“Somebody’s Gotta Keep An Eye On These Geniuses”—
What We Must Do To Restore Owners Capitalism

Keynote Speech by
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It is a high honor for me to be invited to deliver the keynote at this nationally-recognized forum. Even in this day when director forums are rife, the Wisconsin Directors’ Summit has set the standard by which others measure themselves. With such a distinguished list of speakers, moderators, and panelists, to say nothing of this audience of high-level executives and directors, I approach my task with considerable humility—a humility, however, that will cause me neither to pull punches nor temporize, nor to abandon my characteristic bluntness. The fact is that it’s high time for bluntness.

Your agenda lists the title of my remarks as “What Went Wrong in Corporate America?”. But since I’ve talked about that subject in considerable depth in other venues, most notably in a speech to the Community Forum of the Bryn Mawr (Pennsylvania) Presbyterian Church earlier this year, I’m going to spend only a few moments on that subject before turning to my new title: “What We Must Do To Restore Owners Capitalism.”

The new subject broadens my earlier theme to include not only *corporate* America but *investment* America—the mutual funds and other institutions that own the dominant share of our nation’s publicly-held business. Having been responsible for so much of the problem, we money managers must now begin to take responsibility for the solution. Like corporate executives and corporate directors, corporate owners have a lot to answer for, and our society has a right to demand that we all stand up and be counted.

Why is Corporate Governance Necessary?

Corporate governance is at the heart of the issue. As James Madison said about our Constitution, “if men were angels, no government would be necessary.” Similarly, *if business executives were angels, no corporate governance would be necessary*. Even as our nation is not a *democracy*, controlled directly by its citizens, neither is the American corporation. (Even approvals of corporate resolutions by shareholders are non-binding.) Rather, like our nation, the corporation is a *republic*. While supreme power resides with its shareholders, they exercise their power through directors whom they have elected to represent their ownership interests.

During the 1990s, our system of corporate governance broke down. Too many boards failed to adequately exercise their responsibilities to oversee management, and rare was the institutional investor that exercised its responsibilities of corporate citizenship and demanded that oversight. When the *owners* of corporate America don’t care about governance, who on earth *should* care?

What’s to be done? Writing in *The New Yorker* a few months ago, business columnist James Suroweicki gave us an amusing but perceptive answer. He used the example of the 1956 comedy, “The Solid Gold Cadillac,” in which Judy Holliday played Laura Partridge, a small investor whose continual harassment of the board finally gets the company to put her on the payroll as its first director of investor relations. She quickly uses the position to organize a shareholder revolt that topples the corrupt CEO. As Surowiecki concludes: "American companies are the most productive and inventive in the world, but a little adult supervision (by the owners) wouldn't hurt. Laura Partridge had it right a half a century ago: `Somebody's gotta keep an eye on these geniuses.'"

Under our governance system, the board of directors is the first "somebody" to hold management responsible to represent the interests of shareholders. And when the directors don't fulfill that responsibility, the second "somebody" must hold them accountable: the shareholders themselves. Shareholder involvement in corporate governance can provide the necessary "adult supervision" required to move us away from the existing system of *managers* capitalism that we never should have allowed to come into existence in the first place, and to return us to *owners* capitalism, where we began all those years ago, a system in which trusting and being trusted created a virtuous circle of progress.

What Went Wrong in Corporate America?

The fact of the matter is that something has gone profoundly wrong with the very system that we have come to know as American capitalism. The root causes of the disease are deep, and the remedies that are required to cure it will not be easy to come by. For what we have witnessed in the failure of corporate governance in America has been, as journalist William Pfaff described it, "a pathological mutation in capitalism." He was right on the mark. The classic system—*owners* capitalism—had been based on a dedication to serving the interests of the corporation's owners, maximizing the return on their capital investment. But a new system developed—*managers* capitalism—in which "the corporation came to be run to profit its managers, in complicity if not conspiracy with accountants and the managers of other corporations." Why did it happen? "Because," in Mr. Pfaff's words, "*the markets had so diffused corporate ownership that no responsible owner exits*. This is morally unacceptable, but also a corruption of capitalism itself."

