The Culture That Gave Rise To The Current Financial Crisis

Presented by

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I recently received a letter from a Vanguard shareholder who described the current global financial crisis as "a crisis of ethic proportions." Substituting *ethic* for *epic* is not only a fine turn of phrase; it accurately places a heavy responsibility for the meltdown on a broad deterioration in traditional ethical standards. In fact, *The Wall Street Journal* retained that phrase as the title of my op-ed essay that was published just three weeks ago.

Relying on Adam Smith's "invisible hand," through which our own self-interest is said to advance the interests of our communities, our society had come to rely less on strict regulation to govern conduct in the field of free enterprise—in commerce, business, and finance—and to rely more on open competition and free markets to create prosperity and well-being, and to add value to our society.

But that self-interest got out of hand, and it spread to the very core of our national culture. Simply put, we became what has been called a "bottom line" society, one in which progress and success are largely measured in monetary terms. But our society, I think, is measuring the *wrong* bottom line: not only money over achievement, but form over substance; prestige over virtue; charisma over character; the ephemeral over the enduring; even mammon over God. Dollars have become the coin of the new realm, and unchecked market forces totally overwhelmed traditional standards of professional conduct, developed over centuries.

The views expressed in this speech do not necessarily reflect the views of Vanguard's present management.

The result has been a marked change in our society. The traditional standard of conduct in which "*there are some things that one simply does not do*," took a back seat to a new standard: *"if everyone else is doing it, I can do it too."* I would describe this change as a shift from moral absolutism to moral relativism. The moral themes of virtue, loyalty, fidelity, faith, and honor have been debased. Business ethics has been a major casualty of that shift in our traditional societal values, and the idea of professional standards has been lost in the shuffle.

We seemed to forget that the driving force of any profession includes not only the special knowledge, skills, and standards that it demands, but the duty to serve responsibly, selflessly, and wisely, and to establish an inherently ethical relationship between professionals and the society they serve. The old notion of trusting and being trusted—which once was not only the accepted standard of business conduct, but the key to success in the marketplace—came to be seen as a quaint anachronism, a relic of an era long gone.

The proximate causes of the current financial and economic crisis are usually laid to easy credit; the cavalier attitude toward risk of our bankers and investment bankers; "securitization," in which the traditional link between borrower and lender was severed; the extraordinary leverage built into the financial system by derivative securities of mind-boggling complexity; and the failure of our regulators to do their job. But the larger cause of the present crisis was our failure to recognize the sea-change in the nature of capitalism that was occurring right before our eyes.

The "Agency Society" Displaces the "Ownership Society"

That change in capitalism, simply put, was the growth of giant business corporations, controlled not by their own shareholders, but by the agents of the ultimate owners. What went wrong in *corporate* America, aided and abetted by *investment* America, was a pathological mutation in capitalism—from traditional *owners*' capitalism, in which the rewards of investing went primarily to those who put up the capital and took the risks, to a new and virulent *managers*' capitalism, where an excessive share of the rewards of capital investment went to corporate managers and financial intermediaries.

Two major trends set the stage for this baneful change: First, the old "ownership society" shrank radically in size and importance. Only a half-century ago, 92 percent of all shares of our corporations were held by direct stockholders. Today individual investors own barely 30 percent of all shares. Ownership of U.S. stocks by institutions, on the other hand, has soared more than seven times over—from 8 percent of shares all those years ago to more than 70 percent today. But in our new "agency society," with financial intermediaries as a group now holding clear voting control of corporate America, our agents have failed to behave as owners. Indeed, in far too many cases, they have placed their own interests ahead of the interest of their *principals*, largely those 100 million families who are the owners of our mutual funds and the beneficiaries of our pension plans.

