Character Counts
In Business, In Markets, And In Each Firm

Remarks by John C. Bogle, Founder and Former Chairman
The Vanguard Group
Before the Annual Meeting of
Property Casualty Insurers Association of America
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Good morning. It's always a special privilege for me to address colleagues in sectors of the financial services field outside my own. For we all share a broad mandate to help American families to think about tomorrow—to postpone the tempting and immediate pleasures of consumption in favor of investing their assets and protecting their property against the hazards of everyday life, especially important in the world in which America exists today. In financial services, we're all about *tomorrow*—and as the song from the musical "Annie" goes, "the sun'll come out tomorrow, tomorrow, tomorrow—I love you tomorrow, you're only a day away."

While my long career in the mutual fund field hardly gives me adequate credentials to talk knowledgably about the insurance field, perhaps something in my genes will help. My great-grandfather, Philander B. Armstrong, spent his entire career in the insurance field. As a young man, he came from Cincinnati to New York, entering your industry in 1868 when he joined Aetna. He was something of an entrepreneur, and in 1873 he founded the Phoenix Mutual Fire Insurance Company, and a few years later, the Mutual Fire Insurance Company of New York. Of course there were no automobiles then, and fire, a constant hazard, was the main focus of property insurance.

He surely spoke like an insurer. In an 1886 speech to his policyholders at the Mercantile Club in St. Louis, Missouri (no mean trip in those days!), he said, "I believe in large lines thoroughly protected; that no risk can be safely written unless every perceptible hazard of fire is removed for the property to be insured." He also believed that "moral hazard"—call it *character*—was the major risk, and that the *mutual* company was a superior form to the joint stock company. For him, the optimal insurance system was "mutual companies, working under a system of *selection*, *inspection* and *protection*." In offering his policies, he clearly saw the value of low costs, recognizing that, "to reduce expenses to a minimum, it is necessary to do business without agents, brokers, or middlemen," and deal directly with the insured. In all these ways, this great-grandson turned out to be the apple's apple's apple who did not fall very far from the tree.

A Classic Victorian Dinner, A Surprising Announcement

Grandpa Armstrong, as we called him, was also something of a hell-raiser. He was constantly riling his insurance colleagues, creating and then selling his companies and beating the drum of fairness for his policyholders. The on-going conflicts he had with his industry peers were well-covered in the insurance press of those days, and fill several large scrapbooks with page after page of yellowed news clippings. But his high-pressure, high profile life finally wore him down.

So in March of 1891, he invited 70 of his insurance colleagues to a lavish white-tie dinner at Delmonico's in New York City, where he made a surprise announcement. After dessert, when brandy was served and the evening cigars were lit, he arose and told the stunned assemblage that he was leaving the fire insurance field. That very afternoon, he announced, he had sold his interest in Mutual Fire to a British insurer for the then-princely sum of $200,000 (in today's dollars, $4 million). He would take a few years off, he said, and then would turn his full attention and energy to what he described as his first love, life insurance. (His rivals must have breathed a sigh of relief.)

He was as good as his word. After living in California for a time and visiting Japan (imagine *that* trip!), he returned to New York and formed the American Union Life Insurance Company in October 1893. It too was a mutual company, with Grandpa Armstrong declaring the present life insurance system to be "inequitable to policyholders and inimical to the public welfare." He argued that, "life insurance has become one of the necessities of modern civilization and it should be funded *at cost*." In 1917, then about my own age today, he wrote a powerful and rather intemperate *magnum opus: A License to Steal*—subtitled "Life Insurance, The Swindle of Swindles. How Our Laws Rob Our Own People of Billions." His conclusion: "Why talk about correcting the present evil? The patient has a cancer. The virus is in the blood. He is not only sick unto death, but he is dangerous to the community. Bring in the undertaker."

Clearly, my great-grandfather was *a character*, flamboyant and irrepressible. He was described in one editorial as "a new Moses" calling the people to flock from "Egypt" to the American Union as "a city of refuge," yet in another as "a radical alarmist who is free in making statements and economical in proving them." But those press reports of a century-plus ago also make it clear that he also *had* character.[1] Principled and steadfast, he put the policyholder first, an underwriting professional who slashed distribution and operating costs in order to provide a fair level of premiums for policyholders. One editorial described him thus: "They all said it couldn't be done, and he went right ahead and did it…Once fired, he got control of another company and again became master of the old one…Preternaturally wise, he taught us some things about professional obligations, and did a great service to the public."

Those century-old words about character—about wisdom, and service, and professional obligation—stand in sharp contrast to the failure of character demonstrated in mutual fund market timing and late trading scandals. And in the past few weeks, we've seen a similar failure in the property insurance field, reflected in the apparently pervasive bid-rigging scandals have brought unwelcome attention to industry practices of dubious ethical provenance that had previously been accepted as the normal way of doing business. Indeed, the title of my remarks today, "Character Counts"—ironically, a title I selected six months ago—seems almost prophetic, for the painful parallelism of these scandals in your industry and in mine, is one more reflection of how much both your business and mine depend on the character of our industry leadership.

