Just When We Need It Most . . .
Is Corporate Governance Letting Us Down?

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Before the New York Society of Security Analysts
New York City, NY
February 14, 2002

It was well before the Enron debacle when I selected the title for these remarks—"Just When We Need It Most . . . Is Corporate Governance Letting Us Down?" But three weeks ago, as I sat down to begin drafting the speech, the thought occurred to me that I should just shout out "yes!" . . . and then sit down. But I won't do that. I've decided to, as the public accountants say, "reduce it to writing" for one simple reason: We've heard from the press on this subject; we've heard from the academic community; and Lord knows we've heard from the politicians. (In this rare case they are bipartisan. They're all against sin.) We've heard from the Securities & Exchange Commission and from the accounting profession, and we've even heard a bit from Wall Street, but nothing from the Association for Investment Management and Research or the New York Society of Security Analysts. And we've heard nothing from the mutual fund industry. Until now.

The New York Times accurately describes the Enron mess: "A catastrophic corporate implosion . . . that encompassed the company's auditors, lawyers, and directors . . . regulators, financial analysts, credit rating agencies, the media, and Congress . . . a massive failure in the governance system." Of course, there are those who would say those harsh words are an over-reaction, alleging that 99.9% of audits of publicly-held companies are problem-free and that nearly all corporations have ethical managements and auditors who are truly independent. But just because nearly all commercial airline flights are problem-free and nearly all pilots and passengers are law-abiding citizens doesn't mean we should ignore the catastrophe of September 11 and stand idly by without beefing up airport security. Nor, after Enron, should we stand idly by without beefing up corporate governance.

But not just because of Enron. For in the great bull market of 1982-2000, all sorts of subtle—and not so subtle—abuses have crept into corporate reporting, and the integrity of our financial markets has been compromised. As one small voice in the mutual fund industry, I speak today in the hope we can go beyond Enron and consider a whole range of problems in financial reporting and corporate governance, what they mean to the profession of money management and to the average American investor, and what steps firms in mutual fund industry might take to defend the interests of the families who have entrusted us with nearly $7 trillion of their hard-earned dollars.

So today I'd like to briefly examine six issues related to corporate governance. 1) The happy conspiracy to give stock prices primacy over corporate value. 2) Managed earnings, a major manifestation of this conspiracy. 3) Inflated return assumptions on corporate pension plans. 4) Executive compensation, based on inappropriate standards. 5) Independence of accounting firms. And 6) the structure of corporate retirement plans.

1. The Happy Conspiracy

In October 1999, when I last addressed the New York Society (in a speech entitled "The Silence of the Funds"), I spoke of "the happy conspiracy" among corporate managers, CEOs and CFOs, directors, auditors, lawyers, Wall Street investment bankers, sell-side analysts, buy-side portfolio managers, and indeed institutional and individual investors as well. (Only short-sellers are on the outside looking in, and they are a small minority.) Their shared goal: To increase the price of a firm's stock, the better to please "the Street," to raise the value of its currency for acquisitions, to enhance the profits executives realize when they exercise their stock options, to entice employees to own stock in its thrift plan, and to make the shareholders happy. How to accomplish the objective? Aim for high long-term earnings growth (say, 12% per year), offer regular guidance to the financial community as to your short-term progress, and *never* fall short of the expectations you've established.

What's wrong with that? What's wrong, as I said in my earlier remarks, is that when we "take for granted that fluctuating earnings are steady and ever growing . . . somewhere down the road there lies a day of reckoning that will not be pleasant." Well, measured by the level of stock prices, the day of reckoning was indeed close at hand. Shortly after my talk, on March 24, 2000, the stock market made its high. When it reached its low on September 21, 2001, the NASDAQ Index of the "new economy" was off 71.8%, and the NYSE Index of the "old economy" was off -22.7%. While both have recovered nicely since then, the aggregate market capitalization of U.S. stocks is now $4.6 trillion below its $17.1 trillion high.

What we've experienced is a classic bubble. In a bubble, asset prices are wildly-inflated by unrealistic expectations and, well, irrational exuberance. Then reality returns, and with a vengeance. Speculators and day-traders experience financial duress, often severe. Overly-opportunistic investors realize the error of their ways and pull in their horns. Slowly the idea of *value* returns to the stock market. The eternal truth re-emerges: *The value of a corporation's stock is the discounted value of its future cash flow*. All over again, we learn that the purpose of the stock market is simply to provide liquidity for stocks in return for the promise of future cash flows, enabling investors to realize the present value of a future stream of income at any time. Corporations, we again realize, must earn *real* money.

It almost goes without saying that bubbles are inflated by unrealistic expectations. And our financial system seems to thrive on building expectations that are optimistic beyond the pale. Wall Street analysts are unremittingly bullish; of 1,028 stock recommendations made by the typical brokerage firm during the first quarter of 2001, only seven were "sell" recommendations. (As late as last October, 18 out of 20 analysts still rated Enron a buy). Going back to 1981, consensus estimates for future five-year earnings growth have *never* been less then 10.2% and have averaged 11.6%,[1] nearly *twice* the 6.3% *actual* annual growth for the two decades.