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

When most owners either don't or won't or can't stand up for their rights, and when directors lose sight of whom they represent, the resulting power vacuum quickly gets filled by corporate managers, living proof that Spinoza was right when he told us, "nature abhors a vacuum." Little good is likely to result when the CEO becomes not only boss of the business but boss of the board, erasing the "bright line" that common sense tells us ought to exist between management and governance. Put more harshly, in a quote that I came across last spring, "when we have strong managers, weak directors, and passive owners, don't be surprised when the looting begins."

Adam Smith, that patron saint of capitalism, would not have been surprised by this outcome. More than two centuries ago, he wrote: "*it cannot be well expected that the directors of companies, being the managers rather of other people's money than of their own, should watch over it with the same anxious vigilance with which partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they . . . very easily give themselves a dispensation. Negligence and profusion must always prevail.*"

The Prescience of Adam Smith

Adam Smith's words presciently describe corporate America in the recent era. While the actual looting we know about has been limited, negligence and profusion have indeed prevailed, and the managers have given themselves, using Smith's word, "dispensations" that would have appalled the thrifty Scot. We've all heard that the malfeasance in our capitalistic system has been confined to just "a few bad apples." And in the context of our tens of thousands of corporate executives and Wall Street leaders, that's doubtless true. But the fact is that the very *barrel* that holds all of those apples, good and bad alike, has itself developed some major faults and is in need of major rehabilitation.

Ironically, it is the scandals exposed by the malfunction of American capitalism—the acknowledged "bad apples"—that have exposed the weaknesses in the system—the "barrel." Consider the staggering levels of compensation which we pay our chief executives. The compensation of the average CEO has risen from 42 times that of the average worker in 1980 to an astonishing 531 times in 2000, resulting in an extraordinary increase in the portion of corporate earnings that corporate managers have arrogated to themselves.

From 1988 to 2001, the annual compensation of the average CEO rose 443%, from $2,025,000 to $11,000,000, while the compensation of the average worker rose 60% from $16,700 to $26,700—in real terms, virtually no increase at all. It would be one thing if this quantum increase in executive compensation were justified by corporate achievement, but that's simply not the case. From 1988 to 2001, executives promised investors earnings growth averaging 12% per year. However, they delivered growth of only 3.5% (0.5% in real terms)—even *less* than the 5.5% nominal annual growth in our nation's GDP for that period. It's difficult to see any evidence in these figures that could possibly justify the outrageous riches that have been bestowed on our corporate leaders.

Much of that compensation increase was fueled by executive stock options. While options are almost universally described as "linking the interests of management to the interests of shareholders," the fact is that they do no such thing. They are a lottery-like give-away that focuses on easily-manipulated *stock price*, not hard-to-come-by *corporate value*. They ignore dividends and reflect no cost of capital. Rather than holding onto their shares, executives typically sold them at the earliest moment, often without putting up a penny ("cashless exercise"). The very structure of the fixed-price stock option was fatally flawed, used to the exclusion of more rational option forms because—unbelievably!—they did not appear as a cost in the company's income statement. (Indeed, compensation consultants described such options as "free.")

The Beauty of Scandal—Bad Apples Illuminate Bad Barrels

Striking as they do at the heart of our capitalistic system, the corporate scandals of the recent era are unpleasant to witness. But even as "it's an ill wind that blows no good," when the bright spotlight of public attention shines on major scandals, it also illuminates all the nibbling around the edges of ethical practice that, were it not for the scandals, would persist indefinitely. The fact is that we owe a certain perverse kind of debt to the fallen idols of capitalism—the "bad apples" who illuminate the weakened "barrel"—as these examples suggest:

- **Kenneth Lay, Jeffrey Skilling and Andrew Fastow** presided over the collapse of Enron, revealing a whole panoply of financial engineering that quickly turned to fraud. But Enron's bankruptcy also turned the spotlight on the profound failings of a blue-chip board ("America's Third Best Board," according to *Chief Executive* magazine), the co-option of its accounting (and consulting) firm, and the active participation of its bankers in deals of dubious validity.

