Bread and Circuses

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Tonight, I want to talk to you about today's financial markets, investment strategy, and the potential role of common stocks in our Social Security system. But before I get to those subjects—which I imagine are on the minds of most of you—I want to look at American society and our economy as I see it today. Despite our prosperity as we begin this new millennium—unparalleled, I think, in all human history—I look at much of what is transpiring with a jaundiced eye. Hence the title I have chosen for my remarks: "Bread and Circuses."

As you doubtless recall, during the first half of the first century, the Roman emperors kept their popularity high and their populace peaceful by providing what we today cynically call *bread and circuses*. *Bread* was the free grain, given each month to the plebeians. *Circuses* were the shows—the chariot races, the gladiators, the sporting events, the theatre—that took place in the great hippodromes of the Roman Empire. Those stadiums dotted the empire from Constantinople to Britain. The largest was the Circus Maximus in Rome, which seated a mere 250,000 souls. During the first three centuries A.D., actors and athletes became glamorous public heroes, garnering great wealth and political influence. *Bread and circuses* proved a winning formula, and the Roman Empire reached its pinnacle.

The Decline and Fall of the Roman Empire

Now, listen to these words: "In the second century of the Christian Era, the Empire of Rome comprehended the fairest part of the earth and the most civilized portion of mankind. The frontiers of that extensive monarchy were guarded by ancient renown and disciplined valor. The gentle but powerful influence of laws and manners had gradually cemented the union of the provinces. Their peaceful inhabitants enjoyed and abused the advantages of wealth and living. The image of a free constitution was preserved with decent reverence . . . [Yet the Roman Empire would] decline and fall; a revolution which will ever be remembered and is still felt by the nations of the earth." Those famous words are the opening lines of Edward Gibbon's *The Decline and Fall of the Roman Empire.*

By the end of Gibbon's epic, the Roman Empire had dissolved. Constantinople had fallen, the fruitful provinces overwhelmed by the Vandals; Britain was lost; Gaul had fallen; and the brutal Goths had conquered Rome itself. In 410 A.D., "eleven hundred and sixty-three years after the formation of Rome," as Gibbon wrote, "the Imperial City was delivered to the licentious fury of the tribes of Germany and Sythia." Why did it happen? The answer seems to lie in the self-indulgence of its civic order, reflected in the citizens' desire for the solid assurance of bread; for the acceptance of the value of money to express their wants and their property; and for honor and recognition, despite their fading visions of liberty and greatness. As Saint Augustine put it, it was self-love that led to the fall of the Roman Empire.

Tonight, I strike a chord of concern using some of Gibbon's final words: "O man! Place not thy confidence in this present world." For I am troubled by much of what is happening to America's greatness in *this* present world. As I survey our nation at the millennium, I see our business values eroding. Yes, I see marvelous entrepreneurship, brilliant technology, creativity beyond imagination, and, at least in some spots, the idealism to make our nation and our world a better place. But I see far too much greed, egoism, materialism, and waste to please my critical eye. I see too an economy too focused on the "haves" and not focused enough on the "have-nots," underinvesting in education, especially among those who most need it not merely to prosper, but to survive. I see shocking misuse of the world's natural resources, as if they were ours to waste rather than ours to preserve as a sacred trust for future generations, and a political system corrupted by the staggering infusion of money that is, I assure you, rarely given by disinterested citizens who expect no return on their investment.

America's Bread and Circuses

As the millennium turns, we also have our own bread and circuses. That they are not the same as those of ancient Rome is hardly surprising, but they do exist. Much of our bread, as it were, goes, not to keep the masses peaceable, but to a fairly small elite, including the fabulous compensation paid to corporate chief executives and star athletes and entertainers. (Shades of the Roman Empire!). Even more bread has been leavened in the incredible wealth created in the financial markets by aggressive entrepreneurs, venturesome investors, investment bankers, financiers, and the managers of other people's money. So far at least, this paper wealth—real enough if one converts one's stocks into dollars—has manifested itself largely in the *market values* of financial assets. The delivery of the cash flows on which those market values finally depend still lies beyond the horizon. For all its trumped up promise, for example, the earnings growth rate of the so-called New Economy of technology, science, and communications over the past four years has been just 8% per year, not much ahead of the 7% rate of the Old Economy. Nonetheless, the bread of asset values in the marketplace is there today for all to count and enjoy.

