# Corporate Governance: What's Next?

**Keynote Speech by**
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Good afternoon. After looking over—and participating in—your wonderfully comprehensive agenda that covers almost every conceivable aspect of corporate governance and corporate regulation, it's more than a little intimidating to try to crystallize and summarize the wealth of information and opinion that has been presented to you during this busy day.

So, rather than taking that approach, I'd like to discuss three specific items that I believe will soon come to dominate the Board agenda, and then conclude by reflecting on new pressures that will be brought to hear on directors by stockholders, a constituency that has been largely silent during the recent era, pressures to serve their interests above all others. My conclusion may well not surprise you: corporate democracy, long ignored by our largely passive stockowners, will emerge as a major force in governance issues.

Full disclosure being the hallmark of the investment field, let me first set out the three vantage points that have shaped my views:

- First, I've worked in the investment field for 54 years. From 1965 to 1996, I served as chief executive of two large mutual fund management companies, the second of which I founded in 1974. These two institutions were both a) substantial *owners* of corporate stocks (at last count, more than $500-billion-worth), and also b) *owned* by their own stockholders—until 1974, shareholders of a publicly-held fund management company; thereafter, mutual fund investors who mutually owned, through their fund holdings, the stock of Vanguard.

- Second, I've been a long-time student—and outspoken critic—of corporate governance in general, and mutual fund governance in particular. My insider's criticism of fund governance goes back even before we undertook what we called "the Vanguard Experiment" in mutual fund governance—a structure designed to assure that the fund investor, rather than the management company, dines, if you will, at the top of the food chain. My fifth book, on the subject of what went wrong in corporate America, in investment America, and in mutual fund America, will be published by Yale University Press in September.

- Third, in addition to my investment career, I've also served on at least a dozen boards of other organizations—including the compensation, nomination, finance, and audit committees of five public corporations, each with a multi-billion market capitalization—on one of which I continue to serve.

I suppose it's fair to say, then, that I've looked at corporate governance issues from the viewpoint of one who has been a governor, of one who has been governed, and of one who has studied both sides of governance as a dispassionate, indeed, almost academic, observer.

Before I turn to the increasingly powerful role I see for shareholders—especially large financial institutions—let me discuss three important issues under the rubric of "what's next?" for corporate directors. Three issues quickly come to mind:

1) Establishing reasonable assumptions of future returns for corporate pension plans;
2) Considering new and better forms of stock options; and
3) Focusing on the creation of long-term corporate value, rather than on the short-term price of the stock.

## 1. Future Pension Fund Returns

High on the board agenda today ought to be a review of the assumptions of future returns on corporate pension plans. Traditionally, the board has paid little attention to these assumptions, and even the famed oracle of Omaha, as a board member of Coca-Cola, Gillette, and 17 other companies, acknowledges that he's *never* heard a serious discussion of this issue.

Almost without our noticing, however, three things have changed. First, the pension plan assets of many large corporations are now often as large as—or even larger than—the business assets of the corporation itself. For example, the pension assets of the 30 corporations in the Dow Jones Industrial Average recently totaled $400 billion, compared to the collective book value of $700 billion for these businesses themselves. In some cases, the pension fund is relatively small relative to assets (Citigroup, Intel), and in some cases reasonable (IBM, with pension assets of $74 billion and corporate assets of $159 billion). But GM, Ford, and Delta, for example, have far more pension assets (nearly $200 billion) than corporate (just $60 billion).

Second, with the humdrum returns provided by the stock market over the past eight years (at 1225, the current price of the S&P 500 is exactly where it was in December 1998), many pension plans are in shaky shape, and facing great temptation to raise their earnings assumptions, irrespective of what today's financial conditions may dictate. As Morgan Stanley's respected accounting expert Trevor Harris (with Richard Berner) put it, "years of . . . overly optimistic assumptions . . . have created economic mismatches between promises made and the resources required to keep them. Corporate defined-benefit plans as a whole are as much as $400 billion underfunded. Those gaps will drain many plan sponsors' operating performance and threaten the defined-benefit system itself, especially if markets fail to deliver high returns, or if interest rates remain low."

