

Building a Better Financial System

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To “The Old Guard”

at Princeton University

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It’s always a delight to return to the old stomping ground where I received such a great education and a fabulous start to my long career in finance. During this 55-year period, I’ve developed a strong point of view regarding the nature, the structure, and the efficiency (or, truth told, the inefficiency) of our financial system. In my fifth book, *The Battle for the Soul of Capitalism*, published by Yale University Press in the autumn of 2005¹ I’ve explored these issues in depth.

1. Basic Values

The fact is that the basic values I hold about investing were formed during my four years studying at Princeton University as an undergraduate. Here, almost exactly 58 years ago, I happened upon the December 1949 issue of *Fortune* magazine and learned for the first time that something called “the mutual fund industry” existed. When I saw the industry described in the article as “tiny but contentious,” I knew immediately that I had found the topic for my senior thesis, then as now, a requirement for the Bachelor of Arts degree.

Over the next 18 months, I spent countless hours researching and writing my thesis. Remarkably little public information was available about this field, then consisting of some 130 mutual funds with assets aggregating just \$2½ billion. Harvard’s corporate strategy guru Michael Porter advises people considering their careers to “pick a good industry,” and when I chose my

*The opinions expressed in this speech do not necessarily represent the views of Vanguard’s present management.

¹ I’m delighted to report that *Battle for the Soul of Capitalism* has been selected by Tiger Tomes as its “book-of-the-month” for the Princeton Alumni Education Program in April 2008. Please feel free to participate! http://alumni.princeton.edu/main/education_travel/home_study_programs/book_club/

thesis topic I certainly did just that. With an annual growth rate of almost 16 percent since then, the fund industry just may have been the fastest growing business in America. Today, there are 9,000 funds, with total assets that approach \$12 trillion!

Read today, my thesis would probably impress you as no more than workmanlike, perhaps a bit callow, but above all, shamelessly idealistic. And you *can* read it, for six years ago it was published by McGraw-Hill as part of *John Bogle on Investing: the First 50 Years*. (If you wait a half-century, perhaps anything can be published!) On page after page of the thesis, my youthful idealism speaks out, calling again and again for the primacy of the interests of the mutual fund shareholder.

At the very opening of my thesis, I get right to the point: Mutual funds must not “in any way subordinate the interests of their shareholders to other economic roles. Their prime responsibility must always be to their shareholders.” (Important advice that the industry seems to have ignored; witness the disgusting market-timing scandals uncovered by New York Attorney General Eliot Spitzer four years ago.) Shortly thereafter, “there is some indication that costs are too high,” and that “future industry growth can be maximized by concentration on a reduction of sales charges and management fees.” (My advice fell upon deaf ears there as well!)

After analyzing mutual fund performance, I conclude that “funds can make no claim to superiority over the market averages,” perhaps an early harbinger of my decision to create, nearly a quarter-century later, the world’s first index mutual fund. Still later in the thesis, “fund influence on corporate policy . . . should always be in the best interest of shareholders, not the special interests of the fund’s managers.” (Again, my advice fell by the wayside, and shareholders remain ill-served by the passive governance policies of most funds.)

My conclusion powerfully reaffirmed the ideals that I hold to this day: “The principal function of investment companies is the management of their investment portfolios. Everything else is incidental.” The role of the mutual fund is to serve—“to serve the needs of both individual and institutional investors . . . to serve them in the most efficient, honest, and economical way possible.”

This gratuitous advice from a callow college senior was also largely ignored by the fund industry. But the creation of Vanguard in 1974 as a truly *mutual* mutual fund group—operated

on an “at cost” basis for the benefit of its owners rather than its managers—was my attempt to walk the walk that I had talked the talk about nearly a quarter-century earlier. Today, I assure you that my youthful idealism remains intact. Indeed, it is shamelessly reflected not only in Vanguard but in my *Battle* book, an expression of my concern about our American society today, my conviction that our system of capital formation is essential to our economic growth and world leadership, and my acknowledgement that much has gone wrong in our financial system.

