

The Role of the Fiduciary in Risky Financial Markets

Remarks by

John C. Bogle

Founder & Former Chief Executive, The Vanguard Group

Before

The Philadelphia Estate Planning Council

Philadelphia, PA

May 1, 2007

I'm honored to be invited to address the Philadelphia Estate Planning Council this afternoon on two subjects that have been near and dear to my heart for as long as I can remember. Indeed, it's arguable that I've been thinking about fiduciary duty and the financial markets since the autumn of 1950, when, as a Princeton senior, I began the research on the mutual fund industry for my senior thesis.

In fact, a half-century later—proving that if you're patient enough, anything you write can be published—that thesis was published by McGraw-Hill, the final section of my third book *John Bogle on Investing - the First 50 Years*. Even more relevant to my subject today, my fifth book—*The Battle for the Soul of Capitalism* (Yale University Press, 2005)—is heavily focused on fiduciary duty; and my sixth book—*The Little Book of Common Sense Investing* (John Wiley, 2007)—is focused on the financial markets.

Part I. Full Disclosure

Perhaps if I begin with the story of my senior thesis, you'll see, in today's parlance, "where I'm coming from." The fact is that the fundamental values that I hold today about fiduciary duty and the financial markets were formed during my undergraduate years at Princeton University. There, almost 58 years ago, I happened upon the December 1949 issue of *Fortune* magazine and learned for the first time

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

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 at Princeton.

Over the 15 months that followed, I spent countless hours researching the industry and writing my thesis. Then, remarkably little public information was available about this field, which consisted of only some 130 mutual funds with assets aggregating just \$2½ *billion*. Harvard strategy guru Michael Porter advises students considering their future careers to "pick a good industry," and, as luck would have it, I did exactly that when I chose my thesis topic. With an annual growth rate of almost 16 percent since then, the fund industry may well have enjoyed the fastest growth rate of any business in America. Today, there are more than 8,000 funds, with total assets that exceed \$10 *trillion*.

Read today, my thesis would probably impress you as no more than workmanlike, perhaps a bit callow, but above all, shamelessly idealistic. On page after page, 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." (This basic tenet of fiduciary duty was clearly ignored in the market timing scandals of a few years ago, in which some 30 fund groups conspired with hedge fund managers to subvert the interests of the funds' long-term shareholders.) I also argued that "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." (That advice also fell upon deaf ears, and despite the quantum leap in industry assets, fee rates have actually risen, and rather sharply at that.)

After analyzing mutual fund performance, I concluded 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." (Once again, my advice fell by the wayside, and shareholders remain ill-served by the passive governance policies of most fund managers.)

And when I wrote about investment policy, this immature and inexperienced college senior even had the temerity to take on the brilliant British economist John Maynard Keynes. In his *General Theory*,

Keynes argued that even “expert professionals” would gradually focus, not on *investment* (“making superior long-term forecasts of cash flow over the life of a company”), but on *speculation* (“forecasting changes in the general public’s valuation of the company’s shares”).

I cited those very words in my thesis, and then had the temerity to disagree with the great man. In what I accurately predicted would become a far larger mutual fund industry, portfolio managers would “supply the market with a demand for securities that is *steady, sophisticated, enlightened, and analytic* [italics added], a demand that is based essentially on the [intrinsic] performance of a corporation rather than the public appraisal of the value of a share, that is, its price.” Alas, the sophisticated and analytic demand that I had predicted from the industry’s expert professional investors failed to materialize. Call the score, Keynes 1, Bogle 0.

To this very day, nonetheless, I hold fast to the ideals I expressed in my thesis, summarized in its conclusion. “The principal function of investment companies is the management of their investment portfolios”—focusing on investing rather than speculating. 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.”

All of this gratuitous advice from a callow college senior was, alas, largely ignored by fund industry leaders. 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 a quarter-century earlier. Today, I assure you that my youthful idealism remains intact. Indeed, it is shamelessly reflected not only in Vanguard, but especially in my two latest books, which express profound concern about the deterioration in the values of our nation’s capitalistic system, in our concept of fiduciary duty, and in the operation of our financial markets.

Part II. A Fiduciary Society

The fact of the matter is that something has gone profoundly wrong in these critical areas. The root causes of the disease 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. (Precisely what Keynes warned us about all

those years earlier, and, to my shame, what I dismissed.) 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.”

