The Annals of Vanguard—The Story of PRIMECAP Fund

By John C. Bogle

Way back in the summer of 1984, a wonderful—if sort of random—happening took place that would become a highlight in Vanguard's history. I was in California interviewing prospective managers for a new growth fund that I believed we needed to balance out our value-oriented fund lineup, dominated by the Windsor Fund. By the early 1980s, Windsor—led by its peerless portfolio manager, John B. Neff—came to represent fully one-half of our equity-oriented fund asset base. By 1984, with assets of $2.5 billion, Windsor was the nation's largest equity fund. But times change and styles go in and out of favor, and I wanted to be prepared to act before its rapid rate of asset growth inevitably declined.

In the aftermath of the "Go-Go" Era of the 1960s and the stock market crash of 1972-1974 that followed, many growth fund managers had faltered and then failed. (One of the worst failures was Wellington Management's Ivest Fund—down 44 percent(!) during its 1974 fiscal year—finally put out of its misery in 1981.) But among the survivors, we "rounded up the usual suspects," and I visited four of them, with no obvious candidate emerging. Along the way, I learned that Mitchell J. (Mitch) Milias—with whom I had worked fairly closely during his time at Wellington Management Company (1969-1970) before he moved on to the giant Capital Group (American Funds) in Los Angeles—was working on a plan to start a new asset management firm.[*]

PRIMECAP Management Is Formed

Uncomfortable with Capital's growing size, Mitch and Howard B. Schow, his co-manager of the firm's new AMCAP fund, were frustrated by Capital's process for allocating transactions among its huge equity funds (still huge today) and the tiny but growing AMCAP.

[*] Actually, Wellington "acquired" Mitch through our purchase of data provider Financial Dynamics in 1968. We were a public company then (oh, yes we were!), and I persuaded our directors to use stock, not cash, for that purchase. As it turned out, that decision proved not to be stupid, for Wellington's stock would fall from a high of $50 per share to a low of $4.875 following the market crash.

They decided to leave Capital and, along with Theo A. Kolokotrones, start their own firm. Capital was startled, for their professionals *never* leave. (Or, never left 'til then.)

The new partners named their firm PRIMECAP Management Company, opening an office in nearby Pasadena, CA. on September 15, 1983. PRIMECAP gradually attracted a blue-chip list of pension clients. When I dropped in a year later, I renewed my friendship with Mitch and my acquaintance with Howie. We got along famously, and they seemed to resonate to my tentative proposal. Essentially, I said:

> *" . . . We understand the mutual fund business, its operations, and its distribution requirements. We aren't interested in managing money. You understand the stock market and have proven yourselves as professional money managers. But you aren't interested in those peripheral—albeit essential—business activities. So let's start a fund together. We'll do the operations and distribution; as the fund's adviser, you'll do the investing. It won't cost you a penny, for we'll bear all of the costs of forming and operating the fund."*

They liked the idea, but wanted time to consider my offer. While Mitch was eager to do the deal, Howie told him that he was on board "only if we can trust Jack." After those earlier years on the Wellington team together, Mitch told Howie that he and I had a bond of trust that could never break. And so we had our deal, without a single lawyer on either side, and without a single word in writing; a deal unsigned by any of the three participants.

PRIMECAP Fund was incorporated on August 20, 1984, with the same officers and directors as the other Vanguard Funds. (Our total assets were then $8.8 billion.) It began with $100,000 of assets which, in those days, I had to personally provide. (Legal issues precluded Vanguard's ownership of its own funds. Wasn't I lucky!) PRIMECAP commenced investment operations on November 1, 1984, after we had finally inked our signatures on the investment advisory contract.

Let's Look At The Record

PRIMECAP Fund performed well during its early years. During 1984-1986, it outpaced the S&P 500's return by some 16 percentage points. Then, during 1987-1989, it faltered, underperforming the index by 25 percentage points and leaving the Fund's performance, on balance, slightly below par during its first seven years. Perhaps I hadn't adequately schooled my fellow Vanguard fund directors about the inevitable ebb and flow of fund performance, and a few of them urged me to terminate the advisory contract. Of course I refused to do so. (And got away with it!)