2. A Parable

So what’s gone wrong? Let’s begin with a parable that describes how the system really works. It’s my version of a story told by Warren Buffett, chairman of Berkshire Hathaway Inc., in the firm’s 2005 annual report, and it clarifies the foolishness and counterproductivity of our vast and complex financial market system. Here goes:

Once upon a time . . . a wealthy family named the Gotrocks, grown over the generations to include thousand of brothers, sisters, aunts, uncles, and cousins, owned 100 percent of every stock in the United States. Each year, they reaped the rewards of investing: all the earnings growth that those thousands of corporations generated and all the dividends that they distributed. Each family member grew wealthier at the same pace, and all was harmonious. Their investment had compounded over the decades, creating enormous wealth, because the Gotrocks family was playing a winner’s game.

But after a while, a few fast-talking Helpers arrive on the scene, and they persuade some “smart” Gotrocks cousins that they can earn a larger share than the other relatives. These Helpers convince the cousins to sell some of their shares in the companies to other family members, and to buy some shares of others from them in return. The Helpers handle the transactions, and as brokers, they receive commissions for their services. The ownership is thus rearranged among the family members.

To their surprise, however, the family wealth begins to grow at a slower pace. Why? Because some of the return is now consumed by the Helpers, and the family’s share of the generous pie that U.S. industry bakes each year—all those dividends paid, all those earnings reinvested in the business—100 percent at the outset, starts to decline, simply because some of the return is now consumed by the Helpers.

To make matters worse, while the family had always paid taxes on their dividends, some of the members are now also paying taxes on the capital gains they realize from their stock-swapping back and forth, further diminishing the family's total wealth.

The smart cousins quickly realize that their plan has actually diminished the rate of growth in the family's wealth. They recognize that their foray into stock-picking has been a failure and conclude that they need professional assistance, the better to pick the right stocks for themselves. So they hire stock-picking experts—more Helpers!—to gain an advantage. These money managers charge a fee for their services. So when the family appraises its wealth a year later, it finds that its share of the pie has diminished even further.

To make matters still worse, the new managers feel compelled to earn their keep by trading the family's stocks at frantic levels of activity, not only increasing the brokerage commissions paid to the first set of Helpers, but running up the tax bill as well. Now the family's earlier 100 percent share of the dividend and earnings pie is further diminished.

“Well, we failed to pick good stocks for ourselves, and when that didn't work, we also failed to pick managers who could do so,” the smart cousins say. “What shall we do?” Undeterred by their two previous failures, they decide to hire still more Helpers. They retain the best investment consultants and financial planners they can find to advise them on how to select the right managers, who will then surely pick the right stocks. The consultants, of course, tell them they can do exactly that. “Just pay us a fee for our services,” the new Helpers assure the cousins, “and all will be well.” Alas, the family's share of the pie tumbles once again.

Alarmed at last, the family sits down together and takes stock of the events that have transpired since some of them began to try to outsmart the others. “How is it,” they ask, “that our original 100 percent share of the pie—made up each year of all those dividends and earnings—has dwindled to just 60 percent?” Their wisest member, a sage old uncle, softly responds: “All that money you've paid to those Helpers and all those

unnecessary extra taxes you're paying come directly out of our family's total earnings and dividends. Go back to square one and do so immediately. Get rid of all your brokers. Get rid of all your money managers. Get rid of all your consultants. Then our family will again reap 100 percent of however large a pie that corporate America bakes for us, year after year."

They followed the old uncle's wise advice, returning to their original passive but productive strategy, holding all the stocks of corporate America, and standing pat . . . *and the Gotrocks Family Lived Happily Ever After.*

Adding a fourth law to Sir Isaac Newton's three laws of motion, the inimitable Warren Buffett puts the moral of his story this way: "For investors as a whole, returns decrease as motion increases." Accurate as that cryptic statement is, I would add that the parable reflects the profound conflict of interest between those who work in the investment business and those who invest in stocks and bonds. The way to wealth for those *in the business* is to persuade their clients, "Don't just stand there. Do something." But the way to wealth *for their investor/ clients* in the aggregate is to follow the opposite maxim: "Don't do something. Just stand there." For that is the only way to avoid playing the loser's game of trying to beat the market.