Ditto Wall Street strategists: With the Standard & Poor's 500 Index at 1320 as 2001 began, the strategists for twelve of the major firms forecast a rising market, with an average year-end level of 1561—up 18%. But the Index closed at 1148, *down* 13%—a 31 percentage point disparity! Even equity mutual funds got the bull market religion, reducing their cash reserve positions from a nervous 12% of assets when the bull market began in 1982 to an exuberant 3.5% at the high in March 2000, in part reflecting a new investment ethic: "*Benchmark* risk"—the risk of departing from the performance of a stock market index—has superceded "risk of capital loss"—*real* risk.

But the late stock market bubble was built not only on a rampant and pervasive bullishness. It was impacted by the willingness—nay, eagerness—of our corporate governance system to focus on stock

[1] The highest five-year earnings forecast, 14.6%, came at the end of 2000.

prices, driven by short-term earnings too often enhanced by financial engineering and leveraged by wildly unrealistic expectations. Seemingly uncritically, corporations embraced the speculative binge, ignoring the reality that it is corporate *value* that will prevail in the long-term.

2. Managed Earnings

As I was when I spoke previously to your group, I remain deeply concerned about a system in which corporate earnings "guidance"—inevitably given, and readily perceived, through rose-colored glasses—sets the pace for financial reporting. Call it manipulation or even legitimate puffery, putting the best face on corporate earnings may be all right as far as it goes. Certainly, striving to improve earnings through operational excellence should be applauded. But using Byzantine accounting legerdemain to achieve the desired earnings hardly merits applause. And failing to report off-balance sheet liabilities or box-car sized loans, often interest-free and frequently forgiven, to officers is wrong as well. (Indeed the very existence of such loans seem vaguely unethical. I suppose there's a rule of reason here, but when WorldCom lends or guarantees loans to its chief executive totaling $268 *million*, it must breech *some* sort of limit.) To make matters worse, Wall Street, with its own pride at stake in the aggressive forecasts of its analysts' estimates, goes willingly along. Chinese Wall or not, analysts have no desire to express doubt about the prospects of a corporation that is—or may become—an investment banking client, a serious conflict of interest that has sapped the integrity from the reports they produce.

The result: "Pro forma earnings." As Humpty Dumpty might have told Alice, "when I report my earnings per share, it means just what I choose it to mean—neither more nor less . . . the question is who is to be the master—that's all." And so, for example, Yahoo is the master when, having telegraphed that its expected earnings for the third quarter of 2001 would break even, reports in the first paragraph of its earnings release that its net income totaled one cent a share. A footnote, however, points out that the pro forma earnings figure *excludes* "depreciation, amortization, payroll taxes on option exercises, investment gains and losses, stock compensation expenses, acquisition-related and restructuring costs." The *Wall Street Journal* reported that investors were "encouraged" by the news, doubtless pleased that Yahoo "exceeded expectations." But Yahoo is not alone. The fact is that in 2001, 1500 companies reported pro forma earnings—what their earnings *would* have been *if* bad things hadn't happened.

Standard & Poor's, to its credit, has called for a uniform reporting system, one that requires "operating earnings" to take into account restructuring charges, asset write-downs from continuing operations, stock option expenses, and research and development systems purchased from other companies. It's high time for such a standard to be adopted, for the gap between *reported* earnings and *operating* earnings (before write-offs) has gotten completely out of hand. In the 10 years ended 2000, for example, annual *operating* earnings per share for the S&P 500 Index typically exceeded *reported* earnings by fully 11% per year. What is more, while operating earnings *as stated* grew at a 9.0% rate, the growth rate tumbled to just 4.9% after adjustment for pension and healthcare expenses and stock option grants, a reduction of fully 45%.

Post-Enron, it is "off balance-sheet" items that are in the news. It is little less than absurd that when an outside owner holds 3% of the stock in a subsidiary, neither the debt incurred (even when guaranteed by the parent) nor the losses realized (or, for that matter, unrealized) are reported. Let us hope that, with our eyes at last opened to the manipulation that is going on, we establish new accounting principles that will eliminate such a huge loophole and put those hidden liabilities on the balance sheet. But even more, we need common standards for reporting earnings and presenting balance sheets, and must establish a rigorous principle of full financial disclosure that goes beyond measuring up to accounting standards. We need to open the corporate books to all interested parties—especially the millions of shareholders who together *own* the corporation, just as we would if the corporation had a *single* owner.

3. Pension Plan Return Assumptions—Failing the Rule of Reason

Inflated assumptions about future long-term financial market returns earned by corporate pension plans is by no means the worst aspect of the managed earnings issue, but it may be the most obvious. Since 1987, when the FASB ruled that companies could credit pension income in their income statements, the return assumption has come to play an important role in corporate earnings reports. The higher the assumed future returns, the lower the pension contributions, the greater the boost to earnings. In 2000, for example, General Electric recorded a $1.74 billion pension credit, equal to 9% of its pretax earnings. IBM's plan contributed $1.2 billion—more than 10% of its earnings. $200 million of IBM's extra earnings resulted simply from raising its return assumption on its pension plan from 9.5% to 10%.