- **Bernard Ebbers,** CEO of the now-bankrupt WorldCom (recently renamed MCI), gained his fame when the firm cooked the books with an $11 billion (!) accounting scandal. His demise also revealed that he had borrowed a stunning $408 million (!) from WorldCom so as to avoid selling his shares to meet margin calls. (The Sarbanes-Oxley Act now bans corporate loans to executives.)

- **William Esrey and Ronald LeMay** of Sprint gained the spotlight with their $290 million in option compensation, paid to reward them for a merger that in fact was never even consummated. Their subsequent attempt to dodge taxes through an allegedly-illegal tax shelter also raised the issue of collusion by the independent auditor in executive compensation.

- **Dennis Kozlowski,** the CEO of Tyco, gained his first unwelcome attention for a clumsy attempt to illegally evade state sales taxes on $13 million of art purchases, quickly followed by disclosure of the $2 million Roman-theme party given in Sardinia for his wife's birthday, which included the now famous ice statue of Michelangelo's David exuding, as it were, vodka. But the spotlight on those events quickly illuminated a classic case of a manager's confusing the shareholders' money with his own, as he allegedly looted Tyco and its shareholders of $600 million.

- **Jack Welch** of General Electric gained an equally unwelcome spotlight for his extra-marital peccadilloes. But his divorce proceedings illuminated the largely undisclosed "stealth" compensation typically awarded to retired chief executives but rarely disclosed. While his total compensation as GE's CEO seems to have exceeded $1 billion, his lavish retirement benefits included a New York apartment with daily flower deliveries and wine, unlimited use of the company jet, and a nice retirement stipend of $734,000 . . . *per month*.

- **Richard Grasso**, chairman of the New York Stock Exchange, made news—day after day!—with the staggeringly large compensation package ($187.5 million) bestowed on him by those he regulated. But the spotlight also illuminated the salutary (if not explosive!) effects of disclosure, as well as the Big Board's flawed system of governance, and the near-monopoly it maintains for its specialists and member firms.

Each of you in this audience is probably wondering about the other "bad apples" that I might as easily have mentioned. But these six examples should be enough to make the point that the scandals of the past two years have brought into sharp relief the painfully broad and baneful impact of managers capitalism, and the financial shenanigans that it fomented.

What Did The Directors Know?

When executives are paid based on the appreciation in the momentary *price* of a stock—*perception*—rather than the enhancement of the intrinsic *value* of a corporation—*reality*—the temptations for management to hype stock prices is apparently overwhelming. So we quickly developed concepts such as "earnings guidance" and "meeting (or, God forbid, "*failing* to meet") expectations." Never has there been a clearer example of the ultimate consequences of the management consultants' familiar bromide, "if you can measure it, you can manage it."

Pro forma earnings ignored managements' earlier mistakes, and the availability of cookie-jar reserves easily created by mergers gave us *paper* companies that acquired *rock* companies (remember the children's game "rock, paper and scissors"?) for accounting reasons, rather than with any strategic or financial rationale. Accountants, with their consulting contracts ever more valuable, were co-opted, and

Generally Accepted Accounting Principles became an oxymoron. As Wall Street "sell-side" analysts pushed the companies that looked good on, well, paper, "buy-side" institutional managers jumped uncritically on the band wagon. Investors love rising stock prices, and everyone joined in the "happy conspiracy" to drive them even higher.

For a complete list of what went wrong in corporate America, just read Reuters editor Martin Howell's splendid expose, *Predators and Profits,* which lists fully 176(!) "red flags" that were flying as the stock market bubble reached its peak.[1] And it all went on right under the noses of those who were elected to make sure that corporate managements were operating in the interests of the stockholders they represented, i.e., to keep an eye on those managers. Yet the mania went on, stock prices became completely unlinked from corporate value, and the inevitable day of reckoning came for the stock market and for our society. It is simply impossible to believe that directors were unaware of what was going on. Surely it is fair to say that it is our corporate directors who should bear the ultimate responsibility for what went wrong with capitalism in corporate America.