The moral of the story, then, is that successful investing is about owning all of America's businesses and reaping the huge rewards provided by the dividends and earnings growth of our nation's—and, for that matter, our world's—corporations. The higher the level of our own activity by investors, the greater the costs of financial intermediation and taxes, the smaller the net returns that our business owners as a group receive. The lower the costs that investors as a group incur, the higher rewards that they reap. So to realize the winning returns generated by businesses over the long term, the intelligent investor will minimize to the bare bones the costs of our financial system. That's what common sense tells us, and it's the truth.

3. The Index Fund

While on first impression it might seem intimidating to own a share in all of America's businesses and thereby capture whatever returns our stock market is generous enough to deliver, in fact it is amazingly simple. It is, of course, by investing in an index mutual fund, that fund I mentioned early in these remarks, hinted at in my senior thesis and realized by Vanguard's creation of the first index fund in 1975.

The original creation was a fund (“First Index Investment Trust,” now Vanguard 500 Index Fund) that tracked the returns of the Standard & Poor’s 500 Stock Index, whose blue-chip components represent about 80 percent of the value of the U.S. stock market. Later, we created a fund that held 100 percent of the U.S. market (Vanguard Total Stock Market Index Fund), and now also offer an index fund that holds the world’s non-U.S. stocks (Vanguard Total International Index Fund). In some combination of these last two funds, then, an investor can easily hold a *pro rata* share in the ownership of the world’s equity securities.²

All these index funds do is capture the returns of the stock market indexes they mirror. They deduct only trivial amounts of costs (less than 0.2 percent per year) from those gross returns. In a stock market that delivers 8 percent per year, for example, the investor would earn a return of about 7.8 percent. That 0.2 percent cost is represented by the fund’s expense ratio—the amount it costs to operate the fund. By way of contrast, the typical mutual fund has an expense ratio of about 1.4 percent.

But this typical actively-managed equity fund also incurs two additional costs that the index fund does not entail. While the passively-managed index fund has virtually no turnover of the stocks in its portfolio, the average equity fund buys and sells stocks at an astonishing rate, currently about 100 percent per year, adding a *hidden* (but nevertheless very *real*) further cost of about 0.5 percent to 1.0 percent per year. Further, while most index funds are available without sales loads, most mutual funds carry a front-end load of about 5 percent, adding an annual cost of another 0.5 percent to 1.0 percent per year (depending on how long the investor holds his or her shares). Total annual “all-in” cost, then: Index fund, 0.2 percent, regular equity fund roughly 2 percent to 3 percent.³

Doesn’t seem like much, does it? Well consider its impact over say, a 50-year investment lifetime. \$10,000 invested at a return of 8 percent would grow to a total of \$469,000. On the other hand, \$13,000 invested at 5 ½ percent (8 percent less a 2 ½ percent cost) would grow to just \$139,000 or less than 30 percent of the return offered by the index fund.

² Index funds also exist for other sectors of the U.S. and global stock markets, as well as for a variety of taxable and tax-free bonds.

³ And I haven’t mentioned taxes. Index funds, which sell stocks only when they are removed from the index (a fairly rare occurrence), are highly *tax-efficient*. Managed equity funds, with their astonishing levels of buying and selling are highly *tax-inefficient*. The difference: an advantage of as much as a 1 ½ percentage point per year for the index fund.

So it is that through the deduction of a “mere” 2.5 percent in annual costs, the miracle of compounding returns is overwhelmed by the tyranny of compounding costs. For in the investment field, time doesn’t heal all wounds. It makes them worse. *Where returns are concerned, time is your friend. But where costs are concerned, time is your enemy.* The investor in this example, who put up 100 percent of the capital and assumed 100 percent of the risk, earned less than 30 percent of the market return. Our system of financial intermediation, which put up zero percent of the capital and assumed zero percent of the risk, essentially confiscated 70 percent of that return—surely the lion’s share. An investment in a low-cost index fund, held for the long term, eliminates all of the terribly harmful costs of financial intermediation, and thus guarantees that you’ll earn your fair share of whatever returns our stock market offers.

