

It's High Time We Return Capitalism to its Owners

Keynote Speech

John C. Bogle, Founder & Former CEO

The Vanguard Group

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Only a week ago, that consistently passionate voice of the free enterprise system, the editorial page of *The Wall Street Journal*, hit the proverbial nail on the head: “The constant tension at the heart of corporate life: ensuring that the managers serve the shareholders and not themselves.” During the recent era, that constant tension has, far too often, been resolved in favor of the managers, the diametrical opposite of the cause that the *Journal* champions. It is high time that we return capitalism to its owners. Yes, corporate governance is indeed “the new reality.”

The evidence of how far we have departed from Owners Capitalism is pervasive. One corporate scandal has followed another, and the egregious behavior of some of the imperial chief executives whom we so recently lionized provides additional eloquent evidence of the departure. But we should not allow these horrible examples to blind us to the fact that there is a lot of rot in the system itself: An erosion in financial standards; misleading earnings statements; public accountants in cahoots with the companies they audit; mergers without apparent business merit; CEO compensation ratcheted up, year after year, without commensurate business achievement; a focus on short-term *perception*—the momentary but precise price of the stock—rather than long-term *reality*—the enduring but often intangible intrinsic value of the corporation. In all, Managers Capitalism took over the driver’s seat, shoving Owners Capitalism into the back seat.

And the owners didn’t even seem to notice until it was too late. Then, institutional investors were quick to blame corporate directors for their failure to check the self-serving behaviors of CEOs. But these giant shareholders—the 100 largest own 56% of all U.S. publicly-held common stocks—have a lot to answer for themselves. Without the passivity of these institutions in their capacity as owners—or as agents for their own principals, the owners they are supposed to represent—this pathological mutation in capitalism could never have transpired.

Most of these institutional owners manage both pension funds *and* mutual funds. And mutual fund governance is even more flawed than corporate governance. Despite the obvious conflicts of interest involved, fund managers control the entire operating mechanism of the funds that contract for their services. It’s hardly absurd to argue, as I in fact did in a speech in this city six years ago, that our industry’s forbearance in challenging *corporate* governance reflects a fear that *our own* far weaker governance structure might be challenged, an echo of the aphorism that, “people who live in glass houses shouldn’t throw stones.”

For example, while the compensation of U.S. chief executives—which last year averaged something like \$7½ million annually, or 200 times the earnings of the average worker—is stunning, how about paying \$257 million per year to the *management company* (other fees go to the distributor and the administrator) of a money market fund, a fund that inevitably underperformed its peers by the precise

amount of its excess fees? How about paying some \$3.6 *billion*(!) over the past decade to the management of an equity mutual fund that was promoted heavily, and grew so large as to become a closet index fund, but in fact fell short of the Standard & Poor's Index by more than *twice* the costs it incurred? Surely nowhere has the triumph of Managers Capitalism been more obvious than in the money management field, where substantial waste of corporate assets is taking place right before our eyes.

While the governance models of both corporate America *and* mutual fund America have the same flaw, however, the remedies to deal with the fundamental causes of the systemic failures we have observed in both areas are quite different. If that handful of giant institutional owners merely acts to bring corporate America back to its roots, it will happen, and happen relatively quickly. But, with concentration of ownership power so widely diffused among mutual fund owners, legislative change will be required to force the development of a new mutual fund structure which will assure that the *Journal's* standard is met: "the managers serve their shareholders and not themselves."

Corporate America and Democracy

Given the constraints of time, I'll address my remarks this morning largely to the subject of returning corporate America to its owners. Since so few owners hold such great power, all that is required is that they assert their obvious authority. The corporation is the property of its owners, and it is utterly logical that they should be put in a position to have their ownership interests honored. Put another way, I urge a return to corporate democracy.