From Directors to Owners

Or should they? Think about if for a moment. *Why* should the board bear the ultimate responsibility when it doesn't even *have* the ultimate responsibility? Yes, directors have a lot to answer for, but it is the stockholders—the owners themselves—who bear the *ultimate* responsibility for corporate governance. When the directors can't or won't or don't demand that managers place the interests of owners first, it would seem to follow that the owners would step in and do the job themselves. And in corporate America today, owners have the power—the real power, not merely the theoretical power—to do just that. Once dispersed among a diffuse and inchoate group of individual investors, each one with relatively modest holdings, the ownership of stocks is now concentrated—for better or worse!—among a remarkably small group of institutions whose potential power is truly awesome. The 100 largest managers of pension funds and mutual funds alone now represent the ownership of fully 56 percent of all U.S. equities: *Absolute control over corporate America*. Together, these 100 large institutional investors constitute the great 800-pound gorilla who can sit wherever he wants to sit at the board table.

But the gorilla doesn't even come to the meetings. With all that power has come little interest in corporate governance. There is an amazing disconnection between the potential and the reality—the awesome power, yet the rare exercise of it. Yet as the stock market bubble inflated, institutional managers could hardly have been ignorant of what was going on in corporate America. They seemed blissfully unaware of what was going on in the financial statements of the companies into which they were pouring literally hundreds of billions of dollars of their client's assets. Somehow our professional investors either didn't understand, or understood but ignored, the obvious danger signs.

Astonishingly, even after the bear market that has devastated the value of the equity holdings of fund shareholders, the only response we've heard from the mutual fund industry is the sound of silence. Why? Because the overwhelming majority of mutual funds continues to engage, not in the process of *long-term investing* on the basis of intrinsic corporate *values*, but in the process of *short-term speculation* based on momentary stock *prices*.

The typical fund manager has lots of interest in a company's price momentum—its quarterly earnings and whether or not they are meeting the guidance given to Wall Street. But when it comes to what a company is actually worth—its fundamental earning power, its balance sheet, its long-term strategy, its intrinsic value—there seems to be far less interest. Yet focusing on the price of a stock—a

[1] Published in the spring of 2003. Full disclosure: I was so impressed with Mr. Howell's book that I wrote the foreword.

perception—rather than on the value of a corporation—the *reality*—can hardly be a winning strategy over the long run. When Oscar Wilde described the cynic as "a man who knows the price of everything but the value of nothing," he could have as easily been talking about the typical fund manager.

The Mutual Fund Barrel

Without a doubt the mutual fund industry was one of the participants in the "happy conspiracy," reveling as the great stock market bubble expanded to the bursting point. The fact is that when the bull market virus reaches epidemic proportions, there are few investors who *aren't* infected by it. But I would argue that much of the funds' failure to be concerned about their responsibilities of corporate citizenship grew directly from its own governance system. The *mutual fund* governance barrel, if you will, is also deeply-flawed.

For just as owners capitalism turned to managers capitalism in *corporate* America, so owners capitalism turned to managers capitalism in *mutual fund* America. Despite the express language of the Investment Company Act stating that funds must be *organized*, *operated*, and *managed* in the interests of their *shareholders* rather than the interests of their *investment advisers* and *underwriters*, it is the interests of the managers that usually prevail.

It wasn't always that way. While true owners capitalism has never been possible in the fund industry, whose millions of owners are largely individual investors of relatively modest means, for years we enjoyed, if you will, *owners capitalism by proxy*. From the industry's inception in 1924 through the mid-1960s, most fund managers operated as prudent trustees of the assets that investors entrusted to them. The managers of yore, relatively small, privately-owned professional firms who saw themselves largely as fiduciaries of other people's money, put their investors' interests *first*, faithfully honoring the interests of the actual owners.