For companies that are eager to meet earnings expectations—to be clear, almost every company in the nation—it pays to assume the highest possible future return. And it is rather easy to do so if the actuarial consultant—who like the compensation consultant knows, without being told, exactly what he is expected to do—cooperates. There seems to be a lot of cooperation going on, for the future pension fund return assumed by the average U.S. corporation now approaches 10%.[2] Yes, that figure may look conservative in the light of the near-18% average return on the S&P 500 stock index and the 10% return of the Lehman Aggregate Bond Index from 1980 to 2000. But extrapolation—even conservative extrapolation—is no way to approach the future.

Lord Keynes warned: "It is dangerous . . . to apply to the future instructive arguments based on past experience, *unless one can distinguish the broad reasons why past experiences was what it was*."[3] We can easily apply that very line of reasoning to developing reasonable expectations for future market returns. The reason bond returns averaged 10% during the two decades was largely because the yield on the Lehman Bond Index was 10.3% at the start of the period. The reason stock returns averaged nearly 18% during the same period was that the initial dividend yield on the S&P 500 Index was almost 6%, the subsequent earnings growth was more than 6% (together, an *investment* return of 12%), and the rise in the price-earnings ratio added 6% per year. That rise, what I call the *speculative* return, reflects a p/e increase from nine to 30 times.

Today those factors are far different. The Lehman Bond Index now yields not 10%, but 5.7%, virtually guaranteeing substantially lower future bond returns. The S&P 500 Index yields not 6% but 1.5%, reducing this key contributor to stock returns by 75%. Even if we assume a continued 6% earnings growth, the annual *investment* return on stocks would be just 7.5%. Will *speculative* return add to or detract from this figure? It would be, I suggest, *absurd* to expect today's p/e ratio of 24 (based on normalized earnings), having risen at a 6% annual rate during the long bull market, to continue to rise at the same rate, which would take it to 45 times a decade from now. Indeed I'd expect it to decline to perhaps 18 to 20 times. No one—*no one*—can be confident about how much investors will pay for a dollar of earnings in ten years hence. But *if* my expectation is reasonable, the resultant drop in the P/E would create a negative speculative return of 2% per year, reducing the annual return on stocks less than 6%.

Using those assumptions, then, the annual return on a 60/40 stock/bond *market* portfolio would be about 5½%. But since pension funds have typically earned only 80% of the market return, they would probably net 4½%—less than half of the existing 9¾% assumption. The impact of that difference on

[2] Four of our largest blue chip corporations—General Electric, IBM, Exxon, and General Motors—assumed returns averaging 9 ¾%. Enron's assumed pension return, perhaps unsurprisingly, was even higher—10 ½%.
[3] Warren Buffett, to whom I am indebted for inspiring my thinking about pension accounting, cited this quotation in an article in the December 10, 2001, issue of *Fortune* Magazine

corporate earnings surely requires corporate directors to understand the concepts underlying financial market returns, the accounting standards involved, and the financial implication of the choices they make. Warren Buffett notes that these subjects have rarely come up before the 19 boards on which he has served. But it ought to be on the agenda of the finance committees of every public corporation. It is no more than responsible corporate governance, for while raising the *assumption* for pension fund returns can pump up earnings and stock *prices* in the short run, only the actual *realization* of pension fund returns will affect corporate *values* in the long run. We must demand realistic assumptions about the future returns and we must also demand full reporting of past returns, as is required in the UK.

4. Executive Compensation—Is The Sky Really The Limit?

The absurd failure to treat the costs of executive stock options as an expense has also contributed mightily to the overstatement of corporate earnings. Since options involve no charge to earnings, "they're cheap," according to one leading compensation consultant, and that anomaly bears much of the responsibility for the staggering increase in these payments over the years. But stock *prices* are inherently flawed as a means of compensation. Uncritically, we have come 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 accurately-stated earnings). Rather, prices are driven by speculation, reflected in how many dollars investors are willing to pay for each dollar of earnings. But in the long run, virtually 100% of the return on a stock is determined by dividend yield and earnings growth.

For example, the S&P 500 Index rose from 130 in March 1981 to 1527 in March of 2000, a return on capital equal to 13.8% per year. But the rise in the price-earnings ratio from 8 times to 32 times accounted for nearly 800 points of the 1400 point gain, or 7.6% per year, meaning that earnings growth amounted to 6.2% annually. If one were to attribute even a 5% corporate cost of capital—something a company could earn just by putting all of its assets in a certificate of deposit—as a threshold for a stock option grant, corporate management could claim responsibility for a 1.2% annual achievement. Yet when the Index reached 1527, a stock option for 10,000 shares at $130 would have placed a cool $14.6 *million* on the executive's plate. Nice work if you can get it!