The rest is history. During the 24-plus years that followed (see Appendix I), these ebbs and flows continued—in our profession, an inevitability. While PRIMECAP outpaced the S&P 500 in 15 of these years, it again lagged the S&P in 1996 and during 2000-2002 when the bubble of the "new economy" burst, giving way to another bear market. What's more, during the winning years, PRIMECAP often outpaced the market by remarkable margins, while the periodic intervals of sub-par returns were usually by small margins. Result, an initial investment of $10,000 in the fund at its inception would have grown to $515,000 by mid-2015, almost double the $261,000 total return for the S&P 500. (Annualized, 13.7 percent vs. 11.2 percent.)

Vanguard's remarkable cost advantage had a major impact on the fund's success. With PRIMECAP's expense ratio roughly 1 percentage point less than its peer funds, Vanguard's cost advantage accounted for just under 30 percent of the 3.3 percentage point edge that the fund's lifetime record reflects. (Almost one-half of the fund's expenses reflect Vanguard's operations efficiencies and economies, the other one-half is due to the relatively low ratio of advisory fees to the fund's assets.)[†] The magic of low-costs and long-term compounding writ large!

It took a while for the fund to attract the attention of investors. Assets reached $200 million in 1988 (then, we thought that was pretty good!), crossed $1 billion in 1994, and leaped to $22 billion in early 2000. In the tough market environment that followed, assets dipped to $14 billion in 2002. But with good markets (mostly!) since then, good performance, and good cash

[†] PRIMECAP Fund's growth has resulted in a sharply declining expense ratio. Since 1990, it has fallen by one-half; from 0.75 percent to 0.37 percent. Vanguard's operating costs have fallen from 0.24 percent to 0.17 percent; PRIMECAP Management's advisory fees have fallen from 0.51 percent to 0.20 percent. While the fee *rate* may be low, the *dollars* have become large—the advisory fees paid to PRIMECAP management for both PRIMECAP and Capital opportunity funds totaled more than $227 million in 2014 alone.

flows, PRIMECAP begins its fourth decade with $46. A “Gold” rating (from Morningstar) commemorates the fund’s achievement.

Vanguard’s “Four Ps” in Evaluating Fund Managers

What explains our selection of PRIMECAP to manage Vanguards new growth fund? I tried to answer that question in our first annual report (1985). Paraphrasing and supplementing the words in the report:

Developing working relationships with the principals of PRIMECAP has been an important and enjoyable part of our first year in business together. Our selection of the firm was based on these “four Ps”.

1. ***People.*** *Who are the managers of the fund? The people of PRIMECAP are outstanding investment professionals with sterling reputation, borne of a total of 85 years of experience in money management.*
2. ***Philosophy.*** *What are they seeking to accomplish? The implementation of an investment philosophy with a growth orientation. (I also loved the managers’ focus on the long term, which is clear from the fund’s low portfolio turnover—down to just 5 percent annually in 2007-2013.)*
3. ***Portfolio.*** *How do they go about implementing their philosophy? The pension portfolios managed by PRIMECAP includes a mix of blue-chip stocks, some with a growth orientation; some with generous yields; some companies deemed possible subjects of takeover bids, and some in businesses deemed interest-sensitive.*
4. ***Performance.*** *What has their record been? I emphasized that “past performance” wasn’t the first criterion, but the last. Important, yes, but only in the context of the other three factors. I also warned that there would surely be periods of outpacing its peers—and periods when it does not! (An obvious insight rather than a brilliant forecast!) Earning competitive long-term returns is the goal.*

These concepts, it seems to me, have met the test of time.

Annual Report Highlights – 1986-1999[‡]

After those few early years of lagging performance, I frankly chronicled in the **1989 Annual Report** that "our return significantly lagged the excellent return" of the S&P 500, completing our first five years with an 18.4 percent annual return compared to 19.7 percent for the S&P 500. As I looked ahead to the decade of the 1990s, I thought a 10 percent return on stocks might be a reasonable expectation, "perhaps nicely enhanced" by PRIMECAP's managers.

