FOREWORD

As Thomas Carlyle once said, "All that mankind has done, thought, gained, or been; it is lying as in magic preservation in the pages of books." Yet there are precious few books that have focused on the history of the U.S. mutual fund industry, a burgeoning field that has revolutionized the way that Americans save and invest over the past nine decades and that carries the potential to play an even larger role in the future.

From its modest beginnings in 1924—just three funds, with assets totaling only in the tens of millions—mutual funds now comprise America's largest financial institution, and fund assets have steadily grown to some $14 trillion. Through the ups and downs of our economy and international markets, war and peace, and societal and political change, the industry has helped more than 100 million investors invest for their retirement security, their children's education, and other needs—long-term and short-term alike.

Few authors have successfully chronicled this incredible growth. With its story rarely told, the role of its pioneers and their successors in the mutual fund industry has been largely ignored and is now almost forgotten. So when I came across a biography of one of the industry's founding fathers a few years ago, I immediately pushed it to the top of my reading list.

I was not disappointed. *Passion for Reality: The Extraordinary Life of the Investing Pioneer Paul Cabot*[1] far exceeded even my highest expectations. It is a thoroughly researched, comprehensive, candid, elegantly written, and eminently readable volume by Michael R. Yogg, a former investment analyst at Paul Cabot's firm, State Street Research and Management Company, the investment advisor to State Street Investment Corporation. Paul Cabot founded the fund in 1924, and by one measure (the date operations began) it is the nation's oldest mutual fund, a truly American invention.[2]

It is fair to say that if you haven't read this book (or otherwise been inculcated in the industry's early history), you might not realize how far the modern mutual fund industry has strayed from its early ways. Its values have changed, its investment principles have eroded, and its early culture of trusteeship has been debased. Paul Cabot would not be amused by the abandonment of so much of the industry's early "Boston Trustee" character.

Sadly, the long history of State Street is over. The advisory firm was acquired by the Metropolitan Life Insurance Company in 1983, and in 2005 it was resold to BlackRock Investment Management, another financial giant. State Street Investment Corporation was promptly merged into another BlackRock mutual fund—a tragic ending for that pioneering mutual fund. The life of Paul Cabot also inevitably ended, though much more happily. Born in 1898, he lived a rich, full, and exuberant life until death came in 1994.

Two Stories

Michael Yogg's book actually tells two related yet, in a sense, separate stories. One story recounts the remarkable life of a Boston Brahmin of impeccable lineage—one whom the author compares with the fictional protagonist in John Phillips Marquand's *The Late George Apley*. In Yogg's telling, Cabot—according to his family, relatives, friends, business associates, and Harvard classmates—was impulsive, candid, abrupt, and given to a more-than-occasional cigar and a stiff whisky. He was fun company, and had a wide range of interests and pursuits. He was, in a word, a "character."

That narrative, of course, is integral to the second story, the one that caught my attention: the career of Paul Cabot, his investment values, his approach to investment research and strategy, and the record of his stewardship of the mutual fund that he and his firm founded and managed.

Even more, I learned with delight of Cabot's view of the relationship between the manager/agents of the fund as well as that of the investor/principals who entrusted their investments to them. In retrospect, this industry giant of the 1920s–1950s anticipated my view, solidified during the 1970s and 1980s, that stewardship and fiduciary duty must permeate these bonds.

The Boston Trustee

The culture of the Boston trustee—rational, realistic, and intellectual, buttressed by independence and shrewdness—is in Yogg's view "more Yankee than Puritan." Still, Puritan values—trust, prudence, and fiduciary duty—do help to explain (albeit with some grandiosity) why Boston became the ideal place for the money management profession to flourish.

And so it did, particularly when the mutual fund industry was born in 1924. Indeed, my 1951 senior thesis at Princeton University was inspired by a 1949 article in *Fortune* magazine entitled "Big Money in Boston," which lauded the potential of this "tiny but contentious" industry (then managing aggregate investor assets of but $2 billion) as "rapidly expanding, [which] could become immensely influential."[3]

At the time the *Fortune* article was published, more than half of fund industry assets were managed in Boston. The industry in those days was dominated by the "Big Three"—Massachusetts Investors Trust (M.I.T.), State Street, and Incorporated Investors. (Philadelphia's Wellington Fund was the sixth largest fund manager, a sort of interloper among the proud Bostonians.) Their respective leaders—Merrill Griswold, Paul Cabot, and William Parker (whose partner, George Putnam, started his own fund, the George Putnam Fund of Boston, in 1937)—seemed to embody the concept of prudent trusteeship.

After the industry shook off the paralyzing impact of the 1929 stock market crash and the Great Depression that followed, it solidified its basic elements. With Cabot as their leader, the Boston crowd worked with Congress to ensure that mutual funds would be treated as conduits passing along their dividend income, untaxed, to shareholders. By eliminating the double taxation of dividends, the Revenue Act of 1936 cleared the way for the industry's future growth.