Executive pay is out of control because compensation committees aren't doing their job. But of course the consultants *are* doing theirs. Since they are *paid* by management to *advise* management *how much* management should be paid, small wonder that we observed awards for achievement for CEOs in 2000 running from as high as $92 million, to $125 million, to $151 million, and to, believe it or not, $872 million. *For a single individual*! These numbers, of course, find their way into the great compensation database, which in turn ratchets up when awards for 2001 are considered, moving formerly *average* awards into *below average* territory. And so the compensation norms rise again. It is truly a sick system, all the more difficult to cure since "everyone is doing it."

How can we fix it? First, recognize that stock options are compensation and deduct the cost before earnings are calculated, at least avoiding the misapprehension that options are somehow "free" to shareholders. (In fact they reduce the interest of the public shareholders in favor of the interest of the managers, and on unfavorable terms at that.) Second, since stock prices bear a little short-term relationship to corporate value, index the stock's performance to the prices of other stocks, either the market itself (the Standard & Poor's 500, for example), or peers in a company's industry. Those two changes would help greatly to restore the existing imbalance between investors and managers, between ownership and control.

But I wonder if, rather than trying to fix the broken old compensation machine, we shouldn't be building a new one. Why not base options on the *actual earnings growth* achievement by the corporation, rather than the short-term swings in the price of its stock that are explained largely by the hopes and fears of investors. Then compare that earnings growth with growth achieved by the corporation's peers, and pay only for *competitive* success. (There would seem little reason to be generous with the resources of a corporation which consistently finds itself in the bottom quartile among its rivals.) And also set a cost-of-capital threshold. After all, if the corporation consistently earns less than the risk-free interest rate, isn't something fundamentally wrong with either the business or its management?

I'm not against executives making big money. But a sound compensation system must align the interests of managers with the interests of long-term investors, not short-term speculators. A recent NYU study[4] pointed out that most executives exercise options as soon as they vest, perhaps two or three years into the life of a ten-year option, far earlier than common sense would dictate. ("Why commit cash until you have to?") Why? Apparently to sell the stock as fast as they can! The NYU study observed that executives sell virtually *all* of the shares they acquire just as soon as their options are exercised. Alas, the boiler plate language—"the option plan is designed to increase [executive] *ownership* of the company's stock"—simply isn't true.

Executives should be rewarded—and handsomely—if they *earn* their rewards by building the value of the corporation's assets over the long-term, but not by exercising their options whenever soaring stock prices reflect either overstated earnings engendered by financial manipulation or the overheated emotions of the marketplace. It's not a moment too soon for those who seek an enlightened system of corporate governance to stand up and be counted.

5. Are Auditors Independent?

A year and a half ago, in a lecture at New York University entitled "Public Accounting: Profession or Business," I expressed this view:

> Sound securities markets require sound financial information. It is as simple as that. Investors require—and have a right to require—complete information about each and every security, *information that fairly and honestly represents every significant fact and figure that might be needed to evaluate the worth of a corporation*. Not only is accuracy required but, more than that, a broad sweep of information that provides *every appropriate figure that a prudent, probing, sophisticated professional investor might require* in the effort to decide whether a security should be purchased, held, or sold. *Full disclosure*. *Fair disclosure*. *Complete disclosure*. Those are the watchwords of the financial system that has contributed so much to our nation's growth, progress, and prosperity.

Observing that standard of *disclosure*—not merely generally accepted accounting principles, but far more—surely would have helped to prevent the Enron bubble from being inflated to beyond the bursting point. Under that standard, the special purpose enterprises that lie unaccounted for on a firm's balance sheet would have been fully disclosed; similarly, the revenue assumptions based on projecting commodity prices ten years out would have been open to challenge. The wise investor's rule must be: *Trust but verify*. And the rule we need for full disclosure is hardly complex: *Open the books!* While a corporation may want to resist such disclosure, the audit firm should be put in a position to require it. And the more pressure the corporation exerts *against* disclosure, the more countervailing pressure the auditor must exert to require it.

[4] "Executive Stock Options: Puzzles, Problems, and Mysteries," by David Yermack, Stern School of Business.

Audit firms, however, are in no position to exert that pressure today. Why? Because auditing has become, in important aspects, far more a business than a profession. In 2000, attestation fees accounted for only about one-third of the $26 billion of *revenues* earned by the "Big Five" public accounting firms. The remaining two-thirds came from consulting, management, internal audit, tax, and advisory service. And the profit from non-audit revenues almost certainly constituted a far higher proportion of these firms' net *earnings*. How vigorous an advocate for truth-in-earnings, for example, could Motorola's auditor be? The firm was paid $3.9 million in audit fees in 2001, all the while receiving $62.3 million for systems development and "all other services."

In that case, the Audit Committee reported that such a disparity was nonetheless "compatible with maintaining the independence of such auditors." And the same conclusion was drawn at Enron, where $29 million of consulting fees were paid to its accounting firm, even larger than its $23 million of audit fees. But the mix of accounting services with consulting services surely raises a serious question about whether the business priorities of the auditor overwhelmed its accounting probity. When I spoke at NYU, I warned that "studies cannot always confirm what common sense makes clear," for there was no "smoking gun" to make this linkage. Perhaps the Enron debacle will provide the definitive smoking gun. The obvious remedy is the one urged by former SEC Chairman Arthur Levitt: A flat-out prohibition against public accountants providing consulting services to their audit clients. While the post-Enron environment is beginning to make it happen, we ought to make it a matter of law.