The Financial Services Sector

In addition to our dependence on character, we share another important common attribute: In all types of financial services firms—mutual funds, property and casualty insurance, life insurance, and banking alike—the value we provide to our clients is measured largely in dollars and cents. Unlike, for example, producers of food, consumer goods, electricity, automobiles, and perfume, the *worth* of our services—the investment return on a mutual fund, the amount covered by a homeowner's policy, the face value of a life insurance policy—can be easily and precisely measured. And the *cost* of providing our services—the fees and operating expenses, the premiums, the sales commissions—can be precisely measured in dollars and cents as well.

[1] Amusing coincidence: After writing this talk, I saw a headline in *USA Today* describing the pennant-winning Boston Red Sox team as "lots of characters with a lot of character."

As a result, the impact of product cost on product value lies at the very heart of how well we serve our clients. As I've said a thousand-times over: *Costs Matter*. They matter most where they are large, where they impinge directly on the value of the service we provide (that's both mutual funds and insurance); where they are easily measured (that's also both); and where they are compounded over the years (that's only mutual funds, and I'll discuss that issue later on). So a major measure of our character is reflected in the extent to which the costs we operate our businesses are consistent with the value of the services that we provide to our clients.

This is *not* to say that the extra value we provide through careful attention to client needs, through the professional skills we offer that enable clients to avoid the potholes that exist in product selection, and through "the human touch" we apply have no value. Of course they have value! For without these services, many of our clients would never even get started protecting themselves against the vagaries of life and the challenges of building a retirement nest-egg in modern day American.

But it must be obvious that providing real, honest-to-God, dollars-and-cents value to our clients requires offering our services at a fair, reasonable, and competitively-determined price. It is essential not only so that our clients can live within their budgets and meet their goals for protecting their assets and property; it is also essential if we are to achieve success in our own businesses. *Without maintaining its character*—the values of integrity, good conduct, and service to others before service to self—*no financial service firm can achieve long-term success.*

But too many firms in our respective industries, I fear, have compromised those long-term values and focused on short-term profits—self-defeating as that strategy now appears. When New York's Attorney General Eliot Spitzer cast his net and caught the mutual fund firms that had abused the trust of investors—practices that enriched both the coffers of the management companies that controlled the funds involved and the short-term speculators in funds at the expense of their fellow long-term owners—he caught some of the oldest, largest, and once-most-respected firms in our field, a clear parallel to the firms caught in the net he cast in your field. In both cases, these greedy practices reflect badly, not only on the firms involved, but—in a nation of headline readers—cast a dark pall over an entire industry. We are all paying a price for the failure in character we have witnessed.

Meeting that challenge to our reputations demands that we reaffirm our commitment to the kind of ethical behavior that insurance policy holders and mutual fund shareholders alike have every right to expect. In short, we need to reaffirm the principle that *character counts*. Now is the time for the many leaders of character who work in our own fields—persons of integrity who have dedicated their lives and careers to the financial services sector of our economy—to speak up and reaffirm the principles that have been our rock foundation. We have the power to shape events, and the sooner we get on with the task, the better.

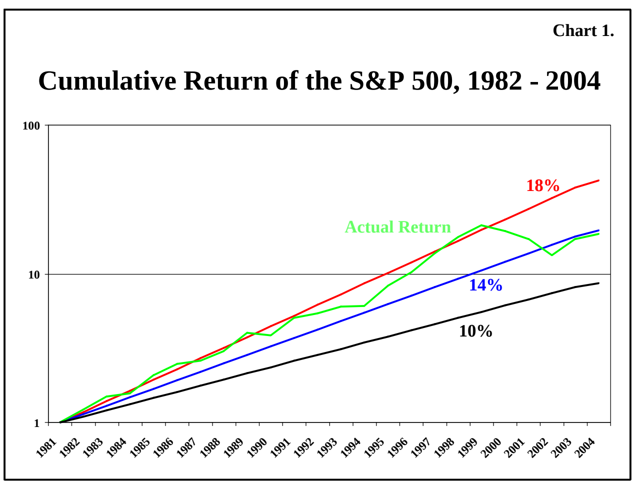
The Financial Markets

I'd now like to turn to a different kind of character, the character of our financial markets. It is almost a commonplace that great bull markets distort our financial system. Surely the great bubble in stock prices during 1998-2000, based largely on the madness of crowds, was no exception. But bubbles eventually burst, and the $17 trillion in market capitalization of U.S. stocks in March 2000, after dropping to $9 trillion, now reposes at $12 trillion—$5 trillion of market value erased.