But over the years, funds became "big business." Managers sold their shares to the public, and many became part of giant financial conglomerates. Amassing assets under management became the fund industry's primary goal, and our focus gradually shifted from stewardship to salesmanship. The principle of long-term investing in highly-diversified equity funds morphed into short-term speculation in ever-more-aggressive specialized funds. Portfolio turnover for the average fund went right through the roof, soaring from the 15% range in the 1950s (a six-year holding period for the average stock) to 110%(!) last year, an average holding period of just eleven months. We were no longer an *own*-a-stock industry. We were a *rent*-a-stock industry, a world away from Warren Buffett's favorite holding period: *Forever*.

Conflicts of Interest Prevail

Just as the scandals that unfolded in corporate America illuminate a whole variety of serious problems, so the recent scandal that unfolded in mutual fund America illuminated this industry's profound conflict of interest between managers and fund owners. The Bank of America, Janus, Strong, and BancOne—and now Alliance—funds stand accused of aiding and abetting (or passively permitting) some shareholders to buy and sell fund shares at prices established earlier, thereby gaining returns at the expense of their fellow shareholders, and benefiting the managers by building the asset base on which they earn fees.

These practices, which have been going on for a long time, enabled at least some managers to happily profit as their shareholders' accounts were effectively looted, albeit in what appear to be relatively small amounts. (Remember what happens when we have "strong managers, weak directors, and passive owners"?) But the bright side—as it were— of this scandal is that it at long last shined the spotlight on the profound conflict of interest that exists in our industry: The trade-off between what's best for the manager and what's best for the fund shareholder.

Fund managers have been rewarded at the expense of fund shareholders for a long time. When the fund's chairman is the management company's chairman; when the fund's officers and employees are supplied by that company; and when the board is populated by even a minority of that company's executives, how could it have been otherwise? If these perverse interrelationships are not incestuous, how would one describe them?

The first level of conflict is the fund's fee structure. The higher the fee, the lower the return to the fund investor, and vice versa—dollar for dollar in commodity-like money market and passively-managed index funds. But even in actively-managed equity funds, the relationship is clear: over time, the *lowest*-cost quartile of funds in the aggregate—and in each category or style—typically outpaces the *highest* cost quartile by two to three percentage points *per year*(!).

But the conflict doesn't end there. It is hardly unusual for managers to let funds grow to musclebound asset sizes, far beyond their ability to implement their earlier strategies, so that fees can swell accordingly. And it is common practice for managers to bring out new, untried, and often speculative funds to capitalize on the fads and fashions of the markets. Fund investors *rarely* make money on such funds (just check the record), but managers *always* do. We can hope that the recent scandals will help this industry to return to its proud past in which stewardship, not salesmanship called the tune.

Part of our stewardship must focus on behaving as responsible corporate citizens, with appropriate involvement in governance. Way back in 1949, *Fortune* wrote that mutual funds were "the ideal champion of . . . the small stockholder in conversations with corporate management, needling corporations on dividend policies, blocking mergers, and pitching in on proxy fights," even as the SEC was calling on mutual funds to serve "the useful role of representatives of the great number of inarticulate and ineffective individual investors in corporations in which funds are interested." Back then the industry owned less than two percent of all stocks. Yet even though our ownership has soared to 23 percent, it was not to be.

The Governance Failure of Mutual Funds

While the majority of large fund managers doubtless go through the motions of proxy voting, endorsing the board slate and most management proposals, though sometimes voting against excessive stock option awards, with rare exception managers assiduously refrain from any form of corporate activism. Part of the reason is that we face a profound conflict of interest when we come to vote the shares of the corporations whose pension and 401(k) assets we manage. In addition, our own weak governance system—where separately owned management companies essentially control the boards and operations of the funds they manage—places us in the role of people who live in glass houses: We've implicitly decided that it doesn't seem like a good idea to cast stones at the governance of corporate America.

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

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

Corporate Democracy

The problem with corporate America and mutual fund America, it seems increasingly clear, lies in the fact that far too many corporate executives and directors have been placed in positions of great power and authority without an adequate understanding of their fiduciary duties, and that far too many institutional intermediaries have failed to take them to task and insist that the interests of shareowners be served. I see no other way to solve that problem than by enabling both groups to assert their obvious authority, indeed, demanding that they do. It seems utterly logical to believe that the owners should be in a position to have the primacy of their interest honored. The corporation, after all, is their property. Put another way, I urge a return to corporate democracy.