Not everyone agrees! Logical or not, the reverse has been authoritatively argued. No lesser a light than top securities attorney Martin Lipton argues that enhancing shareholder ownership rights to nominate directors and to make proxy proposals could "disrupt the proper functioning of the board and limit the ability of the directors to fulfill their fiduciary duties." And in an op-ed essay in *The Wall Street Journal*, Henry G. Manne, dean emeritus of the George Mason University School of Law, argues that "the theory of corporate democracy . . . has long been a standing joke among sophisticated finance economists." (He names no names.) "A corporation is not a small republic . . . and the board is not a legislature . . . a vote attached to a share is totally different from a political vote . . . the essence of individual shareholder participation is 'exit,' not 'voice' . . . and they can exit their corporate 'citizenship' for the cost of a stockbroker's commission." In other words, if you don't like the way your company is being run, just get out—sell to the first bidder, whether or not the price reflects the corporation's intrinsic value. "Like it or lump it," however, doesn't seem a particularly enlightened approach to public policy.

Dean Manne's objections seem to assume that all of those who are interested in embracing ownership rights are "special pleaders with no real stake, activists (whose) primary interest . . . is to facilitate publicity for their own special-interest programs . . . and to interfere with the property and contractual rights of others in order to achieve their own ends," describing corporate democracy as a "form of corporate fraud." Though I'm confident that at least some corporate activists have agendas that might not comport with the public weal, I confess that I don't know quite what to make of such a diatribe.

But I know that I have no such agenda. I hold only this simple conviction: *Owners should be allowed to behave as owners.* If ownership rights are not placed front and center, where should they be placed? Who would *dare* to suggest that barriers should be placed in the way of the right of shareholders to elect as a director anyone they wish to serve as their agent? That owners cannot compel management to be responsive to their demands? That owners must relinquish their right to determine the compensation that executives receive from their company? Aren't these among the essential rights of ownership?

Clearly, they are the rights of the 100% owner, who brooks no interference with his will. And any manager who flatly refused to consider the views of a 50% owner, or even a 20% owner, would soon

be looking for another line of work. What about a dozen institutions, each holding a 3% interest and sharing a particular viewpoint, or wishing to nominate a director? Where does the proverbial shovel break? And does the argument that it *might* break when no single shareholder owns more than, say, 0.10% of the shares justify depriving these shareholders of the same rights? *Not for me it doesn't*. For I believe, after Churchill, that corporate democracy “is the worst form of government . . . except for all those others that have been tried from time to time.” (Including, I hasten to add, those that have been tried in the recent era.)

The legendary Benjamin Graham long ago put his finger on the problem. In the early editions of *The Intelligent Investor*, he had some important things to say about stockholder-management relationships. In “legal rights and machinery, the stockholders as a class are king . . . they can hire and fire managements and bend them completely to their will.” He was—and he *is*—right. But he was—and he *is*—right when he added that “the assertion of rights by stockholders in practice is almost a complete washout. Unless prodded violently into action, they show neither intelligence nor alertness. They vote in sheep-like fashion for whatever management recommends, no matter how poor the record of accomplishment may be . . . This attitude of the financial world toward good and bad management is utterly childish . . . The leading investment funds could contribute mightily to the improvement of corporate managements . . . but have shied away . . . missing a great opportunity for rendering service to the investing public.” And so it remains today.

But it wasn't always so. Way back in 1949, *Fortune* suggested that, “the mutual fund is the ideal champion of . . . the small stockholder in conversations with corporate management, needling corporations on dividend policies, blocking mergers, and pitching in on proxy fights.” And in my 1951 Princeton University thesis that examined the economic role of mutual funds, I devoted a full chapter to their role “as an influence on corporate management,” noting with approval the SEC's 1940 call on mutual funds to serve as “the useful role of representatives of the great number of inarticulate and ineffective individual investors in corporations in which funds are interested.”

Fixing the System

What we need to fulfill that promise of responsible corporate citizenship—shareholder democracy, if you will—does not require radical change in the existing institutional *structure*. But we must seek to muster the courage to address the two principal issues involved in what has come to be called “shareholder access” to the ballot—the company's proxy statement. The first issue is the ability of owners to mount electoral challenges to independent directors.¹ As the Supreme Court of Delaware noted in its 1984 *Unocal* decision, “If the stockholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out.” In a later case (*Blasius Industries*, 1988), Chancellor Allen added, “the shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.”

Yet the cards in the deck of the proxy process are heavily stacked against the ability of owners to exercise their franchise. When the CEO controls the slate—and even when there is a theoretically-independent nominating committee—challenges to management-nominated directors have been rare. Among the thousands of publicly-traded firms, there were an average of just eleven challenges per year during 1996-2002. And only one(!) per year for companies with a market capitalization exceeding a mere \$200 million. In Harvard Professor Lucian Bebchuk's words, “the incidence (of challenges to incumbent directors) is practically zero.”