It's not that we were not warned about the consequences of our failure to honor the fiduciary principle that "no man can serve two masters," and that fiduciary duty imposes a high standard of morality upon those entrusted with managing the property of others. Indeed, it was way back in 1934—75 years ago—in the aftermath of the Great Crash in the stock market that Supreme Court Justice Harlan Fiske Stone warned:

> *The separation of ownership from management, the development of the corporate structure so as to vest in small groups control over the resources of great numbers of small and uninformed investors, make imperative a fresh and active devotion to [the] principle [that "no man can serve two masters] if the modern world of business is to perform its proper function. Yet those who serve nominally as trustees, but [are] relieved, by clever legal devices, from the obligation to protect those whose interests they purport to represent; corporate officers and directors who award to themselves huge bonuses from corporate funds without the assent or even the knowledge of their stockholders; [and] financial institutions which, in the infinite variety of their operations, consider only last, if at all, the interests of those who funds they command, suggest how far we have ignored the necessary implications of that principle. The loss and suffering inflicted on individuals, the harm done to a social order founded upon business and dependent upon its integrity, are incalculable.*

Justice Stone's words, excerpted from his 1934 essay in *The Harvard Law Review*, are equally relevant—perhaps even more relevant—at this moment in history. They could hardly present a more appropriate analysis of the causes of the present-day collapse of our financial markets and the resultant economic crisis now facing our nation and our world.

Perhaps we shouldn't be surprised that not only our business managers but our money managers act first in their own behalf. Indeed, as Vice Chancellor Leo E. Strine, Jr., of the Delaware Court of Chancery has observed, "It would be passing strange if . . . professional money managers would, as a class, be less likely to exploit their agency than the managers of the corporations that make products and deliver services." In the fund industry—by far the largest of all financial intermediaries—that failure to serve the interests of fund shareholders has wide ramifications. Ironically, the failure has occurred despite the clear language of the Investment Company Act of 1940, which demands that, mutual funds "should be organized, managed and operated in the interests of their shareholders"[*] . . . "*rather than* in the interests of (their) advisers."[†]

The Triumph of Speculation over Investment

As control over Corporate America moved from owners to agents, our institutional money managers seemed to forget their duty to act solely in the interest of their own principals, those whose savings were entrusted to mutual funds and whose retirement security was entrusted to pension plans. These new investor/agents not only forgot the interests of their *principals*, but also seemed to forget their own investment *principles*. The predominant focus of institutional investment strategy turned from the wisdom of long-term investing, based on the enduring creation of intrinsic corporate values, to the folly of short-term speculation, focused on the ephemeral prices of corporate stocks. The "own-a-stock" strategy of yore became the "rent-a-stock" strategy of today.

In what I've called "the happy conspiracy" between corporate managers, directors, accountants, investment bankers, and institutional owners and renters of stocks, all kinds of bizarre financial engineering took place. Management became the master of its own numbers, and our public accountants too often went along. Loose accounting standards made it possible to create, often out of thin air, what passes for earnings, even under GAAP standards. One good example—which is already sowing the seeds of yet another financial crisis that is now emerging—is hyping the assumed future returns earned by pension plans, even as rational expectations for future returns deteriorated.

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[*] Investment Company Act of 1940, Section One.
[†] Securities and Exchange Commission decision, March 15, 1981.

Here again, we can't say that we hadn't been warned well in advance. Speaking before the 1958 Convention of the National Federation of Financial Analysts Societies, Benjamin Graham, legendary investor and author of the classic, "The Intelligent Investor, described "some contrasting relationships between the present and the past in our underlying attitudes toward investment and speculation in common stocks."

> *In the past, the speculative elements of a common stock resided almost exclusively in the company itself; they were due to uncertainties, or fluctuating elements, or downright weaknesses in the industry, or the corporation's individual setup . . . But in recent years a new and major element of speculation has been introduced into the common-stock arena from outside the companies. It comes from the attitude and viewpoint of the stock-buying public and their advisers—chiefly us security analysts. This attitude may be described in a phrase: primary emphasis upon future expectations . . . The concept of future prospects, and particularly of continued growth in the future, invites the application of formulas out of higher mathematics to establish the present value of the favored issues. But the combination of precise formulas with highly imprecise assumptions can be used to establish, or rather to justify, practically any value one wished, however high . . . Given the three ingredients of (a) optimistic assumptions as to the rate of earnings growth, (b) a sufficiently long projection of this growth into the future, and (c) the miraculous workings of compound interest—lo! the security analyst is supplied with a new kind of philosopher's stone which can produce or justify any desired valuation for a really "good stock." Mathematics is ordinarily considered as producing precise and dependable results; but in the stock market the more elaborate and abstruse the mathematics the more uncertain and speculative are the conclusions we draw therefrom . . . Whenever calculus is brought in, or higher algebra, you could take it as a warning signal that the operator was trying to substitute theory for experience, and usually also to give to speculation the deceptive guise of investment . . . Have not investors and security analysts eaten of the tree of knowledge of good and evil prospects? By so doing have they not permanently expelled themselves from that Eden where promising common stocks at reasonable prices could be plucked off the bushes?*