The Enron case is not the only sign of accounting failure. Think of Cendant, Sunbeam, Waste Management, Rite-Aid. Think of 607 earnings restatements in the past three years, more than in the entire previous decade. Think even more about the pervasive debasement of accounting standards that permit weird pro-forma earnings, off-balance sheet SPEs, outlandish (and often undisclosed) projections of unpredictable future outcomes, big bath write-offs, capitalized research and development costs, and so on. And then consider the challenges and frustrations that even the Financial Accounting Standards Board has experienced in promulgating effective rules, and that the Public Oversight Board (whose members recently resigned in protest over the SEC Chairman's pronouncements on self-regulation in the accounting business) has faced in maintaining the financial support of the American Institute of Certified Public Accountants. Think of the recent SEC draft report on the failure of peer review. *The existing system of self-regulation simply is not working.* Rejiggering it is not enough. We need a nationally-chartered Federal Accounting Commission to assume the responsibility for ensuring the kind of full, fair, and complete disclosure—*principles*-based disclosure rather than *rules*-based disclosure—that I believe is necessary to restore the credibility of our financial system.

6. Private Retirement Plans

During the past quarter century, we have witnessed a profound shift away from corporate America's traditional reliance on defined benefit (DB) pension plans, and toward defined contribution (DC) savings plans such as profit-sharing and thrift plans. Today, there are almost 60 million participants in DC plans (50 million more than in 1975), compared to 25 million in DB plans (*down* two million in the same period). One commentator described this shift as "a social and economic time bomb."[5] Corporations are shifting the investment risk of retirement savings from the firm to the employee, and it has proven to be a large risk indeed. But it's little noticed and has rarely been a major concern of corporate governance.

The idea of a voluntary and remarkably attractive means of saving on a tax-deferred basis with the plan assets "traveling" with the employee, is certainly a good one. And who could argue with providing each employee with the flexibility to establish a bond-stock allocation consistent with his or her

[5] *Barron's*, November 28, 2001, "Riding for a Fall," by William Bernstein.

time-horizon and risk tolerance. But the great experiment is not working as well as it should, on at least two levels. Not *enough* employees are saving, and those who are saving are not *saving enough*. Fully 25% of eligible employees have not yet even begun to participate in available DC plans, a heavy penalty when the magic of compounding means that *time is money*.

Add to that the fact that 18% of all employees are borrowing from their plans to meet current living expenses, college tuition, and the like, mortgaging part of their future to enjoy the present. While those who *do* save are putting away about 10% of their salaries (including company contributions), in many cases they will fail to reach their retirement savings goals. A recent study reported that the typical employee in a DC plan would earn retirement income, including social security, equal to only 48% of previous income, compared with 60% for the typical employee in a DB plan.

This under-saving would be less of a problem if future returns on bonds and stocks are sustained at the generous levels of the past. But, as I argued earlier, it is unlikely that will be the case. Indeed, future returns at less than one-half the levels of the past are, if not relatively likely, surely quite imaginable. What is more, few—if any—corporate managements or boards seem to have focused on the fact that defined contribution plans, in part because of their heavier mutual fund fee structures, provide even lower returns (by 2.4 percentage points per year, according to one study) than the financial-market-lagging-returns of the defined benefit plans that I mentioned earlier.

Add to that sorry case the counterproductive asset allocations of the participants in defined contribution plans. In a fairly valued stock market when the decade began, the average participant (whose average holding of $33,600 for the 55-through-64 age group itself seems a testimony to the inadequacy of the DC plan) had 70% in fixed-income investments and 30% in equities. But in the highly valued market as 2001 began, the ratio averaged 19% in fixed-income and 81% in equities. Not only has risk risen, but even more risky options are being introduced. Funds with hot past performance are demanded by many plan sponsors, and a self-directed brokerage account option is the newest gimmick. Just imagine the likelihood of success for an employee who engages in day-trading to build a comfortable retirement nest egg!

Thanks importantly to Enron, another flaw in the DC system has come to light. A woeful lack of diversification. Almost a decade ago, in *Bogle on Mutual Funds*, one of the twelve pillars of wisdom I presented was, "Diversify, Diversify, Diversify." And I know of *no* academic, or investment practitioner, or financial adviser who wouldn't agree. Yet the shares of a *single company* represent 20% of the assets of all DC plans, and 48% of the assets of plans that mandate the use of company stock. When all goes well, of course, the employee prospers, both in his career and in his retirement assets. But when things go wrong, the employee can lose both. Company stock is not a panacea, as the employees of Enron, Lucent, Rite Aid, and Global Crossing—and doubtless many more—would agree. Staggering portions of the value of their retirement plans have gone up in smoke.