Not everyone agrees! Logical or not, the reverse has been authoritatively argued. No lesser a light than top securities attorney Martin Lipton argues that enhancing shareholder ownership rights to nominate directors and to make proxy proposals could "disrupt the proper functioning of the board and limit the ability of the directors to fulfill their fiduciary duties." And in a recent op-ed essay in *The Wall Street Journal*, Henry G. Manne dean emeritus of the George Mason University School of Law, argues that "the theory of corporate democracy . . . has long been a standing joke among sophisticated finance economists." (He names no names.) "A corporation is not a small republic . . . and the board is not a legislature . . . a vote attached to a share is totally different from a political vote . . . the essence of individual shareholder participation is "exit," not "voice" . . . and they can exit their corporate `citizenship' for the cost of a stockbroker's commission." In other words, if you don't like the way your company is being run, just get out—sell to the first bidder, whether or not the price reflects the corporation's intrinsic value. "Like it or lump it," however, doesn't seem a particularly enlightened policy.

Dean Manne's objections seem to assume that those who are interested in embracing ownership rights are "special pleaders with no real stake, activists (whose) primary interest . . . is to facilitate publicity for their own special-interest programs . . . and to interfere with the property and contractual rights of others in order to achieve their own ends," describing corporate democracy as a "form of corporate fraud." Though I'm confident that at least some corporate activists have agendas that might not comport with the public weal, I confess that I don't know quite what to make of such a diatribe.

But I know that I have no such agenda. I hold only this simple conviction: *Owners should be allowed to behave as owners*. If ownership rights are not placed front and center, where should they be placed? Who would *dare* to suggest that barriers should be placed in the way of the right of shareholders to elect as a director anyone they wish to serve as their agent? To compel management to function in the way the shareholders wish? To relinquish responsibility for how the executives of their company are compensated? Aren't these the essential rights of ownership?

Clearly, they are the rights of the 100% owner, who brooks no interference with his will. And any manager who flatly refused to consider the views of a 50% owner, or even a 20% owner, would likely be promptly looking for another line of work. What about a dozen institutions, each holding a 3% interest and sharing a particular viewpoint, or wishing to nominate a director? Where does the proverbial shovel break? And does the argument that it *might* break when no single shareholder own more than, say, 0.10%

of the shares justify depriving these shareholders of the same rights? *Not for me it doesn't*. For I believe, after Churchill, that corporate democracy "is the worst form of government . . . except for all those others that have been tried from time to time."

The legendary Benjamin Graham long ago put his finger on the problem. In the early editions of *The Intelligent Investor*, he had some important things to say about stockholder-management relationships. In "legal rights and machinery, the stockholders as a class are king . . . they can hire and fire managements and bend them completely to their will." He was—and he *is*—right. But he was—and he *is*—right when he added that "the assertion of rights by stockholders in practice is almost a complete washout. Unless prodded violently into action, they show neither intelligence nor alertness. They vote in sheep-like fashion for whatever management recommends and no matter how poor the record of accomplishment may be . . . This attitude of the financial world toward good and bad management is utterly childish." He noted, "the leading investment funds could contribute mightily to the improvement of corporate managements . . . but have shied away . . . missing a great opportunity for rendering service to the investing public." And so it remains today.

Restoring Owners Capitalism

Yet the cause is not lost. Even after all these years, perhaps Benjamin Graham's words can awaken us, and force us to consider ways that institutional stockowners, working in concert with corporate directors, can root out the problems that plague our system. Please consider with me these eight ideas of "What We Must Do To Restore Owners Capitalism."

1. **Encourage Corporate Citizenship**. The only way that investors—and particularly institutional investors—will become better owners is if we at last return to behaving as responsible corporate citizens, voting our proxies thoughtfully and communicating our views to corporate managements. The SEC's decision earlier this year to require mutual funds to disclose to our owners how we vote *their*(!) proxies is a long overdue first step in increasing our *motivation* to participate in governance matters.

