

Vanishing Treasures — Business Values and Investment Values

Remarks by John C. Bogle

Founder and former chief executive

The Vanguard Group

The Maclean House 2007 Lecture Series

Princeton University Alumni Education Program

Princeton, NJ

March 15, 2007

I must begin by telling you what a thrill it is to return again to the Princeton campus that has played such a definitive—even determinative—role in my life. Of course I'm honored to be asked by Andrew Gossen, associate director of the alumni education program, to participate in this year's Maclean House series. The theme "Vanishing Treasures," holds great appeal to me, for I'm deeply concerned about "cultures and values that are disappearing in the face of human activity."

When director Gossen wrote to me (by e-mail of course; letter writing seems to be yet another vanishing treasure), he suggested that I focus on corporate ethics. Since the decline of business values and investment values was one of the principal subjects of my fifth book, *The Battle for the Soul of Capitalism*, I promptly tendered my acceptance (yes, by e-mail). So I'm pleased to be with you this evening.

Some of my classmates of the great Class of 1951 needled me about the fact the *The Battle* was published by Yale University Press. But I reminded them to look carefully at my photograph on the back flap of the book jacket. There, the careful observer will see that the black necktie I'm wearing is awash in little orange tigers, a gift from one of my granddaughters. So my loyalty to my alma mater is uncompromised, and Princeton remains nearest and dearest to my heart, echoing that quotation from Sophocles engraved on a plaque on Goheen Walk on the lower campus: "Stranger, you have reached the noblest home on earth." And so Princeton is to me tonight, and so Princeton will remain to me forever.

I. The Battle for the Soul of Capitalism

Let me begin by discussing the deep concerns about the vanishing values of our nation that I expressed in *The Battle for the Soul of Capitalism*. *The Battle* begins with a remarkably modest rewriting of the opening paragraph of Edward Gibbon's *The Decline and Fall of the Roman Empire*, adapted to the present era. Compare the two first sentences. Gibbon: "In the second century of the Christian Era, the Empire of Rome comprehended the fairest part of the earth and the most civilized portion of mankind."

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

Battle: “As the twentieth century of the Christian era ended, the United States of America comprehended the most powerful position on earth and the wealthiest portion of mankind.”

So when I add Gibbon’s conclusion—“(Yet) the Roman Empire would decline and fall, a revolution which will be ever remembered and is still felt by the nations of the earth”—I’m confident that the thoughtful reader did not miss the point. But of course I hammer it home anyway: “Gibbon’s history reminds us that no nation can take its greatness for granted. There are no exceptions.” As one of two reviews—both very generous—of *The Battle* that appeared in *The New York Times* noted, “Subtle Mr. Bogle is not.”

No, I’m not writing off America. But I am warning that we’d best put our house in order. “The example of the fall of the Roman Empire ought to be a strong wake-up call to all of those who share my respect and admiration for the vital role that capitalism has played in America’s call to greatness. Thanks to our marvelous economic system, based on private ownership of productive facilities, on prices set in free markets, and on personal freedom, we are the most prosperous society in history, the most powerful nation on the face of the globe, and, most important of all, the highest exemplar of the values that, sooner or later, are shared by the human beings of all nations: ‘certain inalienable rights . . . to life, liberty, and the pursuit of happiness.’”

But something went wrong. “By the later years of the twentieth century, our business values had eroded to a remarkable extent”—the greed, egoism, materialism and waste that seems almost endemic in today’s version of capitalism; the huge and growing disparity between the ‘haves’ and the ‘have-nots’ of our nation; poverty and lack of education; our misuse of the world’s natural resources; the corruption of our political system by corporate money—all are manifestations of a system gone awry.”

And here’s where the soul of capitalism comes in. The book reads, “The human soul, as Thomas Aquinas defined it, is the ‘form of the body, the vital power animating, pervading, and shaping an individual from the moment of conception, drawing all the energies of life into a unity.’ In our temporal world, the soul of capitalism is the vital power that has animated, pervaded, and shaped our economic system, drawing all of its energies into a unity. In this sense, it is no overstatement to describe the effort we must make to return the system to its proud roots with these words: *the battle to restore the soul of capitalism*. (One reviewer thought that the title was, well, “inflated,” but liked the book anyway.)