And third, pension assumptions have played a major role in the financial engineering of recent years, one of the less attractive developments of the recent era, during which "managed earnings" became something of an art form, often to please the appetite of today's financial markets for companies that consistently meet their "earnings guidance," but also to produce excessive executive compensation as well.

Consider this example: "In 2001, Verizon Communications reported a net income of $389 million and awarded its executives bonuses based on that amount. Net income would have been negative, however, had the company not included $1.8 billion of pension income. Thus, Verizon was able to use pension earnings to convert net income to profits, giving the firm cover to provide managers with higher bonuses. It gets worse. It turns out that Verizon's pension funds did not generate *any* real income in 2001; they had negative investment returns, losing $3.1 billion in value. How, then, could Verizon report

income of $1.8 billion from its pension assets? The company merely increased its projection of future returns on pension assets to 9.25 percent, a move allowed under the accounting rules then in effect. Thus, the $1.8 billion in pension income used to move Verizon into the black did not even reflect actual returns generated by the pension funds. The pension income was simply the result of a change in the accounting assumptions. This certainly did not create any value for the firm or its shareholders." [1]

## Long-Term Historical Returns?

The way these estimates have developed has been little short of scandalous. Hear the typical language, in fact taken from the General Motors Annual Report for 2001: "Our asset return assumption is derived from a detailed study conducted by our actuaries and our asset management group, and *is based on long-term historical returns*." Amazing! The higher that market returns soar, the higher the future returns that GM projected. Equally amazing is the express assumption that returns in the stock market, and for that matter, the bond market, have anything whatsoever to do with actuarial tables. If bonds had provided a four percent return over the past 100 years and today's interest coupon on a 10-year bond were eight percent, would you pick four percent as your assumption of future returns? Or would you pick eight percent? (I hope you don't have to think about the answer for long.)

Yet, using the past as prologue is exactly what corporate America was doing . . . at least as long as the past returns were rising. It was only a matter of time until the projections reached absurd levels. **Chart 1** shows the expected return for the average corporate pension plan was 7 percent in 1981, when the 10-year Treasury yield was almost 14 percent. For a policy portfolio invested 40 percent in bonds and 60 percent in stocks, the implied future annual return required of stocks, then, was just 2.4 percent, less than half of the 4.9 percent yield on the Standard & Poor's 500 Stock Index, at a time when stocks were selling at only eight times earnings.

1.

**Pension Fund Expected Returns, 1981 - 2004**

| Year End | Expected Return | 10-yr. Treas. Bond Yield | Implied Stock Return (60/40) | S&P Yield | S&P P/E |
|---|---|---|---|---|---|
| 1981 | 7.0% | 13.9% | 2.4% | 4.9% | 8.0x |
| 1999 | 9.0 | 5.6 | 11.3 | 1.3 | 30.5 |
| Change, 1981 - 1999 | +29% | -60% | +373% | -73% | +281% |
| 2004 | 8.4% | 4.8% | 10.8% | 1.9% | 20.1x |

Assuming a policy portfolio of 60 percent stocks and 40 percent bonds.

Now advance the clock to the end of 1999, just before the all-time market peak and as the bear market was about to begin. The assumed return had *risen* to 9 percent, even though the bond yield had plunged by 60 percent to just 5.6 percent. Thus, the implied future return required from stocks had soared to 11.3 percent annually, nearly five *times* the earlier level of 2.4 percent, and despite the fact that the lion's share of the market's past return had come, not from the fundamental financial return of dividend yield and earnings growth, but from speculative return, borne of an upward revaluation of earnings.

[1]. Lucian Bebchuk and Jesse Fried, *Pay Without Performance*, (Harvard University Press, 2004), 125-126.

Investors were willing to pay only $8 for each dollar of earnings at the outset, but were exuberantly paying $30.50 at its conclusion. Obviously stocks and bonds, cheap in 1981, were dear in 1999. And yet the expected return of the average pension plan had leaped by almost 30 percent.