Cabot and his fellow Bostonians also played a pivotal role in the drafting of the subsequent Investment Company Act of 1940, which provided investor protections that would pave the way to building investor confidence in the mutual fund industry. The improper practices of some early investment trusts were, happily, regulated away. For sound fund managers, the 1940 Act, in Cabot's words, "merely wrote into the law the discipline which [we] had long practiced."

A Major Flaw in the 1940 Act

But there proved to be a major flaw in the new law. The legislation did not specifically bar the sale of mutual fund management companies at a premium over book value. In 1958, despite a long legal challenge led by the U.S. Securities and Exchange Commission, the courts ruled that such sales were not prohibited by the 1940 Act or by general standards of fiduciary law. Privately-held management companies thus gained the right to sell their ownership stakes to outsiders, then to the public, and finally to giant financial conglomerates.

Paul Cabot did not approve of this change. For him, the private ownership by the managers who ran the funds was essential. Indeed, it represented the very essence of stewardship and fiduciary duty to clients, a moral imperative. He sharply criticized those firms that would sell out to insurance companies and other financial institutions. In 1971, as Yogg reports, Cabot said as much when he recalled the negotiations preceding the 1940 Act:

> Both the SEC and our industry committee agreed that the management contract between the fund and the management group was something that belonged . . . to the fund . . . and therefore the management group had no right to hypothecate it, to sell it, to transfer it, or to make money on the disposition of this contract . . . the fiduciary does not have the right to sell his job to somebody else at a profit.

However, in 1983, Paul Cabot's successors did exactly that. The partners of State Street Research and Management Company sold the firm to the (paradoxically, then-mutual) Metropolitan Life Insurance Company for the astonishing sum—in those ancient days—of $100 million ($242 million in today's dollars). The stated reasoning of the fund's board: "The affiliation of State Street with an organization having the financial and marketing resources of Metropolitan Life will result in the development of new products and services which the fund may determine would be beneficial to its [the fund's] shareholders." Mr. Cabot, still a partner at the time of the deal, was nicely enriched for this violation of his principles.

It is hard to imagine how such "new products and services would be beneficial" to the fund's shareholders, even as they would more likely benefit the management company, which became a subsidiary of the insurance behemoth. In fact, the merger *hurt* the fund shareholders, as "performance lagged, and the manager's position in the industry declined from tops to average." By 2005, Metropolitan Life abandoned the mutual fund business, selling State Street Research and Management Company to BlackRock Financial for an estimated $375 million. One of BlackRock's first moves was to put State Street Investment Corporation out of its misery, merging one of the industry's first two funds into another BlackRock fund. To this day, I refer to this event as "a death in the family."

In *Passion for Reality*, Yogg presents the State Street fund record under Cabot's leadership. It's certainly an impressive one. State Street's decade-long returns exceeded the returns of the Standard and Poor's 500 Index with reasonable consistency (during the 1950s, however, it lagged the Index return). From 1926 through 1979, its annual return averaged 10.4 percent in comparison to 9.0 percent for the Standard & Poor's 500, a 1.4 percentage point margin—surely a singular success. Under the MetLife-BlackRock aegis, however, the fund *lagged* by more than 2 percentage points annually. The abandonment of Paul Cabot's fiduciary principles proved to be a tragedy for State Street's fund shareholders.

The Old Boston Culture Fades

State Street was hardly alone in abandoning its once-Puritan heritage. In 1969, the managers of Massachusetts Investors Trust formed a new firm called Massachusetts Financial Services. For virtually no personal investment, the trustees gained ownership and control of a new management company worth an estimated $25 million. These executives would then sell the firm to Sun Life, a Canadian insurance company, in 1983. Incorporated Investors, the last of the three original pioneers, was acquired by Putnam Management Company in 1963, which in turn was sold to insurance giant Marsh & McLennan in 1970 for an undisclosed sum (estimated at $30 million), and then sold once again in 2007 to a subsidiary of Power Financial Corporation of Canada for $3.9 billion. (If an article similar to *Fortune*'s 1949 piece were written today, would it be titled "Big Money in Canada"?)

Part and parcel of the fund industry's change from its original focus on professional investing, security analysis, and long-term perspective was the gradual development of a sales culture. In the industry's early years, investment managers were largely a step removed from the sales and marketing aspects of their funds, often retaining unaffiliated underwriters and brokers to assume responsibility for that function. Here's what Cabot said:

> At no time have we undertaken any sort of selling campaign believing that good results must eventually attract the investor, and realizing that such results can be most effectively attained through . . . security selection and supervision of securities best suited to meet the needs of the company.