And circuses abound, too. While our nation's largest true circus (the stadium at the University of Michigan) holds but 105,000 citizens—less than half the 250,000 capacity of the Circus Maximus—television screens bring sports and entertainment to worldwide audiences that reach into the billions. But perhaps our greatest circus is our financial markets. Stocks have become entertainment. Electronic trading abounds; day traders move the market in spasms; market turnover is the highest since 1929. CNBC and CNN and Bloomberg alert traders (and, for that matter, the bored) to opinions about each uptick and each downtick in the stock market, each merger, each earnings report. And earnings are always described as relative to widely-known "market expectations." "Exceeded" is good. "Met" is all right . . . usually. "Fell short of," however, can be a disaster that wipes out billions—even tens of billions—of a single corporation's aggregate market value in a moment.

Schools purport to be teaching young students about investing by having stock-picking contests when they should, in my view, be teaching them about the magic of compound interest. And the biggest financial circus of all—today's incarnation of the Circus Maximus—is the garish eight-story NASDAQ MarketSite Tower in Times Square, displaying stock prices on what is proudly billed as "the world's largest video screen." To me, that display closes my case today that we are enjoying a circus: The stock market has become a casino for investors. And as Lord Keynes warned us: "When the capital development of a country becomes the by-product of the activities of a casino, the job is likely to be ill-done."

Of course our bread and circuses are different from those of ancient Rome. But as the old saw goes, "History may not repeat itself, but it rhymes." Nonetheless, I don't want to exaggerate the implications of the analogy between ancient Rome and modern America. While the problems I've commented on are vital and go to the very heart of our wealth-oriented, things-fixated society, today we have the freedom to solve them and to build a better world. All we need is the willpower. As my marvelous cardiologist, Dr. Bernard Lown, recently wrote to me: "The destination for a society deserving of human beings is still distant, but it is up to all of us to hasten the day of arrival." So, I leave to you not only to decide whether I exaggerate our problems, but whether we have the will to solve them.

Investing in Equities Today

Whatever the case, I think considerable caution is called for on the part of investors today. For it is not only secular issues that concern me, but financial issues. In the mutual fund industry, for example, we have seen an industry turn from management and stewardship as its rationale to the Great God of Product Marketing as its rationale. Funds are born, grow (or fail to), and die at an alarming rate. Half of all funds that operated during the 1990s no longer exist. Fund portfolio managers turn over their stock portfolios at 90% a year. (100% would mean that a $1 billion fund sells $1 billion of stocks each year and replaces them with $1 billion of other stocks.) And, following the putatively wise leaders to whom they've entrusted their money, shareholders turn over *their own* mutual fund share holdings at an absurd rate. The average investor now holds a fund, not for 12 to 15 years as in my early years in this business, but for just three years. (So far in 2000, closer to *two* years.)

If a line of demarcation exists between rank speculation and the rampant short-term investment strategies of fund managers and fund shareholders, it is a subtle one indeed. And other signs of speculation abound. The stocks in our New Economy are selling at 102 times earnings, compared to 26 times for the Old Economy—a figure which itself is almost twice as high as the long-term norm of 15 times. Wharton Professor Jeremy Siegel, author of *Stocks for the Long-Term* and long-time bull, tells us that "Big-cap tech stocks are a sucker bet," and Robert Shiller, author of the new best-seller *Irrational Exuberance*, warns that the stock bubble will soon burst. New, risky financial instruments called Spiders and Webs draw in the risk-ignorant (yes, those clever names suggest, investing is just a big, fun circus!); and technology funds (especially internet funds), focus funds (concentrating assets in 20 stocks), and momentum funds ("as long earnings grow, price doesn't matter") implicitly promote extraordinary wealth. Please be careful of these instruments.