What's next? For all of you who are yourselves investors, as well as for those of you who manage your company's investment portfolios, I'd like to take a few moments now to consider the dimension of future returns we might expect to earn on stocks and bonds. While it is never given to us to predict what lies ahead tomorrow—let alone a decade hence—there is far too much mythology and witchcraft surrounding the returns generated in our financial markets. In fact the issues are simplicity writ large. It's all a matter of establishing rational expectations, and that means considering, of all things, the *character* of investment returns.

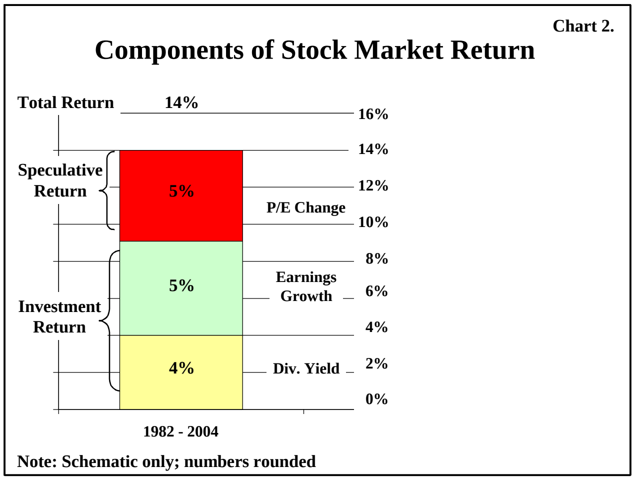
Let's begin with stock returns. We are frequently told that the annual nominal return on U.S. stocks over the long term has averaged about 10% per year. But stock market returns are not actuarial tables. As Lord Keynes pointed out way back in 1936, "it is dangerous to apply to the future inductive arguments based on past experience *unless* one can distinguish the broad reasons why the past experience was what it was." If we are to establish rational expectations for the future, then, we need to understand the *sources* of investment returns. *And we do.* It's not complicated. The sources of stock returns are two: (1) *Investment Return* (Keynes called it *enterprise*), simply the sum of the initial dividend yield and subsequent annual earnings growth; and (2) *Speculative Return*, simply the change in the public's valuation of stocks, measured by how much investors are willing to pay for each dollar of corporate earnings (the price/earnings ratio). The character of investment return is durable, steadfast, and fundamental: The performance of American industry. The character of speculative return, on the other hand, is transitory, reflecting the ever-changing emotions—the hope, the greed, and the fear—of investors.

The importance of this difference in the character of stock returns is underscored by the market's 14% annual return during the 1982-2004 period. **(Chart 1)** The great market bubble we witnessed at the turn of the century had inflated stock returns to unsustainable levels—an astonishing 18% annual return on U.S. stocks from 1982 when the bull market began, through the high in the spring of 2000. This record-smashing return—without historic precedent—was ultimately reduced to an average of 14% per year through October 2004, the net result of the inevitable 50% crash that followed and the subsequent partial rebound—a handsome return by any measure.

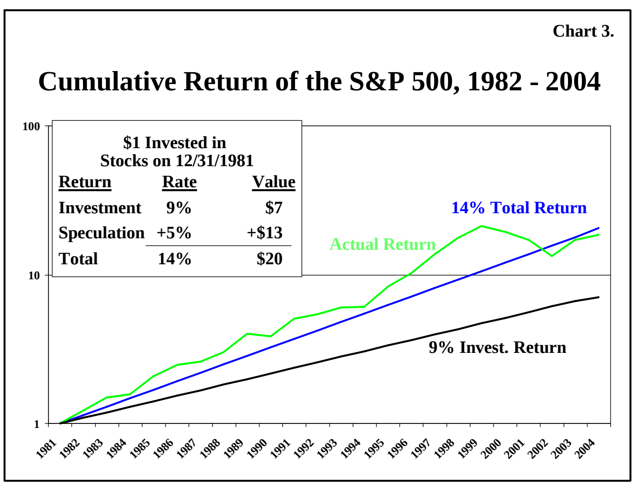


But we'd best not expect future returns at that level, well above the 10% historical average. To understand why, let's consider the character of stock market returns since 1982. **(Chart 2)**: (1) The *investment* return came to 9% per year, including an average dividend yield of 4% plus annual earnings growth of 5%. (2) The speculative return added a full 5% per year as price-earnings ratio soared from 8 times to 22 times—an impressive 175% increase, or, spread over the period, a full 5% per year. Total return, then, nine plus five—14%.[2]

[2] Note: For purposes of simplicity, I have used rounded percentages throughout.