Let's look at how General Motors has reacted to the change, and see what might be reasonable for its pension plan today. Last year, the assumed return reported in the GM Annual Report was 8 ½ percent, close to the norm for the average company. For the stock portfolio, based on realistic expectations using today's 1.9 percent dividend yield and normal earnings growth (say, 6 percent, *not* a particularly conservative estimate), we might say that 7½ percent is reasonable. **(Chart 2)** Looking at the current 4½ percent yield on a conservative bond portfolio of Treasurys and corporates, we'd project bond returns at about that level. Once we deduct estimated plan expenses (say 1½ percent, including fees, turnover costs, etc.—costs that are *universally* ignored by corporate financial executives and actuaries), the arithmetic takes us to a net annual return of 4.8 percent, a little more than half of 8½ percent total GM is projecting. Here, I think, is a company that either got the math wrong, or is trying to engineer upward the earnings it reports to its shareholders. I'll leave it to you to decide.

2.

**Realistic Return Assumptions – Conventional Corporate Pension Plan**

| | 1. | 2. | 3. (1 x 2) | 4. | 5. | 6. (4 – 5) |
|---|---|---|---|---|---|---|
| **Class** | **Allocation** | **Projected Return** | **Return Impact** | **Gross Return** | **Expenses** | **Net Return** |
| **Equities** | **60%** | **7.5%** | **4.5%** | **6.3%** | **1.5%** | **4.8%** |
| **Bonds** | **40** | **4.5** | **1.8** | | | |

## Disclosing the Sources of Pension Returns

When I pursued this issue with the president of General Motors a few years ago (on television, yet!), he said that the old policy portfolio (60 percent stocks, 40 percent bonds) had been abandoned in favor of alternative investments such as venture capital, and "absolute return" investments like hedge funds that would produce superior returns. So let's make some reasonable assumptions about what this new policy portfolio might hold: Perhaps 30 percent in equities, 40 percent in bonds, 10 percent in venture capital, and 20 percent in hedge funds. Now let's see what we need to do to reach that 8½ percent total. (There is, of course, an infinite number of ways to get to this 8½ percent return. In **Chart 3**, I'll present just one.)

**Getting to an 8.5% Return: A Template for Corporate Annual Reports** 3.

| Class | 1. Allocation | 2. Projected Return | 3. Value Added* | 4. Expenses | 5. (2+3-4) Net Return | 6. (1 x 5) Return Impact |
|---|---|---|---|---|---|---|
| Equities | 30% | 7.5% | 3.0% | 1.5% | 9.0% | 2.7% |
| Bonds | 40 | 4.5 | 0.25 | 0.5 | 4.2 | 1.7 |
| Venture Cap. | 10 | 12.0 | 5.5 | 3.0 | 14.5 | 1.4 |
| Hedge Funds | 20 | 10.0 | 6.5 | 3.0 | 13.5 | 2.7 |
| Total | 100% | 7.2% | 2.8% | 1.5% | 8.5% | 8.5% |

*Required to produce expected rate of return.

If we leave our stock and bond market return assumptions unchanged, the equity managers would have to beat the stock market by 3 percent a year, and the bond managers beat the bond market by ¼ percent. Then let's project venture capital at 12 percent, with smart managers who earn almost 18 percent, and hedge funds at 10 percent, with smart managers who earn 17 percent, and then deduct costs. Voila! The pension fund reaches its goal of 8½ percent per year!

Leave aside for the moment that equity managers who can consistently beat the market by 3 percent a year are conspicuous by their absence. Leave aside, too, the risks they'll have to take to do so. Then note that the assumed venture capital returns are far above even the historical norms that were inflated by the speculative boom in IPOs during the market madness of the late 1990s. Then ignore the obviously staggering odds against finding a *group* of "absolute return" hedge fund managers who could consistently exceed those norms by five or six percentage points per year over a decade. Surely most investment professionals would consider these Herculean assumptions absurd.

Of course, one cannot be certain. Assumptions, after all, are only assumptions. And who am I to say that GM won't be Hercules? But I believe that each corporation has a responsibility to present the basis for its pension assumptions to its finance committee and its board. A simple table such as this one can enable its directors to make a fair determination of the reasonableness of the arithmetic upon which the pension plan is relying to make its pension fund return assumptions. Further, serious security analysts should demand the right to review these data, and, if appropriate, challenge the assumptions that are being made.