This obvious reference to Original Sin reflected Graham's deep concern about quantifying the unquantifiable (and doing so with false precision). The implications of that bite into the apple of quantitative investing were barely visible when Graham spoke in 1958. But by the late 1990s, this new form of investment behavior had become a dominant force that continues to be a major driver of the securities speculation that has overwhelmed our financial markets.

Consider with me now how the erosion in the conduct, values, and ethics of business that I have described has been fostered by the profound—and largely unnoticed—change that has taken place in the nature of our financial markets. That change reflects two radically different views of what investing is all about, two distinct markets, if you will. One is the *real* market of intrinsic business value. The other is the *expectations* market of momentary stock prices. The British economist John Maynard Keynes described this dichotomy as the distinction between *enterprise* ("forecasting the prospective yield of the asset over its whole life") and *speculation* ("forecasting the psychology of the markets"). Just as Keynes forecast, speculation came to overwhelm enterprise, the old ownership society became today's agency society, and the values of capitalism were seriously eroded.

It is little short of amazing that long ago, these prescient warnings were issued. Justice Stone warned us in 1934. John Maynard Keynes warned us in 1937. Benjamin Graham warned us in 1958. Isn't it high time for us to heed the warnings of those three far-sighted intellectual giants? Isn't it high time we stand on their shoulders and shape national policy away from the moral relativism of peer conduct and greed and short-term speculation—gambling on expectations about stock prices? Isn't it high time to return to the moral absolutism of fiduciary duty, to return to our traditional ethic of long-term investment focused on building the intrinsic value of our corporations—prudence, due diligence, and active participation in corporate governance?

So, yes, now *is* time for reform. Today's agency society has ill-served the public interest. The failure of our money manager agents represents not only a failure of modern-day capitalism, but a failure of modern-day capitalists. As Lord Keynes warned us, "when enterprise becomes a mere bubble on a whirlpool of speculation, the job of capitalism will be ill-done." That is where we are today, and the consequences have not been pretty.

In all, our now-dominant money management sector has turned its focus away from the enduring nature of the intrinsic value of the goods and services created, produced, and distributed by our corporate businesses, and toward the ephemeral price of the corporation's stock—the triumph of perception over reality. We live in a world in which it is far easier to hype the price of a company’s stock than it is to build the intrinsic value of the corporation itself. And we seem to have forgotten Benjamin Graham’s implicit caution about the transience of short-term perception, compared to the durability of long-term reality: “In the short run, the stock market is a voting machine; in the long run it is a weighing machine.”

The Mutual Fund Industry

My strong statements regarding the failure of modern day capitalism are manifested in grossly excessive executive compensation; financial engineering; earnings “guidance,” with massive declines in valuations if it fails to be delivered; enormous, casino-like trading among institutional investors; staggering political influence, borne of huge campaign contributions; and, in the financial arena, bestowal of wealth to traders and managers that is totally disproportionate to the value they add to investors’ wealth. Indeed, the financial sector actually subtracts value from our society.

Finance is what is known to economists as a “rent-seeking” enterprise, one in which our intermediaries—money managers, brokers, investment bankers—act as agents for parties on both sides of each transaction. Our intermediaries pit one party against another, so what would otherwise be a *zero-sum* game becomes a *loser’s* game, simply because of the intermediation costs extracted by the various croupiers. (Other examples of rent-seekers include casinos, the legal system, and government. Think about it!)