Part of the reason for this unsound concentration—which can multiply the risk of the equity allocation by as much as two or three *times*—is because many companies offer solely company stock for the matching portion of the contribution. Another part of the problem is that employees may be locked into the company stock for an extended period. And still another part of the problem is that most employees are unsophisticated in the seemingly-complex and convoluted world of diversification, asset allocation, and investment selection. They are trusting; they want to demonstrate their loyalty and commitment; and, in candor, they can be tempted by greed, often chasing the high past returns enjoyed by a company whose *stock price* is exploding, without a commensurate increase in *corporate value*.

I hope that corporate directors will carefully evaluate the DC-DB balance in the light of their firm's experience so far. And it's urgent that firms modify their own vested interest in maintaining high employee ownership in their shares. It has been suggested that the proportion of an employee's *entire* investment in the stock of a single company—including employer stock—should be limited to 10% to 20% of his or her *entire* 401(k) account, including the employer portion, and that issue is worthy of discussion. At the same time, companies must educate their employees in the inherently simple principles of investing, in understanding risk, and in the critical role played by investment costs. (It's remarkably easy, for example, to earn virtually 100% of the stock market's return.) If our corporate retirement plan system is "riding for a fall," the title of the *Barron's* article, it's high time to focus on these issues.

A Failure of Corporate Governance

It seems clear that corporate governance is a key participant in the happy conspiracy in which no holds are barred in creating the rosiest possible scenario for corporate earnings. But stock prices cannot depart far from corporate values before there is a powerful reckoning, as we learned when the go-go bubble in "concept stocks" burst in 1968, and learned all over again when the technology-internet stock bubble burst just as the 21st century was beginning. Manias, as Edward Chancellor[6] reminded us in a recent *New York Times* op-ed piece, bring out the worst aspects of our system: "Speculative bubbles frequently occur during periods of financial innovation and deregulation . . . lax regulation is another common feature . . . *there is a tendency for businesses to be managed for the immediate gratification of speculators rather than the long-term interests of investors."*

But the problem is not just that a return to reality is always painful. The problem is that investors finally lose confidence in the integrity of the information they receive. And that is exactly what is likely to happen as a result of the situation I've described today—indeed it seems to be happening right now. We've lived through an era in which Wall Street's conflicted sell-side analysts have lost their objectivity; the buy-side analysts of our large financial institutions have put aside their skepticism; too many of our corporations have forced the fulfillment of their aggressive earnings guidance by fair means or foul; enormous compensation from stock options has driven corporate executives to be more concerned about stock *price* than about corporate *value;* auditors have had important business incentives to be partners of management rather than independent professional evaluators of management's financial reporting; and millions of employees have lost faith in their retirement plan investments. As all of these forces come together, investors will realize that they have assumed risks that were far larger than those for which they bargained. They will demand a higher risk premium—a higher risk premium that will raise the cost of capital and ultimately be a drag on the economy.

Sadly, there is not much evidence that corporate directors are concerned about these issues. Indeed, *Chief Executive* magazine reassures us that all is well in corporate America: "Dramatic improvements in corporate governance have swept through the American economic system in recent years . . . and most directors now seem to take their responsibilities seriously . . . (thanks to) enlightened CEOs and directors who voluntarily put through so many corporate governance improvements designed to make the operations of boards more effective." Ironically, however, when the October 2000 article that included that optimistic appraisal selected "the Best Board of Directors" in America, there at the top of the list, behind only General Electric and (a bit ironically, as it turns out) Hewlett-Packard, stood . . . *Enron*.

Chief Executive described Enron as a "New Economy" company "with a board that works hard to keep up with things . . . and (quoting Enron) 'uses working committees with functional responsibilities in the more complex and recurring areas where disinterested oversight is required.'" The audit and compliance committee and the finance committees, the article reports, each met five times during the prior year. Despite concerns about the large size of the board (18 members) and the number of insiders

6 Author of "Devil Take the Hindmost: A History of Speculation."

(six) *Chief Executive* was "heartened by the overall corporate governance structure." And well the magazine might have been, with a board that included a professor of accounting at Stanford University, a retired UK secretary of state for energy, and the chairman of Alliance Capital, one of America's largest institutional money management firms. *But Enron failed*. Indeed, Enron is the paradigmatic failure in the modern history of corporate America. In its failure, it illustrates nearly all of the central points I have illustrated today—improper financial reporting, opaque financial statements, hidden liabilities, aggressive earnings guidance, grossly excessive executive compensation, happy co-conspirators, and the tragic collapse of its employee savings plan. Moreover, in recent weeks evidence has come to light that something far worse may have been going on: skullduggery worthy of the example set by Samuel L. Insull in the 1920s. Enron is, above all, a failure of corporate governance.

Who Should Govern Corporate America?

If we can't rely on the directors to govern, who can we rely on? Why, the stockholders! The owners of the corporation themselves. And as investing has become institutionalized, these owners now have the *real*—as compared with the *theoretical*—power to exercise their will. While stocks were once owned largely by a diffuse and inchoate group of individual investors with relatively modest holdings, the ownership of stocks—for better or worse—is today concentrated among a remarkably small group of potentially powerful institutions. The mutual funds controlled by the 75 largest fund managers alone own $2.9 trillion of U.S. equities, equal to 20% of the $14.4 trillion market capitalization of the stock market at the beginning of 2001.