Writing in *Daedalus* in the summer of 2004, Nobel Laureate (in Economics) Joseph E. Stiglitz puts the Invisible Hand into proper perspective. Under the assumptions of “perfect competition, perfect markets, and perfect information . . . selfishness is elevated to a moral virtue.” But these assumptions have proven to be false. The fact is that neither corporations, nor markets, nor information are perfect. Far from it! 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 at Princeton in my sophomore year—the problem with “perfect competition is what George Bernard Shaw once said of Christianity: ‘the only trouble with it is that it’s 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 are absent. Economists are just now beginning to discover how non-economic values actually enhance economic performance.”

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.

Part III. Profession vs. Business

While we need to articulate—and enforce—clear standards of fiduciary duty for our professional money managers, we in other areas of the investment profession must also do our part. But that too will be no easy task. For throughout our society we have seen another troubling mutation, much like the mutation in capitalism itself that I described earlier: our professional associations are becoming more like business enterprises, moving away from the stern traditional values of yore toward the, well, flexible values that characterize our modern age. This change is of relatively recent vintage. In 1965, according to an article in *Daedalus*,¹ “everywhere in American life, the professions were triumphant.” But in the four decades that followed, almost without our noticing, that triumph had melted away, as our professions were gradually, “subjected to a whole new set of pressures, from the growing reach of new technologies to the growing importance of making money.”

You’ll have to tell me whether these pressures have affected any of you here today in this organization, composed—in the words of your summary description—of “*professionals* involved in estate planning.” So, let’s step back for a moment and consider what we mean when we talk about professions and professionals. The *Daedalus* article defined a profession as having six common characteristics:

¹ *Daedalus*, The Journal of the American Academy of Arts & Sciences, Summer 2005, “The Professions in America Today: Crucial but Fragile,” by Howard Gardner, Professor at the Harvard Graduate School of Education, and Lee S. Shulman, president of the Carnegie Foundation, pages 13-18.

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.”*

Under this stern definition, it would seem clear that physicians, teachers, engineers, architects, and clergymen would qualify as professionals. At least in the ideal, so would attorneys, accountants, estate planners, and trustees of other people’s money. And yet, profession by profession, the old values are clearly being undermined. The driving force, I think, is the emergence of our “bottom-line” society, in we think we can measure every thing that is important, and that the resultant numbers tell us all we need to know. Einstein surely was on the right track when he said, “Not everything that counts can be counted, and not everything that can be counted counts.” Yet we’ve moved from a world in which, as Protagoras wrote 2500 years ago, “man is the measure of all things,” to a world where “money is the measure of the man.” I doubt that that change can be called progress.

Unchecked, the forces of the market not only constitute a strong challenge to our professions; in some cases, these forces have totally overwhelmed traditional standards of professional conduct that it took centuries to develop. That legitimacy, in sad reality, has already been undermined in most of our professions.² 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.”

² The ideas in this paragraph have been inspired by other articles in the same issue of *Daedalus*.

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." The love of money, again, leads to our ignoring these dangers in our own self-interest, giving credence to Upton Sinclair's comment, paraphrased here: "it's amazing how difficult it is for a man to understand something if he's paid a small fortune *not* to understand it."

In all, professional relationships with clients have been increasingly recast as business relationships with customers. Again, you'll have to tell me whether this change has effected the profession of estate planning. But I can tell you that it has pervaded the mutual fund field—once largely a profession of managing other people's money, now largely a business of gathering assets to manage—with the obvious consequence of putting the manager rather than the investor in the driver's seat. 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 with the participants of so many of our nation's proudest professions—including the law, accounting, estate planning, and trusteeship—having gradually shifted their traditional balance away from that of trusted professionals serving the interests of the clients and the community and toward that of members of commercial enterprises seeking competitive advantage, the losers are the human beings who rely on the objectivity and the integrity of those services.

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).

