What Went Wrong in Corporate America?

Remarks by
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As so many of us have read in the gospel of Matthew: "A prophet is not without honor, save in his own country." Yet by your invitation to speak to you this evening you honor me, even as I stand here in my own country! I live right down the road from this great church, and for the better part of a half-century have regularly attended Sunday worship services in the thrall of such extraordinary preachers as David Watermulder and Eugene Bay, who have helped me beyond measure in gaining enlightment, inspiration, and faith.

While my remarks center on what went wrong in corporate America, being in this sanctuary compels me to begin with some words from the teacher Joseph Campbell: "In medieval times, as you approached the city, your eye was taken by the Cathedral. Today, it's the towers of commerce. It's business, business, business." We have become what Campbell calls "a bottom-line society." But our society, I think, is measuring the *wrong* bottom line: form over substance, prestige over virtue, money over achievement, charisma over character, the ephemeral over the enduring.

I'm sure it does not escape you that Joseph Campbell's analogy proved to be ominous. We have now witnessed the total destruction of the proudest of all America's towers of commerce, at New York's World Trade Center. We have seen a $7 trillion collapse of the aggregate market value of America's corporations—from $17 trillion to $10 trillion, in the worst stock market crash since 1929-1933. And we've seen the reputations of business leaders transmogrified from mighty lions of corporate success to self-serving and less-than-trustworthy executives, with several even doing "perp walks" for the television cameras.

Our bottom-line society has a good bit to answer for. As United Kingdom's Chief Rabbi Jonathan Sacks put it: "When everything that matters can be bought and sold, when commitments can be broken because they are no longer to our advantage, when shopping becomes salvation and advertising slogans become our litany, when our worth is measured by how much we earn and spend, then the market is destroying the very virtues on which in the long run it depends."

Tonight, I'd like to talk to you about what went wrong in our capitalistic system, about what's now beginning to go right, and about what you can do as a part-owner of corporate America. Whether you own a common stock or a share in a mutual fund, or participate in a private retirement plan, you have a personal interest in bringing about reform. Both as shareholders and as citizens, each of us must accept the responsibility to build a better corporate world.

Capitalism – A Brief Review

Capitalism, *Webster's Third International Dictionary* tells us, is "an economic system based on corporate ownership of capital goods, with investment determined by private decision, and with prices, production, and the distribution of goods and services determined mainly in a free market." Importantly, I would add, "a system founded on, honesty, decency, and trust," for these attributes too have been clearly established in its history.

As the world moved from an agrarian society to an industrial society during the 18th and 19th centuries, capitalism came to flourish. Local communities became part of national (and then international) commerce, trading expanded, and large accumulations of capital were required to build the factories, transportation systems, and banks on which the new economy would depend. Surprising as it may seem, at the heart of this development, according to an article in *Forbes'* recent 85th Anniversary issue,[1] were the Quakers. In the 1700s and early 1800s, probably because their legendary simplicity and thrift endowed them with the capital to invest, they dominated the British economy, owners of more than half of the country's ironworks and key players in banking, consumer goods, and transatlantic trading. Their emphasis on reliability, absolute honesty, and rigorous record-keeping gave them trust as they dealt with one another, and other observant merchants came to see that being trustworthy went hand-in-hand with business success. Self-interest, in short, demanded virtue.

This evolution, of course, is exactly what the great Scottish economist/philosopher Adam Smith expected. Writing in "The Wealth of Nations" in 1776, he famously said, "The uniform and uninterrupted effort to better his condition, the principle from which (both) public and private opulence is originally derived, is frequently powerful enough to maintain the natural progress of things toward improvement . . . Each individual neither intends to promote the public interest, nor knows how much he is promoting it . . . (but) by directing his industry in such a matter as its produce may be of the greatest value, *he is led by an invisible hand to promote an end which was no part of his intention."*

And so it was to be, the *Forbes* essay continued, that "the evolution of capitalism has been in the direction of more trust and transparency and less self-serving behavior. Not coincidentally, this evolution has brought with it greater productivity and economic growth. Not because capitalists are naturally good people, (but) because, the benefits of trust—of being trusting and of being trustworthy—are potentially immense, and because a successful market system teaches people to recognize those benefits . . . a virtuous circle in which an everyday level of trustworthiness breeds an everyday level of trust." The system *works!*

Or at least it *did* work. And then something went wrong. The system changed—"a pathological mutation in capitalism," as a recent essay in the *International Herald Tribune*[2] described it. The classic system—*owners'* capitalism—had been based on a dedication to serving the interests of the corporation's *owners* in maximizing the return on their capital investment. But a new system developed—*managers*' capitalism—in which "the corporation came to be run to profit its managers, in complicity if not conspiracy with accountants and the managers of other corporations." Why did it happen? "Because," the author says, "the markets had so diffused corporate ownership *that no responsible owner exists.* This is morally unacceptable, but also a corruption of capitalism itself."