But the power of mutual fund managers is in fact far greater than that. For the pension funds and other institutional accounts run by these 75 managers hold an additional $3.4 trillion of stocks, bringing their total holding to $6.3 trillion, and the voting power to 44%. And if we expand the list to include non-fund managers in the "Institutional Investor 200," the total rises to $7.5 trillion or 52%. A majority of the stock. *Absolute control over corporate America*. Together, this small number of large institutional investors constitutes the great 800-pound gorilla who can sit wherever he wants to sit at the board table.

In the original version of the motion picture "Mighty Joe Young," the protagonist was a fierce gorilla who destroyed every object in his path. But he became serene and compliant whenever he heard the strains of "Beautiful Dreamer." Not to push this analogy too far—especially for those who have never seen the film!—but I fear that mutual fund managers seem to be listening to "Beautiful Dreamer" as they consider their responsibilities of good corporate citizenship. The fund industry can hardly be ignorant of what is going on in Corporate America. Even before Enron came to dominate the pages of our newspapers, day after day we would read of another accounting issue, another corporate compensation excess, another company stock that devastates a thrift plan, another earnings report that has "pro-forma-ed" heaven and earth to produce earnings that meet expectations. But the only sounds we've heard in response are the sounds of silence.

Where is the Mutual Fund Industry?

One searches in vain for a seminar on corporate governance from the industry's spokesman, the Investment Company Institute, or even as little as a break-out session at its general membership meeting on "Earnings Guidance—Blessing or Bane?" or "Do Stock Options *Really* Link Executive Compensation to Shareholder Value?," or even a speech by an industry leader entitled "Serving Fund Shareholders by Eliminating Financial Engineering." The few truly activist fund managers—one thinks of Mutual Shares' Michael Price and Windsor Fund's John Neff—have passed from the scene. When I spoke to you just over two years ago in my speech entitled "The Silence of the Funds," I called on the ICI to sponsor an industry-wide effort to foster the interest of fund shareholders by harnessing the voting power of mutual funds. Failing that, for a small group of fund managers to act as a nucleus in taking up corporate governance issues, with other like-minded managers then climbing aboard the bandwagon. The response, alas, echoed the title of my speech: A silence that was truly deafening.

Perhaps the reason for the silence is that the overwhelming majority of mutual funds are engaged, not in the process of long-term investing on the basis of corporate values, but in the process of short-term speculation based on stock prices. During the past year, for example, one of every ten equity funds turned its portfolio over at an annual rate of more than 200%; four of every ten funds at a rate of more than 100%; and only one of every eight at a rate of less than 25%—itself hardly an austere target. The typical fund manager has lots of interest in a company's price momentum—changes in earnings estimates, and whether reported earnings are meeting the guidance given to Wall Street—but far less interest in what a company is worth—its fundamental earning power and its balance sheet. By focusing on short-term stock prices rather than long-term corporate values, the fund industry has helped to create the over-heated financial environment of the recent era.

We have become, not an *own-a-stock* industry, but a *rent-a-stock* industry.[7] Responsible corporate citizenship and proxy voting are rarely on a fund manager's agenda, because a company's stock may not even remain in the portfolio until the next annual meeting. Or perhaps because corporate activism might hurt the manager's ability to attract institutional accounts and 401(k) plans. Or perhaps because no link is perceived between governance and stock price. Whatever the case, the record shows only sparse attention to corporate governance issues by the corporate governors themselves—in overwhelming measure, the mutual fund industry. "We have met the enemy, and they are us."

Undeterred by the failure of that earlier initiative, I'll now propose another. For a substantial and clearly differentiated cadre of long-term investors *does* exist in our industry—managers who buy stocks but don't sell them. Because selling is not part of their mandate, they hold them, well, *forever*. Their clients profit only as corporate value grows, and when managements are weak, unethical, or operating in their own interests rather than the interests of their shareholders, their only recourse is to replace them. Their holdings are not of trivial dimension. Indeed just *six* of these managers[8] hold some $1.4 *trillion* of U.S. corporate stocks, nearly 10% of all stock outstanding. They are, as you might have guessed, our industry's index fund managers. Their share of stock holdings has grown steadily, and will continue to grow, perhaps even faster, in the years ahead.

A Federation of Long-Term Investors

I propose that these firms—*passive managers*, if you will—come together and discuss ways to make their views felt—on full disclosure, on managed earnings, on executive compensation, on auditor independence, on pension plan return assumptions, on retirement plan investing—and forcefully present those views to the corporations whose shares they own. Such a *Federation of Long-Term Investors*, as it might be named, could become the nucleus of an aggregation of shareholdings that would grow as those *active managers* who adhere to long-term investment strategies join the group. Adding only the Capital Group—surely that firm would meet *anyone's* definition of a long-term investor—would add another two percentage points to the aggregate stock ownership, bringing it to almost 12%. And it may well be that *public* retirement funds, many of which are already providing responsible corporate governance, would also join the effort.