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

Part IV. The Financial Markets

These changes, it seems to me, have had dire consequences for our financial markets. Part of the problem is that the one-time focus on long-term investing has turned overwhelmingly toward short-term speculation, a trend that I've witnessed first-hand. In 1950 (and for a decade and a half thereafter), the average equity mutual held its average stock for six years (16 percent turnover); by last year, the average holding period had plummeted to less than one year (turnover of 105 percent). It's also that the costs of financial intermediation have soared. Last year, we investors paid more than \$400 billion to our stock brokers, investment bankers, pension managers, mutual fund managers, hedge fund managers, and financial advisers (and all of their expensive infrastructure, including lawyers, accountants, marketers, and so on). Indeed, we recently learned that if you didn't make \$140 million last year, you didn't rank among the 25 highest-paid hedge fund managers. (The winning manager was paid \$1.5 *billion*.)

Why should the enormous costs we pay for financial intermediation matter to us? Simply because, as investors as a group, we are *average*. Beating the market is a *zero sum* game. (In an 8 percent stock market, together we all earn 8 percent. No surprise there!) But that's before we deduct the costs of playing the game. After the deduction of intermediation costs, beating the market becomes a *loser's* game. Using Justice Brandeis' formulation, these are "the relentless rules of humble arithmetic."

And cost matters. If the market delivers an annual return of 8 percent, when we deduct costs estimated at 2 ½ percent per year, we together earn 5 ½ percent, less than seventy percent of the total. Compounding the 8 percent return over an investment lifetime (I'm assuming 50 years), \$1,000 would grow to \$47,000—*the magic of compounding returns*. But with a net return of 5 ½ percent, the investor who puts up \$1,000 sees his capital grow to but \$14,000—*the tyranny of compounding costs*. The investor put up 100 percent of the capital and assumed 100 percent of the risk, but captured only thirty percent of the total market return. That's simply not good enough.

The oppressive impact of investment costs is eternal and meaningful, to be sure. But that impact varies with the level of returns the markets produce. So now let's think for a bit what returns we might reasonably expect in the years ahead, and the drain that excessive intermediation costs might impose upon them. Of course no one *knows* what lies ahead, but there are ways to establish reasonable expectations. Before I discuss them, I'd like to present some very subjective comments.

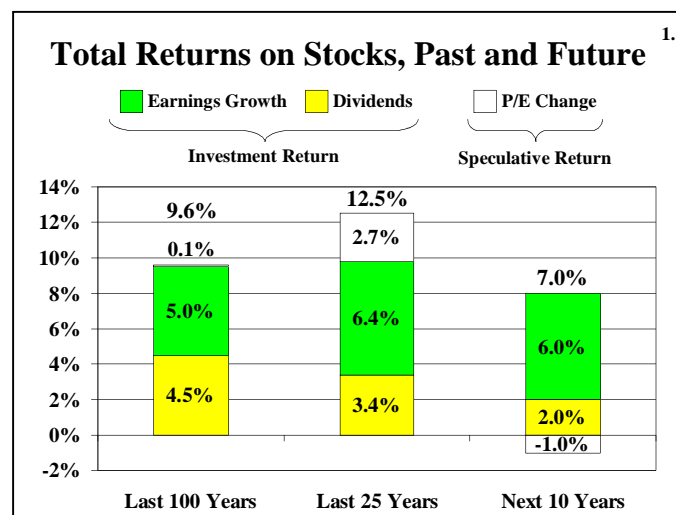
In our omniscient financial markets—dominated by smart, sometimes brilliant, professional investors—largely employed by financial institutions that just happen to be investing other people’s money—we are told, “Don’t think you know more than the market. Nobody does.” And yet I continue to believe, after Pascal, that we should consider not only the *probabilities* that the things that might go wrong actually come to pass, but their *consequences*. Even if our stock market professionals, with their intense focus on the short term, are unconcerned about the impact of these issues on the investors they serve, long-term investors, depending on accumulating assets for their retirement years, cannot afford to ignore them.

It is here that I have serious concerns. (Full disclosure: while I’m an eternal optimist, I’m a conservative investor, believing that virtually every portfolio should have a portion in fixed-income securities as well as equity securities.) I can hardly contemplate the most dire consequences of, for example, the war in Iraq, nuclear proliferation, fragile sources of energy, the spread of religious fundamentalism, global warming, enormous federal budget deficits (with a political system unwilling to deal with them), and the massive potential shortfalls in the ability of our corporations, our cities and our states (to say nothing of our federal government) to fund their pension liabilities. That we’ll somehow “muddle through” challenges like these—now on a global scale in our “the earth is flat” modern world—seems to be the prevailing expectation of our money managers.