The Broken Circle

What caused the mutation from virtuous circle to vicious circle? It's easy to call it a failure of character, a triumph of hubris and greed over honesty and integrity. And it's even easier to lay it all to "just a few bad apples." But while only a tiny minority of our business and financial leaders have been implicated in criminal behavior, I'm afraid that the barrel itself—the very structure that holds all those apples—is bad. While that may seem a harsh indictment, I believe it is a fair one. Consider that *Corporate Sages, Cheats, and Charlatans*, a new book by Reuters editor Martin Howell, lists fully 176(!) "red flags," each of which describes a particular shortcoming in our recent business, financial, and investment practices, many of which I've witnessed with my own eyes.

[1] James Surowiecki, *Forbes*, December 23, 2002.
[2] William Pfaff, September 9, 2002.

It is now crystal-clear that our capitalistic system—as all systems sometimes do—has experienced a profound failure, a failure with a whole variety of root causes, each interacting and reinforcing the other: The stock market mania, driven by the idea that we were in a New Era; the notion that our corporations were trees that could grow not only to the sky but beyond; the rise of the imperial chief executive officer; the failure of our gatekeepers—those auditors, regulators, legislators, and boards of directors who forgot to whom they owed their loyalty—the change in our financial institutions from being stock *owners* to being stock *traders;* the hype of Wall Street's stock promoters; the frenzied excitement of the media; and of course the eager and sometimes greedy members of the investing public, reveling in the easy wealth that seemed like a cornucopia, at least while it lasted. There is plenty of blame to go around. But even as it drove stock prices *up*, this happy conspiracy among all of the interested parties drove business standards *down*. Yes, the victory of investors in the great bull market had a thousand fathers. But the defeat in the great bear market that followed seems to be an orphan.

If we had to name a *single* father of the bubble, we would hardly need a DNA test to do so. *That father is executive compensation, made manifest in the fixed-price stock option*. When executives are paid for raising the price of their company's stock rather than for increasing their company's value, they don't need to be told what to do: Achieve strong, steady earnings growth and tell Wall Street about it. Set "guidance" targets with public pronouncements of your expectations, and then meet your targets—and do it consistently, without fail. First, do it the old-fashioned way, by increasing volumes, cutting costs, raising productivity, bringing in technology, and developing new products and services. Then, when *making it and doing it* isn't enough, meet your goals by *counting it*, pushing accounting principles to their very edge. And when that isn't enough, *cheat*. As we now know, too many firms did exactly that.

The stated rationale for fixed-price stock options is that they "link the interests of management with the interest of shareholders." That turns out to be a falsehood. For managers don't *hold* the shares they acquire. They *sell* them, and promptly. Academic studies indicate that nearly *all* stock options are exercised as soon as they vest, and the stock is sold *immediately*. Indeed, the term "cashless exercise"—where the firm purchases the stock for the executive, sells it, and is repaid when the proceeds of the sale are delivered—became commonplace. (Happily, it is no longer legal.) We have rewarded our executives, not for long-term economic reality, but for short-term market perception.

Creating Wealth—for Management

Even if executives were required to hold their stock for an extended period, however, stock options are fundamentally flawed. They are not adjusted for the cost of capital, providing a free ride even for executives who produce only humdrum returns. They do not take into account dividends, so there is a perverse incentive to avoid paying them. Stock options reward the *absolute* performance of a stock rather than performance *relative* to peers or to a stock market index, so executive compensation tends to be like a lottery, creating unworthy centimillionaires in bull markets and eliminating rewards even for worthy performers in bear markets.

While these issues could be resolved by the use of restricted stock, or by raising the option price each year, or by linking the stock performance with a market index, such sensible programs were almost never used. Why? Because those alternative schemes require corporations to count the cost as an *expense*. (Heaven forbid!) The cost of fixed-price options alone is conspicuous by its absence on the company's expense statement. As the compensation consultants are wont to say, these stock options are "free."

