# Choosing The Right Path

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Psalm One reminds us—as if we should need any reminder!—to choose the right path in our lives. In the psalm, David tells us, "blessed is the man whose delight is in the law of the Lord, the man who shall be like a tree planted near the rivers of water, and whatsoever he doeth shall prosper . . . for the law knoweth the way of the righteous, but the way of the ungodly shall perish."

"Choose the right path." It sounds so easy. Yet too many of the stewards with whom we have entrusted the responsibility for our nation's corporations and financial institutions have chosen the wrong path, a path leading to the acquisition of personal wealth, with all its gaudy trappings, *for themselves* rather than the path that leads to the building of their institutions for the benefit of their *owners*, who have entrusted them with that responsibility of stewardship.

### The "Bottom Line Society"

It is not alarmist, I think, to be concerned about the extent to which our worship of mammon—by which the Bible means "riches"—is superceding our worship of God. As the teacher Joseph Campbell has observed, even our architecture reflects this change. "In medieval times," he writes, "as you approached the city, your eye was taken by the Cathedral. Today, it's the towers of commerce. It's business, business, business." We have become what Campbell calls "a bottom-line society." But our society, I think, is measuring the *wrong* bottom line: form over substance, prestige over virtue, money over achievement, charisma over character, the ephemeral over the enduring, and yes, even mammon over God.

Joseph Campbell's analogy proved to be ominous. Just as the proudest of all of America's towers of commerce, at New York's World Trade Center, collapsed after a terrorist attack, so the aggregate stock market value of America's corporations has collapsed—albeit from a puffed-up, unrealistic 17 trillion dollars—to the recent 10 trillion dollar total that has returned us to (or at least *toward*!) normalcy in valuations. And we've also seen the reputations of business leaders collapse, as yesterday's mighty lions of corporate success are today often seen as self-serving and less-than-trustworthy.

What we've witnessed is the departure of capitalism from its proud roots. Consider how capitalism came to flourish: Late in the $18^{th}$ century, as our industrial society began to emerge, local communities became part of national (and then international) commerce, trading expanded, and large accumulations of capital were required to build the factories, transportation systems, and banks on which the new economy would depend. At the heart of this development, were, of all peoples, the Quakers. With their legendary simplicity and thrift, they had the capital to invest, and quickly came to dominate the British economy. Their emphasis on reliability, absolute honesty, and rigorous record-keeping gave them trust as they dealt with one another, and other observant merchants came to see that being trustworthy went hand-in-hand with business success. Self-interest, in short, demanded virtue. "Good Ethics is Good Business."

## The Virtuous Circle Gets Broken

And so it was to be that capitalism evolved in the direction of *more* trust and transparency and *less* self-serving behavior, and with it greater productivity and economic growth. *Not*, I assure you, because capitalists are naturally good people, (but) because, the benefits of trust—of trusting and of being trustworthy—are immense, and because a successful market system teaches people to recognize those benefits . . . a *virtuous* circle in which an everyday level of trustworthiness breeds an everyday level of trust." The system *works!*

Or at least it *did* work. And then something went wrong. The system changed—"a pathological mutation in capitalism," as an essay in the *International Herald Tribune*[1] described it, from the classic system—*owners* capitalism—a dedication to serving the interests of the corporation's *owners* in maximizing the return on their capital investment, to a new system—*managers* capitalism—in which "the corporation came to be run to profit its managers." Why did it happen? "Because the markets had so diffused corporate ownership *that no responsible owner exists*. This is morally unacceptable," the essay concluded, "but also a corruption of capitalism itself."