This idealism doesn’t let up. The reader doesn’t even finish the first page of Chapter I (“What Went Wrong in Corporate America?”) before reading: “At the root of the problem, in the broadest sense, was a societal change aptly described by these words from the teacher Joseph Campbell: ‘In medieval times, as you approached the city, your eye was taken by the Cathedral. Today, it’s the towers of commerce. It’s business, business, business.’ We had become what Campbell called a ‘bottom-line society.’ But our society came to measure the wrong bottom line: *form over substance, prestige over virtue, money over achievement, charisma over character, the ephemeral over the enduring, even mammon over God*.”

II. Profession vs. Business

Among the most obvious, and troubling, manifestations of the change from the stern traditional values of yore to the flexible values of our modern age—today’s “bottom line” society—is reflected in the gradual mutation of our professional associations into business enterprises. According to a 2005 article in *Daedalus* by Howard Gardner, Professor at the Harvard Graduate School of Education, and Lee S.

Shulman, president of the Carnegie Foundation,¹ it was a mere 40 years ago that *Daedalus* proudly declared: “Everywhere in American life, the professions are triumphant.” Since then, however, the professions have gradually “been subjected to a whole new set of pressures, from the growing reach of new technologies to the growing importance of making money.”

Let’s consider for a moment what we mean when we talk about professions and professionals. Messrs. Gardner and Shulman defined a profession as having six commonplace characteristics:

1. A commitment to the interest of clients in particular, and the welfare of society in general.
2. A body of theory or special knowledge.
3. A specialized set of professional skills, practices, and performances unique to the profession.
4. The developed capacity to render judgments with integrity under conditions of ethical uncertainty.
5. An organized approach to learning from experience, both individually and collectively, and thus of growing new knowledge from the context of practice.
6. The development of a professional community responsible for the oversight and monitoring of quality in both practice and professional educators.

They then add these wonderful words: “*The primary feature of any profession (is) to serve responsibly, selflessly, and wisely . . . and to establish (an) inherently ethical relationship between the professional and the general society.*”

When we think of professionals, most of us would probably start with physicians, lawyers, teachers, engineers, architects, accountants, and clergymen. I think we could also find agreement that both journalists and trustees of other people’s money are—at least in the ideal—professionals as well. And yet, profession by profession, the old values are clearly being undermined. The driving force is our old friend (or enemy), the bottom line society. Unchecked market forces not only constitute a strong challenge to our professions; in some cases, these forces have totally overwhelmed traditional standards of professional conduct, developed over centuries.

That legitimacy, in sad reality, has already been undermined in most of our professions.² Another article in the same issue of *Daedalus* asserts that the idea that “the market is self-regulating and morally self-sufficient” to assure the maintenance of professional standards has clearly proved inadequate. Indeed, that misguided idea lies at the heart of some of our major societal failures of recent years, examples that belie the idea that professionals must accomplish their good works with a commitment to use their mastery to fulfill a “mission that inspires passion, a mission that gives beyond the self.” Of course we’re all aware, as yet another *Daedalus* article expresses it, “that pursuing a noble mission is often painful . . . and that not letting the mission get out of hand is possible only for those who truly believe in the mission and have enough self-perspective to remain wary of dangers such as arrogance, megalomania, misguided beliefs, and distorted judgments.”

These dangers have already come home to roost in some established professions, with incalculable harm to our society. Recent examples of the harsh consequences of this change are easy to come by. In public accounting, our once “Big Eight” (now “Final Four”) firms gradually came to provide hugely profitable consulting services to their audit clients, making them business partners of management rather than independent and professional evaluators of generally accepted (if loose) accounting principles. The failure of Arthur Andersen, and the bankruptcy of its client Enron, was but one example of the consequences of this conflict-riddled relationship.

¹ *Daedalus*, Summer 2005, “The Professions in America Today: Crucial but Fragile,” pages 13-18.

² The ideas in this paragraph have been inspired by other articles in the same issue of *Daedalus*, the Journal of the American Academy of Arts & Sciences.

Think too about the increasing dominance of “state” (publishing) over “church” (editorial) in journalism, and the scandals that reached the most respected echelons of the press—*The New York Times*, *The Los Angeles Times*, *The Washington Post*. A similar transition has taken place in the medical profession, where the human concerns of the caregiver and the human needs of the patient have been overwhelmed by the financial interests of commerce, our giant medical care complex of hospitals, insurance companies, drug manufacturers and marketers, and health maintenance organizations (HMOs).