The net result of the granting of huge options to corporate managers, all the while overstating earnings by ignoring them as an expense, is that total executive compensation went through the roof. In the early 1980s, the compensation of the average chief executive officer was 42 times that of the average worker; by the year 2000, the ratio had soared to 531(!) times. The rationale was that these executives had "created wealth" for their shareholders. But if we actually *measure* the success of corporate America, it's hard to see how that could be the case. During that two-decade period, while corporations had *projected* their earnings growth at an average annual rate of 11½%, they actually *delivered* growth of 6% per year—only half of their goal, and even less than the 6½% growth rate of our economy. How that lag can be the stuff to drive *average* CEO compensation to a cool $11 million in 2001 is one of the great anomalies of the age.

The fact is that the executives had "created wealth" for themselves, but not for their shareowners. And when the stock market values melted away, they had long since sold much of their stock. Let me give you a few examples;

- **AOL Time Warner**. In an extraordinary example of the delusions of grandeur that characterized the information age, the news of this marriage of the "new economy" and the "old economy" as 2000 began, sent the price of Time Warner soaring to a then-all time high of $90 per share. But AOL's revenues began to tumble almost immediately, and the company recently reported losses totaling $98 *billion*(!). But in the first three years, the founder of AOL (and the Chairman of the merged company) sold nearly one-half *billion* dollars worth of his shares, mostly at boom-level prices. Today, the stock languishes at $10, down almost 90% from the high.

- **Sprint**. When they agreed to merge with WorldCom in October 1999, the directors accelerated the vesting of its executives' stock options. Although the merger scheme quickly fell apart, two senior executives quickly sold $290 million of their optioned shares at prices apparently in the $60 range. They also paid the firm's auditors $5.8 million (!) for a clever plan to circumvent the tax laws, and pay not a penny of tax on these gains. (Yet! The IRS is now challenging the tax-evasion device.) Today, Sprint sells at about $13 per share, down 83% from its high.

- **General Electric.** While clearly a blue chip company, the price of its shares has dropped from $60 to $23 per share since August 2000, a cool $370 billion reduction in its market value. Amid growing investor concern about its tendency to smooth its reported earnings by "creative accounting" practices, its once legendary leader is not looking so good lately. Yet his total compensation from 1997 through 2000 came to nearly $550 million, plus another $200 million from the sale of option shares, some at prices of $55 or more. Now retired, he is still well-paid: a pension of $357,000, plus another $377,000 for consulting services, a total of $734,000—*per month*! (He must enjoy an expensive life style that leaves little to spare, for a recent report placed his monthly charitable giving at just $614.) Such is the world of executive compensation in corporate America today.

Clearly, *owners*' capitalism had been superceded by *managers*' capitalism, and managers' capitalism has created great distortions in our society. And chief executives, with all their fame, their jet planes, their perquisites, their pension plans, their club dues, their Park Avenue apartments, seem to forget that they are employees of the corporation's owners, and the owners apparently forgotten it, too. But their behavior has not gone unnoticed. They are now close to the bottom of the barrel in public trust. A recent survey showed that while 75% of the general public trust shopkeepers, 73% trust the military, and 60% trust doctors, only 25% trust corporate executives, slightly above the 23% that trust used-car dealers.

The Failure of the Gatekeepers

What happened? How did it all come to pass? Basically, we have had a failure of just about every gatekeeper we've traditionally relied on to make sure that corporations would be operated with honesty and integrity, and in the interests of their owners. Independent auditors became business partners of management. Government regulations were relaxed, and our elected officials not only didn't care, but actually aided and abetted the malfeasance. The elected representatives of the owners—the Boards of Directors—looked on the proceedings with benign neglect, apparently unmindful of the impending storm.

Let's begin with our public accountants. It would seem obvious that they should have constituted the first line of defense against pushing accounting standards to the edge and beyond, and, hard as it may be to discover, at least some defense against fraud. But the accounting standards themselves had gradually become debased. "Cookie jar" reserves were created after corporate mergers, and off-balance sheet special purpose enterprises flourished, creating debt invisible to the public eye and giving "financial engineering" a whole new meaning. Of course the pressure has always been on accountants to agree with the corporate clients who pay them for their services. But over the past decade, to that seemingly unavoidable conflict of interest has been added the conflict of being business partners with their clients, providing management consulting services whose revenues often dwarf their audit fees. In the year 2000, for example, U.S. corporations paid their auditors nearly $3 billion for auditing services, only one-half of the $6 billion paid for consulting.