I understand that the S.E.C. is also investigating the issue of projected pension returns, and I believe it is only a matter of time until the basis for the assumptions is presented in the financial statements provided to shareholders. In addition, corporations also ought to be required to report the past rates of return their plans have actually achieved, amazingly, now not reported at all. Corporate managers have all too rarely raised the issue of pension return assumptions to the high level of importance it deserves. It's high time for directors, as well as shareholders, to put the issue on the table, to ask fair questions, and to demand responsive answers.

## 2. A New System for Stock Options.

The second issue that ought to be on each board agenda is stock options. Despite vigorous, even violent, opposition from corporate America, including costly lobbying and heavy political contributions aimed at influencing the Congress, the expensing of fixed price stock options on corporate income statements is at long last expected to begin this autumn. I have always held the simple belief that options

are compensation, and that *all* compensation should be expensed. Now that that is finally happening, it opens the door to far more intelligently-designed stock options.

The long overdue expensing of fixed price stock options has created a new dynamic in executive compensation. *Why*? Because for decades, with notably few exceptions, the fixed price stock option has been deemed to be "the only game in town." Of all forms of options, only conventional fixed price options were not counted as a deduction against reported earnings. They were, in the words of the compensation consultants, "free." With other options deemed "expensive," the use of fixed-price options was rarely, if ever, challenged by directors or analysts. But their structure has always been badly flawed.

The first flaw is that the stated rationale for fixed-price stock options—they "link the interests of management with the interest of shareholders," however often repeated and however widely accepted—is a bromide that turns out to be false. Managers don't *hold* the shares they acquire. They *sell* them, and they sell them promptly. Academic studies indicate that nearly *all* stock options are exercised as soon as they vest, and the stock—or at least most of it—is, in turn, sold *immediately*. Indeed, the term "cashless exercise"—in which the firm purchased the stock for the executive, sold it, and repaid itself when the proceeds of the sale were delivered—became commonplace. (Happily, under Sarbanes-Oxley, that practice is no longer legal.)

We rewarded our executives, not for creating long-term economic value—a *reality*—but for pumping up short-term stock market prices—a *perception*. The fact is that executives had created wealth for themselves, but not for their shareowners. Long before the stock market values melted away, executives had made a timely exodus from the market by selling hundreds of billions of dollars of their stocks. To make matters worse, to avoid the dilution caused by the issuance of all those new shares to executives, most companies listed on the New York Stock Exchange followed a policy of buying back their shares in the open market—often at the excessive stock prices of the bubble era.

Even if executives were required to hold most of their stock for an extended period, however, the fixed-price stock option is also flawed as a method of aligning the interest of ownership and management:

- They are not adjusted for the cost of capital, providing a free ride even for executives who produce only humdrum returns.[2]
- They do not take into account dividends, so there is a perverse incentive to avoid appropriate dividend payments.
- They reward the *absolute* performance of a stock rather than its performance *relative* to peers or to a stock market index.

As a result of these conceptual flaws, executive compensation takes on the appearance of a lottery, creating unworthy centimillionaires in bull markets and eliminating rewards even for worthy performers in bear markets. By making the incorrect presumption that stock price, and stock price alone, is *the* measure of executive performance, we produced undeserving executive celebrities and overlooked those who incrementally and consistently added real value to their corporations. As a result, options were the main culprit in creating the "pay without performance" ethic of corporate compensation.

## Fairness in Option Rewards

While building stock ownership by executives is an appropriate corporate objective, it must be done in a way that is fair to the other owners who have purchased their shares at the full market value, and

[2] The cost of corporate capital is generally described as the nominal risk-free interest rate plus an equity premium. In early 2005, approximately 4 ¼ percent for the U.S. Treasury 10-year note, plus, say, 4 percent. Total cost of capital, 8 ¼ percent.

assumed the risks of ownership. Directors should carefully consider the dilution engendered by additional option issuance, as well as the cumulative dilution of previous options. Options have never been "free," and now that expensing is here compensation committees must be particularly sensitive to the magnitude of the dilution in ownership interest that they entail.