In all, professional relationships with clients have been increasingly recast as business relationships with customers. In a world where every user of services is seen as a customer, every provider of services becomes a seller. Put another way, when the provider becomes a hammer, the customer is seen as a nail. Please don’t think me naive. I’m fully aware that every profession has elements of a business. Indeed, if revenues fail to exceed expenses, no organization—even the most noble of faith-based institutions—will long exist. But as so many of our nation’s proudest professions—including accounting, journalism, medicine, law, architecture, and trusteeship—gradually shift their traditional balance away from that of trusted profession serving the interests of the community and toward that of commercial enterprises seeking competitive advantage, the human beings who rely on those services are the losers.

A few years ago, the author Roger Lowenstein made a similar observation, bemoaning the loss of the “Calvinist rectitude” that had its roots in “the very Old World notions of integrity, ethics, and unyielding loyalty to the customer.”³ “America’s professions,” he wrote, “have become crassly commercial . . . with accounting firms sponsoring golf tournaments” (and, he might have added, mutual fund managers not only doing the same thing but buying naming rights to stadiums as well). “The battle for independence,” he concluded, “is never won.” Put another way, we’ve moved from a concept that *there were certain things that one simply didn’t do* (moral absolutism, I suppose) to the idea that *since everyone else is doing it, I can do it, too* (surely a form of moral relativism).

III. Business Values and Investment Values Gone Awry

Now let’s turn to the current state of our commercial enterprises—in particular, our giant publicly-held corporations—and our investment institutions—now largely owned by giant publicly-held financial conglomerates. Of course both represent a peculiar mix of business and profession, but they have moved a long way from the traditional values of capitalism. The origins of modern capitalism, beginning with the Industrial Revolution in Great Britain back in the late 18th century, had to do, yes, with entrepreneurship and risk-taking, with raising capital, with vigorous competition, with free markets, and with the returns on capital going to those who put up the capital. Central to these values of early capitalism was the fundamental principle of trusting and being trusted.

That is not to say that the long history of capitalism has not been punctuated by serious failings. Some were moral failings, such as the disgraceful treatment of laborers, often mere children, in the factories of an earlier era. Other failings included breaking the rules of fair and open competition, exemplified by the oil trusts and robber barons of yore. By the latter part of the 20th century, yet another failure fell upon us: the erosion of the very structure of capitalism. Not only had “trusting and being trusted” come to play a diminishing role, but the owners of our businesses were relegated to a secondary role in the functioning of the system.⁴

³ Roger Lowenstein, “The Purist,” *New York Times Magazine*, December 28, 2003, page 44.

⁴ Thanks to the comments of a discerning member of my Princeton audience, I added several of these criticisms to my text after delivering the speech.

As I see it, 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 32 percent, while indirect ownership by institutional investors has soared from 8 percent to 68 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 their *principals*, but 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 investors seemed not to care when that goal became secondary. While our institutional agents now hold absolute voting control of 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 it is said that money managers have only two types of client they don’t want to offend: *actual*, and *potential*.

And so in corporate America we have witnessed staggering increases in executive compensation not only unjustified by corporate performance but also grotesquely disproportionate to the pathetically small increase in real (inflation-adjusted) compensation of the average worker; financial engineering that dishonors the idea of financial statement integrity; and the failure of the traditional gatekeepers we rely on to oversee corporate management—our regulators, our legislators, our auditors, our attorneys, our directors.

And so developed what I described, way back in 1999, as “the happy conspiracy” between our business sector and our investment sector, mutually reinforcing one another, in which traditional values and long standing virtues were undermined. The web is wide, and includes corporate managers, CEOs and CFOs, directors, auditors, lawyers, Wall Street investment bankers, sell-side analysts, buy-side portfolio managers, and indeed institutional and individual investors as well. (Only short-sellers are on

the outside looking in, and they are a small minority.) Their shared goal: To increase the price of a firm's stock, the better to please "the Street," to raise the value of its currency for acquisitions, to enhance the profits executives realize when they exercise their stock options, to entice employees to own stock in its thrift plan, and to make the shareholders happy. How to accomplish the objective? Aim for high long-term earnings growth, offer regular guidance to the financial community as to your short-term progress, and *never* fall short of the expectations you've established, whether by fair means or foul.

What's wrong with that? What's wrong, as I said in my 1999 remarks, is that when we "take for granted that fluctuating earnings are steady and ever growing . . . somewhere down the road there lies a day of reckoning that will not be pleasant." I was warning, of course, about the aftermath of the classic "new economy" bubble that had developed, where stock prices were wildly-inflated by unrealistic expectations and, well, irrational exuberance. Finally, the eternal truth re-emerges: *The value of a corporation's stock is the discounted value of its future cash flow.* All over again, we learn that the purpose of the stock market is simply to provide liquidity for stocks in return for the promise of future cash flows, enabling investors to realize the present value of a future stream of income at any time.