This added pressure on accountants to accede to management's demands, coming as managers promised quarterly earnings growth that was impossible to deliver, led to a company's *numbers* becoming more important than a company's *business*—a direct contradiction to the advice given to his colleagues by James Anyon, America's first accountant, way back in 1912: "Think and act upon facts, truths, and principles, and regard figures only as things to express them . . . so proceeding, (you will be) a credit to one of the truest and finest professions in the land." The "creative accounting" of the recent era has taken us a long, long way from the wisdom of relying on figures to present facts.

On the regulatory and legislative front, our public servants were also pressed into relaxing existing regulations for accounting standards and disclosure. When proposals for reform came—for example, requiring that stock options *actually be counted* as a compensation expense, or prohibiting accountants from providing consulting services to the firms they audit—the outrage of our legislators, inspired (if that's the right word) both by political contributions and by the fierce lobbying efforts of both corporate America and the accounting profession, thwarted these long overdue changes. Too many of our elected officials ought to be ashamed of themselves for their "play for pay" morality. Two centuries ago, Thomas Jefferson said, "I hope we shall crush in its birth the aristocracy of our monied corporations which dare already to challenge our government in a trial of strength, and bid defiance to the laws of our country." We didn't, of course, do so. But rather than defying our laws in this recent era of managers' capitalism, our monied corporations thwarted remedial legislation (it's a lot easier!), and compromised the highest interests of their investors.

The Role of the Board

That brings us to the board of directors. It is their job to be good stewards of the corporate property entrusted to them. In medieval England, the common use of the word "stewardship" meant the responsible use of a congregation's resources *in the faithful service of God.* In the corporate sense, the word has come to mean the use of the enterprise's resources in the faithful service of its owners. But somehow the system let us down. As boards of directors far too often turned over to the company's managers the virtually unfettered power to place their own interests first, both the word and the concept of stewardship became conspicuous by their absence from corporate America's values.

Serving as rubber-stamps for management, company directors have been responsible for approving option plans that are grossly excessive; audits in which the auditors are not independent appraisers of financial statements but partners of management; and mergers based on forcing the numbers rather than on improving the business. (As it turned out, according to *Business Week*, 63% of all mergers have destroyed corporate value.) Directors also approved ethical codes in which words like “integrity,” “trust” and “vision” were the order of the day, but corporate actions were another story. Some 60% of corporate employees, for example, report that they have observed violations of law or company policy at their firms, and 207 of 300 “whistle-blowers” report they have lost their jobs as a result.

Yet our society has lionized our boards of directors nearly as much as our vaunted CEOs. Early in 2001, for example, *Chief Executive* magazine told us that “dramatic improvements in corporate governance have swept through the American economic system, [thanks to] enlightened CEOs and directors who voluntarily put through so many [changes] designed to make the operations of boards more effective.” In particular, the magazine praised a certain “New Economy” company, “with a board that works hard to keep up with things . . . and working committees with functional responsibilities where disinterested oversight is required,” a company whose four highest values were stated as, “Communication; Respect; Excellence; and Integrity—open, honest, and sincere . . . We continue to raise the bar for everyone (because) the great fun here will be for all of us to discover just how good we can really be.” As it happens, we *do* now know just how good it could be: The company, so good that its board was named the third best among all of thousands of boards in corporate America for 2000, is bankrupt. While its executives reaped billions in compensation, its employees are jobless, their retirement savings obliterated. Its reputation is shredded beyond repair. It is, of course, Enron.

The board of directors is the ultimate governing body of the corporation, and the directors are stewards charged with the responsibility of preserving and building the company over the long-term. Yet the directors of corporate America couldn’t have been unaware of the management’s aggressive “earnings guidance;” nor of the focus on raising the price of the stock, never mind at what cost to the value of the corporation; nor of the fact that the lower the dividend the more capital the company retains; nor that it was management that hired the consultants who recommended to the compensation committee higher compensation for that very same management, year after year, even when its actual accomplishments in building the business were hardly out of the ordinary. Surely it is fair to say that it is our corporate directors who should bear the ultimate responsibility for what went wrong with corporate America.

Oh, No They Shouldn’t!

Or should they? Why should the board bear the ultimate responsibility when it doesn’t *have* the ultimate responsibility? Of course the directors’ responsibility is large indeed, but it is the stockholders themselves who bear the *ultimate* responsibility for corporate governance. And as investing has become institutionalized, stockholders have gained the *real*—as compared with the *theoretical*—power to exercise their will. Once owned largely by a diffuse and inchoate group of individual investors, each one with relatively modest holdings, today the ownership of stocks is concentrated—for better or worse—among a remarkably small group of institutions whose potential power is truly awesome. The 100 largest managers of pension funds and mutual funds alone now represent the ownership of one-half of all U.S. equities: *Absolute control over corporate America*. Together, these 100 large institutional investors constitute the great 800-pound gorilla who can sit wherever he wants to sit at the board table.

