Restoring Trust:
Financial Services in the New Era

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Thank you for honoring me with your invitation to address this remarkable gathering of human beings who care—and care deeply—about the future of financial institutions and the services we provide to the investors who have entrusted us with their hard-earned assets. It is no secret that we gather at a time of special challenge.

How much of a challenge? Just think about how quickly and radically the crucial factors that affect the financial services field have changed. Less than four years ago, as 1999 was about to roll into 2000, the Y2K issue—if you can still remember what that acronym stood for!—was *the* major challenge of the day. We overcame it, and our computers moved into a new century that was billed as a new era of growth for our global economy. In an article entitled, of all things, "The Long Boom," *WIRED* magazine, the hottest publication of the new economy, headlined its story, "We're Facing Twenty-Five Years of Prosperity, Freedom, and a Better Environment for the Whole World. You Got a Problem with That?"

Who could *possibly* have a problem with that? Indeed, readers must have salivated as they anticipated, in *WIRED's* words, "the beginnings of a global boom on a scale never experienced before . . . a period of sustained growth that could eventually double the world's economy every dozen years and bring increasing prosperity for billions of people on the planet . . . growth that will do much to solve seemingly intractable problems like poverty, and ease tensions throughout the world, all without blowing the lid off the environment."

That wildly bullish thesis was based on the triumph of the United States, the end of major wars, waves of new technology, soaring productivity, a truly global market, and corporate restructuring—"a virtuous circle . . . driven by an open society in an integrated world." In all, "a radically optimistically *meme*." (A word I had to look up.[1])

Part of *WIRED*'s forecast was right on the mark. We *were* moving into a new era. But, so far at least, the new era has been the diametrical opposite of those predictions. The long boom in the stock market has been a short bust. The U.S. is engaged in three wars (terrorism, Iraq, and Afghanistan). The growth rate in information technology has slumped. Our economy is recovering only fitfully from the recession. And corporate malfeasance has shaken the confidence of investors to the point that the very nature of modern-day capitalism is—quite properly—being challenged.

Each of these challenges, as it happens, reverberates across every single aspect of the financial services field, interacting like molecules on its participants. This morning I'd like to discuss these

[1] "Meme": A contagious idea that replicates like a virus, passed on from mind to mind. Memes function the same way viruses do, propagating through communication networks and face-to-face contact between people . . . the basic unit of cultural evolution.

reverberations in four major areas, each in its own kind of new era: the financial markets, mutual funds, information technology, and our capitalistic system.

A New Era in the Stock Market

Let's begin with the new era in the financial markets. In the previous era, the stock market boom of the 1990s was unprecedented in its magnitude. Led by technology, dotcoms, and the other "new economy" stocks of the NASDAQ Index, the return on stocks soared to an astonishing *real* (inflation-adjusted) annual rate of 15%, the second best decade in the two-century history of our market, and *more than double* the historic U.S. norm of 6.7%.

But only a few short months after the old decade ended, the market abruptly reversed course. The capitalized market value of U.S. corporations fell with a sickening thud, tumbling from its $17 trillion peak in March 2000, to a low—or *probable* low—of $9 trillion early last October. (The value has now recovered to $11 trillion.) Led by the 78%(!) decline in the NASDAQ Index, the total market fell by 50%. This reversion to the mean should have surprised no one, for the boom and bust cycle has characterized stock markets all through their history. But it has fundamentally, and properly, undermined the once-conventional wisdom that common stock ownership doesn't entail extreme risks.

Those risks came home to roost in the first three years of this decade. Stocks have provided a real annual rate of return of –17%, with the exception of 1930-1933, the *worst* start for any decade in the past two centuries. But with that tumble now behind us, the stock market is likely to provide positive returns in the decade ahead, albeit at levels that are more modest than in the prior decade—say, in the range of 6% to 9% annually. I say that, *not* as a market seer (I'm hardly that!), but rather based on my half-century of observation that in the long run, it is the *reality* of dividend yields and earnings growth—*investment* return—that drive stock prices, not the *perception* of valuations—*speculative* return—reflected in the momentary prices that investors are willing to pay for a dollar of earnings (the price-earnings ratio).

Consider that the 18% nominal annual return of the 1990s was driven largely by a *speculative* return of 8%, as the price/earnings ratio rose from 15 times to 30 times. The 3% initial dividend yield plus a 7% earnings growth produced a 10% *investment* return. With today's dividend yield only about 2%, and—I'm guessing—future earnings growth of 5% or 6%, the coming decade's *investment* return would come to about 7½%. But the price/earnings ratio, now at about 20 times, is hardly cheap, and I can't imagine that speculative return will add much to that total. (It could, of course, reduce it.) Such a new era of more subdued equity returns cannot help but affect both the financial services field and the technology firms that focus on it.