Boy, did I underestimate the stock market's future return! During the decade of the 1990s, as I wrote in the **1999 Annual Report,** the S&P 500 Index delivered an annual return of 18.2 percent. But I was accurate regarding PRIMECAP; the fund earned a return of 21.8 percent; nicely enhancing the market's return by 3.6 percentage points. (In 2000-2002, however, those gains were severely eroded by the bear market. Including those three years, the annual rates of return for the thirteen years including the fall, had tumbled to: S&P 500, 9.7 percent; PRIMECAP, 13.1 percent—a handsome margin indeed.)

Earlier in the **1997 Annual Report**, I again stressed the contribution of Vanguard's staggering economies of scale in putting the wind at the back of our PRIMECAP managers: "Our lower expenses provide our Fund with a head start over our competition. Our expense ratio is now 0.51 percent, far less than the 1.50 percent expense ratio of our average peer. We fully expect this enhancement of roughly 1 percent per year relative return to persist and to abet the growth of the funds under the aegis of PRIMECAP. For, as mutual fund investors are learning, however slowly, *costs matter*."

My role as director of the fund ended on December 31, 1999. But in the years that followed, I have kept the promise that I made in that **1999 Annual Report**: "*I will remain vigorous and active in a newly-created Vanguard unit . . . (and) will continue to keep an eagle eye on your interests as PRIMECAP Fund shareholders.*"

[‡] As I reviewed these annual reports, I found a favorite phrase of mine in the report for 1991 . . . "We bring to the task at hand, not thaumaturgy, but only the diligence, experience, professional skills, and investment competence of our portfolio managers."

That's what I have done, and I'm delighted (personally and professionally!) that the Fund's results since then have been outstanding.

PRIMECAP and Vanguard Capital Opportunity Fund

In 1994, our board exerted substantial pressure on me to modify Vanguard's central value of offering funds with high relative predictability by adding some more aggressive and riskier funds, with less predictability. Unwisely, I went along with that strategy and made a *marketing* decision to do so, not an *investment* decision. (Hard experience had warned me about the lack of wisdom in such an approach.) So in 1995, we formed Vanguard Horizon Funds, four funds with strategies whose outcomes were relatively unpredictable. Among those funds was Vanguard Capital Opportunity Fund.

I selected (I cannot blame anyone but myself) an aggressive manager, California's Husic Capital Management Company, already running a segment of Vanguard's Morgan Growth Fund, to manage the fund's portfolio. Here, Husic would have a more flexible mandate, including the ability to sell stocks short (i.e., betting that their prices would decline). Their implementation of the strategy failed. In 1997, with the S&P 500 up by 33 percent for the year, the total return on Capital Opportunity Fund was minus 8 percent. Incredible! We terminated our relationship with Husic, and PRIMECAP accepted our offer to become the fund's investment adviser.

What's to be said? Again, the **4 P's** paid off. In the 16 years since taking the reins in 1998, Capital Opportunity Fund has earned an annual return of 12 percent per year, compared to 9 percent of the S&P 500, and also has been awarded the "Gold" rating from Morningstar. Beginning its era under PRIMECAP management with just $63 million in assets, the value of the Capital Opportunity portfolio now exceeds $14 billion.

PRIMECAP Management Today

The three original portfolio managers of PRIMECAP Fund were Howie (now gone), Mitch (who retired as senior manager of Capital Opportunity at year-end 2013), and the unsung hero, Theo Kolokotrones, still one of PRIMECAP's leaders. Also added to the staff over the years are now-seasoned investment professionals steeped in PRIMECAP's sturdy investment values, including Joel Fried, Al Mordecai, and Mo Ansari, each running parts of both funds under the Vanguard aegis. They have earned the success that they have achieved.

In Retrospect

As Vanguard's assets and staff had grown—from some $9 billion when PRIMECAP first came on board in 1984 to $2.3 trillion today (a number so large I don't really want to think about it)—much has changed. I've often said (first back in 1992), "For God's sake, let's always keep Vanguard a place where judgment has at least a fighting chance to triumph over process." That's a huge challenge today, for the size of our Vanguard crew has grown from 660 in 1984 to some 15,000 crew members today.