   But investors also need the *ability* to act—"access" to corporate proxy statements—so that we can place both nominations for directors and proposals for compensation policy and business conduct *directly* in the proxies. I am heartened by today's news that the SEC will act favorably on this issue, which I hope will include restraints that keep the process from becoming a circus—for example, extending such rights only to investors who have held their shares for, say, two years, and whose aggregate holdings exceed five percent of the corporations' voting shares.

2. **Clearly Separate Ownership from Management**. We need to recognize the bright line between *directing*—the responsibility of the governing body of an institution—and *managing*—the responsibility of the executives who run the business. It's called *separation of powers*. An independent board chairman should be boss of the board; while the CEO should be boss of the business, an independent chairman should be the boss of the board. We need higher standards of director independence; and directors should rely on outside advisors, or even a small staff, to provide them with independent information that is bereft of management bias, not only on compensation and accounting matters, but on everything else. These steps will begin the process of reforming board governance and clarifying the role of directors as stewards of the property of the owners.[2]

[2] *Put Investors First: Real Solutions for Better Corporate Governance*, by Scott C. Newquist, provides an excellent review of what is needed, especially in Chapters 6, 7, and 8. I also wrote the foreword for this book.

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

   It must be obvious that the sharp decline in trading costs that has come with electronic communication networks has enabled, and doubtless encouraged, managers to trade with carefree abandon. In fact, however, trading activity has risen even faster than unit trading costs have declined, so that aggregate trading costs have risen, to the detriment of investors. The iron law of investing has not been repealed: "*Gross* return of the stock market, less the costs of financial intermediation, equals the *net* return earned by investors."

   Sterner measures to enhance a long-term focus may be required, and we ought to keep an open mind about them. Warren Buffett once suggested (tongue-in-cheek, he reports) that the Federal government impose a 100% tax on capital gains realized on stocks held for less than six months, *to be paid even by non-taxable institutions*. But we oughtn't dismiss out-of-hand variations of this tax theme. And while we're about it, why not consider the creation of a special class of stock which rewards investors with a premium dividend on the shares they have held for longer than, say, one year. If we have the *will* to foster a long-term focus by investors, we can find the *way*.

4. **Fix the Stock Option Mess**. I expect that, at the end of the tedious process followed by the Financial Accounting Standards Board, GAAP will require that the cost of fixed-price stock options be expensed, putting them on an equal footing with other stock-based compensation. But directors and owners should not be fooled into awarding such options. They are fundamentally flawed: Options are indifferent to dividends; their prices are not adjusted for the cost of capital; they don't relate rewards to the performance either of peers or of the stock market itself (indexed options); they pay off for raising momentary stock prices rather than building enduring corporate values and cash flow; and they rarely require that the optionees hold their stock, once purchased, for the long-term. Any option plan that fails to correct these shortcomings fails to represent the interests of the long-term shareholders of the corporation. Restricted stock surmounts most of these obstacles; tomorrow's options should do so as well.

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

   While that harsh policy may be too much to expect, serious work has already begun to improve the reporting of financial results and increase their relevance. The soon-to-be-published *It's Earnings That Count*,[3] presents two supplemental income statements that the author dubs "enterprising" (showing the company's return relative to its total capital base), and "defensive" (showing the extent to which a company depends on outside sources of capital). Do we really need three earnings reports? (Including the present weak GAAP statement.) For anyone who recalls the rule of the ancient carpenter, "measure twice, cut once," measuring *thrice* can hardly be harmful.

[3] *It's Earnings That Count*, by Hewitt Heiserman, to be officially published this month. I also wrote the foreword to this book.

6. **Bring Back Dividends!** Earnings are easily subjected to manipulation and interpretation, but dividends speak for themselves. Benjamin Graham reminded us of something that we've long forgotten: "There is no truth more fundamental in investment than that dividends and market value are the *only* concrete returns a public stockholder ever gets on his investment. Earnings, financial strength, and increased asset values are of vital importance only because they will ultimately effect his dividend and market price." Again, he was—and *is*—right.