But with all that power has come little interest in corporate governance. That amazing disconnection between the potential and the reality—awesome power, yet largely unexercised—reminds me of the original version of the motion picture “Mighty Joe Young.” In the film, the protagonist was a fierce gorilla who destroyed every object in his path. But whenever he heard the strains of “Beautiful

Dreamer" he became serene and compliant. Not to push this analogy too far—especially for those who have not seen the film!—but I fear that, as institutional managers consider their responsibility for good corporate citizenship, they are hearing the sweet strains of "Beautiful Dreamer" playing in the background.

Yet mutual fund managers could hardly have been ignorant of what was going on in corporate America. Even before the stock market bubble burst, the industry's well-educated, highly-trained, experienced professional analysts and portfolio managers *must* have been poring over company fiscal statements; evaluating corporate plans; and measuring the extent to which long-term corporate goals were being achieved, how cash flow compared with reported earnings, and the extent to which those ever-fallacious "pro forma" earnings diverged from the reality. Yet few, if any, voices were raised. Somehow our professional investors either didn't understand, or understood but ignored, the house of cards that the stock market had become. We have worshiped at the altar of the precise but ephemeral price of the stock, forgetting that the eternal sovereign is the intrinsic value of the corporation—simply the discounted value of its future cash flow.

We have yet to accept our responsibility for our abject failure, for the fact is that we have become, not an *own-a-stock* industry, but a *rent-a-stock* industry. During the past year, for example, the *average* equity fund turned over its portfolio at a 110% rate—meaning that the average stock was held for just *eleven* months. When a company's stock may not even remain in a fund's portfolio by the time the company's next annual meeting rolls around, proxy voting and responsible corporate citizenship will rarely be found on the fund manager's agenda. What is more, money managers may avoid confrontation because even valid corporate activism could hurt the manager's ability to attract the assets of a corporation's pension account and 401(k) thrift plan, or limit its analysts' access to corporate information. Further, despite convincing information to the contrary, fund managers generally perceive only tenuous linkage between governance and stock price. But for whatever reason, the record clearly shows that the stockowners themselves—and especially the mutual fund industry—pay only sparse attention to corporate governance issues. "We have met the enemy, and he is us."

Actions and Reactions

As Sir Isaac Newton said, "for every action there is an equal and opposite reaction," and the reaction to the stock market boom and the mismanagement of so many of our corporations, to state the obvious, is already upon us. The first reaction to the bull market, of course, was the bear market that holds us in its throes to this day. The stock market, having quickly doubled from the start of 1997 to the high in March 2000 then dropped by half through mid-October 2002. That combination of percentages—plus 100% then minus 50%—of course produces a net gain of *zero*. (Think about it!) But with the modest recovery that then ensued, stocks are just 10% higher than their levels were when 1997 began.

The sharp decline, it seems to me, has brought us "back to (or at least toward) normalcy" in valuation. And even *after* the great bear market, the return on stocks during 1982 through 2002 averaged 13% per year, surely an attractive outcome for long-term stock owners. Through the miracle of compounding, those who owned stocks in 1982 and still held them in 2002 had multiplied that capital *ten times* over. So for all of the stock market's wild and wooly extremes, *owners* who bought and held common stocks have been well-compensated for the risks they assumed. For such investors, the coming of the bubble and then its going—the *boom* and then the *bust*—simply did not matter.

But that doesn't mean there weren't winners and losers during the mania—and lots of both. Simply put, the winners were those who *sold* their stocks in the throes of the halcyon era that is now history. The losers were those who bought them. Let's think first about the winners. A large proportion of these shares that were sold were those of corporate executives who had acquired vast holdings of their companies' stocks through options, and those of entrepreneurs whose companies had gone newly-public as Wall Street investment banking firms underwrote huge volumes of initial stock offerings, many already defunct. *Fortune* magazine recently identified a group of executives in just 25 corporations in those categories, whose total share of sales came to $23 billion—nearly a billion dollars each.