A New Era for Mutual Funds

The investment business is especially market-sensitive, and the stock market boom led to an even more powerful boom in the asset management field. Indeed, revenues of mutual fund companies grew at a real rate of 20% a year during the 1990s, *six and one-half* times the GDP growth rate. We never had it so good!

But when the bear market arrived, that same market sensitivity brought our industry's growth to a screeching halt. While mutual fund assets grew from less than $1 trillion to nearly $7 trillion during the 1990s, they now stand at a smaller, but still healthy, $6 trillion, a stability engendered by our healthy bond and money market fund assets. Equity fund assets, however, have tumbled from $4 trillion to $2.3 trillion, with a cash inflow of $310 billion in the twelve months ended September 2000 reversing to an *outflow* of $45 billion during the past year.

The stock market boom and bust, as well as the burgeoning panoply of investor services that information technology has engendered, have played a vital role in the mutual fund industry—and the outcome has not been entirely happy. We exploited the idea of a tech-led "new economy," promoted our highest-flying funds, and created some 500(!) new, and risky, aggressive growth and sector funds with technology and telecommunications stocks at their very core. Further, we turned each new *potential* tech advance in the services we provide into a *reality*, speeding up our activity levels. Fund portfolio turnover soared to an average of more than 100% per year, and the turnover of our fund investors' capital reached an annual rate of 40%, suggesting a typical average holding period of but 2½ years, stunningly short-term for what I've always thought of as the finest medium for long-term investing ever designed by the mind of man.

Counterintuitively, despite the staggering economies of scale we enjoy in this burgeoning industry, equity fund expense ratios kept rising. With high turnover costs, sales charges, and other expenses, fund all-in costs now approach 3% per year. The unsurprising result of this 3% cost: During the 1984-2002 period, when the stock market itself (the Standard & Poor's 500 Stock Index) delivered an annual return of 12%, the average *mutual fund* delivered a return of only slightly over 9%. To make matters worse, most fund investors didn't come to the party until stock prices were hitting all-time highs, and when they arrived, they invested their resources in the industry's most speculative funds. Result: The average fund *shareholder* earned only about 2.6% per year, less than they would have earned had they left their money in the bank. The fund industry has a lot to answer for, and our new era portends huge challenges.

A New Era for Technology

With the burgeoning mutual fund industry and its sister financial institutions leading the way in using IT, the 1990s were a golden era for information technology. Tech revenues grew at five *times* the rate of our nation's gross domestic product. But as our economy slowed and funds and other financial users of IT faced the pressure of the bear market, growth slowed dramatically. Today, technology revenues are growing at a rate that is tracking GDP one-for-one. And while future IT may return to a level of, say, twice GDP growth, achieving that goal would be no small achievement for the now-giant technology industry.

Equally important is what's happening *within* the technology environment. While the earlier era of incredible innovation revolved around "killer apps," data systems, and the rise of the personal computer, we are now rapidly moving toward the integration of technology into the mainstream of day-to-day business, a trend most obvious among financial services firms. But while such firms garnered high returns on their earlier information technology investments, cost-cutting now seems to be the order of the day. The focus is on improved systems integration and, believe it or not (as the London *Economist* put it), "the revival of old-fashioned branch networks."

In the earlier era, investment managers surfeited investors with cascading information; developed program trading; created complex, exotic investment strategies; and provided services that enabled investors to trade endlessly at minimum costs. If we *could* provide the service, we *did* provide it, and information technology was our *master*. In the new era, we must make information our *servant*, critically examining whether the speeded-up trading services and plethora of information we give to our investor clients have, by focusing on the here and now rather than the long pull, been counterproductive.

These challenges come at a time when other information technology challenges abound—in personal privacy, in data security, in useless spam and unsolicited information, and in computer viruses. Given the interlinked complexities of our existence in our new wired society, when technology fails us, it fails us greatly, as in the Columbia space shuttle disaster and the recent power failure that left the entire

northeastern United States in the dark. In today's world, the effects of system failure can be devastating. The new era for technology, then, promises lower growth and higher risks.

A New Era for Corporate Governance

The combined challenges of a more subdued stock market, a mutual fund industry that has failed to measure up to the trust of investors, and a commensurate slowing of IT growth have hardly made our environment an easy one. But there is more. The accompanying breach of trust by corporate America, the giant engine that drives much of our nation's growth, was, perversely speaking, the icing on the cake.