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[7] I am indebted to Steve Galbraith, Chief U.S. Investment Strategist at Morgan Stanley, for this formulation.
[8] In order of size, the firms are Barclays Global Investment, State Street Global Advisers, Vanguard, Mellon Financial Corp, Deutche Asset Management, and TIAA-CREF's indexed assets.

But there are other active managers with a long-term focus who may well want to join the effort. One ray of hope recently appeared from Legg Mason's Bill Miller—he of value investing fame and conqueror of the S&P 500 Index for an unprecedented eleven consecutive years—clearly a man to whom we should listen. Mr. Miller, according to press reports, has assembled his own group of managers who are considering placing ads in *The Wall Street Journal* and other publications listing good governance best practices. If these practices are not followed, he and his group won't vote in favor of items such as option plans. "If options are compensation [as they clearly are]," Miller warns, "companies have to adjust earnings and compensation has to be reasonable." He also proposes to challenge aggressive assumptions on future pension returns. There must be other Bill Millers out there who care about restoring the integrity of our financial markets, and perhaps our Federation of Long-Term Investors will gradually grow to represent ownership of perhaps 25% or more of the shares of America's corporations—no, not yet a fully-grown 800-pound gorilla, but a strapping young 400-pounder, who will grow bigger with each passing year.

The Name of the Game

It seems self-evident that the financial strength of our citizens-investors, our securities markets, and indeed our nation will be well-served by a return to full disclosure, sound financial statements, and corporate integrity, in large measure because it will help foster a return toward long-term investing based on corporate value, and away from short-term speculation based on stock prices. In part because of our industry's over-weaning focus on the short-term prices, we have gotten the corporate governance we deserve. But if we focus on long-term value, I suggest we will also deserve the better governance that will follow.

Mutual funds—and, in fairness, other institutional and individual investors as well—and all the other participants in the happy conspiracy have short-sightedly adopted the view that the greatest good lies in driving stock prices to the highest possible levels. A moment's reflection makes the foolishness of that proposition clear. *For in the long run, stock prices are determined by corporate value—by the cash flows the firm generates.* The swings above and below that value path simply reshuffle the allocation of investment returns from one investor to another. Hear Warren Buffett on this subject: "The longer the shareholder holds his shares [of a corporation], the more bearing that business results will have on his financial experience."

Mr. Buffett seeks not only long-term *returns*, but long-term *shareholders*. Thus, he prefers Berkshire-Hathaway's stock to trade at or around its intrinsic value—neither materially higher or lower. Such linkage means that business results during a given period will benefit the people who own the company during that period—a linkage, in turn, that is maintained if the shareholder group has a collective long-term, business-oriented investment philosophy rather than a short-term market-oriented strategy—*exactly* the focus I urge on the mutual fund industry. Mr. Buffett's goal is to maximize shareholder return—not to maximize the price of Berkshire shares—for his goal is to minimize the benefits going to some shareholders at the expense of others. That is a far cry from the philosophy of pumping up earnings through aggressive accounting and providing free stock options that enable executives to cash out at the drop of a hat.

It may seem heresy to denigrate the Great God of stock price maximization. But who, really, is served when a stock soars far above and then plummets far below the corporation's intrinsic value. In a recent *Wall Street Journal* op-ed essay entitled "Dare to Keep Your Stock Price Low," [9]the authors struck

[9] By Joseph Fuller and Harvard Professor Michael Jensen

directly at the fallacy of pumping up a stock's price by reaching for unprecedented earnings growth driven by unrealistic internal corporate goals and manipulation of information. "Valuation that becomes unhinged from the underlying realities of the business can rob investors of savings, cost people far more innocent than senior management their jobs, and undermine the viability of suppliers and communities. Conforming to market pressures for impossible growth leads to damaged companies," exactly opposite to the interest of investors in our system of democratic capitalism.

But there's even more at stake than that. This nation's founding fathers believed in high principles, in a moral society, and in the virtuous conduct of our affairs. Those beliefs shaped the very character of our nation. If *character counts*—and I have absolutely no doubt that character *does* count—the failings of today's business and financial model, the willingness of those of us in the field of money management to accept practices that we know are wrong, the conformity that keeps us silent, the selfishness that lets greed overwhelm reason, all erode the character we'll require in the years ahead, especially in the post-September 11 era. The motivations of those who seek the rewards earned by engaging in commerce and finance struck the imagination of no less a man than Adam Smith as "something grand and beautiful and noble, well worth the toil and anxiety." I can't imagine that anyone in this room today would use those words to describe our corporate governance system at the outset of the 21st century.

So there's a lot at stake in reforming our financial system and in returning to the fine roots of our national character. But it will be almost impossible to accomplish if the owners of our corporations fail to recognize that corporate citizenship entails not only rights but responsibilities. Corporate governance *has* let us down, and it has let us down just when we needed it most. But if the firms in the mutual fund industry realize that—as representatives of the owners of nearly half of the corporate stock in our nation—they are the *ultimate* governors, we can make sure that corporate governance never lets us down again.

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