What Does an Investor Do?

Where this leaves us as investors, nonetheless, is not at all clear. Rush for the exit from a clearly risk-exposed stock market? I don't think so. For no one can be certain what will happen in tomorrow's markets, or in next week's, or in next year's, or even over the long-term—say, a quarter century. To imply, however, as so many do, that held for the long-term, stocks will *always* provide higher returns than will bonds implies: (a) that we know more about the world a quarter-century hence than we do about the world tomorrow, which is patently absurd; (b) that the stock market is a sort of actuarial table where past experience, like clockwork, will be repeated in the future, which I assure you it is not; and (c) that as investors come to accept as a certainty that America's productive capacity and growth is assured and that our powerful economy has eliminated much of the risk in stocks, and as stock prices are driven to high multiples of earnings reflecting those expectations, such a process can somehow be *repeated* all over again, which flies in the face of common sense. So please don't take generous future stock returns as a given.

If we are entering an era in which stock returns will be lower, where does the investor turn? I think the answer is deceptively simple: Carefully consider your investment balance between the growth potential and the riskiness of stocks and the income productivity and principal stability of bonds, and get the balance *right*—for you. Don't let your emotions—your hopes, your fears, even your greed—get in the way. *Focus, not on the probabilities of earning generous returns, but on the consequences of assuming excessive risks.* But despite my reservations about our society today and my serious concerns about present levels of the stock market, don't *abandon* stocks. If you lack the financial ability to weather the potential storms; or if you need income, as you will when growth of your capital is threatened; or if you lack the courage to stay the course, reduce your equity holdings—gradually and prudently—down to, as Baron Rothschild said, "the sleeping point."

Social Security and Retirement Income

With the stock market at these levels, then, how should we think about the introduction of self-directed equity accounts under the Social Security System? It is one of the major political issues of the day, indeed an issue that is shaping up to be a major element in the upcoming presidential campaign. In a sense, it is an issue about bread. But here it is not the government's largesse to the masses, as in ancient Rome, but the responsibility of our working generations for our retired generations. Let me divide the issue into two distinctly independent parts: First, the effect of Social Security equity accounts on the existing system of benefits; and, second, on the optimal structure of a new system of retirement savings plans. *They are two completely different issues.*

As to the existing system, it is clearly in trouble. Given existing demographics, the revenues will begin to fall short of benefits in 2025, when the bread going out exceeds the bread coming in. Then the (nominal) fund will begin to be depleted, and will be exhausted by 2037. Absent a massive reduction in future benefits, any diversion of the present 12.4% Social Security tax to individual private plans would simply reduce the present level of contributions to the system and bring the day of retribution even closer. So, the problems in the system will have to be solved by other means that are by no means politically attractive, among them: (a) using a more accurate cost-of-living adjustment, gradually reducing the overly-generous growth rate of benefits; (b) increasing the number of years for computing benefits from 35 to 38; (c) subjecting all benefits to normal taxation; (d) extending coverage to newly-hired state and local workers; (e) accelerating the increase in the retirement age.

As difficult—even as unpalatable—as these steps may be, there would then be sufficient room to allow voluntary contributions into self-directed plans of that very 2% per year that is so often bruited about. (Legislation to make these very changes has already been introduced by Senators Daniel Moynihan and Robert Kerrey, and others.) It will take guts and determination to adopt these structural changes, but without them the coming Social Security shortfall will *never* be resolved. Remember the old adage: "You can't get blood out of a turnip."

Structuring Social Security Equity Accounts

As to how to structure the voluntary system, I have no doubt about the most economically-feasible method. My key principle: *The retirement savings of America's families are too important to be entrusted to the mutual fund industry*. If financial service firms are given this opportunity to handle Social Security savings accounts, the plan would, simply put, fail. Why? Assume that future stock market returns were, say, nine percent per year. Then, the funds used in the equity program would earn about 5 ½%. The difference: Investment costs. Existing all-in mutual fund costs—sales charges, management fees, operating expenses, the cost of portfolio transactions, and the opportunity cost of holding cash reserves—as funds do—now total *at least* 2 ½% per year. Fees to cover the extra costs of administering these accounts, which will have far smaller balances and more frequent contributions than are typical in the industry today, would likely cost at least another 1%. Total costs: 3 ½%. Such a cost would reduce a *stock market* return of 9% to a *mutual fund* return of 5 ½%—even *less* than the 6% yield of the Treasury bonds that represent the nominal asset base of the Social Security fund.

