Owners Capitalism vs. Managers Capitalism

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I'm honored to be with you today to discuss the profound issues regarding corporate governance in our nation today, and to offer some thoughts on the role that Investor Relations professionals might play in their resolution. In the year and one-half since Enron blew up in our faces—doesn't it seem like an eternity ago?—a score or more of large, once-reputable companies have been scandalized, the "Big Five" accounting firms have shrunk to the "Final Four," Wall Street's reputation has withered—and deservedly so—as much as its research turned out to be sales promotion for investment banking clients, and rarely has a week gone by without some new disclosure of wrongdoing in corporate America.

It's not yet clear how much of these distasteful goings-on represent criminal behavior. And we have often been reminded that there have been, so far, few convictions and almost no jail sentences. But when that's the best defense is the best that capitalism can offer to justify its status, Adam Smith must be turning over in his grave.

How often have you heard that the problems of American capitalism are confined to just "a few bad apples"? In the context of our tens of thousands of corporate executives and Wall Street leaders, of course that's true. But the fact of the matter is that something has gone profoundly wrong with the very system that we have come to know as American capitalism. To maintain the earlier metaphor, the very *barrel* that holds all of those apples, good and bad alike, has itself developed some major cracks, and is in need of major repair.

All of us involved in investor relations have our work cut out for us. I use "us" deliberately, for that's one of the roles I have played from the time I answered my first letter from an (appropriately!) irate shareholder shortly after I founded Vanguard in September 1974, right up to yesterday afternoon, when a shareholder on my flight down here from Philadelphia asked me why, in view of my reputation for thrift, I was flying in the first-class section. (The answer, I told her, was that I got a free step-up with my frequent flyer miles. But she didn't seem satisfied. I think, truth told, that she shouldn't have been!)

The root causes of the disease in our system are deep, and the remedies that are required to cure it will not be easy to come by. For what we have witnessed in the failure of corporate governance in America has been, as journalist William Pfaff described it, "a pathological mutation in capitalism." He was right on the mark. The classic system—*owners* capitalism—had been based on a dedication to serving the interests of the corporation's owners, 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," in Mr. Pfaff's words, "the markets had so diffused corporate ownership *that no responsible owner exists*. This is morally unacceptable, but also a corruption of capitalism itself."

That transmogrification—that *grotesque transformation*—of a system of owners capitalism into a system of managers capitalism required only two ingredients: (1) the diffusion of corporate ownership among a large number of investors, none holding a controlling share of the voting power; and (2) the unwillingness of the *agents* of the owners—the boards of directors—to honor their responsibility to serve, above all else, the interests of their *principals*—the shareowners themselves.

When most owners either don't or won't or can't stand up for their rights, and when directors lose sight of whom they represent, the resulting power vacuum quickly gets filled by corporate managers, living proof that Spinoza was right when he told us, "nature abhors a vacuum." Put more harshly, in a quote that I came across last month, "when we have strong managers, weak directors, co-opted accountants, and passive owners, don't be surprised when the looting begins."

Of course the actual *looting* we know about has been small. But when we consider the staggering levels of compensation which we pay our chief executives—the average CEO's compensation has risen from 42 times that of the average worker in 1980 to 121 times in 1988, and to an astonishing 531 times in 2000 (now it's "only" about 411 times)—it's certainly fair to say that there has been an extraordinary increase in the portion of corporate earnings that corporate managers have arrogated to themselves.

Consider the facts: From 1988 to 2001, while the annual compensation of the average worker rose 60%—from $16,700 to $26,800—the compensation of the average CEO rose 443%, from $2,025,000 to $11,000,000. It would be one thing if this quantum increase in executive compensation was justified by corporate achievement. But that's simply not the case. From 1988 to 2001, executives promised investors growth in *operating* earnings that averaged 12%, but delivered only 3.5%—less than the 5.5% annual growth in our nation's GDP for that period. And even that humble record greatly overrates the accomplishment of our corporate leaders. *Reported* earnings—earnings reduced by write-downs of bad corporate investments—averaged $24.70 for the companies in the Standard & Poor's 500 Stock Index in 2001, barely above reported earnings of $23.75 in 1988. It's difficult to see any evidence of extraordinary accomplishment in these figures.

