Economic Markets and Public Purpose

(With Some Reflections by Adam Smith)

A Lecture by

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It seems almost fated that I'd come to address you during these days of crisis in our economy and travail in our financial markets, for we have much in common. Both the Reinvestment Fund and The Vanguard Group—the firm that I created almost 35 years ago—are financial service organizations that were created to march to a different drummer, organizations that have done their best to set a new standard—to "rediscover a public purpose," using a phrase from the title of the recent monograph authored by your Jeremy Nowak and Ellen Seidman—in our investment sector, putting service to the community (in your case) and service to investors (in our case) before service to self.

The sad fact is that it is in the field of finance where the seeds of our economic crisis and market travail were sown. The financial sector is easily enough seen as a monolith, driven by opportunism rather than service, by marketing rather than management, by self-interest rather than community good, by complexity rather than simplicity, by short-term speculation rather than long-term investment, and by salesmanship rather than stewardship. Vanguard is among the few—the *very* few—exceptions to this profile, so it is only appropriate that we meet together today, in common cause.

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

I applaud The Reinvestment Fund (TRF), and the worthiness of your cause of community development. Through place-based revitalization focused on targeted financial investments, real estate development, and social service, you bring hope to those in the lower reaches of the nation's economic mainstream. In doing so, according to the standards cited in another Nowak essay, you demand of yourselves: (1) efficiency; (2) minimum intrusiveness into the community; (3) a market-building horizon; and (4) the most direct route to the intended outcome. You also recognize that, since the capital that you put to work does not receive a conventional return on investment, you depend on public subsidy and private philanthropy, all in the name of community development.

With the exception of that final point, there are remarkable similarities between TRF and Vanguard. We too have sought a better way to invest the hard-earned dollars of those human beings who have entrusted their savings to our care. I've challenged the financial system and done my best to improve it—to build a better world for investors. Vanguard was built on a firm foundation of service to our shareholder-owners rather than service to ourselves, in a unique *mutual* mutual fund structure in which our fund shareholders actually *own* the funds' management company. Vanguard operates on an "at-cost" basis, and our structure and fiscal discipline have resulted in cumulative savings to our shareowners of nearly $100 billion so far, subtracting less value from society than any financial firm on the face of the globe. In short, our rise to dominance in the financial field has come simply because we are (1) structurally correct; (2) mathematically correct; and (3) strategically correct. It is hardly a stretch to say that, although your implementation of those principles is vastly different from ours, you share them in philosophy and spirit.

Our core investment strategy is the index fund—a fund that, at its best, simply owns the entire stock market (or the entire bond market). Operated at rock-bottom cost, this strategy guarantees that our shareholders receive neither more nor less than their fair share of whatever long-term returns on investment that our stock and bond markets are generous enough to provide. The index fund, arguably, is an exercise in plain and simple engineering.

Think about it. In the 2005 book, *Power, Speed and Form. Engineers and the Making of the Twentieth Century,*[1] the best engineering is described as embodying "efficiency, economy,

[1] David P. Billington and David P. Billington Jr., Oxford University Press, 2005.

and elegance"[2]—the very kind of ingenious simplicity and effectiveness that characterize the index fund. It is the antithesis of the discredited "financial engineering," the excessive costs, the product complexity, and the rampant speculation that created the global financial crisis that Wall Street has inflicted on Main Street. We created the first index mutual fund in 1975, and today it is the largest mutual fund in the world.[3]

This afternoon, I'd like to discuss the current state of our economy and financial markets, with the emphasis first on what went wrong, and second on what we might do to assure that our financial system takes on a greater sense of public purpose. I'll do so by focusing on four quotations from Adam Smith, ranging from the obvious to the prophetic, to the idealistic. I'll conclude with a few closing words about how all of this fits in with the message of my new book, *Enough. True Measures of Money, Business, and Life*.

Adam Smith I – The Invisible Hand

To say that the nation's financial sector has ignored the principles of efficiency and economy—to say nothing of elegance—would be to put one's head in the sand. The fact is that the bubble that led to the current financial and economic crisis; the easy credit; the cavalier attitude toward risk taken by our bankers and investment bankers; "securitization," in which the traditional (and essential!) link between borrower and lender was severed; the complicity of our rating agencies with the issuers of all those collateralized debt obligation; the extraordinary leverage built into the financial system by derivative securities of mind-boggling complexity; the failure of our regulators to do their job, and the susceptibility of our elected representatives to the temptations of political contributions. 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 crisis in capitalism also comes, in part, from our conviction that the Invisible Hand—described by Adam Smith more than 230 years ago in his seminal work, *The Wealth of Nations*—would benignly serve our society. Hear Smith's words:

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[2] In fact, in my 1951 thesis at Princeton University, I urged that mutual funds be operated "in the most efficient, economical, and honest way possible." If honesty is understood to represent a certain kind of elegance, the ideas are identical.
[3] Assets of our Index 500 Funds total $125 billion; assets of their near-counterpart, our Total Stock Market Index Fund, total $95 billion, $220 billion in all.