Corporations, we again came to realize, must earn *real* money. Yet, going back to 1981, consensus estimates for future five-year annual earnings growth projected by corporate managers have averaged 11.6%, nearly *twice* the 6.3% *actual* annual growth actually achieved over the two decades. As a result of the happy conspiracy between business executives and financial institutions—relying on market expectations rather than business realities—we witnessed a bubble in stock market prices that inevitably burst, as all bubbles do, sooner or later. Then, the idea of *value* slowly returns to the stock market.

It is truly astonishing how pervasive have been the failures in our capitalistic system. While it's often alleged that these problems have been limited to just "a few bad apples," the evidence suggests that the barrel that holds all those apples, good and bad alike, has developed some serious problems. For example:

- Yes, there have been "only" a few Enrons, WorldComs, Adelphias, and Tycos. But during the past five years, there have been 5,989 restatements of earnings by publicly-held corporations, with stock market capitalizations aggregating more than \$4 trillion, often reflecting overly aggressive accounting procedures.
- Yes, the investment banking scandals involved "only" twelve firms, but among them were eight of the nine largest firms in the field. As a result of the investigations by New York attorney general Eliot Spitzer, they ultimately agreed to pay some \$1.3 billion in penalties
- Yes, similarly, there were "only" a handful of insurance companies involved in the bid-rigging scandals, also uncovered by Mr. Spitzer. But, again, they included the largest companies in the field: American International Group, Marsh & McLennan, ACE, Aon, and Zurich, all of which agreed to settle the litigation and paid billions of dollars in penalties.
- And yes, while a few of the largest mutual fund managers were not implicated in the disgraceful market timing scandals unearthed by Mr. Spitzer and his staff, many of the 23 firms that *were* involved were giants, holding more than \$1.5 trillion of investor assets, fully one-quarter of the fund industry's long-term asset base.

IV. The Mutual Fund Industry Loses Its Way

With this background, I now turn to the very mutual fund industry where I've spent my entire career. So it is especially painful for me to acknowledge that the mutual fund industry is in many respects the poster child for the deterioration in business values and investment values that I've just described. I've been involved in this industry even before I began my career in 1951, and in fact spent well over a

year researching the fund industry for my senior thesis in Economics, inspired by an article that I happened upon in *Fortune* magazine in December 1949. The thesis was entitled “The Economic Role of the Investment Company.”

When I wrote my thesis, assets of mutual funds totaled about \$2 billion; today assets *exceed* \$10 trillion, a 17 percent annual rate of compound growth that was exceeded by few, if any, other enterprises. (Asset of life insurance companies, by way of contrast, grew from \$53 billion to \$4.7 trillion—from 25 *times* fund assets in 1951 to less than one-half today.) The mutual fund industry has become America’s largest financial institution.

Yet the record is clear that we have lost our way. Once a profession with elements of a business, we have become a business with elements of a profession—and too few elements at that. Once focused on management and investing, we are now focused on marketing and asset gathering. Once focused on stewardship, we are now focused on salesmanship. We have become an exemplar—alas, even a leader—in the new “bottom line” society that I earlier described. Lest you think that indictment is too strong, let me drive this point home with seven hard examples:

