Institutional Investor

MONEY MANAGEMENT

Calm Under Fire

Bill McNabb took the reins of Vanguard during the worst financial crisis in more than half a century. He avoided layoffs, and the firm attracted $139 billion in inflows since early 2008. But can he create a meaningful presence for Vanguard outside the U.S.?

By Julie Segal

CEO Bill McNabb is steering Vanguard toward growth by offering investors a cheaper and safer alternative

BILL MCNABB ENJOYED A VERY SHORT HONEYMOON PERIOD LAST SEPtember after becoming just the third chief executive of Vanguard Group since John Bogle founded the now $1.21 trillion money management behemoth nearly 35 years ago. Two weeks into his new job, investment bank Lehman Brothers Holdings filed for bankruptcy, setting off a crisis of confidence that rocked equity and credit markets around the world. That same day, September 15, McNabb, a 23-year veteran of Vanguard, was fielding questions from increasingly nervous institutional investors at the firm's biannual client meeting in Washington. He reassured them that Vanguard — a conservative money manager that has no proprietary trading business and is rarely pressed for such assurances — had little exposure to Lehman or to risky structured securities.

Shortly after returning to company headquarters in Valley Forge, Pennsylvania, McNabb hit the phones with Vanguard's "Swiss army," a team of client-service representatives that enlists senior, and even top, management when investor call traffic soars, as it did last fall. McNabb, a father of four known for his calm demeanor, says his experience on the front lines had a profound effect on him.

"What haunts me is that people lost a lot of money last year," says McNabb, 52, who headed up Vanguard's institutional business for 13 years and its international division for two before being tapped to replace the then 54-year-old Jack Brennan as CEO. "Yes, on a relative basis we've done well, but you can't eat relative performance, and you can't spend relative performance."

It's that kind of empathy, coupled with bargain-basement fees and a unique structure in which investors in the funds actually own the company, that has long endeared Vanguard to its customers. These elements are part of a business model initiated by the famously frugal Bogle — who created the first retail index fund, popularized indexing and drove down costs in the mutual fund industry — and then shepherded for 12 years by the hard-charging Brennan, who is credited with moving the firm into lucrative exchange-traded funds, advice and guidance for individuals and third-party distribution of its no-load mutual funds.

Although much less well known in money management circles than either of his predecessors, McNabb may be better suited to lead Vanguard through the aftermath of the financial crisis. George Wilbanks, a partner at New York executive-search firm

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Russell Reynolds Associates, suggests that the company benefited from having McNabb, with his vast sales experience, as its front man when the market madness hit. "He's very client-centric in a way you didn't quite see as visibly with Jack Brennan. In October, if you clicked on the very first page of Vanguard's site, you saw a ten-minute video of Bill McNabb talking candidly about the market," says Wilbanks, who also praises McNabb's push to distribute outside the U.S. and his efforts, along with now-chairman Brennan, to raise Vanguard's profile in Washington as debates over industry regulation have heated up.

"He's not a blowhard, just a straightforward, honest, very trusted guy," says Jeffrey Immelt, the CEO of General Electric Co., who has known McNabb since they were fraternity brothers in the 1970s at Dartmouth College (which Brennan and CIO George Sauter also attended). "Both he and Jack Brennan were like that at 20, and they're like that in their 50s."

During his early days as CEO, McNabb crafted a crisis strategy he hoped would ensure that Vanguard didn't just survive the financial collapse but thrive in it, by offering anxious investors a safer alternative. Over the past year, he has moved to push the company's business further into the global market, ramp up its third-party sales of funds, including ETFs, and grow its institutional and quantitative equity businesses.

