend toward accepting index investing has helped them. Active management has continued to struggle against the indexes."

In July 2014, a month when investors withdrew a net $11.4 billion from U.S. equity mutual funds, Vanguard Total Stock Market Index, Vanguard Institutional Index, and Vanguard Total International Stock Index recorded inflows of $2.6 billion, $2.2 billion, and $1.8 billion, respectively.

As of last July 31, according to Morningstar data, net flows to Vanguard open-end mutual funds (except money market funds and funds of funds and including "obsolete" funds) in the previous twelve months was $102.1 billion.

Net flows into Vanguard exchange-traded funds (ETFs) for the year ending last July 31 was $58.3 billion. The combined one-year net flow for these two categories was $160.5 billion, which brought Vanguard's outstanding mutual fund AUM to $2.49 trillion, up from $2.07 trillion on July 31, 2013.

In the coveted and growing IRA space, Vanguard is one of five big IRA custodians that together account for 45% of the $6.6 trillion that's in traditional IRA assets, according to Boston-based Cerulli Associates, which declined to disclose more precise data.

[Full disclosure: I worked at Vanguard from 1997 to 2006 as a writer in the retirement area.]

A big lead

At $64.8 billion, net flows into Vanguard funds in the first half of 2014 were greater than the flows of the next five fund families *combined*, according to Morningstar’s mid-year analysis, which covered more than 750 fund families. Vanguard’s net flow was more than four times greater than the net flows of its closest rival, JP Morgan, which took in $14.7 billion.

Moreover, Vanguard immense positive flows contrasted with the large net outflows from some of its largest competitors. PIMCO, the actively managed bond fund specialist that rode the long bond bull to fortune and glory, saw net outflows of $32.3 billion in the first half of this year.

Long-standing Vanguard rival Fidelity saw net open-end and ETF fund outflows of $3.5 billion in the first half of this year. (In the corner of a vast wall mosaic in Vanguard’s main cafeteria in Malvern, Pa., the three-masted man o’war “Vanguard” fires its cannons at the frigate “Fidelity.”)

At the start of this year, Vanguard had already surpassed Fidelity as the largest manager of 401(k) assets. As of December 31, 2013, Vanguard had $613.5 billion in 401(k) assets and Fidelity had $612.4 billion, according to Morningstar. (Fidelity remained the qualified plan recordkeeping leader, with some $1.4 trillion in assets.)

In the target date fund market, where Vanguard has benefited from the swing toward funds-of-index-funds—a trend driven in part by regulatory scrutiny and class-action suits against plans with high fund fees—Vanguard runs an increasingly close second to Fidelity. Vanguard’s TDF assets grew almost 15% in 2013, to $166.1 billion, while Fidelity’s grew by less than 2%, to $185.6 billion, according to Morningstar.

Tailwinds

A number of factors have been cited for Vanguard’s success, besides its low costs. These include the company’s brand strength, presence in both the institutional and retail markets, and appeal to fee-only advisors—who rely on Vanguard’s low costs to create room for their own layer of asset management fees.

Such strengths evidently make up for the fact that Vanguard doesn’t spend much on advertising or marketing, doesn't pay for distribution (not even 12b-1 fees), and sticks to the direct channel, which represents only a fraction of the total financial services industry.

"There are a couple of things going on," Rawson told *RIJ*. "First, Vanguard's reputation has only grown over time. And it never hurts when Warren Buffett says he likes the [Vanguard] 500 Index fund, which he did in his annual letter. More importantly, the whole ethos and practice of low-cost investing comes to the fore in a low interest environment. They have the lowest cost, so they're winning that battle."

Vanguard's average fund expense ratio is just 19 basis points. That average expense ratio is about four basis points, or more than 16%, less than Vanguard charged 15 years ago. According to the late Robert Slater's 1997 book, "Jack Bogle and the Vanguard Experiment," the flight from mutual funds during the deep 1974-75 recession convinced Bogle that retail investors wouldn't start buying funds again unless transaction costs and management fees were exceptionally low.

The markets have also vindicated Bogle's faith in index investing. "Personally, I'm a big believer in active management," Rawson said. "But if you look at the average returns of active funds, they've done horribly."

The exodus of top producers from wirehouses during and after the financial crisis, and the consequent growth of the registered investment advisor channel, has also helped Vanguard, he added.

"A lot of former wirehouse advisers have set up their own shops," he said. "At a wirehouse, they would never have done business with Vanguard, because they worked on commission and Vanguard doesn't pay for distribution. But now, as RIAs, instead of getting a commission, those advisors are charging their one percent management fee and using Vanguard funds."

Other firms may have difficulty imitating Vanguard's successful formula, for a couple of reasons. The firm's zero transaction costs and low fund expense ratios, for instance, are a result of its cooperative ownership structure and its direct marketing model. There are no private owners or shareholders to reward, and no distributors to incentivize.

That model eliminates conflicts of interest between the company and its customers. The lack of conflict has, over time, engendered a high level of consumer trust in the firm—and numerous surveys have shown that trust is the first consideration among consumers when choosing a financial services provider.