In the uniform and uninterrupted effort to better (man's) condition, the principle from which (both) public and private opulence is originally derived, is powerful enough to maintain progress. Each individual neither intends to promote the public interest, nor knows how much he is promoting it . . . (but) by directing his industry in such a manner as to its produce may be of the greatest value, he is led by an invisible hand to promote an end which was no part of his intention.

Yet somehow the invisible hand of self-interest has gone awry. Trusting and being trusted were essential elements explaining why the invisible hand worked for society, but today we seem to rely far less on these essentials. Despite the vital role of self-interest in providing the plenty of modern society, we need something more. We need to restore trust and we need to raise our society's expectations of the proper conduct of our citizens, and especially of our leaders.

During the past two centuries, as capitalism came into its own, we took the virtues of trust and trusting, and of trustworthy leadership for granted. The free market system demanded them. Hear, for example, Federal Reserve Chairman Alan Greenspan, speaking in 2004:

> " . . . One can hardly overstate the importance of reputation in a market economy . . . Rules cannot substitute for character of those with whom we do business . . . I hope and anticipate that trust and integrity again will be amply rewarded in the marketplace as they were in previous generations. There is no better antidote for the business and financial transgressions of recent years."

But if then-Chairman Greenspan believed in 2004 that the Invisible Hand of self-interest would do its job, by 2009 he'd concluded quite the opposite. His intellectual analysis, he conceded, was based on a false premise. In his testimony before Congress last October, Greenspan acknowledged that the crisis had been prompted by "a once-in-a-century credit tsunami," which had arisen from the collapse of a "whole intellectual edifice . . . Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity—myself especially—are in a state of shocked disbelief," he said. This failure of self-interest to provide self-regulation was, he said, "a flaw in the model that I perceived as the critical functioning structure that defines how the world works."

It's worth dwelling on that phrase: "*the critical functioning structure that defines how the world works*." As the *New Yorker* writer John Lanchester observed: "That's a hell of a big thing to find a flaw in." Here's another way of describing that flaw, Lanchester continued: "the people in power thought they knew more than they did. The bankers evidently knew too much math and not enough history—or maybe they didn't know enough of either." But they must have know nthat their financial self-interest would result in private opulence for them, even as it was destined, finally, to result in public penury.

Adam Smith II – The Impartial Spectator

There has also been a societal change that underlies the failure of modern-day capitalism. It was well-described in a letter I received a while ago from a Vanguard shareholder, who described it 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. (*The Wall Street Journal* retained that phrase as the title of my op-ed essay that was published in April of this year.)

But the characters of that traditional ethical behavior seemed to fade, replaced by new values in 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 became the coin of the new realm, and unchecked market forces totally overwhelmed traditional standards of professional conduct, developed over centuries.

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.

Such a change belies Adam Smith's idealism. Even before he wrote *The Wealth of Nations*, Smith wrote *The Theory of Moral Sentiments*, in which he introduced us to the Impartial Spectator. While the Invisible Hand has become part of our language, the idea of the Impartial Spectator is barely known beyond Smith's acolytes. The *Impartial Spectator* is the imaginary observer who becomes the force that arouses in us principles that are both generous and noble. While Smith described him as "the man within," who gives us our highest calling, Smith also seems to see the Impartial Spectator as the powerful voice of the society in which we exist, perhaps even as the soul, or even as the Supreme Being. Listen to Smith's words:

> *It is reason, principle, conscience, the inhabitant of the breast, the man within, the great judge and arbiter of our conduct . . . It is this impartial spectator who calls to us, with a voice capable of astonishing the most presumptuous of our passions, that we are but one of the multitude, in no respect better than any other in it; and that when we prefer ourselves so shamefully and so blindly to others, we become the proper objects of resentment, abhorrence, and execration. It is from him only that we learn the real littleness of ourselves. It is this impartial spectator . . . who shows us the propriety of generosity and the deformity of injustice; the propriety of reining the greatest interests of our own, or the yet greater interests of others . . . in order to obtain the greatest benefit to ourselves . . . It is not the love of our neighbor, it is not the love of mankind, which upon many occasions prompts us to the practice of those divine virtues. It is a stronger love, a more powerful affection, the love of what is honourable and noble, the grandeur, and dignity, and superiority of our own characters.*

With these powerful words—and the concept of the Impartial Spectator as the voice of our society—Adam Smith—yes, Adam Smith—seems to speak directly to the positive force of traditional ethical values.