¹ My ideas have been importantly informed by the fine analysis prepared by Lucian Bebchuk, Professor of Law at Harvard University School of Law, in “The Case for Shareholder Access to the Ballot,” *The Business Lawyer*, Volume 15 (2003).

Corporate managers, not surprisingly, strongly object to changing the system to facilitate challenges to their slate. The Business Roundtable warns that shareholder participation in the nominating process “has the potential to turn every director election into a divisive proxy contest,” involving heavy cost and the diversion of management effort. But even if that could happen, there is no reason that a well-designed access proposal couldn’t resolve most of the difficulties. Managers also argue that potential directors would be deterred from serving, but that seems a specious, even self-serving, reason for allowing those at the top of the business pyramid to have complete protection from challenge and possible removal from office.

The entrenched business interests also allege that even limited access to the slate would open the door to “special interest” directors, less-well qualified directors, and dysfunctional boards. But these developments could only occur with the consent of the owners, and there is no reason to assume that a majority of owners would vote for unqualified or irresponsible directors. While a board constantly engaged in civil war would hardly serve the owners’ interests, however, it is not at all clear that those interests aren’t equally ill-served when harmony is so embedded that no dissent can be brooked. Surely we can all think of individual cases in which shareholders have paid a high price for collegiality so deep-seated that it stifles dissent.

What is more, *all* directors, no matter how nominated, have a fiduciary duty to act solely in the interests of the shareholders of the corporation. It’s up to the owners, not the managers, to weigh the pros and cons of the issues surrounding electoral challenges and board composition and, by exercising their franchise, decide them. It’s called corporate democracy.

Beyond the Board Slate

The second issue regarding shareholder access to the corporate ballot is the ability of owners to make proposals regarding corporate activities. In an earlier era, the Securities and Exchange Commission allowed most such shareholder proposals to be excluded from the proxy because they were related to the “ordinary business” of the corporation. In recent years, however, proposals to limit excessive compensation have often been ruled not subject to the “ordinary business exclusion,” and have been included in proxies. It is high time that owners began to demand that executive compensation be related to the *real* business achievements of executives in *building long-term corporate value*.

The short-term price of a stock, as we must have learned by now, is an absurd basis for compensation. We ought to be demanding such benchmarks as a company’s five-year return on total capital relative to peers and to American industry in total, and growth in cash flow. How *much* extra return on capital, or how *much* cash flow growth should be required for the CEO to earn box-car bonuses, I do not know. But I wonder how many companies would dare to follow the threshold set by General Electric for the compensation of CEO Jeffrey Immelt: 10% cash flow growth each year for five consecutive years. That strikes me as a shareholder-friendly approach!

And that only begins the list of where owners should get involved. No, I don’t think our giant institutions have the talent and ability to manage the businesses they effectively own. But they ought to demand the right to approve large mergers and acquisitions, and the right to eliminate anti-takeover provisions, staggered boards, and poison pills, and the right to say grace over dividend policy, indeed the right to submit to a vote of shareholders *any* proposal that is designed to assure that a company is managed in the interests of its shareowners.

Changing the System

These changes will require SEC initiatives, and I confess to being disappointed in the Commission's recent proposals to give shareholder access to nominating directors. Given the pressure from The Business Roundtable, it's easy to understand the tortuous process that has been proposed: In year one, a "triggering event" with high trigger must take place—only a shareholder holding at least 1% of the company's shares could propose shareholder access, and if the proposal won a majority vote (or if there were a 35% vote to withhold support from one of the directors), then in year two shareholders who have held at least 5% of the company's stock for at least two years could nominate up to three candidates, and bear the costs of trying to persuade other owners to vote for their candidates. If a majority of shares approved, likely some years after the company first got into trouble, there would be a small change in the board.

While well-intentioned, the SEC proposal is too severe. Given that nearly all institutional investors have demonstrated far more willingness to *vote* for a reform proposed by others than to *propose* a reform on their own, a proposal for access should require only some reasonable dollar holding (say, \$25 million to \$100 million). Further, any group of institutions who hold more than, say, 10% of a company's shares for at least two years should be exempt from the limitations, able to propose new directors, or even an entire slate, in the proxy without delay, and with costs reimbursed by the company.