The root cause of that breach of trust was the gradual metamorphosis of traditional *owners*' capitalism to a new system of *managers*' capitalism. From its earliest days at the start of the nineteenth century, capitalism was based on trust. It had to be. As makers of goods and services and buyers and sellers met face-to-face in the marketplace, a virtuous circle of trust developed: "Make me a good product, sell it to me at a fair price, and I'll be back for more." Seeking a reasonable return on their investment, the owners of the business—those who put up the capital—watched over it with care.

But over the next two centuries, the need for capital grew to staggering proportions. The ownership of business inevitably moved from private entrepreneurs to public investors. And as shareholdings became diffused among millions of investors, none with a dominant position, the control of firms shifted from owner to manager. But the institutional structure that developed to assure that management would serve the owners was not up to the task. The power of the board of directors gradually eroded, creating a vacuum that was filled by the newly-imperial chief executive, who came to be seen not only as boss of the business, but boss of the board. Public accountants, once independent professional evaluators of a firm's financial statements, became management's business consultant and partner, and financial reporting standards eroded.

Simultaneously, stockholders turned their focus from the *long-term*—the eternally tough job of building *the intrinsic value of the corporation* in a competitive, innovative, capitalistic economy—to the short-term—the far easier task of building the *momentary price of the corporation's stock* by hyping reported operating earnings. Net result: Bad business decisions; foolish capital expenditures; unwise mergers; and grotesquely excessive executive compensation. Mega-grants of stock options were given away, on the false rationale that transitory stock prices were a valid measure of business success. In all, it was a dark era for capitalism.

What's to be Done?

Yet if it's always darkest before the dawn, as the optimist in me believes, then this is a great moment to be part of this challenged but nonetheless vibrant sector of our economy. After all, we've been through something akin to "a perfect storm"—the simultaneous interaction of a bear market, a beleaguered fund industry, a slowdown in tech growth, and a breach of investor confidence—yet we're all here together to consider ways to build a better world. If you thrive on challenge, you'll love the coming decade.

Let me close with my views as to some directions in which we should move:

1. In the new era with a more subdued stock market, we'd best wake up to the fact that the existing level of financial intermediation costs will consume an unacceptably large proportion of the returns earned by investors. While a 3% cost consumes only(?) 20% of a 15% stock market return, it consumes 40%(!) of a 7½% return. If we are to give mutual fund investors a fair shake,

taking costs out of the system is essential. Reduced management fees are one step; reduced marketing costs another; and reduced portfolio turnover costs yet another.

2. Information technology firms must make a vital contribution to improving financial service efficiency and investor services. We need to provide to our shareholders, not just more *information*, but more *relevant* information, about likely returns, potential risks, the impact of costs, the perils of hair-trigger investing, and the need to stay the course. We also must drag every penny of waste out of our operations. IT can help immeasurably in this task, but as the theme of this conference suggests, there are "*new rules for profitability*." One new rule must be to capture the *efficiency* of technology to reduce, not only the costs borne by fund *managers*, but the costs borne by fund *shareholders*.

3. During the great bull market, mutual fund firms have prospered in an era of *salesmanship*, organizing, offering, and promoting risky funds at the best time for distributors to sell them and the worst time for investors to buy them. The new era cries out for a return to our roots of *stewardship*—putting the shareholder first. That will require resilience, but we must bounce back in a new and better direction.

4. In the speculative, high turnover era of the bull market, mutual funds managers forgot their duty to act as responsible corporate citizens. And when *owners* don't care about corporate governance, *who on earth should*? When we at last return to our roots as long-term investors—and index funds must be in the, well, vanguard of this trend—we will serve, not only our fund shareholders, but our society well.

5. Our task is not, as it is so often said, "restoring the confidence of investors in the integrity of our financial system." It is restoring the *integrity* of the system. Stock owners need effective governance, a lid on executive compensation, and honest accounting. And if we don't get it, we need the right to gain access to corporate proxy statements in order to nominate directors and demand proper corporate practices. When we again begin to act as *owners* and implement those reforms, the confidence of investors will return, as surely as the dawn follows the darkness.

So the mission is clear. All that remains is the tough, tough job of implementation. While there may be some sunshine patriots and summer soldiers in the financial services field who would shrink from the exciting challenges we face today, most of us would rater persevere, knowing that in Thomas Paine's words, "the harder the conflict, the more glorious the triumph." I'm delighted to contribute whatever I can to this vital mission in the service of America's investors, and I urge you to join me.

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

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