Expensing of fixed price options, furthermore, demands the consideration of options that will do what they are supposed to do; link the interests of management with the interests of owners. Directors should not be tricked into awarding options in the traditional form, for other forms of options can mitigate the flaws I described earlier. With the accounting playing field now leveled off, it is time that we turn to forms of options that are designed to reward executives for more substantial accomplishments than pushing stock prices momentarily higher; options whose prices take dividends into account; options whose prices are adjusted for the cost of capital; options that index the price of the corporation's stock to those of corporate peers and/or of the stock market itself; and options that reward executives for building enduring corporate values.

To further discourage management focus on short-term results, options should be issued on a long-term basis, with executives required to hold a substantial amount of their stock during, and even after, their employment by the company. (I once asked a CEO if his company had any requirement that the shares he acquired through options should be held for a certain period. He responded, "Why on earth would anyone want to do *that*!" And he was, from his own point of view, absolutely right. But not from the owner's perspective.) Boards that see their duty as placing the interest of the owners ahead of the interest of the managers will carefully consider these issues, and require new, more rational forms of stock option compensation.

## 3. Stock Price vs. Corporate Value

The third major issue I expect to see on the board agenda involves how we measure corporate value. To our discredit, with all our focus on hard numbers and immediate gratification, we have come to focus on the momentary precision of the price of the stock, rather than the eternal vagueness of the value of the corporation. But stock *prices* are inherently flawed as a means of compensation. Uncritically, we came to accept stock prices as a measure of executive prowess and success, ignoring the fact that short-term fluctuations in stock prices are based only tangentially on the level of corporate earnings (even earnings that are accurately stated). Rather, short-term prices are driven by speculation, reflected in how many dollars investors are willing to pay for each dollar of earnings on any given day. But in the long run, nearly all of the return on a stock is determined by its dividend yield and its earnings growth, with changes in price-earnings multiples contributing almost nothing.

Our financial market system is a vital part of the process of investing, and of the task of raising the capital to fund the nation's economic growth. We require active, liquid markets and ask of them neither more nor less than to provide liquidity for stocks in return for the promise of future cash flows. In this way, existing stockowners can realize the present value of future cash flows, and new buyers can invest their capital to acquire those flows. But in return for those advantages comes the disadvantage of the moment-by-moment valuation of corporate shares. We demand hard numbers to measure investment accomplishments. *And we want them now*! Markets being what they are, of course, we get them, and stock prices have become our measuring stick.

But the hope, greed, and fear that make markets all tempt investors to speculate on prices. And that is what Warren Buffett's mentor Benjamin Graham meant when he warned about paying much heed to "Mr. Market," the imaginary investor who comes by every day and offers to buy our stocks at their current prices. When we listen to Mr. Market, we allow the emotions of the moment to take precedence

over the economics of the long term. As the wise Ben Graham pointed out, "in the short-run, the stock market is a *voting* machine; in the long-run it is a *weighing* machine."

It was Graham's view that corporations managed with a view toward enhancing their long-term intrinsic value—gaining extra *weight*, if you will—would prove to be better investments than those managed with a view toward building short-term stock prices by engineering short-term earnings with a view toward gaining extra *votes*. By the same token, the record is clear that fund managers that hold *companies* for the long-term and allow intrinsic value to build over time, have provided higher returns to their clients than managers that hold *stocks* for the for the short-term and trade them whenever Mr. Market offers a tempting but momentary price.[3]

Yet the Information Age that is part of our generation's lot in life has led us to the belief that the momentary *precision* reflected in the price of a stock is more important than the eternal *imprecision* in measuring the intrinsic value of a corporation. Put another way, investors seem to be perfectly happy to take the risk of being precisely wrong rather than approximately right. This triumph of perception over reality was reflected—and magnified!—in the recent bubble. The painful bear market that we subsequently endured simply represents the return to—or at least toward—reality. We now know that the price of the stock fails the test of providing a consistent and reliable measure of the value of the corporation. Corporations have led investors astray, but institutional investors colluded in the happy conspiracy to push prices even higher. When Oscar Wilde described the cynic as "one who knows the price of everything and the value of nothing," he could, alas, as easily have been describing most professional security analysts. In the present era, all too few investment managers buy and hold for the long-term; for all too many, the game is all about acting on the changing valuations that "Mr. Market" offers each day.