I know something about how the financial system works, for I’ve been part of it for my entire 58-year career. The mutual fund industry is the paradigm of what’s gone wrong with capitalism. Here are just a few examples of how far so many fund managers have departed from the basic fiduciary principle that “no man can serve two masters,” despite the fact that the 1940 Act demands that the principal master must be the mutual fund shareholder:

1. The domination of fund boards by chairmen and chief executives who also serve as senior executives of the management companies that control the funds, an obvious conflict of interest and an abrogation of the fiduciary standard.
2. Focusing on short-term speculation over long-term investment, the ultimate triumph of expectations investing over enterprise investing, resulting in great financial

benefits to fund managers and brokers, and commensurately great costs to fund investors.

3. Failure to exercise adequate due diligence in the research and analysis of the securities selected for fund portfolios, enabling corporate managers to engage in various forms of earnings management and speculative behavior, largely unchecked by the professional investment community.
4. Failure to exercise the rights and assume the responsibilities of corporate ownership, generally ignoring issues of corporate governance and allowing corporate managers to place their own financial interests ahead of the interests of their shareowners.
5. Soaring fund expenses. As fund assets soared during the 1980s and 1990s, fund fees grew even faster, reflecting higher fee rates, as well as the failure of managers to adequately share the enormous economies of scale in managing money with fund shareholders. Example: the average expense ratio of the ten largest funds of 1960 rose from 0.51 percent to 0.96 percent in 2008, an increase of 88 percent. (Wellington Fund was the only fund whose expense ratio declined. Excluding Wellington, the increase was 104 percent.)
6. Charging fees to the mutual funds that managers control that are far higher than the fees charged in the competitive field of pension fund management. Three of the largest advisers, for example, charge an average fee rate of 0.08 percent of assets to their pension clients and 0.61 percent to their funds, resulting in annual fees of just $600,000 for the pension fund and $56 *million* for the comparable mutual fund (and presumably holding the same stocks in both portfolios).
7. Diluting the value of fund shares held by long-term investors, by allowing hedge fund managers to engage in "time zone" trading. This vast near-industry-wide scandal came to light in 2003. It involved some 23 fund managers, including many of the largest firms in the field—in effect, a conspiracy between mutual fund managers and hedge fund managers to defraud regular fund shareholders.
8. "Pay-to-play" distribution agreements with brokers, in which fund advisers use *fund* brokerage commissions ("soft dollars") to finance share distribution that benefits primarily the *adviser*.
9. Spending enormous amounts on advertising—almost a half-billion dollars in the last two years alone—to bring in new fund investors, using money obtained from existing fund shareholders.

10. Creating exotic and untested "products" that have proved to have far more ephemeral marketing appeal than enduring investment integrity.

Each one of these ten practices, it seems clear, represents a violation of the fiduciary principle.

A Piece of History

While the overwhelming majority of financial institutions are operated primarily in the interests of their manager/agents and at the expense of their principals, not quite all do so. I now present one exception to this rule, drawing again on my personal experiences in the mutual fund industry. As far back as 38 years ago, I expressed profound concern about the nature and structure of the fund industry. Only three years later, my convictions led to action, and 35 years ago this September, I founded a firm designed, to the best of my ability, to honor the fiduciary principle.

I expressed this principle when doing so was distinctly counter to my own self-interest. Speaking to my partners at Wellington Management Company in September 1971—1971!—I cited the very same words of Justice Stone which I cited earlier in these remarks. I then added:

> *I endorse that view, and at the same time reveal an ancient prejudice of mine: All things considered . . . it is undesirable for professional enterprises to have public stockholders. This constraint is as applicable to money managers as it is to doctors, or lawyers, or accountants, or architects. In their cases, as in ours, it is hard to see what unique contribution public investors bring to the enterprise. They do not, as a rule, add capital; they do not add expertise; they do not contribute to the well-being of our clients. Indeed, it is possible to envision circumstances in which the pressure for earnings and earnings growth engendered by public ownership is antithetical to the responsible operation of a professional organization. Even though the field of money management has elements of both, there are, after all, differences between a business and a profession.*

My candor—Wellington Management was then owned largely by public investors—may well have played a supporting role in my dismissal as chief executive of Wellington Management Company in January 1974. While it's a saga too complex to detail this evening, my firing gave me the chance of a lifetime—the opportunity to create a new fiduciary-focused structure for our funds. I proposed just such a structure to the directors of the Wellington funds. Wellington Management Company, of course, vigorously opposed my efforts.