In short, our capitalistic system—as *all* systems sometimes do—has experienced a profound failure, a failure with a whole variety of root causes, each interacting and reinforcing the other: And the stock market mania; the turn of the millennium; the information age; the notion that our corporations were trees that could grow not only to the sky but beyond; the rise of the imperial chief executive officer; the failure of our auditors and boards of directors, who forgot to whom they owed their loyalty; our regulators and legislators, who actually made things *worse*; the disingenuous hype of Wall Street's stock promoters; the frenzied excitement of the media; the eager and sometimes greedy members of all of us in the investing public, reveling in the easy wealth that seemed like a cornucopia, sitting back and enjoying the ride, at least while it lasted; and the change in our financial institutions from being stock *owners* to being stock *traders*. Too many wrong paths! But as it drove stock prices *up*, this happy conspiracy among all of the interested parties drove business standards *down.*

## Executive Compensation Gets Out Of Hand

We find the most egregious example of how *owners*' capitalism has been superceded by *managers*' capitalism in soaring compensation to management. As stock option grants were far too liberally bestowed, chief executive compensation has ratcheted steadily upward, rising from 42 times the compensation of the average worker in 1980 to an astonishing 531 (!) times in 2001, when the *average* CEO earned $11 million.

Yet the business accomplishments of our CEOs were hardly out of the ordinary. During that same period, CEOs predicted annual earnings growth for their firms averaging 11½%, but then delivered only half—one half!—that amount, just 6%, even *less* than the 6½% annual growth of our economy. The fact is that the executives had "created wealth" for themselves, but not for their shareowners. And when the stock market values melted away, they had long since sold hundreds of billions of dollars worth of their stock, leaving their owners holding the bag.

This situation came about in part because directors and investors alike forgot that the CEO is, truth told, an *employee* of the corporation. Yet we came to treat the CEO not only as boss of the business, but boss of the board. The whole idea of *separation of powers* was lost. Paraphrasing James Madison, we forgot that "if CEO's were angels, no corporate governance would be necessary." Too many directors

[1] William Pfaff, September 9, 2002.

failed to consider that their overriding responsibility was to represent the largely faceless, voiceless shareholders who elevated them.

Put another way, it is the responsibility of those who serve on the boards of directors to ensure that the enterprise's resources are used in the faithful service of its owners—to be good stewards, if you will, of the corporate property entrusted to them. But as boards of directors turned over to the company's managers the virtually unfettered power to place their own interests first, both the word and the concept of stewardship became conspicuous by their absence from the list of values on corporate America's agenda. So it is our corporate directors who bear the ultimate responsibility for what went wrong in corporate America.

## The Silence Of The Funds

Or should they? Why should the board bear the ultimate responsibility when it doesn't even *have* the ultimate responsibility? It is the stockholders themselves who bear the *ultimate* responsibility for corporate governance. And as investing has become institutionalized, stockholders have gained the *real*—as compared with the *theoretical*—power to exercise their will. Once owned largely by a diffuse and inchoate group of individual investors, each with relatively modest holdings, today the ownership of stocks is concentrated—for better or worse!—among a remarkably small group of financial institutions whose potential power is truly *awesome*. The 100 largest managers of pension funds and mutual funds alone now represent the ownership of one-half of all U.S. equities: *Absolute control over corporate America*. But the only sound we've heard so far from our institutional community is the sound of silence.

Our nation deserves better. For just as corporate directors should act as responsible stewards of the corporation's resources, so should our money managers act as responsible stewards for the investors who have entrusted their hard-earned assets to them. Yet, in part because the mutual fund field has become, not an *own-a-stock* industry, but a *rent-a-stock* industry, we have faltered in our solemn responsibility to be good corporate citizens. When the average fund holds the average stock in its portfolio for just *eleven* months, we become stock *traders* rather than stock *owners*, and pay only sparse attention to corporate governance issues. "We have met the enemy, and he is us."

## The Parable Of The Dishonest Steward

And this brings me to this morning's second reading, from Luke 16. In the parable of the dishonest steward, St. Luke tells us about "a certain rich man which had a steward, who was accused of wasting his goods." The rich man says "thou mayest no longer be my steward; give an account of thy stewardship." The steward does so, but, to make himself look good to the debtors, only after telling them that they owe the rich man far less than their true debts. The rich man accepts the action of the dishonest steward, but warns him, "if ye have not been faithful in that which is another man's, who shall give you that which is your own?" He then adds, "no man can serve too masters; ye cannot serve both God and mammon." Then Jesus speaks directly to the Pharisees: "Ye are they which justify yourselves before men, but God knoweth your hearts, for that which is highly esteemed among men is abomination in the sight of the Lord."