Much of the compensation increase has been fueled by executive stock options—described by compensation consultants as "free" simply because (unbelievably!) they do not appear as a cost in the company's profit and loss statement. Options are almost universally described as "linking the interests of management to the interests of shareholders." *But the fact is that there is no such linkage.* Rather than holding onto their shares, executives typically sell them at the earliest moment the options can be exercised, too often leaving their shareholders holding the bag.

Who's Responsible?

Despite the overwhelming reality of the performance of business executives, corporate directors rewarded them handsomely anyway, so surely directors must bear a heavy share of the responsibility for the problems that corporate America has created for its owners. Too many corporate directors failed to consider that their overriding responsibility was to represent, not management, but the largely faceless, voiceless shareholders who elected them—failed, if you will, to honor the director's golden rule: "Behave as if the corporation you serve had a single absentee owner, and do your best to further his long-term interests in all proper ways." Those words, indeed, were the words used by Warren Buffett in his Berkshire Hathaway Annual Report in 1993, a full decade ago. As a group, alas, our corporate directors have failed to measure up to that standard.

Two centuries ago, James Madison said, "if men were angels, we wouldn't need government." Today, I would echo that idea: *If chief executives were angels, we wouldn't need corporate governance.* Extending this analogy of political systems to corporate systems when I recently spoke to the Business Council, I said that we should avoid corporate governance based on the *dictatorship* of the CEO. While *democracy* might not be possible, I suggested, at least we should establish a *republic*, with the elected representatives of the shareholders fully empowered to assure that the corporation held high the interests of the shareholder, above all competing claims. (The assembled group of CEOs, by and large, didn't seem to care for the analogy, and there was a rather heated response from the floor.)

There is powerful evidence that directors failed to do just that. The result: a raft of misleading corporate financial statements and the grotesquely excessive executive compensation that helped create the stock market bubble and—bubbles being bubbles—its subsequent burst. Yet the directors of corporate America couldn't have been unaware of the management's aggressive "earnings guidance." Nor that management's focus was on raising the *price* of the *stock*, never mind at what cost to the *value* of the *corporation*. Nor that dividends were lowered in order to provide more capital for unwise expansion. Nor that the estimated future returns of 9% to 10% or more on the company's pension fund were, simply put, "pie in the sky."

Nor could directors possibly have been unaware 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 for so-so accomplishments—or worse—in building the business. Nor that shares acquired by executives through stock options were sold as soon as they vested. Nor that the company's accounting firm was receiving consulting fees many times the amount of its auditing fees, substantially vitiating both its independence and its integrity. And all those director "nor that's" describe only the *major* aberrations in the barrel of capitalism. Surely it is fair to say that it is our corporate directors who should bear the ultimate responsibility for what went wrong with capitalism in corporate America.

Oh, No They Shouldn't!

Or should they? Think about it for a moment. *Why* should the board bear the ultimate responsibility when it doesn't even *have* the ultimate responsibility? It is the stockholders themselves—surely this audience, above all, knows *that*!—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 the gorilla doesn't even come to the meetings. With all that power has come little interest in corporate governance. There is an amazing disconnection between the potential and the reality—awesome power, but rarely exercised. Yet institutional managers could hardly have been ignorant of what was going on in corporate America. As the stock market bubble inflated, the mutual fund industry's well-educated, highly-trained, experienced professional analysts and portfolio managers seemed blissfully unaware of what was going on in the financial statements of the companies into which their funds were pouring literally hundreds of billions of dollars. Somehow our professional investors either didn't understand, or understood but ignored—I'm not sure which is worse!—the house of cards that the stock market had become.