While risk abounds, however, stocks are selling at valuations that are in fact somewhat higher than long-term norms, implying optimism on the part of investors. Over the past century, stocks have sold at about 14 times corporate earnings; today they’re selling at about 18 times, reflecting a more confident outlook about what lies ahead. What’s more, as we’ll soon see, stocks currently offer a risk premium over bonds that is extremely low by historical standards. And as former Federal Reserve chairman Alan Greenspan has said, “History has not dealt kindly with the aftermath of protracted periods of low risk premiums.”

But whatever may come to pass in the world, in America, and in our robust economy, please don’t forget this unfailing principle: in the long run it is the reality of business—the *investment* return on stocks, consisting of the dividend yields and earnings growth generated by our corporations—that drives the returns generated by the stock market itself. Over the past century-plus, for example, the nominal *investment* return earned by stocks was 9.5 percent, consisting of an average dividend yield of 4.5 percent and average annual earnings growth of 5.0 percent. (**Chart 1**) Speculative return, which added a mere 0.1 percent per year, reflecting a modest rise in the price/earnings ratio, brought the total nominal return on

stocks to 9.6 percent per year. In the long run, then, investment returns are driven almost entirely by *economics*.



But in the shorter-run, *emotions*—reflected in speculative return—can add to, or subtract from those economics that generate long-term returns, often by substantial magnitudes. During the past 25 years, for example, the annual investment return earned in the U.S. stock market was 9.8 percent, relatively close to the historic 9.5 percent historical norm. But speculative return contributed another 2.7 percent, reflected in the willingness of investors to increase the amount they paid for each dollar of corporate earnings from 9 times to 18 times, based on the trailing 12-month reported total earnings of the S&P 500, a 100 percent increase, spread over a quarter century. (Early in 2000, the P/E ratio actually reached an astonishing 32 times, only to plummet to 18 times as the new economy bubble burst.) Net result: during the past 25 years, speculative return enhanced the market’s annual return by nearly 30 percent.

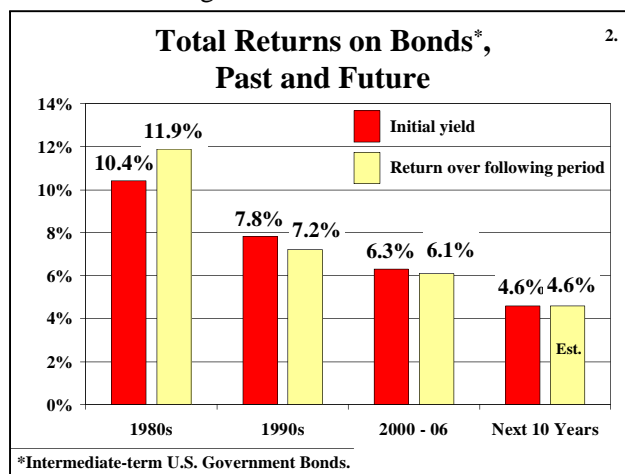
Did it matter? You better believe that it did! Compounded over the full quarter-century period, that enhancement was little short of astounding. The annual investment return of 9.8 percent produced a 935 percent cumulative gain. But the total annual return of 12.5 percent on stocks grew to a cumulative return of 1,800 percent. That seemingly modest incremental speculative return of 2.7 percent per year produced an extra enhancement of 865 percent for equity investors.

But we can’t count on a recurrence of this remarkable bonus. For this simple methodology tells us that we’re facing an era of subdued returns in the stock market. First, today’s dividend yield on stocks is not 4.5 percent (the historical norm), but slightly below 2 percent. Thus we can expect a dead-weight

loss of 2.5 percentage points per year in the contribution that dividend income makes to investment return. Next, let's assume that corporate earnings will continue to grow (as, over time, they usually have) at about the pace of our economy's nominal growth rate, say 6 percent per year over the coming decade. (That may be a bit optimistic.) If these assumptions are correct, then the most likely investment return on stocks would be in the range of 8 percent.