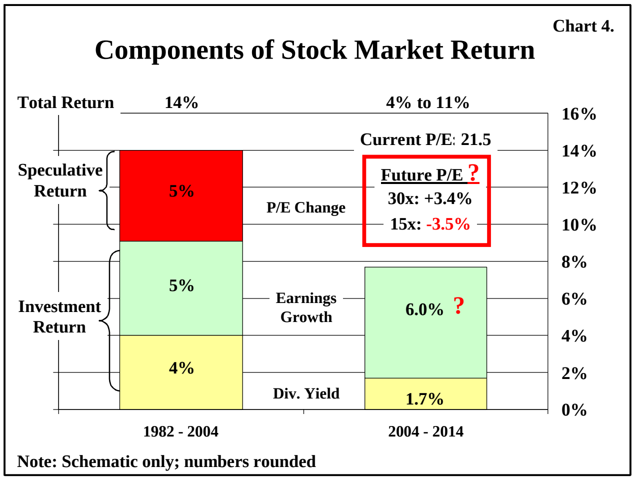


In the very long run, it is investment return—*economics*—that dictates stock prices. The ebb and flow of speculative return—*emotions*—amounts to little. But in the 1982 to 2004 period, speculation played a major role, greatly leveraged by the impact of compounding. While $1 invested in stocks grew to $20 over that long period, **(Chart 3)** speculative return accounted for fully $13 of that value. Investment return contributed but $7 to the total return of $20, only about *one-half* the contribution of its speculative partner.



Stock Returns in the Years Ahead

Now let's look ahead. It's important to recognize that the conditions that set the stage for the Great Bull Market no longer prevail. The dividend yield today is 1.7%, a fraction of the 4% yield in 1982, representing a dead-weight loss of a full 2.3 percentage points in the future contribution of dividends to investment return. **(Chart 4)**. Even if we are lucky enough to achieve 6% earnings growth, then, the annual *investment* return over the coming decade would come to just 7.7%.



In addition, today's relatively expensive price/earnings ratio of 22 times is a far cry from the cheap level of 8 times when the bull market began. While we can't be sure of the future P/E level, we can set some parameters. If the P/E ratio ten years hence were to rise, for example, to 30 times, the speculative return would increase the investment return by 3.4% per year, suggesting a total return on stocks of about 11% per year during the coming decade. On the other hand, were the P/E to tumble to 15 times—and that's the long-term norm—the resulting annual return of *minus* 3 ½% would slash the total return on stocks to just over 4%.

That's a broad range, reflecting as it does, our inability to predict the hope, greed, and fear of investors in the years ahead. So let's fine-tune it by working with what *you* expect. When I polled your group in an opinion survey, I asked two simple questions. First, "At what rate do you expect corporate earnings to grow during the next ten years: **4%** or less annually, **5%**, **6%** or **7%** or more?" None of you expected more than 7%, nor less than 4%. You were equally divided between 5% and 6%, so let's agree on **5½%**. With today's dividend yield of 1.7%, then, this group expects an *investment* return of **7.2%**.

Second, I asked, "What P/E ratio do you expect to prevail in 2014: less than **15** times, **15** to **20** times, **20** to **25**, **25** to **30**, or more than **30** times?" Only one of you expected a P/E of more than 25 times, with about half of you above **20** times and half below. So the consensus was about 20 times—meaning a negative speculative return of –**1.7%** per year over the decade. Combined with your expected investment return of **7.2%**, then, you expect a *total* rate of return on stocks of about **6.5%** annually. **(Chart 5)** Whether reality will be better, or worse, than the forecast based on your reasonable expectations, only time will tell. But I agree with you that subdued returns on U.S. stocks lie in prospect. (My own guess is in the 6%-8% annual range.)

Chart 5.

Here's What You Expect

Initial Div. Yield:	**1.7%**
Earnings Growth:	**5.5**
Total Investment Return:	**7.2%**
Speculative Return:	**-0.7%**
Total Return:	**6.5%**

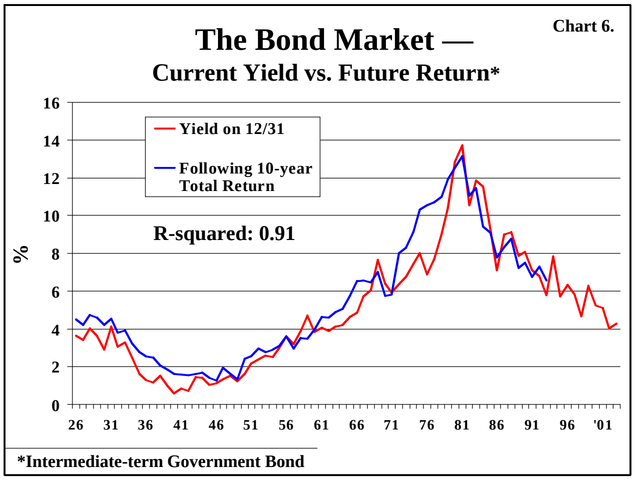
What About Bonds?

