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How the Vanguard Effect Adds Up To $1 Trillion

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In the usually bleak debate over the economic health of average Americans and the utility of the finance industry, here's a happy statistic: A private-sector wealth-transfer machine has saved average investors $1 trillion. That machine is Vanguard, and its model is worth highlighting -- and maybe even emulating.

Let me explain the math.

Vanguard has saved investors $175 billion in fees since it was founded in 1974. This is based on the historical difference between the asset-weighted average expense ratio of an active mutual fund versus that of a Vanguard fund. The difference is multiplied by the firm's assets each year -- in other words, the amount an investor would have paid if Vanguard didn't exist.

The firm has also saved investors about $140 billion in trading costs or turnover. Every time a fund manager makes a trade, it costs a tiny amount. Generally speaking, every additional 1 percent in turnover comes with 0.01 percent in extra costs. Active mutual funds have an average turnover approximately 50 percentage points higher than a Vanguard fund.

Finally, there is the "Vanguard Effect": The company's influence leads other funds to lower their fees in order to better compete. For example, the average fee for active funds has dropped from .99 percent in 2000 to .77 percent today. This decline benefits the investors who make up the $10 trillion in active mutual-fund assets. In other words, Vanguard has saved non-Vanguard investors about $200 billion in active funds alone.

So to sum it all up: $175 billion in fee savings, $140 billion in trading cost savings, and $200 billion in savings from competition, which brings us to a grand total of $515 billion in lifetime savings. How, then, do we get to $1 trillion?

We have to assume that Vanguard's lifetime isn't over. In fact, the company is in its prime, having grown assets from $1 trillion in 2006 to $3.3 trillion today. This year, Vanguard has taken in $174 billion, which is about 70 percent of the net cash that has gone into all U.S. mutual funds and ETFs. Assuming a conservative growth rate of 10 percent annually, the firm should easily reach $6 trillion in less than 10 years.

That future growth is where you get an additional $500 billion or so in investor savings, which brings us to the $1 trillion. And remember -- that money doesn't sit under a mattress. It compounds and is turned into even more money for people who will ultimately use it for things like retirement, a new house or a college education.

There's another element to all this, and it stems from innovations made by John Bogle, Vanguard's creator. First was the introduction of the index fund, which is arguably the financial-industry equivalent of the MP3 -- a disruptive technology that has revolutionized the mutual-fund business. Second was Bogle's decision to set up the company using a mutual ownership structure. The funds own Vanguard and the investors own the funds. In fact, the only interest Bogle has is as an investor in the funds. The result? Profits are given back to shareholders in the form of lower costs, which in turn builds trust, and so on.

All that seems worth celebrating -- especially if it adds up to $1 trillion.

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