Opening up the director nomination process is only one of the major issues that must be resolved if we are to return capitalism to its owners. We also need new SEC rules that clarify and broaden the issues that may be raised by owners in corporate proxies without running afoul of the "ordinary business" exclusion.

No, shareholders aren't there to tell a corporation how to run its business. But they have a right to a fair process in which they can tell a corporation to do a better job. If these changes sound to you like a call for anarchy, consider that unless a majority of shares were voted in favor of the change, nothing would happen. (Indeed, even if an overwhelmingly favorable vote is obtained, companies can—and do!—ignore it, since shareholder votes are non-binding. Under state law, votes are "precatory," a word I have come to detest. Surely we need rules that return these rights to shareholders.) Doesn't the whole underpinning of our capitalistic system depend upon the notion that the will of shareholders shall be done?

But owners don't need to remain asleep at the switch until changes are at last put into place. Even today, owners can make their will felt in other, more subtle, ways too. If they're not satisfied with a company's leadership, they can withhold votes from directors who are CEOs. (In less than a week we'll see how they feel about Michael Eisner's record at Disney Company. While the company's earnings have been flat for about a decade, his aggregate compensation of nearly \$1 billion(!) represents a shocking raid on the company's treasury. To its credit, ISS is recommending that institutions withhold their votes for him.) Owners can also withhold votes for individual directors serving compensation, nominating, and audit committees if they are not measuring up to their responsibilities.

While these votes are not, in and of themselves, likely to directly result in change, if enough owners use the ballot box to express their disapproval, companies will have to pay heed. Sending a strong message will help! Owners can also use their franchise to vote against auditors who are also providing consulting services, or at least against those whose fees for consulting services constitute a disproportionate relationship to audit fees. And of course owners can, and I believe should, be more aggressive in rejecting option plans that involve cumulative dilution that is excessive. Truth told, even today, owners have untapped powers, and they ought to put them to use—now, in this 2004 proxy season.

Passivity in the Face of Power

The pervasive passivity of stock owners in pressing their own interests presents an ironic counterpoint to the astonishing concentration of voting power among a relative handful of institutional managers. The nation's 100 largest financial institutions hold 56% of all shares of U.S. corporations. Overwhelmingly (77 of the 87 private firms), these giant institutions are managers of *both* mutual funds and pension funds, responsible for \$5.4 trillion of the \$5.5 trillion private (non-state) total invested in stocks. We can examine the behavior of these investment managers to get some sense of why this passivity exists.

One major reason is the short-term investment horizons that have, over the past several decades, come to characterize the field of money management. While corporate governance issues would seem to call for vital concern by the long-term investor, it is not much of an issue for the short-term speculator. So as mutual fund turnover leaped from a remarkably stable 15% annual rate during the 1950s and early 1960s to 100% (or more) since the late 1990s, interest in governance faded accordingly. If a six-year holding period for the average common stock in a fund portfolio once marked mutual funds as an *own-a-stock* industry, surely the one-year holding period of today marks us as a *rent-a-stock* industry. Given the hyper-short-term trading activity that now characterizes institutional investing, the forbearance of portfolio managers from governance issues actually reflects a perverse common sense. Why spend money on evaluating a company's governance when you likely won't even be holding your shares when the next proxy season rolls around?

But there's more than short-termism that accounts for the absence of funds from the governance scene. Consider that index funds—and other funds that follow essentially static buy-and-hold strategies—comprise some 25% of the assets of the Institutional 100. Yet the voices of these consummate long-term investors have been, if not totally silent, at least seriously muted. And even active managers engaging in what passes for low turnover in the current environment (say, below 35%) have generally refrained from intrusion into the affairs of the corporations in which they invest. One obvious reason for this passivity is the desire to avoid controversy. In the asset-gathering business that money management has become, a high profile on a divisive issue is more liability than asset.

Another reason for such forbearance is conflict of interest. While such conflicts are regularly denied, it is easy to imagine that private institutional managers would be reluctant to vote against the entrenched corporate managements that have hired them to manage most of the more-than-\$2 trillion of equities in their pension plans and 401-k thrift plans.