Adam Smith III – Managers of Other People's Money

Perhaps the most powerful single development that fostered the change in our societal values 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. That change in capitalism, simply put, was the growth of giant business corporations—*corporate* America—controlled not by their own shareholders, but by the money manager agents of the ultimate owners—*investment* America.

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 the 100 million families who are the owners of our mutual funds and the beneficiaries of our pension plans—a direct violation of the traditional concept of fiduciary duty.

Fiduciary duty, of course imposes a high standard of morality upon those entrusted with managing the property of others. It's not that we have not been warned about the consequences of our failure to honor the fiduciary principle that "no man can serve two masters." 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. Indeed, they sound like they were written, well, yesterday. 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.

In short, the managers of our public corporations came to place their own interests ahead of the interests of their owners, exploiting the powers of their agency, yet unchecked by traditional gatekeepers such as directors, accountants, and regulators, and even the owners themselves. For true owners now play but a small and gradually vanishing role in our investment world. Our now-dominant money-manager agents blithely accepted the new environment in which management self-interest held sway. Indeed, they fostered it by accepting as holy writ whatever earnings our corporations reported, and by generally ignoring corporate governance issues such as proxy access, executive compensation, board composition, and even mergers and acquisitions and dividend policy. Indeed, these agents turn over their portfolios with such alacrity that is fair to say that the old *own-a-stock* industry is now a *rent-a-stock* industry.

You will not be surprised to learn that Adam Smith presciently described the characteristics of today's corporate and institutional managers (many of which are themselves controlled by giant financial conglomerates) with these words:

> *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.*[4]

Like Justice Stone's warning about the consequences that follow when business operates in its own self-interest, Smith's ancient warnings about the consequences of money-manager capitalism—*agency capitalism*—could hardly have been more accurate.

So what's to be done? I propose that we undertake the "Fiduciary Duty" solution: To create, out of our disappearing ownership society and our failed agency society, a new fiduciary society. Here, our money-manager agents would be required—by federal statute—to place the

[4] In Smith's era, profusion was defined as "lavish or wasteful expenditures, excess amount of money, squandering, waste, etc."

interests of their principals ahead of their own interests, a consistently enforced public policy that places a clear requirement of fiduciary duty on our financial institutions to serve exclusively the interests of the owner/principals whom they are duty-bound to serve. That duty would require the long overdue return of our institutional agents to traditional standards of professional stewardship:

- Focus on long-term investing rather than short-term speculation.
- Due diligence in security analysis and investment research.
- Effective and responsible participation in the governance of our publicly-owned corporations.
- Pressing the managers of the business corporations whose shares are held in their portfolios to govern in the interest of *their* owners.
- An ethical responsibility to serve society at large.
- Elimination of all conflicts of interest that inhibit the placing first and foremost the interest of the investor/principals.

Adam Smith IV – Wealth, Greatness, Invention, and Ennoblement

It is high time for our corporations and our money managers to return to the idea of stewardship and faithful service. We need to restore the *integrity* of our system of capital formation. We need to demand that our financial institutions focus on long-term investment rather than on short-term speculation. We need our corporations to be run to benefit their outside owners, not their inside managers to return to the way capitalism operated when it began all those years ago. In this ideal sense, full-market capitalism is a thing of beauty. In this fourth quotation from the master, hear now Smith's vivid description:

> *The pleasures of wealth and greatness strike the imagination as something grand and beautiful and noble, well worth the toil and anxiety . . . [they] keep in continual motion the industry of mankind, to build houses; to found cities and commonwealths, to invent and improve all the sciences and arts, which enoble and embellish human life; which have entirely changed the whole face of the globe, and [have paved] the great high road of communication to the different nations of the earth.*

I can't imagine that anyone here this afternoon would use those words to describe modern-day capitalism. I certainly wouldn't! So the task is to at last return to the nobility of the original values of capitalism, the virtuous circle of integrity and trust and trustworthiness that is its obligation to our society. In the era that lies ahead, the prudent fiduciary, the trusted businessman, and the honest steward must once again be our paradigms. For the fact is that, in the long run, *good ethics is good business, part of that virtuous circle that builds our society*.