If it sounds like I’m pushing Vanguard’s index funds on you, well, there’s something to that. But only because soundly-operated index funds are the ideal way to invest for the long-term, by reason of their rock-bottom costs and long record of tracking their respective indexes with a remarkable precision. But don’t take my word for it. The index fund has received incredibly strong endorsements from the most respected financial experts in the nation. Warren Buffett, his partner Charlie Munger, Nobel Laureates Paul Samuelson, William Sharpe, and Gary Becker (Princeton ’51); respected endowment fund managers from Yale (David Swenson) and Harvard (Jack Meyer). Innumerable financial professors including Burton Malkiel (Princeton ’64). Journalists, financial authorities—the list is almost endless. What’s more, the giant \$140 billion Federal Thrift Savings Plan is invested largely in index funds, along with trillions of dollars in the nation’s public and private pension plans.

But perhaps the crowning endorsement comes from investors who have actually owned Vanguard 500 Index Fund during its entire history. Let me present a specific example: at a dinner held in September, 2006, celebrating the 30th anniversary of the fund’s initial public offering, the counsel for the fund’s underwriters reported that he had purchased 1,000 shares at the original offering price of \$15.00 per share—a \$15,000 investment. He proudly announced that the value of his holding that evening (including shares acquired through reinvestment of the fund’s dividends and distributions over the years) was \$461,771. Of course that was a year ago. At the close of business yesterday, the value was \$543,657. There’s a number that requires no comment!

4. Our Financial Economy

If you've been following my argument, you might well be thinking that the reason that the index fund does so well is that it doesn't fall prey to the shortcomings of our financial system as a whole, yet our financial system now dominates over economies that fact that over the past two centuries, our nation has moved from being an agricultural economy, to a manufacturing economy, to a service economy, and now to a predominantly financial economy. But our financial economy, by definition, subtracts from the value created by our productive businesses. Think about the Gotrocks family again. While investing in American business is a *winner's* game, beating the stock market before those costs is a *zero-sum* game. But after intermediation costs are deducted, beating the market—for all of us as a group—becomes a *loser's game*.

Yes, the more that our financial system *takes*, the less our investors *make*. Yet the financial field is where the money is made in modern-day America, the breeding ground for the wealthiest of our citizens. (If you made less than \$140 million dollars last year, you didn't make *enough* to rank among the 25 highest-paid hedge fund managers.) When we add up all those hedge fund fees, all those mutual fund management fees and operating expenses; all those commissions to brokerage firms and fees to financial advisors; investment banking and legal fees for all those mergers and IPOs; and the enormous marketing and advertising expenses entailed in the distribution of financial products, we're talking about some \$580 billion dollars *per year*. That sum, extracted from whatever returns the stock and bond markets are generous enough to deliver to investors, seriously undermines the odds in favor of success for our citizens who are accumulating savings for retirement.

Yet the fact is that the finance sector has become by far our nation's largest generator of corporate profits, larger even than the *combined* profits of our huge energy and health care sectors, and almost three *times* as much as either manufacturing or information technology.⁴ Twenty-five years ago, financials accounted for only about 6 percent of the earnings of the 500 giant corporations that compose the Standard & Poor's 500 Stock Index. Ten years ago, the financial sector share had risen to 20 percent. And last year, the financial sector profits had soared to an all-time high of 27 percent. If we add the earnings of the financial affiliates of our

⁴ For the record, the 2006 operating earnings of the S&P 500 totaled \$787 billion. The earnings of the major sectors (in billions) were: Financials \$215; Energy \$121; Health Care \$79; Manufacturing and Technology each \$81.

giant manufacturers (think General Electric Capital, for example, or the auto financing arms of General Motors and Ford) to this total, financial earnings now likely exceed 33 percent of the earnings of the S&P 500. While, given the recent collapse of collateralized debt obligations that have already led to the demise of the careers of CEO's of our nation's largest bank and largest brokerage firms, that share may decline this year as it remains enormous.