We have become—inevitably, I think—an aggregation of many different units—technology (by far the largest), investment management (managing index funds, bond funds, and money markets, and overseeing our external managers), marketing and distribution (with the number of our "wholesalers" calling on brokers and registered investment advisers across the nation apparently burgeoning to a staff of 60 by 2013), product development, financial and accounting, legal and compliance, and record-keeping for the accounts of some 20 million shareholders.

Introspection

I write this brief history lest we forget the way we were—led by a single-minded virtual dictator, hell-bent on creating a revolution in fund investing, exemplified by the creation of our (still) unique fund-shareholder-owned/mutual structure in 1974; and our creation of the world's first index mutual fund a year later. These founding precepts continue to drive our growth. I did my best to place a higher priority on investing rather than marketing; never (well, almost never) seeking growth for growth's sake. (My first rule for marketing: "Market share must be earned and not bought.") Yes, I was used to getting my own way, and I was not the world's best listener. But above all, I was interested in serving—effectively, economically, and honestly (the words from my ancient Princeton University thesis) the "down-to-earth, honest-to-God human beings" who are our clients, and building a crew who shared my belief in that mission.

In those ancient days, we acted quickly, we had no committees and no silos. And we brooked little patience for dissent unsupported by reason. We operated on strict principles of fiduciary duty to our shareholders—who represent our sole responsibility—and made our commitments with a bond of trust.

The best part of those "good old days" is exemplified by Vanguard PRIMECAP Fund, and now Vanguard Capital Opportunity Fund. For the partners in that unlikely venture of thirty years ago—a relatively small and manageable unit in a giant fund complex—it has surely worked out well. PRIMECAP has well earned their advisory fees by producing the extraordinary returns that these funds have delivered to the shareholders who placed their trust in us. The firm has added luster to Vanguard's reputation in actively-managed funds.

Of course, Vanguard has changed. So has PRIMECAP. But lest I commit the apparent sin of "nostalgia," so has the investment profession changed; so has the financial system; so has the nation; so has the world and almost everything that's in it. But as long as we don't ignore our proud past and continue to maintain our investment strategy and human values, Vanguard will continue to stand tallest among our peers for as far ahead as we can imagine.

John C. Bogle

(Memorandum drafted June 2014; updated July 2015.)

Appendix I: PRIMECAP Fund Data, 1984 - 6/2015

	Annual Returns			Cumulative Returns				
	PRIMECAP Fund	S&P 500	Multi-Cap Growth Funds Avg.	PRIMECAP Fund	S&P 500	Multi-Cap Growth	PRIMECAP relative to S&P 500	Total Assets (in $Mil)
				1.00	1.00	1.00	1.00	
1984*	4.9%	2.6%	2.8%	1.05	1.03	1.03	1.02	2
1985	35.8	31.8	30.8	1.42	1.35	1.34	1.05	54
1986	23.5	18.7	14.7	1.76	1.60	1.54	1.10	133
1987	-2.3	5.3	3.1	1.72	1.69	1.59	1.02	165
1988	14.7	16.6	14.3	1.97	1.97	1.82	1.00	186
1989	21.6	31.7	31.4	2.40	2.59	2.39	0.92	279
1990	-2.8	-3.1	-3.4	2.33	2.51	2.31	0.93	305
1991	33.1	30.5	46.0	3.10	3.28	3.37	0.95	486
1992	9.0	7.6	7.9	3.38	3.53	3.64	0.96	646
1993	18.0	10.1	14.2	3.99	3.88	4.15	1.03	791
1994	11.4	1.3	-2.5	4.45	3.94	4.05	1.13	1,554
1995	35.5	37.6	33.9	6.02	5.42	5.42	1.11	3,237
1996	18.3	23.0	18.8	7.13	6.66	6.44	1.07	4,204
1997	36.8	33.4	22.0	9.75	8.88	7.86	1.10	8,186
1998	25.4	28.6	26.0	12.23	11.42	9.90	1.07	11,210
1999	41.3	21.0	49.3	17.28	13.82	14.79	1.25	17,912
2000	4.5	-9.1	-12.4	18.06	12.56	12.95	1.44	21,762
2001	-13.3	-11.9	-26.1	15.65	11.07	9.57	1.41	18,888
2002	-24.5	-22.1	-29.9	11.82	8.62	6.71	1.37	14,378
2003	38.0	28.7	34.7	16.30	11.10	9.03	1.47	21,726
2004	18.5	10.9	10.7	19.32	12.30	10.00	1.57	27,296
2005	8.7	4.9	8.9	20.99	12.91	10.89	1.63	28,543
2006	12.5	15.8	7.4	23.61	14.95	11.69	1.58	31,505
2007	11.6	5.5	14.6	26.35	15.77	13.39	1.67	33,395
2008	-32.3	-37.0	-42.2	17.83	9.93	7.74	1.80	21,974
2009	34.6	26.5	35.5	24.00	12.56	10.49	1.91	28,832
2010	13.0	15.1	18.3	27.12	14.46	12.41	1.88	30,506
2011	-1.8	2.1	-4.1	26.64	14.76	11.90	1.80	27,571
2012	15.4	16.0	14.9	30.74	17.12	13.66	1.80	29,254
2013	39.86	32.39	34.84	42.99	22.67	18.42	1.90	39,639
2014	18.83	13.69	9.27	51.09	25.77	20.13	1.98	46,310
6/2015	0.73	1.23	4.79	51.46	26.09	21.09	1.97	46,108