Now let's consider what returns bonds might provide in the coming decade. Alas, the *past* gives us no clue. Perhaps surprisingly, it is the *present* that provides the best guide to the future. For as Keynes' analysis suggests, the long-term *investment* return on bonds—remember, "forecasting the prospective yield of assets over their whole life"—depends almost entirely on the interest payments they generate. The source of bond returns is the interest coupon. Result: *The current yield-to-maturity of bonds will explain a remarkably high proportion of their return over the subsequent ten years.*

Yes, speculative return—the short-term impact of interest rate fluctuations—can and will cause price volatility during the interim. But think about it: If rates drop and stay down, the positive impact of the resulting increase in a bond's price will be moderated by the negative impact of the lower reinvestment rate. And if rates rise, the negative impact of the reduced principal value will be moderated by the positive impact of the higher reinvestment rate. For the long-term bondholder, the future level of rates is far less important than the present rate.

In fact, the correlation between the initial yield of a bond and its subsequent ten-year return has averaged a healthy 0.91, close to a *perfect* 1.00. **(Chart 6)** In 1980, for example, the yield on an intermediate-term U.S. Treasury bond was 12.4%; the return during the subsequent decade was 12.5%. In 1990, the yield was 7.7%; the return in the following ten years was 7.5%. Today, with a diversified portfolio of Treasury and corporate bonds providing a yield of about 5%, bond returns in the coming decade are likely to range between 4% and 6%.

So with respect to stock and bond returns alike, we're looking at a new era of subdued returns, dependent far more on the strong and fairly durable character of investment return than on the evanescent and largely unpredictable character of speculative return. If my guess on the range of future returns is anywhere near right—6% to 8% for stocks (higher than your guess), 4% to 6% for bonds—the equity risk premium would approximate 2%, somewhat below historical norms. In an uncertain world, only time will tell the extent to which my rational expectations—or yours—will prevail, but either one is a far more useful guide to the future than relying either on our emotions or on historical data.

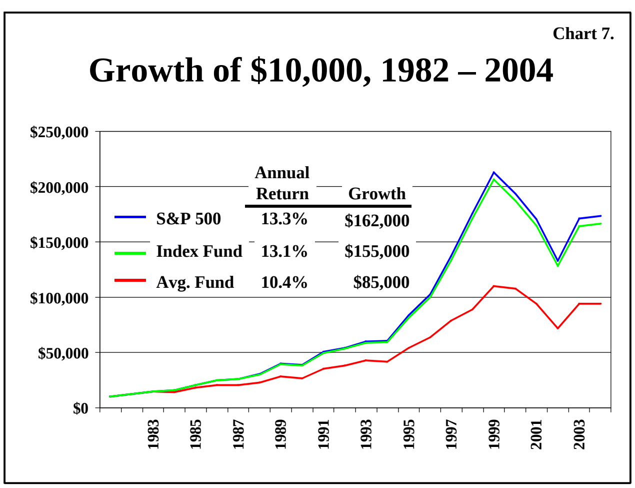


Market Returns vs. Investor Returns

Now let me pause a moment to make a major point. Whatever returns the financial markets are kind enough to deliver in the years ahead, please—*please!*—do not make the mistake of equating those returns with *the returns investors actually earn*.

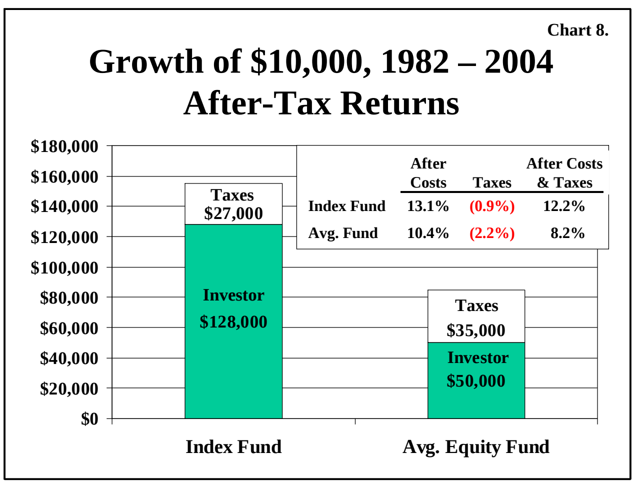
The fact—and it is hardly a secret—is that the returns of equity fund investors as a group must—and do—lag the stock market's returns by the amount of the aggregate costs of our system of financial intermediation. Those costs are not trivial. In the mutual fund field, for example, equity fund advisory fees and operating expenses (unweighted by fund size) average **1.6%** of assets per year; portfolio turnover costs (given the industry's present astonishing annual turnover rate of 110%) come to perhaps **1%** per year; and sales charges on fund purchases (amortized over a decade) add at least another **0.5%** annually. Result: all-in fund costs of as much as **3%** per year.