Astonishingly, even after the bear market that has devastated the value of the equity holdings of fund shareholders, the only response we've heard from the mutual fund industry is the sound of silence. Why? Because the overwhelming majority of mutual funds continues 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. Yet focusing on the price of a stock—*perception*—rather than on the value of a corporation—*reality*—can hardly be a winning strategy over the long run. 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 the typical fund manager.

The Mutual Fund Barrel

Clearly, if we are to return to a system of owners capitalism, the active participation of institutional investors is essential and the mutual fund industry must be involved. That will not be easy, for the deeply-flawed *mutual fund* governance barrel makes the *corporate* governance barrel seem pristine. Think about it:

Fund independent directors in actuality have only two important responsibilities: Obtaining the best possible investment manager and negotiating with that manager for the lowest possible fee. Yet their record has been absolutely pathetic. They follow a zombie-like process that makes a mockery of stewardship. Able but greedy managers have overreached and tried to dip too deeply into the shareholders' pockets, and directors haven't slapped their hands. They have failed as well in negotiating management fees. "Independent" directors, over more than six decades, have failed miserably. Fee reductions mean nothing to "independent" directors, while meaning everything to managers. So guess who wins?

I would not have the temerity to use such highly charged language. Those words were actually written by Warren Buffett in his recent Berkshire Hathaway annual report. Mr. Buffett is, of course, right. And I dare to add, "as usual." Of course the managers win. For the chairman of the *fund* is almost invariably the head of the *management company*. And as Mr. Buffett has observed: "negotiating with oneself seldom produces a barroom brawl."

Just as owners capitalism has turned to managers capitalism in *corporate* America, so has owners capitalism turned to managers capitalism in *mutual fund* America. Despite the clear language of the Investment Company Act stating that funds must be *organized*, *operated*, and *managed* in the interests of their shareholders rather than the interests of their investment advisers, mutual funds are in fact operated in the interests of their managers. *But it wasn't always that way*.

True owners capitalism has never been possible in this industry, whose millions of owners are largely individual investors of relatively modest means. But from the industry's inception in 1924 through the early 1960s, fund managers operated largely as prudent trustees of the assets that investors entrusted to them, and put their investors' interests *first*. The managers of yore were privately owned, relatively small professional firms whose role was focused largely on *stewardship*. In the sense, then, that fiduciaries faithfully honored the interests of the actual owners—the mutual fund shareholders—it was indeed the era of owners capitalism, if you will, by proxy. But over the years, the focus of the mutual fund industry has gradually shifted—from management to marketing, from stewardship to salesmanship, and—just as in the case of corporate America—from owners capitalism to managers capitalism.

Funds vs. Active Investors—Then and Now

One of the main victims of that change came in our industry's role in corporate governance. As those earlier privately-owned trusteeships whose managers focused on long-term investing in highly-diversified equity funds gradually metamorphosed into giant publicly-held corporations whose managers focused on short-term speculation in ever-more-aggressive specialized funds, portfolio turnover went right through the roof. Up until 1966, it was a rare year when annual turnover exceeded 16%, an average holding period of six months. But today fund managers turn their portfolios over at an astonishing average annual rate of 110%(!), an average holding period of just eleven months. We are no longer an *own*-a-stock industry. We are a *rent*-a-stock industry, a world away from Warren Buffett's favorite holding period: *Forever*.

But while a fund that *owns* stocks has little choice but to regard proper corporate governance as of surpassing long-term importance, a fund that *rents* stocks could hardly care less. The 1949 *Fortune* magazine article that led me to write my Princeton senior thesis about mutual funds, which in turn got me my first job in this business, shows how much our attitude toward corporate governance has changed. *Fortune* wrote, all those years ago, that mutual funds were "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," even as the SEC was calling on mutual funds to serve "the useful role of representatives of the great number of inarticulate and ineffective individual investors in corporations in which funds are interested." Back then the industry owned less than two percent of all stocks. Yet even though our ownership has soared to 23 percent, it was not to be.