While the moral of Luke 16 is not a model of clarity (Why, after learning about the forgiveness of the debts, would the rich man praise the dishonest steward?), it does send us three clear messages. First, that the ever-present devil places before all of us the temptation to choose mammon rather than God as our master. Second, that when we business people justify our actions as acceptable behavior because "everyone else is doing it," we ignore the warning, "that which is highly esteemed among men is abomination in the sight of the Lord."

And third, the wonderful "no man can serve two masters." Jesus tells us that we cannot serve "both God and mammon," yet in *corporate* America, we see managers serving their own interests before serving their stockholders. And in *investment* America, we see those who manage the investments serving their own interests first, subordinating their duty to preserve and protect the wealth of the investors they serve. Dishonest stewards? You be the judge.

## God and Mammon

But *I* believe that it is high time to return to the idea of stewardship—faithful service. We need to restore the *integrity* of our system of capital formation. We need to demand that our financial institutions focus on long-term investment rather than on short-term speculation, on the enduring reality of intrinsic corporate values rather than the ephemeral perception of momentary stock prices. But, no, mammon is not going to be driven out of capitalism. The truth is that, properly directed, it actually *belongs* there! But as we "render unto Caesar the things that are Caesar's, and unto God the things that are God's," we must strike a far better balance in our business practices.

But the prudent fiduciary, the trusted businessman, and the honest steward shouldn't behave in an ethical way only because our clients will finally drag us, kicking and screaming, into doing what's right. The fact is that in the long run *good ethics is good business, part of a virtuous circle that builds our society*. When our rule of conduct became "I can get away with it," or, more charitably, "I can do it because everyone else is doing it," integrity and ethics go out the window and the whole idea of capitalism is soured.

Calling for integrity, ethics, and a return to the eternal standards of long-term investing is more than mere moralizing. Our very society depends on it, for our economic growth depends upon capital formation. "*When the capital development of a country becomes a by-product of the activities of a casino,* "as the great economist John Maynard Keynes warned us, "*the job is likely to be ill-done.*" Well, we've just witnessed what "the casino society" has wrought, and it's high time for a whole new mindset. Especially in the mutual fund industry, we need to go "back to the future," returning to our traditional focus on stewardship.

## A Call For Virtue

Today we are at the beginning a wave of reform in corporate governance and turning to the task of moving America's capital development process away from speculation and toward enterprise. It will be no mean task. For there's even more at stake than improving the *practices* of governance and investing. We must also establish a higher set of *principles*. While this call for virtue in the conduct of the affairs of corporate America—and investment America, too—may sound like a hollow "do-good" platitude, the fact is that in the long run the high road is the only possible road to national achievement and prosperity, to making the most of those priceless assets in which America has been endowed by her Creator.

On this point, I am unable to find more compelling wisdom than some splendid words attributed, perhaps apocryphally, to Alexis de Tocqueville—words that resound far beyond the parochial business issues I've addressed this morning into the larger world around us, troubled and unsettled and risky. Surely these words that are especially appropriate in this sanctuary where we sing and pray together this morning:

> "I sought for the greatness and genius of America in her harbors and her rivers, in her fertile fields and boundless forests, and it was not there.

"I sought for the greatness and genius of America in her rich mines and her vast world commerce, and in her institutions of learning, and it was not there.

"I sought for the greatness and genius of America in her democratic Congress and her matchless Constitution, and it was not there.

"Not until I went into the churches of America and heard her pulpits flame with righteousness did I understand the secret of her genius and power.

"America is great because America is good, and if America ever ceases to be good, America will cease to be great."

And so it is with corporate America and investment America too. It's about us choosing the right path—*the path of righteousness*—just as Psalm One urges us. And its about demanding honest stewardship, as Luke 16 reminds us, from those with whom we have entrusted the responsible care of America's corporations and her financial institutions. Only if we choose the path to goodness can we lead America down its path toward greatness.

May the Lord help us in that quest.

Amen.

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