These efforts are paying off. Investors poured $84 billion into Vanguard in 2008 and another $55 billion during the first six months of this year. Last year's figure includes $41 billion invested in equity funds, an asset class that saw outflows at almost every other manager, plus $25 billion in ETFs, with more than $13 billion in new money going into target-date mutual funds, the most in the industry. This new cash helped the 12,500-employee company land the No. 1 spot in stock and bond flows in 2008, according to Strategic Insight, a New York–based mutual fund research firm. On the institutional side of the business, defined contribution sales were up 12 percent in 2008 over 2007, while defined benefit sales jumped by 87 percent. Vanguard's bond funds had attracted $36 billion through June 30, 2009, as a result of their good performance and shareholders' search for safety.

As of the same date, Vanguard's share of the U.S. mutual fund market had grown to 15 percent, up from 13 percent a year earlier; the firm is the largest U.S. mutual fund company in terms of assets, according to Strategic Insight. Its $1.21 trillion under management — down 10 percent from the same month last year but less severely so than its competitors — includes $329 billion in bonds, $198 billion in money market funds, $611 billion in equity and $72 billion in balanced funds. Roughly 78 percent of those assets are managed internally by its fixed-income and quantitative equity groups; the rest is farmed out to fundamentally driven active managers, like Boston-based Wellington Management Co. As of the end of June, 45 percent of the firm's assets were passively managed.

The shareholder-owned Vanguard has consistently performed better than its peers because its modest fees allow investors to earn a bigger percentage of the market's returns. "The cost advantage is so material that even if Vanguard missteps the advantage shines through," says Don Phillips, managing director of Chicago-based fund tracking firm Morningstar. "On the fixed-income side, because of its low cost structure, Vanguard doesn't have to stretch for yield or duration to beat peers."

EVEN AS MANY OF ITS ASSET MANAGEMENT RIVALS HAVE undergone major shake-ups in recent months, Vanguard has taken a cautious, measured approach. It doesn't do spontaneous. McNabb, for example, had been rumored to be Brennan's successor two years before he actually took over as CEO. Although Brennan's decision to step down at 54 was a bit of a shock within the investment management industry, internally he'd already told senior staff that he believed

The Cult of Vanguard

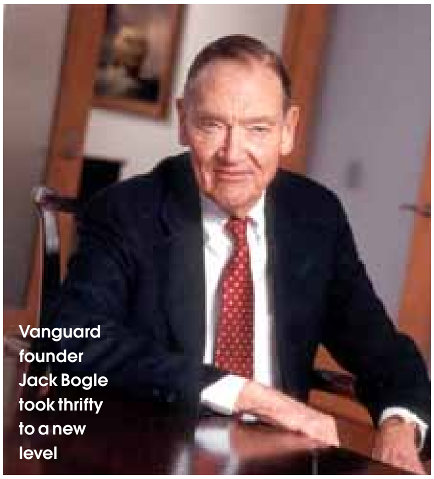
Getting fired isn't always a bad thing. Just ask shareholders of Vanguard Group.

Founder John Bogle launched the first retail index mutual fund in 1975, a year after being ousted — for engineering a merger that ultimately failed — from his role as president of Wellington Management Co., a Boston-based asset manager that today is a subadviser for some Vanguard funds.

Driven by an entrenched thriftiness he developed early in life, Bogle started a company specializing in index funds that was owned by shareholders and provided services at cost. Over the years, Vanguard developed an ethos, still strong today, that fosters teamwork, regarding success as collective rather than individual and valuing employees. Vanguard has never had layoffs, something virtually unheard of in the asset management industry, especially during the recent crisis.

"We have such strong Kool-Aid that if you didn't like the flavor, you wouldn't stick around," says CIO George Sauter.

Managing director of planning and development Mike Miller experienced this tight-knit community culture firsthand in November 2008, when his son Matt, now 21, was hit by a car and critically injured while training for a triathlon by biking through the Blue Ridge Mountains near the University of Virginia, in Charlottesville, where he was a premed student.