   History tells us that higher dividend payouts are actually associated with *higher* future returns on stocks. Yet despite the evidence that earnings retention leads to counterproductive capital allocations, the dividend payout rate has been declining for years. To state the obvious, investing for income is a *long-term* strategy and investing for capital gains is a *short-term* strategy. (The turnover of dividend-paying stocks is *one-half* the turnover of non-dividend paying stocks.) It is high time that owners and managers unite to bring a new focus on the issue of dividends.

7. **Reform the Fund Industry**. It will take a mutual fund industry focused on stewardship and long-term investing to act as responsible corporate citizens. But unlike corporate America, ownership is so diffused that there is no natural bloc of giant owners to lead the way. So we must build a shareholder-oriented board structure, dismantling today's incestuous conflict between managers and shareholders. We must amend the Investment Company Act of 1940 to require an independent board chairman, limit the manager to a single board seat, and enable the board to retain its own staff to provide information that is independent and objective. We also must establish a federal standard of fiduciary duty that requires fund directors to place the interest of the fund's shareholders ahead of the interests of fund officers, advisers, and distributors, just as the existing preamble suggests. We also need full disclosure of the often-staggering compensation paid to management company executives, including their share of the company's profits. (As the recent goings-on at the New York Stock Exchange drove home, sunlight is a powerful disinfectant.)

8. **"Institutions of the World, Unite!"** At least since 1998—long before the recent spate of corporate and mutual fund scandals—I've been calling for mutual funds and other private institutional investors to make their will known by taking an active, even collective, role in governance. While many of these institutions are focusing on short-term speculation, there remains a strong cadre of others; hence the working designation I suggested for the group, *"The Federation of Long-Term Investors."* Index funds—the consummate long-term investors, who simply buy and hold the stocks in their benchmark portfolios—now represent 12% of mutual fund assets and an estimated 25% of pension fund assets. Such funds would constitute the core of such a federation, joined by the active managers that eschew a short-term focus. While most of the managers with whom I've discussed these issues are publicity-shy (neither notoriety nor controversy are good for the marketing side of the house), I haven't given up. My combative style endears me to few, so I'm hopeful that strong leaders who share my conviction will emerge to lead this embryonic effort.

Conclusion

Taken together, these eight changes would forcefully continue the present wave of reform in corporate governance and help turn America's capital development process away from speculation and toward enterprise. But there's even more at stake than improving the *practices* of governance and investing. We must also establish a higher set of *principles.* This nation's founding fathers believed in high moral standards, in a just 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 ethical failings of when today's business and financial model; the manipulation of financial statements; the willingness of those of us in the field of investment management to accept practices that we know are wrong, the conformity that keeps us silent, the selfishness that lets our greed overwhelm our reason; all have eroded the character of capitalism. Yet character is what we'll need most in the years ahead; more than ever in the wake of a great bear market and the investor disenchantment it reflects; more than ever in these days when economies around the globe are struggling to find their bearings; more than ever in the strife-ridden world around us, where America's strength lies more than ever in her values, her ideals, her goodness.

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 what capitalism has been about in the recent era. The sooner we can again apply those words to our business and financial leaders—and mean them—the better. And there's no one here this evening who can't be part of this vital mission.[4]

What is that mission? It is restoring owners capitalism by taking it back to its roots: "trusting and being trusted," as I said at the outset, no more than what St. Paul told us in Corinthians I: "It is required of stewards that they be found trustworthy." The bad apples that I listed earlier—too often arrogant, greedy, and vainglorious, convinced that "we did it all by ourselves," bereft of doubt that they deserve every penny they've been paid, and imperial by nature—have illuminated a whole host of weaknesses in the troubled barrel of capitalism. *They've given us the opening to fix the system. Let's take it.*

Yes, "somebody's gotta keep an eye on those geniuses." If the corporation's directors don't do it, why then, the owners must. It *is* as simple as that.

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[4] I've used the thoughts in the previous two paragraphs to close every speech I've given on the subject of corporate governance during the past two years. I hope you'll agree that they're worth repeating.

Note: The speech was delivered on February 24, 2003. The opinions expressed in this speech do not necessarily represent the views of Vanguard's present management.