Now let's consider speculative return in the coming decade. The present price/earnings multiple on stocks now looks to be about 18 times. If the P/E ratio remains at the present level a decade hence, speculative return would neither add to nor detract from that possible 8 percent investment return. My guess (it is little more than that) is that the P/E might ease down to about 16 times, reducing the market's return by about 1 percentage point a year to an annual rate of 7 percent. (You don't have to agree with me. If you think the P/E will leap to 25 times, add 3 percentage points to the investment return of 8 percent, bringing the total return on stocks to 11 percent. If you think the P/E will drop to 12 times, subtract 4 percentage points, reducing the total return on stocks to 4 percent.)

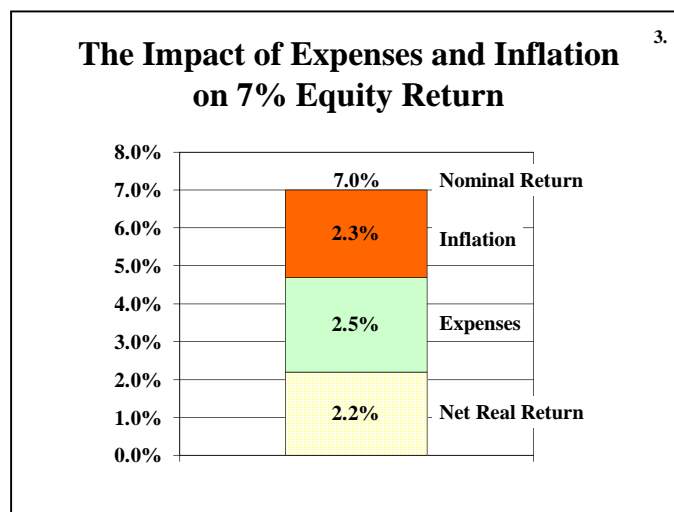
Now let's look at bonds. Here the arithmetic is much easier. The long-term returns on bonds are largely—if not entirely—produced by the interest payments that they generate. Unlike earnings and dividends, the interest payments on bonds are fixed, and speculative return—reflected in the change in the level of interest rates—however important in the short-term, has far less impact over time. (A ten-year U.S. Treasury bond for example, is retired at par at the end of the period.) As a result, the current interest rate proves to be an excellent predictor of returns in the subsequent decade, with an historic correlation of an astounding 0.91—almost perfect. This relationship clearly prevailed in the 1980s (initial interest yield 10.4 percent, subsequent 10-year return, 11.9 percent), in the 1990s (7.8 percent and 7.2 percent), and so far in the first decade of the 21st century (6.3 percent and 6.1 percent). **(Chart 2)** With the yield on the 10-year Treasury currently at 4.6 percent, reasonable expectations suggest a likely return in the range of 4.6 percent for such bonds over the coming decade.



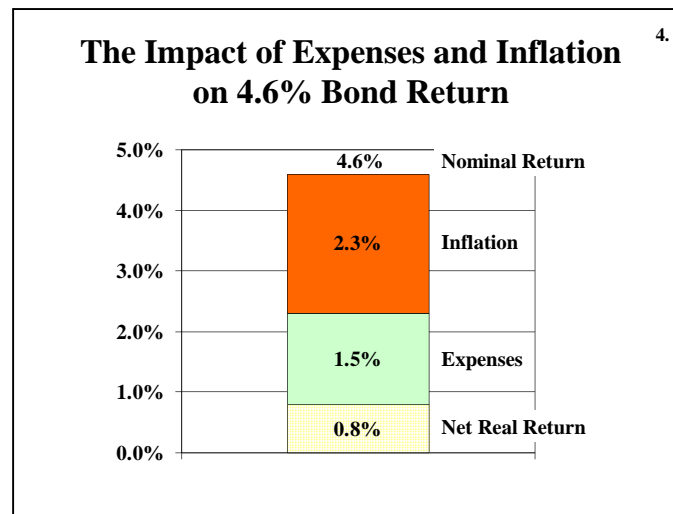
Yes, under these (likely) circumstances, the risk premium for holding stocks vs. Treasuries would be just 2.4 percent annually, only about one-half of the long-term annualized risk premium of 4.6 percent (9.6 percent for stocks; 5.0 percent for bonds). But when rational expectations belie historical experience, it is current reality that must lead the way. (As Lord Keynes wrote: “when the facts change, I change my mind. What do *you* do?”)