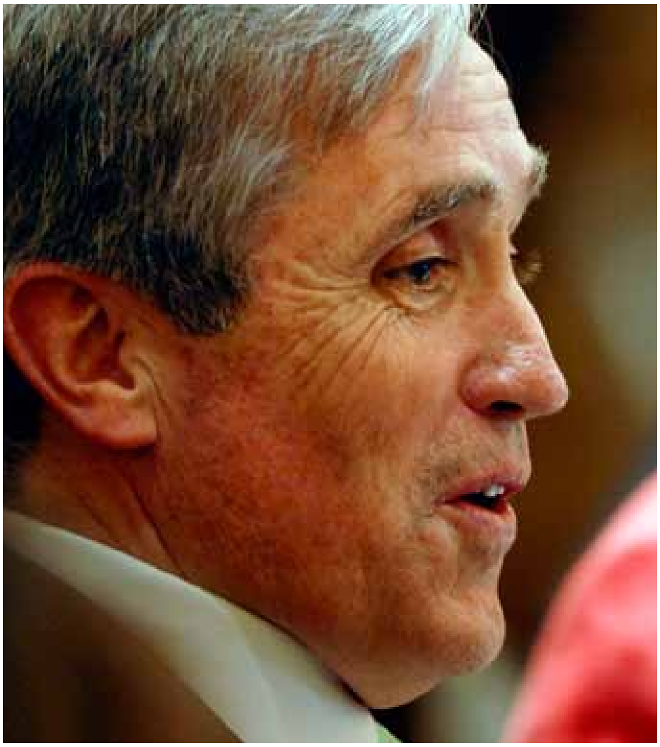


Vanguard founder Jack Bogle took thrifty to a new level

The morning after the accident, Vanguard chairman Jack Brennan called Miller at the Charlottesville hospital. "I don't know where to go," Brennan said. The chairman, who Miller had thought was just calling to check on the status of his son, was actually down in the lobby and needed directions to Matt's room. Two days later three more visitors arrived: CEO Bill McNabb; Chris McIsaac, head of institutional asset management at the time; and Tim Buckley, head of retail. "This place is family," Miller tells *Institutional Investor*. Matt survived his injuries, and after multiple reconstructive surgeries and with the support of family and friends, he took his finals, earning a 4.0 grade point average.

Bogle, now 80, is an outspoken critic of the mutual fund industry, using the bully pulpit of his Bogle Financial Markets Research Center, housed at Vanguard, to berate the leadership of other companies for their high fees and lack of stewardship. He doesn't spare the firm he founded, either. "Vanguard is a much bigger place than it once was," Bogle explains. "It's a challenge to keep that [employee- and investor-friendly] culture intact." — *J.S.*

VANGUARD GROUP VIA BLOOMBERG NEWS



The supercompetitive Jack Brennan, Vanguard's second CEO and current chairman, has been raising the firm's profile in Washington

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leaders should pass the torch after ten or 12 years.

Born F. William McNabb III, the oldest of five children, the new Vanguard CEO grew up in Rochester, New York, where he developed a love for competitive sports, including soccer and basketball. His father, a lawyer, moved the family to the Boston area when McNabb was 14. A good student, McNabb majored in government at Dartmouth and spent much of his free time rowing on a team that ultimately ranked among the top five in the U.S. He says the team dynamic he experienced informs his management style to this day.

Following his graduation in 1979, McNabb spent two years at the Haverford School near Philadelphia, teaching Latin as well as coaching rowing, soccer and basketball. In 1981 he enrolled at the Wharton School of the University of Pennsylvania to get an MBA in finance. McNabb was then hired as a credit analyst at Chase Manhattan Bank in New York, where, while working on troubled buyouts, he glimpsed the problems that can result from excessive leverage. "Many of these deals should never have been done," he says. "I couldn't believe we were part of this."

In 1986 McNabb landed a job at Vanguard overseeing guaranteed investment contracts. Brennan, who had graduated from Dartmouth three years before him, had a passion for Vanguard that was contagious. "Jack talked about the values of the organization, building a cohesive team, setting aggressive objectives and going after them," McNabb recalls. "Coming out of the Wall Street environment and New York, which was so political and which focused on the individual as opposed to the firm, that had a lot of appeal."