So what should we do? I favor the appointment of a truly independent "Social Security Reserve Board." Removing politics from the system, such a Board would create a new all-stock-market index fund which, after all is said and done, will necessarily provide exactly the same *gross* market return that hundreds of equity funds, randomly selected, will provide. The Board would decide whether and how much to fine-tune the investment program (i.e., whether to own, say, tobacco stocks, or how much to invest in foreign stocks, decisions which are politically sensitive but in the long run economically indifferent). Social Security participants would have the option to divert 2% of their present tax contribution to this all-stock-market fund (or a comparable all-bond-market index fund) and have but one opportunity per year to adjust the stock/bond allocation.

Then—and this is vital—the Board would eliminate all of the counterproductive bells and whistles that the mutual fund industry offers today: No phone calls to check the daily price, or anything else; one statement per year, provided by the existing Social Security record-keeping system; and no liquidity whatsoever until retirement. Such a program could be administered at a minuscule cost which, when spread over the hundreds of billions of assets in the account would permit earning, not 5 ½% annually, but very close to the assumed market return of 9%. Result: A simple, truly productive long-term program, used solely for the purpose for which Social Security is intended: Retirement.

How large would the financial difference be between the two programs—one administered by the fund industry versus one administered by the Social Security Reserve Board? Enormous! Assume that a 25-year old earns $25,000 per year, with base salary growing at 4% per year, and retirement at age 65, and investing two percentage points of his or her Social Security contribution in an equity account. Mutual fund program earning a 5 ½% net return: Final value $140,000; annual income (at 6%) $8,400. Reserve Board program earning 9%: Final value, $320,000; annual income, $19,200. Just think of that difference, accounted for entirely by costs. Is there really any choice?

Beyond the Dreams of Avarice

While this difference is, well, enormous, the absolute values are not huge, even when added to the regular Social Security benefits. (Of course, the basic benefits would be reduced for participants who have elected to use the new plan and thus contribute 10.4% of earnings, rather than 12.4%, to their basic program.) So I expect that many, perhaps even most, Americans will ultimately come to realize their own responsibility for providing a higher level of retirement income, especially as we live longer and longer.

By far the best means of accomplishing this goal is by offering, not just *some*, but *all*, citizens the ability to accumulate capital through tax-deferred savings plans. *There is simply no more effective means for the accumulation of capital than an investment that combines (a) extra investment return; (b) tax deferral; (c) and time*. It is the magic of compounding writ large. Such programs are available today through traditional IRAs and Roth IRAs, and through corporate profit-sharing plans, 401(k) thrift plans and 403(b) educational plans. But all entail stringent limitations on total contributions that approach the punitive. Such plans ought to be available to a broader portion of families, and the limits ought to be relaxed. Doing so would not only increase our pathetic national savings rate—now at an extremely low level—but would also encourage motivated citizens to assume more of the responsibility for providing their own retirement income. Then, as we bring more individuals closer to self-sustained retirement, we can rethink the design and funding of the basic Social Security program.

A few centuries ago, Dr. Johnson said, “we are not here to sell a parcel of boilers and vats, but the potentiality of growing rich beyond the dreams of avarice.” So today we should be here “not to sell a parcel of financial products and mutual funds, but retirement plans that offer the potentiality of growing rich beyond the dreams of avarice.” Consider this potential for a wholly voluntary tax-deferred retirement plan: Assume again that a 25-year old earns $25,000 at the outset, followed by salary increases of 4% annually until retirement. Then assume contributions of 15% per year to a tax-deferred fund, plus a 4% corporate match. If the fund earned a return of 9% per year, the accumulation at age 65 would be $3,030,000. At a 6% withdrawal rate, annual family income would total $182,000 from this source alone. Even taking possible inflation into account, it’s hard to imagine that income wouldn’t provide for a comfortable retirement.