We're moving, or so it seems, to a world where we're no longer *making* anything in this country; we're merely *trading* pieces of paper, swapping stocks and bonds back and forth with one another, and paying our financial croupiers a veritable fortune. We're also adding even more costs by creating ever more complex financial derivatives in which huge and unfathomable risks—now beginning to emerge—are being built into our financial system. “When enterprise becomes a mere bubble on a whirlpool of speculation,” as the great British economist John Maynard Keynes warned us 70 years ago, the consequences may be dire. “When the capital development of a country becomes a by-product of the activities of a casino, the job of capitalism is likely to be ill-done.”

Once a profession in which business was subservient, the field of money management and Wall Street has become a business in which the profession is subservient. Harvard Business School Professor Rakesh Khurana was right when he defined the conduct of a true professional with these words: “*I will create value for society, rather than extract it.*” And yet money management, by definition, extracts value from the returns earned by our business enterprises.

There's another difficult reality here, for the financial economy. While my simple insight provides a solid framework for understanding stock market returns, however, I failed to consider the extent to which speculation in the financial economy (emotions) might influence changes in the business economy (enterprise). But when I learned of the work of the great American economist, Hyman Minsky (1919-1996), who dedicated his career largely to what he described as the “financial instability hypothesis,” I recognized that yet another element of risk—here, clearly, meaning uncertainty—existed.⁵

“In 1974, Minsky observed a fundamental characteristic of our economy that linked finance and economics: ‘The financial system swings between robustness and fragility, and these

⁵ In the following four paragraphs, I quote investment adviser Frank K. Martin, CFA, writing in the 2006 annual report of his firm, Martin Capital Management.

swings are an integral part of the process that generates business cycles.’ Moreover, according to Minsky, the prevailing financial structure is a central determinant of the behavior of the capitalist economy. Likewise, the dynamism of profit-driven motives influence economic activity within the context of a given institutional structure in that the structure itself changes in response to profit seeking. Resonating with the ideas of economist Joseph A. Schumpeter, Minsky emphasized that:

Financial markets will not only respond to profit-driven demands of business leaders and individual investors but also as a result of the profit-seeking entrepreneurialism of financial firms. Nowhere are evolution, change, and Schumpeterian entrepreneurship more evident than in banking and finance, and nowhere is the drive for profits more clearly the factor making for change.

“The financial system takes on special significance in Minsky’s theory, not only because finance exerts a strong influence on business activity, but also because this system is particularly open—or, as some might claim, prone—to innovation, as is abundantly evident today. Continues Minsky: ‘Since finance and industrial development are in a symbiotic relationship, financial evolution plays a crucial role in the dynamic patterns of the economy.’

“The *raison d’être* for money managers, and basis by which they are held accountable, is the maximization of the value of the investments made by their clients. Not surprisingly, therefore, business executives became increasingly attuned to short-term profits and the stock-market valuation of their firm. The growing role of institutional investors fostered continued financial-system evolution by providing a ready pool of buyers of securitized loans, structured finance products, and myriad other exotic innovations.”

To drive this point home, think of investing as consisting of two different games. Here’s how Roger Martin, dean of the Rotman School of Management of the University of Toronto, describes them. One is “the *real* market, where giant publicly held companies compete. Where real companies spend real money to make and sell real products and services, and, if they play with skill, earn real profits. This game also requires real strategy, determination, and expertise; real innovation and real foresight.”

Loosely linked to this game is another game, the *expectations* market. Here, “prices are not set by real things like sales margins or profits. In the short-term, stock prices go up only when the expectations of investors rise, not necessarily when sales, margins, or profits rise.”

To this crucial distinction, I would add that the expectations market is not only a product of the expectations of active investors but the expectations of active speculators, trying to guess what these investors will expect, and how they will act as each new bit of information finds its way into the marketplace. *The expectations market is about speculation. The real market is about investing.* The only logical conclusion: the stock market is a giant distraction that causes investors to focus on transitory and volatile investment expectations rather than on what is really important—the gradual accumulation of the returns earned by corporate business.