## The Wisdom of Benjamin Graham

Benjamin Graham, as usual, expressed the eternal truth:

> "Common stocks have an important investment characteristic and an important speculative characteristic. Their investment value and average market price tend to increase irregularly but persistently over the decades, as their net worth builds up through the reinvestment of undistributed earnings. However, most of the time common stocks are subject to irrational price fluctuations in both directions, as a consequence of the ingrained tendency of most people to speculate or gamble—i.e., to give way to hope, fear, and greed.
>
> "There is no truth more fundamental in investment than the simple statement that dividends and market value are the only concrete returns which a public stockholder ever gets for the money he puts into a company. Earnings, financial strength, increased asset values—all these may be of vital importance to him, but only because they will immediately or ultimately affect his dividend and his market price."

Graham would have been dismayed to observe the decline in influence of his philosophy of focusing on long-term investing and corporate value and the rise in the attention given to corporate stock prices and their sensitivity to changes in quarterly earnings. So is his student and protégé Warren Buffett, among the most pristine of corporate managers. As an investor, he is attuned, not to the vote of the short-term, but to the weight of the long-term. He describes his favorite holding period as "forever." With long-term returns that have exceeded by a wide margin the returns achieved by even the most successful

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[3] Over the past decade, the low-turnover quartile of funds in each objective category outpaced the high-turnover quartile by an average of 2.25 percentage points per year, a 27 percent increase in relative return.

other major investment organizations, his results speak for themselves. What is more, his philosophy as a money manager is in lockstep with his philosophy as a corporate manager.

Mr. Buffett's firm is publicly-held, and he regularly hammers home to his shareholders the message that he "prefers Berkshire stock to trade at or around its intrinsic value—neither materially higher nor lower." He explains that, "intrinsic value is the discounted value of the cash that can be taken out of the business during its remaining life. When the stock temporarily over-performs or under-performs the business, a limited number of shareholders—either sellers or buyers—receive out-sized benefits at the expense of those they trade with. *(But) over time, the aggregate gains made by Berkshire shareholders must of necessity match the business gains of the company."*

What a refreshing perspective, all the more important because it's true. And the sooner that corporate directors push their managements to focus less on momentary stock prices and more on the business gains and long-term strategies that build corporate intrinsic value, the better it will be, not only for our markets, but for our investors and our society. For as Lord Keynes warned us, "when enterprise becomes a mere bubble on a whirlpool of speculation, the job of capitalism is likely to be ill-done."

## Conclusion - Will the Sleeping Giant Awaken?

Let me conclude by crystallizing the three board agenda items I've just described: 1) grossly excessive pension return assumptions and earnings management; 2) extraordinary executive compensation—largely through improperly structured stock options—based on peers rather than performance; and 3) focus on stock prices rather than corporate values. In a broader context, each is a reflection of what has been called a "pathological mutation" in capitalism, in which traditional *owners*' capitalism—with corporations run in the interest of those who invest their capital, assume the risks, and demand the rewards of ownership—has turned into *managers'* capitalism—with corporations increasingly operated in the interests of management. (The worst form of managers' capitalism, it turns out, is in the mutual fund field, where fund management companies hold virtually total dominion over the interests of almost 100 million fund shareowners. But that's a story for another day.)

What is paradoxical is that this development has occurred despite the emergence of a power block of owners, the proverbial 800-pound gorilla who has the power to sit wherever he wants, whenever he wants, at the board table of corporate America. I refer, of course, to the institutionalization of investment America, in which the largest 100 mutual funds and pension managers alone hold 52 percent of all the shares of stock in the U.S. If you are a director of virtually any of our, say, 5000 largest corporations, more than half of your shares are likely to be held by these giant institutions.