Enough. True Measures of Money, Business, and Life

I wrote my new—7th—book largely because I care deeply about the issues I've discussed today. The crisis in capitalism, the failure of our agency system, the need to restore our traditional values that have been so severely eroded, not only in our communities but in our financial system, in our businesses, and even in our own lives. The story of *ENOUGH.* begins with a sort-of-poem by Kurt Vonnegut entitled "Joe Heller," that appeared in *The New Yorker* in April 2005. It was a tribute to the late author of *Catch 22*—one of the seminal books of the post-World-War-II era, and one of its most successful. I can summarize the short poem in just a few words:

> At a party given by a billionaire on Shelter Island, Kurt Vonnegut tells Heller that their host, a hedge fund manager, had made more money in a single day than Heller had earned from his wildly popular novel *Catch - 22* over its whole history. Heller responds, "Yes, but I have something he will never have . . . enough."

Enough. I was stunned by the profound and simple elegance of that word. Think about it. We live in wonderful and sad times—wonderful in that the blessings of democratic capitalism have never been more broadly distributed around the globe, sad in that the excesses of that same democratic capitalism have rarely been more on display.

The rampant greed that has overwhelmed our financial system and our corporate world runs deeper than money. Not knowing what *enough* is subverts our society's traditional values, as self-interest and greed replace community interest, and service to self takes priority over service to others. Unchecked, our failures ultimately result in the corruption of our character and our values. So in a broader sense, we *all* bear some of the responsibility for what has gone wrong in America.

When I read Vonnegut's poem in 2005, I felt like I'd been struck by a bolt of lightning. When I was invited to give the commencement address at Georgetown University's business school two years later, in May 2007—as it happens, only a few short months before the burst came in the great bubble that had enveloped our stock market, our financial system, our real estate values, and our economy—I decided to use "Enough" as my theme, and began it with Vonnegut's poem. Here's what I then said to those newly-minted MBAs:

> "If you enter the financial field, do so with your eyes wide open, recognizing that any endeavor that extracts value from its clients may, in times more troubled than these, find that it has been hoist by its own petard. It is said on Wall Street, correctly, that 'money has no conscience', but don't allow that truism to let you ignore your own conscience, nor to alter your own conduct and character."

> "(But) no matter what career you choose, do your best to hold high its traditional professional values, now swiftly eroding, in which serving the client is always the highest priority. And don't ignore the greater good of your community, your nation, and your world. As William Penn pointed out all those years ago, 'We pass through this world but once, so do now any good you can do, and show now any kindness you can show, for we shall not pass this way again.'"

As it turned out, the warning I set forth in that speech—the need to recognize "that any endeavor that extracts value from its clients (and indeed subtracts value from our society) may, in times more troubled than these, find that it has been hoist by its own petard"—proved not only eerily prophetic, but surprisingly timely. For the financial sector was indeed about to be blown up by its own dynamite.

Soon after the speech to those Georgetown University MBAs, I expanded it into the book, published last November. It is a short book (250 pages) with ten impassioned chapters, each highly opinionated, each linked by a consistent theme that you'll recognize by the time I reach about the third iteration:

In our Money system—

- Too much cost, not enough value.

- Too much speculation, not enough investment.
- Too much complexity, not enough simplicity.

In Business—

- Too much counting, not enough trust.
- Too much business conduct, not enough professional conduct.
- Too much salesmanship, not enough stewardship.
- Too much management, not enough leadership.

In our Lives—

- Too much focus on things, not enough focus on commitment.
- Too many twenty-first-century values, not enough eighteenth-century values.
- Too much "success," not enough character.

This is a book, as it has been said, laced with both searing criticism and soaring idealism, one might even say Adam Smithian (if only I had his gifts for the well-turned phrase.) And I believe that both TRF and Vanguard continue to share my basic values. We are as one, I think, in our belief that—if they are to benefit our society—economic markets must, finally, have a public purpose. You at TRF are an exemplar of one approach to implementing this concept, and I salute you for your commitment. We at Vanguard are an exemplar of a very different approach, but an approach in which acceptance in the marketplace of ideas (and investment strategies) are quite literally growing by the day. Let us both "Press on, Regardless."