1. In 1951, mutual fund management companies were relatively small organizations, *privately-held* by their principals, managed by investment professionals who were prudently investing to earn a sound return on the capital invested by their fund shareholders. Today, mutual fund management companies are behemoths, largely owned by giant *publicly-held* financial conglomerates, run by businessmen whose highest priority is earning the maximum possible return on the capital invested by their firms in the management companies that they acquired.
2. In 1951, the vast majority of equity mutual funds were conservative, broadly diversified among blue-chip stocks, and offered returns that generally paralleled those of the stock market itself, making fund selection by investors fairly straightforward. Today, mutual funds come in a bewildering variety that would shame the mere 28 flavors of ice cream once offered by Howard Johnson’s restaurants. The age-old middle-of-the-road equity funds now account for only about one-tenth of today’s 4,300 such funds, including not only the standard nine-box Morningstar variety (large-, medium-, and small-cap; value and growth styles, and a blend of the two), but also a plethora of specialty funds (technology, internet stocks, energy, gold, etc.) and foreign funds (Japan, Korea, Turkey, emerging markets, etc.), placing a staggering premium on selecting the “right” fund.
3. Conforming to the temper of the times, fund managers led the way in changing their focus, yes, again, from the wisdom of long-term investing to the folly of short-term speculation. In 1951 (and for nearly two decades thereafter), portfolio turnover averaged about 16 percent per year; during the last five years, portfolio turnover of the typical fund has averaged about 100 percent per year—six *times* as high. Yes, even my one-time “own-a-stock” industry has become a “rent-a-stock” industry.
4. Managed largely by prudent investment committees making painfully deliberate investment decisions in 1951, investment management in the fund industry today is handled largely by individual portfolio managers with the ability to act immediately, indeed precipitately, in responding to fluctuations in the prices and valuations of specific stocks. In part for marketing reasons, we have developed a “star system” in which particular managers are portrayed, at least by implication, as having a durable talent for providing superior returns. Yet the fact is that nearly all of these one-time stars eventually prove to be insignificantly different from average. Indeed, they often turn out to be comets, losers who light up the sky for a moment and then

flare out. There is no evidence that this sea change in investment approach has been advantageous for mutual fund shareholders. To the contrary.

5. In 1951, fund advertisements were limited to dull “tombstone ads” and funds were extremely limited in promoting their performance. For a time, they could not even present their total annual returns. Today, funds that have enjoyed strong returns (usually funds following extreme and/or risky strategies) freely hawk their own wares, bragging about their performance (when it’s good!) in newspapers, magazines, and on television. (Alas, past performance is not only not predictive of the future, but, at least in speculative markets, predictive of quite the opposite.) Ultimately, of course, it is the fund shareholders who pay for all of this promotion.
6. As a result of all of this proliferation and promotion of funds, fund investors, eager to catch the next favorable market trend, move their money around at a frantic rate. Believe it or not, the average holding period of a mutual fund owner in 1951 was some sixteen years. Today it has shrunk but four years, admittedly, up from only two years in 2000, the peak of the illicit market timing scandals. Then, too many fund managers—including, as I noted earlier, some of the industry’s largest firms—conspired with favored hedge fund clients to allow rapid short-term trading in fund shares that diluted the returns of their long-term shareholders—a classic example of the change from the days “when there were some things one just didn’t do,” to “everyone else is doing it, so I can do it too.” And I’ve seen both, first-hand.
7. Importantly, fund costs have increased by staggering magnitudes since I joined the field all those years ago. In 1951, with fund assets at \$2.5 billion, the average equity fund carried an expense ratio (expenses relative to assets) of 0.77 percent. Last year, with equity fund assets at \$6.3 *trillion*, the average fund carried an expense ratio of nearly double that amount: 1.43 percent. Result, expressed in dollars: fund expenses rose from \$15 million to \$51 *billion*—260 *times* as large.⁵ Not only have basic fee structures risen, but the staggering economies of scale in managing other people’s money have been arrogated by fund managers to their own benefit. Exceptions to this pattern are rare: Among seven of the eight largest funds of 1951, the average expense ratio has actually increased from 0.60 percent to 1.10 percent. Only one fund actually reduced its costs to investors, from 0.60 percent to 0.32 percent. (That fund would be Vanguard’s Wellington Fund.)

So, yes, it’s fair to say that the idealistic principles I expressed in my ancient thesis—that funds “should be operated in the most honest, efficient, and economical way possible . . . that the industry should focus on reducing sales charges and expense ratios,” and that “the principal role of the mutual fund should be to serve its shareholders”—have not only not been realized, but have been violated. Accordingly, the earlier business values and investment values of our industry became vanishing treasures.

V. Grounds for Hope

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:

⁵ Asset-weighted expense ratios of equity funds rose from 0.60 percent to 0.80 percent.

“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.”

Writing in *Daedalus* in the summer of 2004, Nobel Laureate (in Economics) Joseph E. Stiglitz puts the Invisible Hand into perspective. Under the assumption of “perfect competition, perfect markets, and perfect information . . . selfishness is elevated to a moral virtue.” But those assumptions are false. As Stiglitz’s fellow Nobel Laureate Paul Samuelson observed in the first edition of his classic *Economics: An Introductory Analysis*—a textbook that I read right here in 1948-49—the problem with “perfect competition is what George Bernard Shaw once said of Christianity: ‘the only trouble with it is that its never been tried.’” Nonetheless, Stiglitz continues, “societies in which there are high levels of trust, loyalty, and honesty actually perform better than those in which these virtues—*virtues*—are absent. Economists are just now beginning to discover how non-economic values—*values*—actually enhance economic performance.”