In fact, the institutional ownership figure rises to something like 65 percent if we include *all* managers of private and public pension funds, mutual funds, the Federal Thrift Savings Plan, endowment funds of college and other non-profit organizations, trust companies and so on. Hard as it is to imagine, a half-century ago, this institutional community barely existed. (Then mutual funds owned less than one percent of all stocks; today funds own nearly 25 percent.) Yet, the institutional gorilla—call him King Kong, if you will—has been conspicuous not by his presence in, but by his absence from, the corporate governance scene, not by his voice but by his silence.

How many corporations represented here today—how many corporate secretaries, or senior officers, or attorneys, or directors—have heard anything from any of these institutions? I don't know the answers, but I do have some impressions that suggest that these owners are passive. For as far as I know:

- No large shareholder has made a single proposal in a corporate proxy statement that was opposed by management.

- No large shareholder that has commented in Congress at the hearings for the Sarbanes Oxley bill.
- No large shareholder has demanded that the S.E.C. grant even more substantial access to the proxy process than the extremely limited access presently proposed to permit institutions to nominate corporate directors.
- No large shareholder has urged the Financial Standards Accounting Board to get on with the job of requiring stock options to be expensed.
- No senior executive of a major financial institution who has spoken out on the subject of the rights and responsibilities of shareholders.
- And finally, you directors can tell me how many investors have expressed concerns to you or your managements about the issues of stock options, pension returns assumptions, and focus on intrinsic value that I've just discussed.

Imagine that! The evidence is compelling that institutional shareholders—who, one would think, would be in, well, the vanguard of owners' capitalism—simply don't have much interest in the governance and management of the corporations they collectively control. And it is the lassitude of these owners that has permitted managers' capitalism to sit in the saddle and ride corporate America. As it has been said, "when we have strong managers, weak directors, and passive owners, don't be surprised when the looting begins."

Of course corporate directors are hardly blameless in this scandal. Too many directors have, I think, been placed in positions of awesome power and responsibility without fully recognizing that their *fiduciary* duty—one could even argue their *sole* duty—is to act as faithful stewards of the corporation's assets in the service of its owners. Yet the word "stewardship" and the concept of stewardship have been conspicuous by their absence from the governance scene.

In the recent era, lots of our traditional gatekeepers failed to honor their responsibilities—auditors, attorneys, investment bankers, professional money managers, regulators, even our legislators let us down—but corporate directors, given their specific task to "manage the affairs of the corporation" as so many corporate charters say, must bear the final responsibility for the financial overreaching of the recent era.

But, wait a minute. Why should *that* be? Directors don't even *have* the final responsibility to protect the interest of the owners. The final responsibility lies with the owners themselves. And if the owner of American business don't give a damn about the affairs of the companies they own, who on earth *should*? Nonetheless, my bet is that owners—especially institutional owners—will finally stand up and be counted, gradually gaining both the opportunity and the motive to assure that corporations are run in their interests and in the interests of those that they represent.

I am not unaware, of course, that in this age of short-term investing and speculation, most of today's institutional holders of stocks comprise a rent-a-stock industry, rather than an own-a-stock industry, and have ignored, even derogated, their ownership rights. They may be stock *holders*, but with their high portfolio turnover (100 percent or more) and their short holding periods (one year or less) they are not stock *owners* in the traditional sense. I predict that will change, as these institutions finally come to recognize—or are forced, by law, or by moral suasion, or by public demand, to recognize—their fiduciary duty to the pension beneficiaries and mutual fund shareholders whom they are duty-bound to serve. When they do, and this powerful sleeping giant I've described as King Kong awakens, he will properly demand that the corporations he controls respond to his ownership interests.

As James Madison reminded us, "if men were angels, government would not be necessary." And I remind you all that "if CEOs were angels, corporate governance would not be necessary." But of course it *is* necessary, and directors have a major role to play. The corporate structure is, like our nation, a republic in which voters elect their representatives through a democratic process. Quoting Warren Buffett, there's just one rule for these representatives to observe: "Directors should behave as if there was a single absentee owner, whose long-term interest they should try to further in all proper ways." The board that fails to place that rule at the top of its agenda is making a big mistake. Those who do not accept the ultimate triumph of corporate democracy, however remote it may seem today, will be on the wrong side of history.

Note: The opinions expressed in this speech do not necessarily represent the views of Vanguard's present management.
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