McNabb concentrated on the 401(k) business, which was still nascent, and began building Vanguard's fund lineup. Three years later Brennan charged a group of up-and-comers, including McNabb, with taking a fresh look at the way the defined contribution business was organized. After six months, McNabb and his colleagues had produced detailed recommendations for integrating the different pieces into a strategic business unit. Brennan hired James Gately, a veteran of Prudential Insurance, to implement the reorganization and assigned McNabb to "do whatever Jim wants," which turned out to be running marketing and strategy in an area where Vanguard is now preeminent.

When Gately moved to retail in 1995, McNabb took over the institutional division and joined senior staff. Six years ago, when Vanguard was assessing its effort to provide back-office services to advisers — a segment dominated by Charles Schwab & Co. — he took a chance and pulled the company out of the custody area altogether, shifting its focus to offering funds through advisers.

WHEN LEHMAN BROTHERS STARTED REELING LAST SEPtember, McNabb had barely moved into his new office. Reflecting Vanguard's emphasis on low costs, this work space, decorated with hand-me-downs from the two former CEOs and gray industrial carpet, could never be mistaken for former Merrill Lynch & Co. CEO John Thain's lavish digs. He shows off the plain wood chairs and desk, the faded sketches of a naval vessel on the Nile River left behind by Bogle and a poster from the Philadelphia Zoo, where McNabb is a board member. Tallying up the cost, he says, mimicking a MasterCard TV commercial: "Furniture inherited from both Jacks, zero. Frame for the free poster from the Philadelphia Zoo, ten bucks."

Shortly after stepping into the CEO role, McNabb cut Vanguard's budget to avoid layoffs as revenues toppled amid the market chaos. On September 14, one day before Lehman filed for bankruptcy, top executives — including Robert Auwaerter, principal and head of the fixed-income group; John Hollyer, principal and head of the risk management group; and chief counsel Heidi Stam — met for crisis planning in Valley Forge while McNabb and CIO George (Gus) Sauter dealt with questions from 401(k) sponsors and other investors at the institutional client conference in Washington. Although the firm had sniffed early signs of trouble and started positioning its fixed-income funds, including money markets, much more conservatively by the summer of 2007, McNabb was concerned that panicked shareholders might pull their cash. It didn't help matters when New York–based Reserve Management Corp.'s Primary Fund — which was invested in Lehman paper — "broke the buck," becoming only the second money market fund ever to fall below $1 a share.

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— Jeffrey Immelt, CEO, General Electric Co.

McNabb was already well aware of problems in the money markets. He had been turning away $1 billion deposits all year from big institutional investors looking for a safe harbor for their cash because rivals' money funds were invested in far riskier products. Vanguard was concerned that the hot money would dilute yields for long-term shareholders. "By the time of Lehman, we had 50 percent of our money market funds in Treasuries and agency securities," says David Glocke, who runs the $198 billion money fund business for Vanguard. Beginning in September the firm temporarily halted its internal securities-lending program. Unlike managers who had been investing collateral in higher-yielding instruments that were frozen after Lehman collapsed, Vanguard was conservative. McNabb, though, wanted to let markets calm down before allowing new loans.

"Investors thought Armageddon was coming," Auwaerter says of the down market of fourth-quarter 2008, into which his traders were selling. Although other fund companies were dumping their most liquid securities first, Auwaerter directed his traders to strike a balance so that Vanguard's funds wouldn't be left holding just the illiquid assets. Bond-fund cash flows started turning around in December and have been positive ever since.

In October, as Brennan worked with Treasury and Federal Reserve Board officials to stabilize money markets, McNabb decided to participate in the government's insurance program for the funds. "You don't want to be the best house on the condemned block," says Michael Miller, managing director of planning and development and one of the only members of the senior staff to be recruited from outside the company. "We wanted to make sure the block didn't get condemned."