Nonetheless, after months of study, the directors of the funds accepted my recommendation that we separate the activities of the funds themselves from their adviser and distributor, so that the funds could operate solely in the interests of our fund shareholders. Our new structure involved the creation of a new firm, incorporated on September 24, 1974, The Vanguard Group of Investment Companies, owned by the funds, employing their own officers and staff, and operated on an "at-cost" basis, would be unique in the field, a truly *mutual* mutual fund organization.

While Vanguard began with a limited mandate—to provide only administrative services to the funds—I realized that, if we were to control our own destiny, we would also have to provide both investment advisory and marketing services to our funds. So, almost immediately after Vanguard's operations commenced in May 1975, we began our move to gain substantial control over these two essential functions. By year's end, we had created the world's first index mutual fund, run by Vanguard.

Early in 1977, we abandoned the supply-driven, commission-based, broker-dealer distribution system that had been operated by Wellington since 1928, in favor of a buyer-driven, "no-load" approach under our own direction. Later that year, we created the first-ever series of defined-maturity bond funds, segmented into short-, intermediate-, and long-term maturities, focused on high investment quality. Then, in 1981, Vanguard assumed responsibility for providing the investment advisory services to our new fixed-income funds as well as our established money market funds. (As you can imagine, none of these moves was without controversy!)

Let me give you some sense of the importance of those changes. Since our formation, the assets of the Vanguard funds have grown from $1 billion-plus to some $1 trillion today. Some 82 percent of that trillion—$820 billion—is represented by our passively-managed index funds, bond funds, and money market funds that we at Vanguard manage, distribute, and advise. Some 25 external investment advisers serve our remaining (actively-managed) funds, with Wellington advising by far the largest portion of those assets. (Most of these funds have multiple advisers, the better to mitigate the risk of underperformance relative to their peers.)

More than parenthetically, that long string of business decisions was made during a long period in which Vanguard's very existence was in doubt. For the Securities and Exchange Commission had initially refused to approve Vanguard's assumption of marketing and distribution responsibilities. Only after a struggle lasting six (interminable!) years did the SEC reverse itself. In February 1981, by unanimous vote, the Commission declared that:

> *The Vanguard plan is consistent with the provisions, policies, and purposes of the (Investment Company Act of 1940). It actually furthers the Act's objectives . . . enhances the funds' independence . . . benefits each fund within a reasonable range of fairness . . . . . . (provides) substantial savings from advisory fee reductions (and) economies of scale . . . and promotes a healthy and viable mutual fund complex in which each fund can better prosper.*

A Prescient SEC?

Indeed! The SEC's words now seem prescient. In fact, "can *best* (rather than *better*) prosper" would have been more accurate. Measured by Morningstar's peer-based rating system—comparing each fund with other funds having distinctly comparable policies and objectives—Vanguard ranked first in performance among the 40 largest fund complexes. Largely because of the competitive returns that we've delivered to our fund shareholders, our market share of the assets of long-term funds (stock and bond funds) has risen from 4 percent of industry assets in our early years to 15 percent today.

Advisory fee reductions and economies of scale? Once again, *indeed.* Vanguard's low-costs are legendary, by far the lowest in the field. Last year, over all, our operating expense ratio came to 0.20 percent of average assets, compared to 1.30 percent for the average mutual fund. That 1.1 percentage point saving, applied to one trillion of assets, now gives our shareholders an average savings of $11 billion annually. Do low costs matter? Of course they do! As the world of investing is at last beginning to understand, low costs are the single most reliable indicator of superior fund performance. Yes, as we read in Homer's *The Odyssey,* "fair dealing yields more profit in the end."

If you are willing to accept—based on that solid data—that Vanguard has achieved both *commercial* success (asset growth and market share) and *artistic* success (superior performance and low costs), you must wonder why, after nearly 35 years of existence, *no* other firm has elected to emulate our shareholder-oriented structure. (A particularly ironic outcome since I chose the name *Vanguard* in part because of its conventional definition as "*leader* in a new trend.") The answer, I think, can be expressed succinctly: under our at-cost structure, all of the darned profits go not to the managers, but to the fund shareholders, resolving the transcendent conflict of interest that besets the mutual fund industry. In any event, the leader, as it were, has yet to find its first follower.