Cumulative	5046	2509	2009
Annualized	13.7	11.2	10.5

*Fund began operations on 11/1/1984.

Appendix II: Capital Opportunity Fund Data, 1995 - 6/2015								
	Annual Returns			Cumulative Returns			Cap. Opp. Relative to S&P 500	Total Assets (in $Mil)
	Capital Opportunity Fund	S&P 500	Multi-Cap Growth Funds Avg.	Capital Opportunity	S&P 500	Multi-Cap Growth		
				1.00	1.00	1.00	1.00	
1995*	-1.8	11.1	3.2	0.98	1.11	1.03	0.88	81
1996	13.4	23.0	18.8	1.11	1.37	1.23	0.82	117
1997	-7.9	33.4	22.0	1.03	1.82	1.50	0.56	63
1998	32.0	28.6	26.0	1.35	2.34	1.88	0.58	206
1999	97.8	21.0	49.3	2.68	2.83	2.81	0.94	2,367
2000	18.0	-9.1	-12.4	3.16	2.58	2.46	1.23	5,056
2001	-9.7	-11.9	-26.1	2.85	2.27	1.82	1.26	5,209
2002	-27.9	-22.1	-29.9	2.06	1.77	1.28	1.16	3,696
2003	49.7	28.7	34.7	3.08	2.28	1.72	1.35	6,398
2004	21.8	10.9	10.7	3.75	2.52	1.90	1.49	8,548
2005	8.4	4.9	8.9	4.06	2.65	2.07	1.54	8,408
2006	16.9	15.8	7.4	4.75	3.07	2.22	1.55	9,329
2007	10.6	5.5	14.6	5.26	3.23	2.55	1.63	9,711
2008	-39.0	-37.0	-42.2	3.21	2.04	1.47	1.57	5,510
2009	49.0	26.5	35.5	4.78	2.58	2.00	1.85	8,455
2010	11.1	15.1	18.3	5.31	2.96	2.36	1.79	8,623
2011	-6.1	2.1	-4.1	4.99	3.03	2.26	1.65	7,229
2012	18.4	16.0	14.9	5.90	3.51	2.60	1.68	7,557
2013	42.80	32.39	34.84	8.43	4.65	3.51	1.81	11,669
2014	18.95	13.69	9.27	10.03	5.29	3.83	1.90	13,713
6/2015	3.47	1.23	4.79	10.38	5.35	4.01	1.94	14,134

Cumulative	938	435	301
Annualized	12.5	8.8	7.2

*Fund began operations on 8/14/1995.

Since PRIMECAP Management assumed management responsibilities, 2/1/1998

Cumulative	917	191	169
Annualized	14.2	6.3	5.8