Such costs appear to be the primary, if not the sole, reason for the 2.9% lag between the annual return of 13.3% on the stock market and the 10.4% return of the average U.S. equity fund from the beginning of the bull market in 1982 to 2004. **(Chart 7)** Of course, actually owning the stock market carries costs, too. But, with no advisor fees or sales charges, low operating costs, and the absence of significant portfolio turnover costs (because there's almost no portfolio turnover), the best stock market index funds have all-in costs of 0.2% or less, earning about 13.1% per year.



What a difference that cost differential makes! A $10,000 initial investment in the index fund would grow to **$165,000**, while the same investment in the average equity fund have grown to just **$95,000**. Put another way, simply owning the market through a low-cost index fund produced a gain of **$155,000**, while owning the managed equity fund produced a gain of only slightly more than half as much, just **$85,000**. Put another way, the equity fund investor who, mind you, put up 100% of the capital and assumed 100% of the risk—enjoyed just 52% of the profit offered during this strong stock market. On the other hand, the index fund investor, who simply bought and held the stock market portfolio, received 96% of the market's return. I call this phenomenon the *magic* of compounding *returns*, offset by the *tyranny* of compounding *costs*.

But it gets worse. For all that portfolio turnover in actively managed mutual funds is notoriously tax-inefficient. During that same period, estimated taxes on income and capital gains would have reduced the fund's return by another 2.2% annually, to 8.2%, while owning the market through a low cost index fund would have reduced its return by just 0.9%, to 12.2%. **(Chart 8)** Compounded on an after-tax basis, **$10,000** invested at the outset in the average managed equity fund would have grown by **$50,000**, while the same investment in an unmanaged index fund would have grown by **$128,000**—more than 150% higher! Relying on *no management* through a passive index fund, it turns out, was two-and-one-half *times* as profitable(!) for taxable investors than relying on *active management* through a typical equity fund.



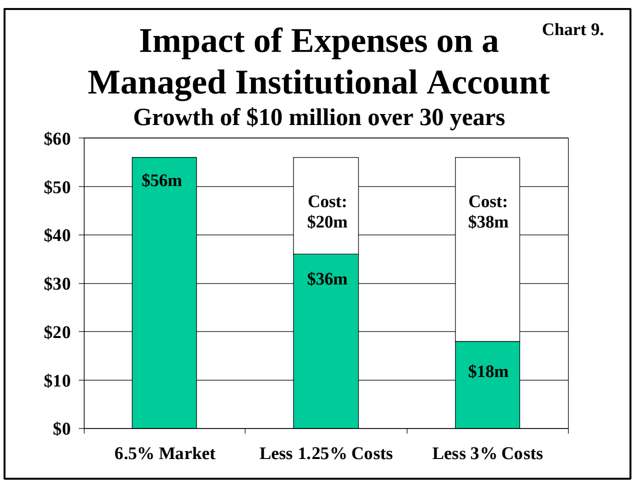
So long as gross return in the markets, minus the intermediation costs of our financial system and the tax costs of our Federal, state, and local governments, equals the net return that flows through to investors—in fact, a tautology—it must be obvious that if the fund industry is to assure that mutual fund investors receive a reasonable share of the market's future returns, we must not only take a substantial chunk of costs out of the mutual fund system itself, but focus far more heavily on developing long-term investment strategies that minimize—as index funds do—the taxes to which our precipitous realization of capital gains subjects our investors.

Listen to Ben Graham

Because we trade stocks with *one another*, of course these high management fees and tax costs can provide no net benefits to fund investors. Once we deduct fees and transaction costs from investor gross returns, investing is obviously a loser's game. Here's how Benjamin Graham, Warren Buffett's great mentor, described the role of institutional investors on Wall Street: "The stock market is technologically remarkably well organized. But in fact, it is a huge laundry in which institutions take in (giant) blocks of each others washing, to the tune of 30 *million* shares a day, without rhyme or reason." (That was in 1976. Imagine what Ben Graham would have thought about today's stock market laundry, where we wash three *billion* shares a day!)

To be sure, for those who manage large institutional portfolios, the costs of management may be considerably smaller, perhaps on average of **0.5%** (50 "basis points"). When we add in turnover costs of another **60** basis points and custody fees of **5** basis points, plus another, say, **10** basis points for the costs associated with the changes in managers that seem to occur with some frequency, these costs can still add up to a hefty annual total of **1.25%** or more, no mean drag on the long-term returns earned even by an apparently low-cost institutional portfolio.

But don't forget this: we've been looking at the impact of investment costs on returns—and returns earned during one of the strongest periods for stocks in all history. If future returns are lower than in the past, the impact of costs will be higher. For example, mutual fund costs (excluding taxes) of 3% would consume "only" 25% of a 12% stock market return, but fully 46%(!) of the 6.5% annual return that you arrived at through our reasonable expectations methodology of a few minutes ago. Even a 1¼% cost would consume almost one-fifth of such a 6½% return. Compounded over 30 years, a **$10** million initial investment in the stock market itself, compounded at **6½%**, would grow by **$56** million. But compounded at **5¼%**, after costs of 1¼%, it would grow by just **$36** million. And compounded at 3 ½%, after costs of 3%, a mutual fund investor would increase his or her wealth by just $18 million—less than one-third of the market's compounded return. **(Chart 9)** If it doesn't alarm you to see $38 million of a $56 million stock market return consumed by costs, I'm not sure I've gotten my point across!