To Build the Financial World Anew

Vanguard represented my best effort to align the interests of fund investors and fund managers under established principles of fiduciary duty. I leave it to wiser—and surely more objective—heads than mine to evaluate whether or not I overstate or hyperbolize what we have accomplished, even as I freely acknowledge that we owe our accomplishments to the three simple principles: the firm is (1) structurally correct (since we are owned by our fund investors); (2) mathematically correct (since it is a tautology that the lower the costs incurred in investing, the higher the returns); and (3) ethically correct (since we exist only by earning far greater trust and loyalty from our shareholders than any of our peers). Measured by repeated evaluations of loyalty by independent research firms, there's simply no close rival for our #1 position. Please be appropriately skeptical of that self-serving claim, but look at the data. In a 2007 survey, one such group concluded, "Vanguard Group generates far more loyalty than any other company."[*]

Creating and restructuring Vanguard was no easy task. Without determination, expertise, luck, timing, and the key roles played by just a handful of individuals, it never could have happened. So when I suggest that we must now go beyond restructuring the nature and values of a single firm to restructuring the nature and values of the entire money management business, I am well aware of how difficult it will be to accomplish that sweeping task.

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[*]Cogent Research data, as reported in *The Wall Street Journal*, date March 15, 2007. Our loyalty score (percentage of strong *supporters* minus strong *detractors)* was plus 44; the number two firm was rated at plus 21. The fund industry scored a pathetic *minus* 12.

What we must do is develop a new *fiduciary* society which guarantees that our last-line owners—those mutual fund shareholders and pension fund beneficiaries whose savings are at stake—their rights as investment principals. These rights must include:

(1) The right to have their money-manager/agents act solely in their behalf. The client, in short, must be king.

(2) The right to rely on due diligence and high professional standards on the part of our money managers and securities analysts who appraise securities for our portfolios.

(3) The assurance that our agents will act as responsible corporate citizens, restoring to their principals the neglected rights of ownership of stocks, and demanding that corporate directors and managers meet their fiduciary duty to their own shareholders.

(4) The right to demand some sort of discipline and integrity in the mutual funds and financial "products" that we offer.

(5) The establishment of advisory fee structures that meet a "reasonableness" standard based not only on *rates* but *dollar amounts*, and their relationship to the fees and structures available to other clients of the manager.

(6) In all, measuring up to the 1940 Act standard that funds are in fact "organized, operated, and managed in the interest of their shareholders," by eliminating of all conflicts of interest that could preclude the achievement of these goals.

I should note that this final provision would seem to preclude the ownership of money management firms by financial conglomerates, now the dominant form of organization in the mutual fund industry. Among today's 40 largest fund complexes, only six remain privately-held. The remaining 34 include 13 firms whose shares are held directly by the public, and an astonishing total of 21 fund managers owned or controlled by U.S. and international financial conglomerates—including Goldman Sachs, Bank of America, Deutsche Bank, ING, John Hancock, and Sun Life of Canada. Painful as such a separation might be, conglomerate ownership of money managers is the single most blatant violation of the principle that "no man can serve two masters."

Of course it will take federal government action to foster the creation of this new fiduciary society that I envision. Above all else, it must be unmistakable that government intends, and is capable of enforcing, standards of trusteeship and fiduciary duty under which money managers operate with the *sole* purpose and in the *exclusive* benefit of the interests of their beneficiaries—largely the owners of mutual fund shares and the beneficiaries of our pension plans. If, as corporate reformer Robert Monks accurately points out, "capitalism without owners will fail," it's high time we began the task of reform.

The Role of Government

The accomplishment of that task cannot be left to the fainthearted, and will likely require the appointment of a national commission composed of our wisest, most respected, and best-informed citizens. The federal government will likely need to preempt, at least in part, the multiple state laws under which our corporations have been chartered ever since our nation's founders granted that power to the individual states. While most of us cherish the belief that the separation of the economy from the state is as essential for capitalism as it is for liberty, we also understand that from time to time the people's government must step in and work to solve novel and complex problems. This is one of those times.