My advice to investors is to ignore the short-term noise of our emotions reflected in our financial markets and focus on the productive long-term economics of our corporate businesses. Shakespeare could have been describing the inexplicable hourly and daily—sometimes even yearly or longer—fluctuations in the stock market when he wrote, “[It is] like a tale told by an idiot, full of sound and fury, signifying nothing.” The way to investment success is to get out of the expectations market of stock prices and cast your lot with the real market of business.

Simply heed the timeless distinction made by Benjamin Graham, legendary investor, author of *The Intelligent Investor*, and mentor to Warren Buffett. He was right on the money when he put his finger on the essential reality of investing: “In the short run the stock market is a voting machine . . . (but) in the long run it is a weighing machine.”

5. Rebuilding the Financial Systems – a Framework

I’ve described a financial system that has grown to enormous and excessive proportions. The root causes of this change are deep, and the remedies that are required to cure it will not be easy to come by. What we have witnessed, in the words of journalist William Pfaff, is “a pathological mutation in capitalism.” 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 exists. This is morally unacceptable, but also a corruption of capitalism itself.”

When most owners either don’t or won’t or can’t stand up for their rights, and when corporate 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.”

There were two major forces behind this baneful change: First, the “ownership society”—in which the shares of our corporations were held almost entirely by direct stockholders—gradually lost its heft and its effectiveness. Since 1950, direct ownership of U.S. stocks by individual investors has plummeted from 92 percent to 30 percent, while indirect ownership by institutional investors has soared from 8 percent to 70 percent. Our old ownership society is now gone, and it is not going to return. In its place we have a new “agency society” in which our financial intermediaries now hold effective control of American business.

But these new *agents* haven’t behaved as agents should. Our corporations, pension managers, and mutual fund managers have too often put their own financial interests ahead of the interests of the *principals* whom they are duty-bound to represent, those 100-million families who are the owners of our mutual funds and the beneficiaries of our pension plans. As Adam Smith wisely put it 200-plus years ago, “managers of other people’s money (rarely) watch over it with the same anxious vigilance with which . . . they watch over their own . . . they very easily give themselves a dispensation. Negligence and profusion must always prevail.” And so negligence and profusion among our corporate directors and money managers have prevailed in present-day America.

The second reason for the debasement of the values of our capitalistic system is that our new investor/agents not only seemed to ignore the interests of the investor *principals* whom they are duty-bound to serve, but they also seemed to forget their own investment *principles*. In the

latter part of the twentieth century, the predominant focus of institutional investment strategy turned from the wisdom of long-term investing to the folly of short-term speculation. During the recent era, we entered the age of expectations investing, where projected growth in corporate earnings—especially earnings guidance and its subsequent achievement, by fair means or foul—became the watchword of investors. Never mind that the reported earnings were too often a product of financial engineering that served the short-term interest of corporate managers and Wall Street security analysts alike.

But when long-term *owners* of stocks become short-term *renters* of stocks, and when the momentary precision of the price of the stock takes precedence over the eternal vagueness of the intrinsic value of the corporation itself, concern about corporate governance is the first casualty. The single most important job of the corporate director is to assure that management is creating value for shareholders; yet our new agent/investors seemed not to care when that goal became secondary. While these institutional agents now hold absolute voting control over corporate America, all we hear from these money managers is the sound of silence. Not only because they are more likely to be short-term speculators than long-term investors, but also because they are managing the pension and thrift plans of the corporations whose stocks they hold, and thus face a serious conflict of interest when controversial proxy issues are concerned. This conflict is pervasive, for, as it is said, money managers have only two types of client they don't want to offend: *actual*, and *potential*.