Winners and Losers

Other winners included the financial intermediaries—investment bankers and brokers who sold the high-flying stocks to their clients, and mutual fund managers who sold more than half a *trillion*(!) dollars in speculative funds to the public. Why were they winners? Because the investment banking, brokerage, and management fees for their activities reached staggering levels. More than a few individual investment bankers saw their annual compensation reach well into the tens of millions, and at least a half-dozen owners of fund management companies accumulated personal wealth in the billion dollar range, including one family said to be at the $30 billion level.

The losers, of course, were those who *bought* the stocks. "Greater fools?" Perhaps. But paradoxically, in order to avoid the dilution in their earnings that would otherwise have resulted from issuing those billions of optioned shares, the very corporations that issued those shares at dirt-cheap prices bought them back at the inflated prices of the day. But most of the buying came from the great American public—often in their personal accounts, and often through ever more popular 401(k) thrift plans—sometimes *directly*, by buying individual stocks*;* sometimes *indirectly*, through mutual funds. Greed, naiveté, the absence of common sense, and aggressive salesmanship all played a role in the rush to buy speculative stocks—technology, the internet, telecommunications—that were part of the "new economy." During the peak two years of the bubble, $425 billion of investor capital flowed into mutual funds favoring those types of speculative growth stocks and $40 billion actually flowed *out* of those stodgy "old economy" value funds.

Clearly there was a massive transfer of wealth—a transfer, I believe, of as much as $2 trillion—during the late bubble, from public investors to corporate insiders and financial intermediaries. Such transfers, of course, are not without parallel all through human history. For whenever *speculation* takes precedence over *investment*, there is always a day of reckoning for the investors in the financial markets.

Fixing the Governance System

It's important to understand this history of what went wrong in corporate America and its impact on our financial markets, because only if we understand the root causes can we consider how to remedy them. So as I promised at the outset, I'm going to discuss the progress that is being made to right those wrongs. Newton's law holds here as well, for the reaction to the failures of our capitalistic system was swift in coming. Surprisingly, however it was not the generalized problems of pushy earnings, faulty accounting, hyped expectations, imperial executives, loose governance, excessive speculation and even the great bear market that were the catalysts for reform. Rather, it was a handful of scandals—those few "bad apples," including Enron, Adelphia, WorldCom, Global Crossing—that galvanized the public's attention and generated the powerful reaction that, at long last, will help to bring the reform we need in our financial markets.

This pervasive reaction to the unacceptable actions of those we trusted to be our corporate stewards came swiftly.

- Last July, Congress passed the Sarbanes-Oxley bill, requiring senior corporate managers to attest to the validity of their companies' financial statements, providing for disgorgement of profits by executives who sell stocks and later restate earnings, and replacing self-regulation of accountants with a new federal Public Company Accounting Oversight Board, as well as other salutary provisions.

- In August, The New York Stock Exchange approved a powerful set of corporate governance rules for its listed companies—most of the major corporations in America—including substantially greater director independence, and new standards for audit committees and compensation committees. It even contemplated a "lead director" who is independent of corporate management. These changes should at long last lead to a separation of the powers of *governance* from the powers of *management*, and help us to return to a system of *owners'* capitalism.

- Just last month, The Conference Board Blue-Ribbon Commission on Public Trust and Private Enterprise—on which I was privileged to serve—completed its recommendations of a powerful set of "best practices" for public corporations. Our report on executive compensation included a recommendation that *all* types of stock options be treated as corporate expense, at last making it clear that fixed price options are not "free." On corporate governance, we recommended an *independent* nominating/governance committee; the establishment and enforcement of codes of ethics; and the separation of the Chairman and CEO roles, making clear the distinction between ownership and management. On accounting standards, our Commission's recommendations include further strengthening of audit committees and auditor rotation, and a challenge to the remaining Big Four (also known as "the Final Four") accounting firms to focus on quality audits, and to eliminate *all* consulting and tax services that involve advocacy positions, including those grotesque tax-shelters designed so executives can circumvent the law.

Two centuries ago, James Madison said, "If men were angels, we wouldn't need *government*." Today I say to our corporate leaders, "If chief executives were angels, we wouldn't need *corporate governance*." Through the reactions of Congress, The New York Stock Exchange, and The Conference Board Commission, to say nothing of the media, we're on our way to getting better governance right now.

Astonishingly, however, the reaction of institutional investors to the failings of our system has yet to occur. Even after the bear market that devastated the value of our clients' equity holdings, the only response we've heard from the mutual fund industry is the sound of silence. The reason for that silence seems to be that the overwhelming majority of mutual funds continue to engage, not in the process of long-term investing on the basis of intrinsic corporate *values*, but in the process of short-term speculation based on momentary stock *prices*. The typical fund manager has lots of interest in a company's price momentum—its quarterly earnings and whether or not they are meeting the guidance given to Wall Street. But when it comes to what a company is actually worth—its fundamental earning power, its balance sheet, its long-term strategy, its intrinsic value—there seems to be far less interest. When Oscar Wilde described the cynic as "a man who knows the price of everything but the value of nothing," he could have as easily been talking about fund managers.