But that's only the beginning of the problem. While the votes of the mutual funds in a company's thrift plan presumably must be voted as a whole, the corporation itself could direct its pension managers to vote the shares of the corporations held in its pension plan in any way it wished. But it doesn't take a lot of imagination to realize that corporations, too, are unlikely candidates for aggressively voting the shares their pension plans hold in other corporations. Why be known as a trouble-maker among your Business Council colleagues? So, whether tacit or explicit, a system has emerged in which "let he who is without sin cast the first stone" has become the watchword of behavior for corporations that control trillions of dollars worth of shares of other corporations—a sort of American *Keiretsu*.

Further, of course, passivity in governance pays. Let others undertake the hard work and costs of activism. If their efforts are successful, the passive-ists—holding, say, the remaining 95% to 99% of shares, will not only reap the rewards, but increase their chances of getting the pension and thrift business of the activists. Thus, the decision to remain silent becomes what is called—I don't much care for the expression—a "win-win" decision.

So it is that most corporate activism has been left to TIAA-CREF and to the state and local government pension funds. There are 13 such funds in the Institutional 100, directly managing in-house some \$220 billion of equities. (Labor unions are also active in promoting reform, but even in the aggregate, their assets are relatively small). These owners can play a far larger role than their size would indicate. For while mutual funds and pension funds have rarely *initiated* reform proposals, they have on at least some occasions been willing to *support* proposals initiated by others. If the activists succeed in getting well-articulated proposals with demonstrable benefits into corporate proxies, support from otherwise passive private institutional managers could easily follow.

Mutual Funds as Proxy Voters

A new development may well inspire mutual funds to join those investors to become more conscious of their responsibilities of corporate citizenship, and to take their voting responsibilities more seriously. Early in 2003, the Securities & Exchange Commission approved a requirement that funds (the “agents”) report to their owners (the “principals”) how *their* (the owners’) shares were voted in corporate proxies. While such disclosure would seem totally logical, the fund industry brought out its biggest guns to battle the proposal, and even long-time rivals Fidelity and Vanguard joined together in expressing their opposition in a *Wall Street Journal* op-ed piece signed by their chairmen. (“Politics makes strange bedfellows.”) Despite the opposition, the SEC stood its ground, and in August we’ll learn how each mutual fund voted each of its corporate proxies during the 2004 season. It’s about time, and it *will* matter.

For I believe that the requirement to disclose proxy votes will begin the process of giving mutual funds the *motivation* to become better corporate citizens. For example, The Vanguard Group, which has traditionally regarded regular voting of proxies as a fiduciary duty, adopted more aggressive proxy voting guidelines in 2003. While the funds had previously endorsed 90% of director slates, last year they ratified all directors in only 29% of the slates, withholding votes from at least one nominee in a stunning 71% of the cases. The Vanguard funds also voted against auditors at 21% of the firms, and against 64% of stock option plans. I believe that active voting policies by mutual funds will become more evident with each passing year. Once owners become used to acting like owners, once corporate citizens understand their rights and responsibilities in a democracy, once institutions begin to cooperate with their peers for the common good, we can at last begin the process of replacing Managers Capitalism with Owners Capitalism.

Some Mind-Expanding Wisdom

But there is more that needs to be done. And some important ideas about radical reform have been put forth by Robert A.G. Monks. Few individuals have been as deeply involved in corporate governance issues—and even fewer have played as constructive a leadership role—as Mr. Monks, founder of ISS as well as the corporate activist firms Lens, Inc., and Lens Governance Advisors. His fact-filled 564-page tome *Corporate Governance* (with Nell Minow) is a must-read for those who seek to understand what went wrong in corporate America and what needs to be done. More recently, in *Capitalism Without Owners Will Fail—A Policy Maker’s Guide to Reform* (with Allan Sykes)², he sets forth a framework for fixing the system. His wisdom is worth considering.