Mutual Funds and the Governance Failure

This industry's notorious passivity on corporate governance issues means that we bear no small share of the responsibility for the ethical failures in corporate governance, the excessive executive compensation, the earnings overstatements, and the co-opting of accountants that we've seen during the recent era. But it's going to take a lot of work to bring mutual funds into a 21st century world of increased investor activism, for we face a profound conflict of interest when we come to vote the shares of the corporations whose pension and 401(k) assets we manage. In addition, our own weak governance system—where separately owned management companies essentially control their associated funds—places us in the role of people who live in glass houses: We've implicitly decided that it doesn't seem like a good idea to cast stones at the governance of corporate America.

Nowhere was that fact made more obvious than in the fund industry's almost unanimous opposition to the SEC's proposal that we disclose to our own shareholders how we vote the proxies of the companies they own via our portfolios. While it would seem utterly obvious that a fund manager (the *agent*) would be expected to report his actions to the fund owners (the *principals*), the industry fought the proposal. But in this opening skirmish in the battle to at long last return this industry to the role it must play in restoring owners capitalism in corporate America, if the industry *lost*, the shareholders *won*.

The Curious Paradox

The task of returning the mutual fund industry—and indeed institutional investing in general—to its traditional focus on long-term investing and good corporate citizenship will be no mean task. It is a curious paradox that the increasing problems created by managers capitalism in mutual funds has, by making funds reluctant to assume their responsibilities of corporate citizenship, been a major force in the rise of managers capitalism in corporate America. For as I noted at the outset of my remarks, when no responsible owner exists, capitalism itself is corrupted.

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 *is*—right. But he was—and *is*—right when he added that "the assertion of rights by stockholders in practice is almost a complete washout. They show neither intelligence nor alertness unless prodded violently into action. They vote in sheep-like fashion for whatever management recommends and no matter how poor the record of accomplishment may be . . . this attitude of the financial world toward good and bad management is utterly childish."

Yet the cause is not lost. Even after all these years, perhaps Benjamin Graham's words can awaken us, and force us to consider ways that institutional stockowners, working in concert with corporate managers, can root out the problems that plague our system. Here are four suggestions:

1. **Encourage Corporate Citizenship**. The only way investors—and particularly institutional investors—will become better owners is if we at last return to behaving as responsible corporate citizens, voting our proxies thoughtfully and communicating our views to corporate managements. The SEC's recent decision to require mutual funds to disclose how we vote our proxies is a long overdue first step in increasing our *motivation* to participate in governance matters. But we also need the *ability* to act—"access" to corporate proxy statements—so that we can place both nominations for directors and proposals for compensation policy and business conduct *directly* in the proxies. The sooner the SEC acts on this issue, the better.

2. **Clearly Separate Ownership from Management**. We need to recognize the distinction between *directing*—the responsibility of the governing body of an institution—and *managing*—the responsibility of the executives who run the business. It's called *the separation of powers*. We need an independent board chairman, *not* the CEO; we need higher standards of director independence; and we may well require outside advisors or even a small staff to provide directors with independent information that is bereft of management bias on compensation, accounting, and other matters.

3. **Return to a Long-Term Focus.** Investor relations executive can help to unite owners and managers in returning the focus of corporate information to long-term financial goals, cash flows, intrinsic values, and strategic direction. Quarterly "earnings guidance," pernicious yet still omnipresent, should be *eliminated.* So should efforts to meet financial targets through creative accounting techniques.

4. **Let Sunlight Shine on Accounting**. Given the enormous latitude accorded by "Generally Accepted Accounting Principles," owners must demand, and managers must provide, full disclosure of the impact of significant accounting policy decisions. Indeed, maybe we ought to require that corporations report earnings not only on a "most aggressive" basis, (presumably what they are reporting today), but on a "most conservative" basis as well.