Fixing the Investment System

It must be clear that we need not only good *managers* of corporate America, but good *owners*. That goal will *not* be easy to accomplish. For it will require shareholders—especially institutional shareholders—to abandon the focus on short-term speculation that has characterized the recent era and return at last to a focus on long-term investment. We need to return to behaving as *owners* rather than as *traders*, to return to principles of prudence and trusteeship rather than of speculation and salesmanship, and to return to acting as good stewards of the assets entrusted to our care. For example:

- Institutions and individual investors must begin to act as responsible corporate citizens, voting our proxies thoughtfully and communicating our views to corporate managements. We should be prepared to nominate directors and make business proposals in proxies, and regulators should facilitate these actions. The SEC's recent decision to require mutual funds to disclose how we vote our proxies is a long overdue first step in this process.

- Shareowners must demand that corporations focus the information provided to the investment community on long-term financial goals, cash flows, intrinsic values, and strategic direction. Quarterly "earnings guidance," so omnipresent today, should be *eliminated.* So should efforts to meet financial targets through creative accounting techniques.

- Given the enormous latitude accorded by "Generally Accepted Accounting Principles," owners must demand full disclosure of the impact of significant accounting policy decisions. Indeed, we ought to consider requiring that corporations report earnings both on a "most aggressive" basis, (presumably what they are reporting today), and on a "most conservative" basis as well.

- Mutual funds must report to their owners not only the *direct* costs of mutual fund investing (such as management fees and sales loads), but the *indirect* costs, including the costs of past and expected portfolio turnover and its attendant tax impact. Funds must also desist from advertising short-term investment performance (and perhaps from *any* performance advertising, at all).

- Policymakers must develop differential tax strategies aimed at stemming excessive speculation. Some years ago, for example, Warren Buffett suggested a 100% tax on short-term capital gains, paid not only by taxable investors, *but also by tax-exempt pension funds*. While that tax rate *might* seem a tad extreme, perhaps a 50% tax on very short-term gains on trading stocks would force investors to come to their senses.

- Perhaps most important of all, investor/owners must demand that corporations step-up their dividend payouts. Despite the absence of evidence that earnings retention leads to sound capital allocations, the payout rate has been declining for years. Yet history tells us that higher dividend payouts are actually associated with *higher* future returns on stocks. Investing for income is a *long-term* strategy, and investing for capital gains is a *short-term* strategy; the turnover of dividend paying stocks is at but one-half of the rate for non-dividend paying stocks.

Back to the Future

Calling for a return to the eternal principles of long-term investing is more than mere moralizing. Our very society depends on it, for our economic growth depends upon capital formation. Way back in 1936, Lord Keynes warned us, "When enterprise becomes a mere bubble on a whirlpool of speculation, the position is serious. *For when the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done."* As a nation we can't afford to let that happen. The fact is that we need a whole new mindset for institutional investors, one in which *speculation* becomes a mere bubble on a whirlpool of *investment.* In the mutual fund industry, we need to go "back to the future," to return to our traditional focus on stewardship and abandon the focus on salesmanship that has dominated our recent history.

While the changes I have suggested will help return us to our roots, however, the fact remains that there is more profit potential for financial service firms in marketing (generating huge assets to manage) than in management. For, as both simple mathematics and the investment record of the past clearly indicate, beating the market is a loser's game, simply because of the staggering toll taken by the costs of financial intermediation. When fund investors realize that fact, they will vote with their feet, and send their hard-earned dollars to funds that get the message. By doing so, using Adam Smith's metaphor, "it is the individual who acts in his own interests to better his financial condition who will promote the natural progress of things toward improvement." Similarly, when an investor puts his money into mutual funds that invest rather than speculate, he earns the highest possible proportion of whatever returns the financial markets are generous enough to provide (of course, we know them to be low-cost market index funds), promoting the public interest without intending to, or even knowing, he is doing so.