But wait a minute! While that 9% might (or might not) represent a realistic future return on stocks, the fact is that it is a rare investor indeed who earns—*and keeps*—100% of the stock market's return. Indeed it is a certainty that while all investors must and do earn the market's gross return *before* the costs of investing are deducted, it is an equal certainty that all investors must and do lag the market's gross return by the amount of their own investment costs. And in the mutual fund field, as I've noted in my earlier comments, that cost can presently be fairly accurately estimated at 2 1/2% per year. Result: In a 9% market, fund investors would earn 6 ½%.

That seemingly small difference in annual return makes an enormous difference in long-term wealth accumulation. "Rich" may still be there, but, as if by sleight-of-hand, "beyond the dreams of avarice" is deleted. $1,370,000 mysteriously vanishes, since the account earning 6 ½% has a final value of $1,660,000, compared with $3,030,000 for the account earning the market's 9% return. Why? Because while the *magic* of compounding *returns* has continued to balloon the accumulated capital, the *tyranny* of compounding *costs* has thrown a wet blanket over your wealth-building potential.

Garnering the Stock Market's Return

And it's easy to do, simply by effectively minimizing—indeed almost neutralizing—the costs of investing by owning the entire stock market without sales commissions, without opportunity costs, with minimal operating costs, and with substantially no transaction costs—a virtual guarantee that you will garner a return that is close to 100% of the market's return. Such a tax-deferred plan, held by most of the millions of America's families, would *begin* to turn over to the individual the Federal government's responsibility for providing retirement income. Accomplishing this goal requires only (a) some liberalization of contribution limits; and (b) the wisdom and ability of investors to make fully informed investment choices, in particular, knowledge about costs. You need to realize the merits of accentuating the positive (magic) of compounding and eliminating the negative (tyranny) of costs, the better to achieve the stock market's return.

Given my concerns about the long-term implications of "bread and circuses" on our society, expressed at the outset, and my concerns about the substantial near-term risks in the stock market, you may wonder how I can possibly countenance owning stocks for the long run. The answer is straightforward. Throughout her history, America has faced serious challenges—wars, depressions, disunity, crime, drugs, racial injustice, and faltering educational standards, to name just a few—and we have always striven to overcome them—sometimes with success, sometimes far too slowly. Today's problems, if they aren't repeating the past, surely seem to rhyme with those that led to the decline and fall of the Roman Empire. But if an enlightened and aware citizenry—led by new leaders with the kind of moral values and idealistic virtues manifested by George Washington and Thomas Jefferson and Abraham Lincoln and Theodore Roosevelt and Woodrow Wilson—America can and will meet her challenges. We always have.

Also, never forget that I may exaggerate the problems of bread and circuses in our financial system today. Even Gibbon warned that, "there exists in human nature a strong propensity to depreciate the advantages, and to magnify the evils, of the present times." And perhaps I've done just that. The stock market, while it seems to face outsized short-term risks today, in the long run it is brutally rational. It is the *economics* of investing—corporate earnings and dividends—that make investing so productive. What gets in the way of investors in capitalizing on those productive economics are the counterproductive *emotions* of investing, as we drive the prices at which stocks change hands far too high, and then far too low. Just remember this: *Investment succeeds*. *Speculation fails*.

Today's speculation in the stock market will doubtless be corrected, for, sooner or later, all bubbles burst. But investors should expect that, over the 40-year horizon that I presented in my retirement plan examples, wild and wooly market swings driven by emotions will continue to be endemic to investing. Regular investing in highly-diversified investment portfolios—and the all-market index fund is as diversified as you can get in U. S. stocks—through thick and thin, and at low cost, is the best way to take our emotions out of investing and capitalize on the productivity of our economy. So think fundamentally, think diversification, think positive, think long-term, and be sure, always, to stay the course.

You'll be well-rewarded.

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