Traditionally, America's political parties have been philosophically divided between a so-called liberal tradition favoring the use of the national government to foster equality and social justice, and a so-called conservative tradition favoring limited national government in the name of protecting liberty, freedom, and personal responsibility. According to David Brooks of *The New York Times,* however:

> *Through much of American history there has always been a third tradition, now dormant, which believed in limited but energetic government in the name of social mobility and national union. This third tradition was founded by Alexander Hamilton, embraced by Henry Clay, taken up by Abraham Lincoln and brought into the 20th century by Theodore Roosevelt. . . . Hamilton came from nothing and spent his political career trying to create a world in which as many people as possible could replicate his amazing success. [He] looked around after independence and saw a country destined to become the greatest empire of the earth, and sought to liberate and stir Americans to exploit the full range of their capacities.*
>
> *Hamilton believed in using government to enhance market dynamism by fostering more equitable competition. He believed government could usefully promote social revolutions . . . rejecting the formula, assumed too often today, that you can be for*

government or for the market, but not for both. He saw entrepreneurial freedom, limited but energetic federal power, and national greatness as qualities that were inextricably linked. It was always the cause America represents—universal freedom—that was uppermost in Hamilton's mind, spurring individual initiative, but also gathering the fruits of that energy in the cause of national greatness.

Were Alexander Hamilton alive today, I simply cannot imagine that he would not agree with the notion that it's high time to restore the integrity of our system of capitalism, and high time to rethink the nation's investment process. In today's wrongheaded version of capitalism, corporate managers are in charge of our business wealth, almost unchecked by traditional gatekeepers; and the investment community is too heavily focused on short-term stock prices and too lightly focused on long-term intrinsic corporate values to challenge their domain. I believe that a federal standard of fiduciary duty would play a major role in reversing that focus.

Given the vicious circle in which corporations, in important degree, act as if they own themselves, our investment intermediaries have proven reluctant to use their latent power. Further, even for those intermediaries who have the motivation to exercise it, hopelessly archaic proxy rules serve to handcuff the exercise of that power. And the prospects seem increasingly dim for opening even a tiny crack in the rigid regulatory doorway that precludes owners from their rights of ownership by denying them reasonable access to corporate proxy statements. With mutual fund managers firmly ensconced in the driver's seat of the governance of the funds themselves, we are captives of a system in which both corporate directors and fund directors seem not only unwilling but unable to take on the role and responsibility of the gatekeeper as a steward, one who holds the interests of the shareholder as his highest priority.

Summing Up

So I await—with no great patience!—the return of the standard so beautifully described by Justice Cardozo all those years ago, excerpts from his words:

Those bound by fiduciary ties . . . (are) held to something stricter than the morals of the marketplace . . . a tradition unbending and inveterate . . . not honesty alone but the punctilio of an honor the most sensitive . . . a level of conduct . . . higher than that trodden by the crowd.

The change in the rules of the game that I advocate—applying to institutional money managers a federal standard of fiduciary duty to their clients—would be designed in turn to force these managers to use their own ownership position to demand that the managers and directors of the business corporations in whose shares they invest also honor their own fiduciary duty to the holders of their shares. Finally, it is these two groups that share the responsibility for the prudent stewardship over corporate assets and investment securities alike that have been entrusted to their care, not only reforming today's flawed and conflict-ridden model, but developing a new model that, at best, will restore traditional ethical mores.

I close with a Biblical quotation (John 10: 11-13): *I am the good shepherd: the good shepherd giveth his life for the sheep. But he that is a hireling, and not the shepherd, whose own the sheep are not, seeth the wolf coming, and leaveth the sheep, and fleeth: and the wolf catcheth them, and scattereth the sheep. The hireling fleeth, because he is an hireling, and careth not for the sheep."*

This parable reminds us that our financial hirelings didn't protect us sheep from the wolves that created this financial crisis, either because they didn't see them coming, or saw them and decided to flee the pastures of capitalism. So we must work to develop a new culture, an ethical culture, in which we act as our own shepherds, and demand that our fiduciary-hirelings place our interests first.