That doesn't mean, however, that the trusted fiduciary, the honest businessman, or the good merchant should behave in an ethical way only because their clients have dragged them, kicking and screaming, into doing what's right. The fact is, as I noted at the outset, that in the long run *good ethics are good business, part of that virtuous circle that builds our society*. When in recent years our rule of conduct became "I can get away with it," or, more charitably, "I can do it because everyone else is doing it," integrity and ethics go out the window and the whole idea of capitalism is soured.

Man's Better Nature

If my appeal to man's better nature seems hopelessly out of tune with the discouraging era I've described this evening, I can only remind you that Adam Smith, that patron saint of capitalism, would be on my side. Even before *The Wealth of Nation*s, he wrote *The Theory of Moral Sentiments*, reminding us of the better nature that "has lighted up the human heart, capable of counteracting the strongest impulses of self-love . . . It is reason, principle, conscience, the inhabitant of the breast, the man within, the great judge and arbitrator of our conduct who calls to us with a voice capable of astonishing the most presumptuous of our passions that we are of the multitude, in no respect better than any other in it . . . he who shows us the propriety of reining in the greatest interests of our own for the yet greater interests of others, the love of what is honorable and noble, of the grandeur, and dignity, and superiority of our characters."

At last we are beginning a wave of reform in corporate governance and are undertaking the task of turning America's capital development process away from speculation and toward enterprise. It will be no mean task. For there's even more at stake than improving the *practices* of governance and investing. We must also establish a higher set of *principles*. This nation's founding fathers believed in high moral standards, in a just society, and in the virtuous conduct of our affairs. Those beliefs shaped the very character of our nation. If *character counts*—and I have absolutely no doubt that character *does* count—the ethical failings of today's business and financial model, the financial manipulation of corporate America, the willingness of those of us in the field of investment management to accept practices that we know are wrong, the conformity that keeps us silent, the selfishness that lets our greed overwhelm our reason, all erode the character we'll require in the years ahead, more than ever in the wake of this great bear market and the investor disenchantment it reflects. The motivations of those who seek the rewards earned by engaging in commerce and finance struck the imagination of no less a man than Adam Smith as "something grand and beautiful and noble, well worth the toil and anxiety." I can't imagine that anyone in this sanctuary this evening would use those words to describe what capitalism is about today. The sooner the better when we can again apply those words to our business and financial leaders—*and mean them.*

A Call For Virtue

So there is much work to be done. But it's about much more than assuring that the "bottom line" of business is not only stated with probity, but focused on investing based on long-term corporate value rather than speculating on short-term stock prices. It is the enduring reality of intrinsic value—make no mistake, the worth of a corporation *is* neither more nor less than the discounted value of its future cash flows—*not* than the ephemeral perception of the price of a stock that carries the day. And the enterprises that will endure are those that generate the most profits for their owners, something they do best when they take into account the interests of their customers, their employees, their communities, and indeed the interests of our society. *Please don't think of the ideas merely as foolish idealism.* They are the ideals that capitalism has depended upon from the very outset. Again, hear Adam Smith: "He is certainly not a good citizen who does not wish to promote, by every means of his power, the welfare of the whole society of his fellow citizens." So it's up to each one of us in this sanctuary tonight to speak up, to speak out, and to demand that our corporations and our fund managers represent our interests rather than their own—the owners first, not the mangers. Please don't think that your voice doesn't matter. In the words of the motto I've tried to ingrain in the minds of our Vanguard crewmembers, "Even one person can make a difference."

While a call for virtue in the conduct of the affairs of corporate America—and investment America, too—may sound like a hollow "do-good" platitude, the fact is that in the long run the high road is the only possible road to national achievement and prosperity, to making the most of those priceless assets that America have been endowed by her Creator. On this point, I am unable to find more compelling wisdom than some splendid words attributed, perhaps apochryphally, to Alexis de Tocqueville. I hope these words will resound far beyond the parochial issues I've addressed this evening into the larger world around us—troubled as it is and at the brink of war—words that are especially appropriate in the sanctuary where we convene:

> "I sought for the greatness and genius of America in her harbors and her rivers, in her fertile fields and boundless forests, and it was not there.
>
> "I sought for the greatness and genius of America in her rich mines and her vast world commerce, and in her institutions of learning, and it was not there.
>
> "I sought for the greatness and genius of America in her democratic Congress and her matchless Constitution, and it was not there.
>
> "Not until I went into the churches of America and heard her pulpits flame with righteousness did I understand the secret of her genius and power.
>
> "America is great because America is good, and if America ever ceases to be good, America will cease to be great."

And so it is with corporate America and investment America too. If we return to goodness, we can again strive for greatness. Let's, all of us together, make sure that happens.