So what’s to be done? While the quest to restore these values and these virtues 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 those who hold their stocks directly, but those 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 treasures of capitalism. Here, I think, Adam Smith’s Invisible Hand would be helpful.

For only if intelligent investors 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*. (My

latest book, published this month, drives this message home: *The Little Book of Index Investing—The Only Way to Guarantee Your Fair Share of Stock Market Returns.*)

But we need more. Since our agency society has so diffused the beneficial ownership of stocks among 100 million or so 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 long overdue.

We also need to raise our society’s expectations of the proper conduct of the leaders of our businesses and financial institutions. So, in addition to Adam Smith’s almost universally-*known* Invisible Hand, we need to call on his almost universally-*unknown* Impartial Spectator. This impartial spectator first appears in Smith’s earlier *Theory of Moral Sentiments*—the force that arouses in us values that are so often generous and noble. It is the inner man shaped by the society in which he exists, even the soul, who gives us our highest calling. In Smith’s words, “It is reason, principle, conscience, the inhabitant of the breast, the man within, the great judge and arbiter of our conduct.”

This Impartial Spectator, Smith tells us, “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, for the yet greater interests of others . . . in order to obtain the greatest benefit to ourselves. It is not the love of our neighbour, 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, Adam Smith—yes, Adam Smith—touches on nearly all of those traditional ethical principles of which I spoke at the outset. While our corporate values and investment values may be “vanishing treasures,” those virtues have not entirely vanished. Indeed, there are scores of examples—although never nearly enough—of corporations and financial institutions that have held to their traditional bearings despite the powerful forces that are driving our society away from them.

As I express these thoughts this evening, I note a wonderful irony: the very same 1949 issue of *Fortune* that inspired my Princeton thesis included a feature essay entitled “The Moral History of U.S. Business.” Alas, I have no recollection of reading it at that time. But I read it a few years ago, a full half-century later. As I reflect on the vanishing treasures capitalism—the debasement of the values of businesses and investors—they seem to be related to the kind of moral responsibility of business that was expressed in that ancient *Fortune* essay. It began by noting that the profit motive is hardly the only motive that lies behind the labors of the American businessman. Other motives include “the love of power or prestige, altruism, pugnacity, patriotism, the hope of being remembered through a product or institution.” Yes, all of the above.

As I have said in other forums, I also agree with *Fortune* on the appropriateness of the traditional tendency of American society to ask: “what are the moral credentials for the social power (the businessman) wields?” One answer came in the form of some comments written in 1844, words cited in

the *Fortune* essay. William Parsons, “a merchant of probity,” described the good merchant as “an enterprising man willing to run some risks, yet not willing to risk in hazardous enterprises the property of others entrusted to his keeping, careful to indulge no extravagance and to be simple in his manner and unostentatious in his habits, not merely a merchant, but a man, with a *mind* to improve, a *heart* to cultivate, and a *character* to form.”

When I read those inspiring demands, uttered 163 years ago, they seemed directed right at me, and at the theme of my remarks this evening. As for the mind, I still strive every day—I really do!—to improve my own mind, reflecting on current events, reading history, and challenging even my own deep-seated beliefs. As for the heart, no one—no one!—could possibly revel in the opportunity to cultivate it more than I. Just three weeks ago, after all, I marked the eleventh (!) anniversary of the amazing grace represented by the heart transplant that I received in 1996. And as for character, whatever moral standards I may have developed, I have tried to invest my own soul and spirit in my family, in my life’s work, and in the character of the little firm I founded all those years ago, a firm focused on stewardship—a business, yes, but a business with strong elements of a profession.

While (as we say at Vanguard) “even one person can make a difference,” the task of restoring the vanishing values of business and investing is far larger than one person can handle. We need wisdom and introspection from our business and investment leaders to learn from the lessons of history and to realize that, however profitable the operation of today’s businesses and investment institutions may be to their managers, in the long run today’s practices will be self-defeating. We need investors everywhere to join together to demand the development of that fiduciary society I have described, and we—all of us—need to awaken our fellow citizens to respect that Impartial Spectator who demands virtuous conduct and a return to traditional values by the leaders of our corporate businesses and our investment institutions. Without that, those treasures will indeed vanish.