Vanguard's strategy is working. In January, following the worst of the market carnage, Cambridge, Massachusetts–based Cogent Research ranked the firm No. 1 in mutual fund investor loyalty, based on its annual survey of affluent investors. Patricia Brochier, senior manager of human resources for Nissan North America, who runs the company's retirement plan, says she values Vanguard's "reputation for integrity, [its] low fund fees and [its] stability" during the recent financial crisis, noting that "there was no change with respect to the level or quality of services Vanguard provided to us during this challenging time."

Despite the market troubles, McNabb continues to pursue his long-term goals. His strategy of offering the firm's funds outside the U.S. is moving forward. In January he named Joe Brennan (no relation to Jack), who had headed portfolio review, as CIO of Australia and Paul Lohrey, previously head of strategic analysis for the quantitative equity group, as CIO of Europe. In February, Vanguard opened an office in the U.K. headed by Tom Rampulla, who had run sales for the financial-adviser services unit. In March, McNabb asked James Norris to become a managing director and move to the U.K. to oversee international operations. Norris, who joined the firm in 1987 as Bogle's assistant and once ran its institutional retirement business, has opened offices in South Korea and Zurich.

McNabb believes that international, which now represents only about 6 percent of Vanguard's total assets, should account for a much bigger slice of the firm's business. "[When] we opened our U.K. office this year, a couple of reporters I met with said, 'You guys are going to bring cost pressure to a whole new level,' and all I can say is, 'Yep,'" he quips. One competitor, who asked not to be named, says Vanguard will have to overcome the entrenched distribution network dominated by banks and insurance companies in Europe. McNabb responds that Vanguard's "low-cost, high-quality approach" will persuade clients to switch, despite such established networks. Vanguard also plans to expand its global offerings for institutional investors by offering customized separate accounts. This effort is being directed by Jeffrey Molitor, another Vanguard veteran. A third focus of the firm's international expansion is financial advisers.

> **Vanguard is a game changer, and it will force competitors to respond to its presence and lower fees.**
>
> **— Don Phillips,** Managing Director, Morningstar

In entering these markets, Vanguard hopes to leverage non-U.S. investors' growing awareness of fees. When asked whether the recent market turmoil has hurt its efforts, Norris says: "We couldn't have picked a better time. There is incredible upheaval, significant retrenchment and a flight to quality and conservatism — and that's us."

The firm could also benefit from an industrywide move toward indexing. In a recent Greenwich Associates survey, 20 percent of institutional investors said they'll transfer assets into passive management because of massive stock market losses. That's up sharply from 4 percent in October 2008.

On another front, McNabb is going to push forward on advice. Vanguard has an advantage in this area, because it offers one-time services from certified financial planners for free, whereas most brokerage firms charge. The firm created 40 percent more financial plans for its clients in 2008 than it did in 2006 (it would not reveal the total number). Tim Buckley, managing director and head of Vanguard's retail investor group, attributes the rise to last year's crisis and the growing percentage of retirement-age customers.

McNabb will also continue to distribute mutual funds and ETFs through financial advisers. Financial adviser services are Vanguard's fastest-growing business, generating a compound annual growth rate since 2001 of 17.12 percent. "Vanguard can provide low-cost funds for [advisers'] clients' portfolios," says Greg Barton, promoted to head the institutional business when McNabb became CEO last year.

McNabb has been deft at steering Vanguard through a choppy year. What investors will now want to see is whether he can implement plans to export the Vanguard model globally and expand the company's reach without tampering with its loyalty-inspiring culture. "McNabb deserves credit for pushing further into international, even at this time in the market cycle," says Morningstar's Phillips. "Vanguard is a game changer, and it will force competitors to respond to its presence and lower fees. McNabb recognizes that Vanguard has a sensational strategy, and he just needs to execute on that." ••

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