So, especially if we are right in our expectations of a lower return environment, fund management fees and marketing expenses and operational costs, under both competitive and regulatory pressure, *must* decline. That incredible 110% portfolio turnover in the great laundry that is Wall Street must also decline, and with it total fund transaction costs. And, yes, index funds—funds that buy and hold, selling only to meet cash outflows—that closely match the return of the stock market and operate at extremely low cost must and will continue to grow. Yes, costs matter. *Costs Matter*!

In St. Louis 118 years ago, Grandpa Armstrong hit the nail on the head:

> Policyholders and Gentlemen: You must recognize (1) that companies having the smallest expense will have the ultimate advantage; (2) that companies having this advantage are the most desirous of correcting present abuses; and (3) that companies which cannot long survive the present condition of affairs are determined to nullify every

> effort for reform. To save our business from ruin we must at once undertake a vigorous reform. *To do this, the first step must be to reduce expenses.*

That advice was good enough when it applied to the fire insurance line in 1886. It is even *more* valuable when applied to all sectors of the financial services field in 2004. Why? Because more than ever we must respond to the failure of character demonstrated by the practices of the executives and managers who represent some of the leading firms in both of our fields.

The Vanguard Story

In today's world, where a long-term focus on professional standards and service to clients has too often been driven out by a short-term emphasis on business opportunism, over-reaching, and even greed, can the old-fashioned values of character and integrity—and even virtue—withstand the competition? I answer that question with a resounding "yes." Of course it won't be easy, but let me conclude my remarks on an optimistic, idealistic note, discussing, with some hesitancy, the results of "the Vanguard Experiment" that began just thirty years ago.

When Vanguard was founded on September 24, 1974, our idea was to create a company that stood for stewardship. It would be mutual, owned by the shareholders of its funds, and organized, operated, and managed for their benefit. We would operate at the lowest possible operating cost, and eliminate all sales commissions on share purchases, and hence eliminate distribution by stock brokerage firms. Our idea was to minimize the potential conflicts that exist between the interests of fund owners and fund managers.

But it would not be enough merely to employ such a novel *structure*; the firm would also develop a novel *strategy*, focused on sectors of the fund business where the benefits of minimal costs were most obvious and immediate: Market index funds, corporate and municipal bond funds, and money market funds—sectors in which the principle that gross return minus cost equals net return would be most easily perceived. The strategy could not fail.

And it didn't! Assets under Vanguard management, $1.4 billion at our inception, today exceed $750 billion, a 23% annual growth rate. Of course, as mutual funds became the investment of choice among American families during the period, our entire industry boomed too. Yet our market share has risen from **1.7%** of industry assets in 1981 to a remarkable **10%** currently—*one-tenth of all mutual fund assets*. Had we grown only at the industry rate, our assets would today be $125 billion. Thus, some $625 billion of our growth has been accounted for by our enormous growth in market share, achieved for a time without the enormous marketing and advertising expenditures incurred by our major competitors.

Further, in the areas in which the benefits of our low cost structure and the focus of our strategy were designed to dominate, our market share has become enormous. Among our direct-marketing (largely no-load) peers, our market share is **74%** in stock index funds; in the much smaller bond-index fund sector, it is even larger, at **83%**. Among corporate bond funds our share is **46%**, and among government bond funds it is **58%**. Among municipal bond funds it is **47%**, and among municipal money market funds our share is **34%**. And among taxable money market funds for individual investors it is **37%**. You will recall that these were the areas initially targeted by our low-cost strategy.

But Vanguard was not designed for the purpose of building market share. Indeed, at our very outset, I set down two principles that would drive our business: "One, market share is a *measure*, and not an objective. Two, market share must be earned, and not bought." Our idea was to create advantages for investors that would, sooner or later (and we didn't care which) become obvious to them. So we would focus, not on doing things because they would sell, but on doing things because they were right for our investors. Our motto—made explicit in a speech I gave to our crew in 1990—was *If You Build It, They Will Come.*

The Company and the Vision

What we wanted to create way back in 1974, was "a superior company with liberating vision." These words, however, are not my own. They are the words of Robert Greenleaf, founder of the Servant-Leadership movement. Here is what he wrote, some forty years ago:

> What distinguishes a superior company from its competitors is not the dimensions that usually separate companies, such as superior technology, more astute market analysis, better financial base, etc.; it is *unconventional* thinking about its dream—what this business wants to be, how its priorities are set, and how it organizes to serve. *It has a radical philosophy and self-image.* According to the conventional business wisdom, it ought not to succeed at all. Conspicuously less successful competitors seem to say, "the ideas that the company holds ought not to work, therefore we will learn nothing from it.
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> In some cases, the company's unconventional thinking about its dream is born of a liberating vision. But in our society liberating visions are rare. They are rare because a stable society requires that *a powerful liberating vision must be difficult to deliver.* Yet to have none is to seal our fate. We cannot turn back to be a wholly traditional society, comforting as it may be to contemplate it. There must be change—sometimes great change. There must be a place for servant leaders with prophetic voices of great clarity who will produce those liberating visions on which a caring, serving society depends.

I leave to far wiser—and far more objective—heads than mine the judgment about whether or not Vanguard meets Mr. Greenleaf's definition of a superior company. Of course, I hope that it does. But I have no hesitancy in saying our firm is the product of unconventional thinking about what we want to be, how we set priorities, and how we organize to serve our clients. And surely our competitors—even the most successful of them—must look with a sort of detached bemusement and skepticism at our emergence as an industry leader. We have dared to be different, and it seems to be working just fine.

The fact is that in many respects, Vanguard sprang from a well-spring of idealism. Our objective was to build a model institution that would offer financial services in a better way then our rivals. As we saw it, we would do away with the structural and strategic limitations that obstructed our industry from measuring up to its potential to serve investors. Have we succeeded? You have seen where we stand in our marketplace today, and can evaluate the results yourselves.

Yet as proud as I am of the means, methods, and manner in which Vanguard has measured up to my idealistic goals, I must confess to you that we will *never* finally achieve them. Like all of your firms, our firm operates in a rough and tumble, dog-eat-dog business in which rigorous competition begins each day at dawn, and even at the arrival of dusk hasn't much subsided. Like all of you, we operate in a world in which we are tempted, fallible, and flawed, but there is no reason we can't acknowledge our shortcomings and mistakes and then do our best to correct them. But I profoundly believe that the endeavor to serve our clients before we serve ourselves, and serve them with the highest possible ethics, integrity, and character is, finally, the *only* foundation for durable business success.

Such a focus is especially important in the financial services field, where so much of our conduct is properly subject to traditional standards of fiduciary duty, and—at least in the case of mutual funds and other investment advisory organizations—normative standards of trusteeship. Not only because the value of our services is measured in dollars, but because the cost of our services has such a direct and measurable impact on that value.

The Press Observes the Core Issue

The recent glimpses of reality into how business is conducted in the U.S. too often seems to almost directly contradict the ideals I've just expressed. So let's see ourselves as others see us, through the eyes of respected *New York Times* journalist Floyd Norris, as he examined the pervasiveness of character issues across the various sectors of the financial services field less than two weeks ago.

> *The financial industry is reeling after charges of wrongdoing and a denouncement of practices that it—and its regulators—had viewed as acceptable. The insurance industry scrambled yesterday to change practices a day after Eliot Spitzer filed a lawsuit against the country's leading insurance brokerage firm, and accepted guilty pleas to criminal charges from two executives of a major insurer who admitted to joining in rigging bids to make it appear that its customers' business went to companies based on competitive bids when that had not really happened . . .*
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> *A couple of years ago, it was no secret that research analysts for investment banks almost never recommended selling a stock, or that they tended to recommend companies whose securities were underwritten by the investment banks. But no one seemed to think change was needed. Then Mr. Spitzer came up with e-mail messages in which some analysts seemed to admit that they thought companies they were recommending were grossly overvalued. The eventual result was . . . a change in the way Wall Street research is conducted and disseminated . . . Whether that will result in better research has yet to be seen, but the industry is very different from what it was.*
>
> *In the mutual fund industry, Mr. Spitzer found evidence of late trading . . . that appeared to be theft from fund customers, and (it) outraged investors. Practices involving sales of funds by stock brokers in return for payments from the fund companies are also changing, even though the industry had regarded them as quite normal before the investigations began . . . both the insurance business and the mutual fund industry are now being forced to highlight to the customers just how much money is being paid. With fees clearer, the possibilities of price competition grow.*

While the malfeasance of some *bad apples* shouldn't itself sour an entire field, my critical eye sees far too much evidence that the financial services *barrel*, if you will, still has some serious problems. It's hard to imagine that the direction of change following the evidence of over-reaching of major participants both in your industry and mine will not bring a greater focus on transparency, disclosure, service, and giving our clients a fair shake—not only for their sake, but for our own sakes as well—serving them, as I wrote in my senior thesis on mutual funds at Princeton University way back in 1951, "in the most honest, efficient, and economical way possible." Our character is being tested today, and our character will continue to be tested in the years ahead. It's up to everyone in this room today to make certain that it is not found wanting.

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