But over the years, distribution and marketing gradually became more and more inextricably linked with management and research. Today, the modern mutual fund has become a powerful marketing machine. This change in focus has ill-served investors. To his credit, Paul Cabot resisted the powerful tide, and even ceased the public offering of shares of State Street Investment Corporation in 1944 when assets totaled $55 million. By 1990, when assets had increased to $525 million, the fund was reopened by Metropolitan Life.

Strategy Follows Structure

Of the industry's largest fifty firms today, forty are held under public ownership, including thirty that are owned by financial conglomerates. Such a structure clearly calls for two distinct sets of fiduciary duties. The management has an obvious obligation to its own (now largely public) shareholders, but it also has a responsibility "to place the interests of its mutual fund shareholders ahead of the interests of its directors, officers, investment advisers, and underwriters," to paraphrase the express language of the 1940 Act. The Biblical warning that "no man can serve two masters" has seldom been more brazenly ignored.

It is apparent that the absentee ownership structure places more focus on gathering assets to manage, creating new mutual funds to meet the fads and fashions of the day (the industry pioneers typically managed only a single fund, but today the average manager handles 117 funds—117 separate sets of fiduciary duties!), building firm revenues, and minimizing manager expenses (but not necessarily fund expenses). Success is measured by increasing the firm's profits. In stark contrast, success under a structure dedicated solely to fund shareholders is measured by earning above average, risk-adjusted returns for them. Since all managers cannot, by definition, provide above-average returns (on average, inevitably, their performance will be average), the focus must be on low costs for fund shareholders. Such an idea, of course, is antithetical to the interests of the management company shareholders.

Ultimately, the marketplace must respond to this dichotomy. And so it has. As Boston largely turned away from the industry's original professional values and prudent stewardship and moved toward the new values of marketing and salesmanship, its domination of the field first eroded before vanishing. From being home to one-half of the industry's asset base in 1949, Boston's share has fallen to about one-sixth, currently a hair behind Philadelphia's share. That share, in turn, is held almost entirely by a single firm: Vanguard, a reconfiguration of that original Wellington Fund. It was founded by Walter L. Morgan in 1928, a surprisingly unsung pioneer who shared the values of those early Bostonians exemplified by Paul Cabot.

Today's Vanguard reflects much of the industry's "old time religion." If Puritan Boston can be likened to Quaker Philadelphia—characterized, as Quakers often are, by plainness, simplicity, and thrift—then that dominant Philadelphia firm has held firmly to Cabot's founding concepts. (In a curious parallel, Vanguard's shareholder-owned, "at-cost" structure also has many parallels to the original structure of M.I.T.) By offering its funds to shareholders on a no-load basis, Vanguard is not beholden to an external distributor. In addition, Vanguard has now become the industry's largest firm, largely because of its creation and advocacy of the market index mutual fund. (Full disclosure: I founded Vanguard in 1974 and ran the firm for 23 years.) The goal of closely matching the stock market's return—a simple goal—and operating at rock-bottom costs and focusing on long-term investment has made all the difference.

I applaud this book as a vital link to returning the mutual fund industry to the high fiduciary standards that were once its hallmark. Far too few investors are aware of how far the fund industry has departed from its founding values, and many will profit greatly from understanding that shift, acting accordingly, and demanding that the industry "go back to the future." By the same token, far too few industry participants seem aware that today's ethically challenged industry structure was built all those years ago on a far firmer foundation. Michael Yogg's beautifully presented narrative of Paul Cabot and State Street—yes, through the "magic preservation" of history that Carlyle described—gives us an all-too-rare insight into what has been lost, and provides an analysis that should inspire investors to force the mutual fund industry to heed the better angels of its original nature.

John C. Bogle
Founder of the Vanguard Group
Valley Forge, Pennsylvania
September 2013

ACKNOWLEDGMENTS

This book builds upon the research and scholarship of others. While the notes make this clear, some contributors deserve special mention. Natalie Grow's PhD dissertation, "The 'Boston-Type Open-End Fund'—Development of a National Financial Institution: 1924–1940," placed Paul Cabot's activities in context and greatly enriched my understanding of the events of this period. Her bibliography of sources was an especially useful aid. But I only found these sources, and others, due to the resourcefulness of Paul Keane, a researcher (and something of a detective) working in the Washington, D. C. area.

While I heard all of the Paul Cabot stories directly from the source himself, I would not have remembered them all without the interviews, particularly those conducted by Jessica Holland for the Columbia University Oral History Research Office Collection.

The best part about writing a book is the new friends one makes and the old friendships that are rekindled. The following contributed to this work by supplying information, documents, photographs, advice, and, most importantly, encouragement: Bernard Bailyn, Frederick Ballou, Bob Beck, George Bennett, Peter Bennett, Francis H. Burr, Frederick C. Cabot, Paul Cabot Jr., Paul Cabot III, Wayne DeCesar of the National Archives and Records Administration, Charles Ellis, Charles Flather, Bill Frohlich, Bart