Had I not found agreement with this harsh indictment of the present-day capitalism from some of the most respected names in investing, I might be a little less certain of my ground. But leaders of great repute in the business community and the investment community have stood up and spoken out, making a positive difference. Consider, for example, the eminent financier, economist, and historian Henry Kaufman. In his remarkable 2000 book On Money and Markets, here's what he said:

“Unfettered financial entrepreneurship can become excessive—and damaging as well—leading to serious abuses and the trampling of the basic laws and morals of the financial system. Such abuses weaken a nation's financial structure and undermine public confidence in the financial community . . . Only by improving the balance between entrepreneurial innovation and more traditional values—prudence, stability, safety, soundness—can we improve the ratio of benefits to costs in our economic system . . . When financial buccaneers and negligent executives step over the line, the damage is inflicted on all market participants . . . and the notion of financial trusteeship too frequently lost in the shuffle.”

Dr. Kaufman is not alone. Felix Rohatyn, the widely-respected former managing director of Lazard Freres, is another of the wise men of Wall Street who have spoken out. Here's what he wrote in *The Wall Street Journal* a few years ago:

“I am an American and a capitalist and believe that market capitalism is the best economic system ever invented. But it must be fair, it must be regulated, and it must be ethical. The last few years have shown that excesses can come about when finance capitalism and modern technology are abused in the service of naked greed. Only capitalists can kill capitalism, but our system cannot stand much more abuse of the type we have witnessed recently, nor can it stand much more of the financial and social polarization we are seeing today.”

The fact is that, in some important respects, the Invisible Hand of capitalism has failed us. Here are the familiar sentences that Adam Smith wrote in *The Wealth of Nations*.

“It is not from the benevolence of the butcher, the baker, or the brewer that we expect our dinner, but from their regard to their own self-interest. By directing (our own) industry in such a manner as its produce may be of the greatest value, (we) intend only our own gain, and (we are) led by *an invisible hand* to promote an end which was no part of (our) intention.”

So what's to be done? While the quest to restore those non-economic but transcendently vital values of trust, loyalty and honesty is hardly for the faint of heart, it's easy to conceptualize the path we need to follow. If each individual investor out there—not only that minority who hold their stocks directly, but those millions who hold their stocks through mutual funds—would only look after their own economic self-interest, then great progress would be made in restoring the vanishing values of capitalism.

Here, I think, Adam Smith's Invisible Hand would in fact be helpful. For if intelligent investors would only move away from the costly folly of short-term speculation to the priceless (and price-less!) wisdom of long-term investing—abandoning both the emotions that betray sound investment strategy and the expenses that turn beating the market into a loser's game—will they achieve their financial goals. When they do—and they will—our financial intermediaries will be forced to respond with a focus on long term investing in *businesses*, not short term speculation in *stocks*.

But we need more. Since our agency society has so diffused the beneficial ownership of stocks among our 100-million mutual fund shareholders and pension beneficiaries, we also need

to create, out of our disappearing ownership society and our failed agency society, a new “fiduciary society.” Here, our agent /owners would be required by federal law to place the interest of their principals first—a consistently enforced public policy that places a clear requirement of fiduciary duty on our financial institutions to serve exclusively the interests of their beneficiaries. That duty would expressly require their effective and responsible participation in the governance of our publicly-owned corporations, and demand the return of our institutional agents to the traditional values of professional stewardship that are so long overdue.

Old Guard – Part II

Some men wrest a living from nature; this is called work.

*Some men wrest a living from those who wrest a living from nature;
this is called trade.*

*Some men wrest a living from those who wrest a living from those who
wrest a living from nature; this is called finance.*

In that one long career, I've done my best to make the world of finance work effectively for those scores of millions of our citizens who wrest their livings from nature and from trade. But, the more I observe of finance, the more I wonder about the grotesque distortions it periodically creates in our markets, in our business enterprises, and in our society.

ENOUGH

True story, Word of Honor:

Joseph Heller, an important and funny writer
now dead,
and I were at a party given by a billionaire
on Shelter Island.

I said, "Joe, how does it make you feel
to know that our host only yesterday
may have made more money
than your novel 'Catch-22'
has earned in its entire history?"

And Joe said, "I've got something he can never have."

And I said, "What on earth could that be, Joe?"

And Joe said, "The knowledge that I've got enough."

Not bad! Rest in Peace!