Now, let’s assume that 7 percent is a rational expectation for future nominal returns in the stock market, and 4.6 percent in the bond market. While the marketers whose job it is to gather assets for their financial services firms can afford—in their own self-interest—to ignore the reality of inflation and do their sales presentations using nominal dollars, investors have no such luxury. Unless we focus on real, inflation-adjusted returns, we will seriously jeopardize our future financial security. The financial markets are telling us that inflation is expected to be about 2.3 percent over the coming decade. Thus, the *real* return on stocks would average 4.7 percent.

It’s all too easy for sellers of financial products to focus on historical stock market returns rather than looking ahead, to disregard the impact of inflation, and to ignore the impact of investment costs, pretending that those relentless rules of humble arithmetic that I earlier discussed do not exist. But when we think in terms of prospective returns, and then real returns, mutual fund costs take on a whole new level of significance. At their present estimated annual level of 2.5 percent—including expense ratios, sales loads, and the hidden costs of that huge annual portfolio turnover—fund costs would consume more than 50 percent of that projected real return of 4.7 percent for the stock market, leaving a net real return of just 2.2 percent a year during the coming decade. **(Chart 3)** (I haven’t even dared to mention the cost of taxes, in an industry where tax-inefficiency is rife.)



Similar arithmetic, of course, prevails in the bond market. Prospective returns will be lower than in the past, inflation will take its toll, and costs will overpower the return that remains. At 2.3 percent per year, inflation would confiscate exactly 50 percent of the bond market’s nominal return of 4.6 percent, leaving a real bond market return of 2.3 percent. And estimated annual costs of at least 1.5 percent for the average bond mutual fund (expenses plus sales loads) would, in turn, confiscate nearly 70 percent (!) of that real return, reducing it to barely 0.8 percent per year. **(Chart 4)**



It’s at this point that the role of the financial professionals and investment fiduciaries intersects with these investment realities. To what extent is it appropriate for investment professionals—including estate planning professionals—to offer high cost “products” to their clients? To what extent are the trustees of our institutionally-managed pension plans and the directors and managers of our mutual funds focused on providing their plan beneficiaries and fund shareholders with their fair share of the future returns—future *real* returns—earned in our financial markets?

At a minimum, it would seem that stock and bond funds alike should be focused on *very* low costs, be broadly diversified against the potential hazardous consequences that I described earlier, minimize portfolio turnover and its attendant costs, and be considering the reduction or elimination of sales loads. (Shades of my Princeton thesis!) In addition, participants in our system of financial intermediation should bring these attributes to the fore in choosing the funds that you determine to offer to your clients.

I was warned that mentioning index funds would not be universally popular with this audience, but in a likely future environment of lower returns on equities, I have no choice. For the passively-

managed, low-cost, broadly-diversified, and tax-efficient no-load index fund would provide even higher real returns relative to those earned by actively-managed equity funds than the enormous advantage it has achieved over the past quarter century. Like it or not, the index fund remains, if I may take the liberty of citing the subtitle of my new *Little Book*, “the *only* way to guarantee your fair share” of whatever returns our markets are generous enough to provide in the years ahead.

I conclude by reiterating my theme that the link between fiduciary duty and financial markets is not only an unbreakable one, but that in today’s risky investment world, it is more important than ever. Trusteeship, fiduciary duty, and professional standards are not just idle phrases. They represent the very essence of good business—ethical conduct, fair-dealing, “just and equitable principles of trade” (in the lexicon of NASD regulations)—in which service to clients, and for that matter, service to society, is the paramount value. Writing about professional obligations in the spring edition of the Yale School of Management Quarterly Review, Harvard Business School professor Rakesh Khurana suggests this stern standard as the watchword of the true professional: “*I will create value for society, rather than extract it.*”

Markets being markets, and the relentless rules of humble arithmetic being, well, the relentless rules of humble arithmetic, our financial services industry turns out to be not only an extractive industry, but, at least in the part of it which I have spent my long career, one that has lost its traditional professional bearings. I lay my ideas on the line with you today in the hope that you will not only seek ever higher levels of professional conduct in your own careers, but spread the truth about investing not only to your colleagues, but to your clients, those human beings whose success in preserving and enhancing their capital ultimately defines the success you will achieve in your own careers and lives.