Fund Spy

The Vanguard Group Rules

Its reign is contested, though, from without and within.

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25 Jun 2018

Vanguard remains a class act on top of the retail mutual fund world, and it is poised to stay that way under new CEO Tim Buckley, a firm veteran who took over in January of this year. The firm Buckley inherited has come a long way since its days as a disruptive upstart in the 1970s, but it hasn't lost its drive to bring more investors into the fold and further transform the industry it now dominates. Its size and prominence, though, do not exclude it from pressures other industry participants face, and in certain respects they introduce challenges that are uniquely Vanguard's own.

In highlighting these themes, this Fund Spy reflects Morningstar's ongoing stewardship evaluation of Vanguard, which includes a recent visit with Buckley and other firm leadership.

Mutual Ownership and Low Costs Have Birthed a Giant

That Vanguard would separate itself from other asset managers was evident to Harvard Business School's strategy expert Michael Porter as early as the 1990s. Vanguard's corporate structure removes the potential for conflict between profit-maximizing owners, whether private or public, and fund shareholders, because Vanguard's U.S. funds own the firm, thereby granting indirect ownership to the U.S. fundholders themselves. This legal reality, in turn, fosters an investor-oriented, cost-conscious philosophy that pervades the firm.

Vanguard's "at cost" policy of charging investors only enough to cover firm operating expenses doesn't mean it is a nonprofit organization. Nor does it solve all the dilemmas that come with overseeing huge sums of money. Indeed, Vanguard does not disclose how much it pays senior leadership and therein lies the possibility for justifying outsize salaries as part of the cost of doing business. In the end, though, Vanguard has proven its commitment to investors by consistently lowering fees. Since 2000, the asset-weighted U.S. average expense ratio Vanguard fundholders paid fell by more than half to 0.11% in 2017, versus 0.62% for the rest of the industry on average. [1]

Low fees have helped Vanguard field a competitive lineup of both active and passive strategies, and investors continue to flock to the firm as a result. Its $4.4 trillion of

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assets in U.S. retail open-end and exchange-traded funds, as of May 2018, represented a 24% share of that market, nearly 3 times its closest competitor. Its $82 billion of inflows year to date through May is more than any other mutual fund family and if one excludes the $54 billion of second-ranked iShares, Vanguard's haul is greater than the rest of the fund industry's $28 billion combined.

Vanguard's Plans to Become Bigger and More Influential
Vanguard could be just getting started. The firm has prioritized growing its asset-management business outside the U.S. Granted, that's been true for some time but with fee pressures mounting and changes to distribution models, Vanguard is poised to make headway. Currently, Vanguard's non-U.S. business has about $400 billion in assets. The vast majority of those assets are in passive strategies as Vanguard's refusal to pay for distribution makes it easier to use index-tracking offerings to gain a foothold in a new country. The firm, though, plans to add active options as each overseas business gets established and it is patient in doing so. Vanguard first entered Canada in late 2011, for example, but only now is it debuting four low-cost actively managed mutual funds, including Vanguard U.S. Value Windsor, a clone of Vanguard Windsor (VWNDX).

Vanguard aims to revolutionize investment advice, too. It launched Personal Advisor Services in May 2015, which combines automation with human expertise in the service of discretionary asset management. It is available to investors with at least $50,000, who pay 0.30% per year. PAS already has more than $100 billion in assets, acquired mostly from clients with whom Vanguard already had a relationship. PAS' growth potential puts pressure on advisors to align the fees they charge with the value they provide, value which Vanguard estimates comes mostly from behavioral coaching—a role technology is unlikely to displace entirely.

Competitive Threats From Without and Within
Growing bigger and more influential isn't a foregone conclusion. Vanguard faces threats both from without and within. Rivals like BlackRock, Schwab, and Fidelity have undercut Vanguard on fees charged for certain ETFs. As public and private companies, those families are unlikely to match Vanguard's low costs across their lineups, but they now offer stiff competition for core ETF and index fund flows.

Superior client service could help Vanguard keep cost-undercutting rivals at bay, but the firm has had its stumbles. Understaffing and abnormally high levels of paper transactions in 2016 led to difficulty handling critical transactions, such as transfer-of-asset requests. More recently, technical glitches have caused erroneous messages about account balances and other problems.

In response, Vanguard has added staff, invested in technology, and in 2017's second quarter launched a lab-testing approach to improve all aspects of the client experience. The first lab removed jargon from the transfer-of-assets form, reducing its complexity as well as its length. Vanguard anticipates that 12 labs will be operative in the U.S. by the end of 2018, and in 2019 this approach will go global.

Even if Vanguard's client service becomes the gold standard, the firm still faces significant challenges in its underappreciated active management business. Vanguard's roughly $1 trillion of assets in active strategies would on its own rank as the industry's fifth-biggest asset manager, and it includes standout subadvised offerings from PRIMECAP as well as Wellington Management. But Vanguard's active business, like those of many others, has been in outflows thus far in 2018 and its active U.S. equity business has been in consistent outflows since 2008.

Flows into Vanguard's taxable-bond funds have been robust in recent years, but the team supporting those funds is in flux. Gregory Nassour, who had co-headed Vanguard's U.S. corporate bond desk and served as the lead manager on Vanguard Short-Term Investment-Grade Inv (VFSTX) and Vanguard Intermediate-Term Investment-Grade (VFICX), abruptly resigned from the firm in April 2018 and left no clear successor for his broader team leadership role. Two comanagers have been replaced on the funds, but the Morningstar Analyst Rating of each dropped to Bronze from Silver.

More broadly, Vanguard's use of external subadvisors for most of its active funds requires the discovery and ongoing evaluation of investment talent. Vanguard has had its share of failures, most notably with Vanguard Growth Equity, which the firm merged into Vanguard US Growth (VWUSX) in 2014. These failures raise the question of whether it can still pick good managers, especially in non-U.S. markets where Vanguard's active business has ample room to grow.

Picking good managers may not be enough. Vanguard must also find active managers with enough capacity to handle all the money that may come their way. The firm's practice of adding subadvisors to funds with swelling asset bases increases capacity but brings the additional challenge of making sure the subadvisors' skill levels and styles truly complement one another.

Finally, Vanguard could do more to encourage its managers, active as well as passive, to invest alongside fundholders. According to Morningstar data, the percentage of Vanguard's U.S. assets in which at least one manager has more than $1 million invested stands at 12%. Even considering Vanguard's gargantuan passive business, its manager investment falls short of best-in-class asset managers such as Dodge & Cox's 100% or American Funds' 99%.

Conclusion
Vanguard's challenges and shortcomings notwithstanding, it is a leading steward and disruptive presence in the asset-management industry. Because of Vanguard's innovations, such as launching the first index fund in 1975 and embracing no-load distribution in 1977, investors today keep more of what the market gives. Vanguard's unique mutual ownership structure and its investor-oriented, low-cost approach has proven to be a winning combination and that's unlikely to change anytime soon.

[1] John C. Bogle, *Character Counts: The Creation and Building of The Vanguard Group (*New York: McGraw-Hill, 2002), 270; //investor.vanguard.com/expense-ratio/.

Alec Lucas, Ph.D. does not own shares in any of the securities mentioned above. Find out about Morningstar's editorial policies.