Bring Back Dividends!

But there is something even more important than these four items on my agenda: *Bring back dividends*! Benjamin Graham also reminded us of something that we've long forgotten: "There is no truth more fundamental in investment than that dividends and market value are the *only* concrete returns a public stockholder ever gets on his investment. Earnings, financial strength, and increased asset values are of vital importance only because they will ultimately effect his dividend and market price." Again, he was—and *is*—right. And it is high time that owners and managers unite to bring a new focus on the issue of dividends. History tells us that higher dividend payouts are actually associated with *higher* future returns on stocks. Yet despite the absence of evidence that earnings retention leads to sound capital allocations, the payout rate has been declining for years. To state the obvious, 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 one-half the turnover of non-dividend paying stocks.)

Investing for growth, as Lord Keynes reminded us, is all about speculation on price, while investing for income is the heart of "enterprise," the word Keynes chose to describe the long-term yield on any investment. Things haven't changed much: way back in 1936, he said that "In one of the greatest investment markets in the world, namely, New York, it is rare for an American to 'invest for income,' and he will not readily purchase an investment except in the hope of capital appreciation. This is only another way of saying that he is attaching his hopes to a favorable change in the conventional basis of valuation, i.e., that he is a speculator. But the position is serious when enterprise becomes a mere bubble on a whirlpool of speculation. 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."

More reliance on dividends should mean less reliance on earnings. Lest we forget, dividends are "real," in contrast to those illusory earnings per share that are manufactured each quarter, under generally accepted accounting principles that, even if honestly administered, depend on myriad estimates of things unknown. The focus on corporate earnings above all else bears much of the responsibility for our highly leveraged balance sheets, for unwise capital commitments, for mergers done solely for financial reasons and bereft of a business rationale, and for that misbegotten financial engineering that was a triumph of form over substance. Dividends, on the other hand, remind us that "cash is king," and calls the tune for long-term returns. A return of dividends to their formerly high standing on the agenda of stockowners would do much to reduce today's high turnover and excessive speculation.

As the focal point of a two-way communication channel—from management to shareholders and security analysts, and vice versa—you Investor Relations executives have a key role to play in all of these areas. The cooperation between owners and managers that I call for today will require not only a more *active* use of this two-way channel, but a more *open* use. Long-term shareholders who engage in candid communication with management, cooperative rather than confrontational, describing what they want from their investment—including what dividends they want—will play a major role in the restoration of owners capitalism.

The Restoration of Owners' Capitalism

As James Surowiecki wrote in last week's *New Yorker*, "shareholder activism is on the rise." This year, there are not only 30% more shareholder resolutions and far higher votes in favor of them, but an unprecedented number of actual approvals. However, like our nation, the corporation is a *republic* controlled by its elected representatives, rather than a *democracy*, controlled by its citizens directly. So even approvals by shareholders are non-binding. But it's only a matter of time until investors who want to change managements or restore reasonableness to executive compensation will gain access to corporate proxy statements. And the mere availability of that option will almost surely improve the sensitivity of directors to the interests of the owners. If the owners of corporate America don't care about these issues, who on earth *should* care?

To make his point, Mr. Surowiecki uses the example of the 1956 comedy, "The Solid Gold Cadillac." Judy Holliday played Laura Partridge, a small investor whose continual harassment of the board finally gets the company to put her on the payroll as its first director of investor relations. She uses the position, however, to organize a shareholder revolt that topples the corrupt CEO. As Surowiecki concludes: "American companies are the most productive and inventive in the world, but a little adult supervision (by the owners) wouldn't hurt. Laura Partridge had it right a half a century ago: 'Somebody's gotta keep an eye on these geniuses.'"

That "somebody" must be the owners. For it is shareholder involvement in corporate governance that will be required to return us to owners capitalism, and eradicate the system of *managers* capitalism that we never should have allowed to come into existence in the first place. It's high time we all work together to achieve that mission.

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