“Government involvement is clearly needed in corporate governance to guarantee the nation’s citizens the neglected rights of ownership of their stocks. What is needed is a clear and consistently enforced public policy that gives all owners’ representatives, the intermediary investment institutions and their fund managers, the clear fiduciary requirement to be active with

² Available at www.ragm.com/library/topics/ragm_sykesPolicyMakersGuide.html

respect to companies held in their portfolio accounts, and the confidence that they will not be placed at a competitive or reputational disadvantage with their competitors by complying. Above all else, it must be unmistakable that government intends, and is capable of enforcing, the trustee and fiduciary laws for the *sole* purpose and *exclusive* benefit of their beneficiaries' interests—the great part of the funded pensions of most citizens—in an even-handed way.

- “1. In support of the fundamental principle that there should be no power without accountability, government should affirm that creating an effective shareholder presence in all companies is in the national interest and that it is the nation's policy to aid effective shareholder involvement in the governance of publicly owned corporations.
- “2. All pension fund trustees, mutual funds and other fiduciaries must act solely in the long-term interests of their beneficiaries and for the exclusive purpose of providing them with benefits, in order to ensure the functioning of an appropriate board of directors.
- “3. To give full effect to the first two proposals institutional shareholders should be made accountable for exercising their votes in an informed and sensible manner. Votes are an asset which should be used to further beneficiaries' interests on all occasions, and their voting should be virtually compulsory.
- “4. To complete and powerfully reinforce the other three proposals, such shareholders should have the exclusive right and obligation to *nominate at least three* non-executive directors in each company (held in their portfolios).”

Wrapping Up

The title of Mr. Monk's monograph—*Capitalism Without Owners Will Fail*—is not an overstatement. Corporate America can only be an engine of the nation's growth and prosperity and a major source of innovation and experiment if its *managers* are focused on creating long-term value for its *owners*. To the extent that managers sit unchecked in the driver's seat, furthering their own interests at the expense of their owners, capitalism cannot flourish. Since no one—*no one!*—looks after assets as well as their owners, we must return them to their former preeminence.

But even after needed system-wide reforms are put into place, the need to create an ownership ethic will remain. Changing the focus of management compensation from short-term stock prices to long-term corporate value will be a large plus. We might also consider a substantial tax, for taxable and tax-exempt investors alike, on capital gains realized in extremely short periods. We should consider paying a higher dividend to investors who hold their shares for longer periods—say, for more than three years. To move away from the focus on short-term fund performance, we should press for investment advisory contracts that, subject to safeguards, last for five years, with premiums for returns that exceed the market standard and penalties for returns that fall short. And the cause of owners capitalism would also be importantly furthered if we all took just a few moments to educate the man-on-the-street about the folly of short-term speculation and the wisdom of long-term investing.

And we need to plant the seeds of cooperation among long-term investors. Index mutual funds, indexed pension accounts, and index-like investment pools operated under quantitative strategies would form the initial core. (Two of the three largest institutional equity managers and three of the largest six are primarily indexers.) And there are other notable long-term active managers (for example, Capital Group, Wellington, Dodge and Cox) that would be prime candidates for subsequent membership. For too many years, I've called for such a “Federation of Long-Term Investors” to discuss issues of corporate governance and corporate citizenship. But it is only a matter of time until the idea gains traction. One

way or another, institutional investors that own *companies*, as distinct from those that trade *stocks*, must cooperate to make their will felt for the common good.

The Economist of London expressed a similar sentiment as it described “the ideal owner”—a long-term stockholder, perhaps even a permanent owner, whose goals are closely aligned with the corporation . . . “Everything now depends on financial institutions pressing even harder for reforms to make boards of directors behave more like overseers, and less like the chief executive’s collection of puppets . . . Financial institutions must also fight to restore their rights as shareholders and use their clout to elect directors, who would be obliged to represent only their collective interest as owners. Chief executives would still run their firms; but, like any other employee, they would also have a boss.”

The task of returning capitalism to its owners will take time, true. But if the will is there, the way will be there as well. For “the New Reality”—increasingly visible with each passing day—is that proper corporate governance is not merely an ideal nor a luxury, but a vital necessity. The role of the owners, I underscore, is to do no more than assure that the interests of directors and management are aligned with those of the shareholders. And when there is a conflict of interest, it is the shareholders who should make the decision. It is in the national public interest and in the interest of investors that the owners begin to realize that enlightened corporate governance is not merely a right of business ownership. It is a responsibility to the nation.

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