BOOK REVIEW

The Clash of the Cultures: Investment vs. Speculation. 2012.
By John C. Bogle,
John Wiley & Sons, Inc., www.wiley.com. 353 pages, $29.95.

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Abstract

John Bogle's story is an oft-told tale, yet even Bogle junkies will learn some fascinating new facts from the latest book by the founder of the Vanguard Group. Every thoughtful investor can benefit from his wisdom, served up with refreshing modesty by a giant in a field notorious for outsized egos.

John Bogle's story is well known among investment professionals. After writing his Princeton University senior thesis on the fledgling mutual fund industry, he joined Wellington Management, where he rose to chief executive officer. Fired in the wake of the 1972–74 bear market, Bogle rebounded by founding the Vanguard Group. There, he pioneered and tirelessly championed the index fund, one of the most important financial innovations of the past half century.

It is an oft-told tale, yet even Bogle junkies will learn some fascinating new facts from *The Clash of the Cultures: Investment vs. Speculation*. For instance, Bogle recounts that in 2004, he unsuccessfully tried to persuade the chairman of Putnam Investments' funds to convert to the "mutual mutual fund" organizational structure introduced by Vanguard, in which fund shareholders own the management company. In 1994, he purchased 100 shares of T. Rowe Price in order to stay informed about the activities of a Vanguard competitor. His $4,189 investment has grown to $208,960, and the dividend alone now runs $4,325 annually, underscoring the point that investment *management* has proven far more lucrative than investment.

Readers may also be surprised to learn that Bogle's premise for launching the first index fund was not that markets are invariably efficient; sometimes, he writes, they are "wildly inefficient." Rather, he documented that costs of investment management—particularly those associated with excessive portfolio turnover—had directly reduced the return investors could have earned if a cost-effective means of holding the market portfolio had been available to them. In one study he conducted on this matter, Bogle found that the stocks held by actively managed mutual funds at the start of the year performed better than the funds' actual portfolios 52% of the time.

In this book (his 10th), Bogle takes up the cudgels on behalf of investors, who he believes have been poorly served by most of the investment industry. He deplores the evolution of money management from a profession—by definition, a group of practitioners who put their clients' interests ahead of their own—to a business that frequently earns profits at the expense of its clients. Bogle quotes Delaware Court of Chancery chancellor Leo Strine's remark that although legal scholars make much of the agency problem created by the separation of ownership from control of operating companies, they have largely ignored a similar problem in the ownership of investment organizations by public stockholders or financial conglomerates, rather than by the owners of the assets under management. One troubling conflict of interest that Bogle sees in this separation is the extreme reluctance of money managers to vote against corporate management in proxy battles, lest they hurt their chances of winning mandates from the corporations' 401(k) plans. He notes that the California State Teachers' Retirement System, which faces no such conflict, votes against management 23% of the time.

If Bogle had his way, institutional investors would use their voting power to push for essential corporate reforms. For one thing, he would rein in CEOs' compensation, which has grown from 42 times to 320 times the average U.S. salary since 1980 on the premise that the corporate kingpins have created massive shareholder value. In reality, he asserts, the average corporation's real profits have failed to keep pace with GDP growth over the period. Bogle criticizes the profligate use of stock options in executive pay, noting that the modest amount of resulting annual shareholder dilution can cumulate to as much as 25% over a decade. Also in the governance area, Bogle wants corporations to refrain from making political contributions unless 75% of their shareholders approve of the practice.

Another major focus of *The Clash of the Cultures* is captured by its subtitle, *Investment vs. Speculation*. Bogle defines these two terms as, respectively, forecasting an asset's yield over its full life and forecasting the psychology of the market. He sees a place for speculation in a healthy capital market but argues that the balance has shifted too far away from investment. For example, he contends that the exchange-traded fund (ETF) is a sound concept but thinks the financial industry has gone overboard by offering variants that dangle the lure of a quick buck. Some of these innovations have turned out to have severe design flaws. For instance, one ETF designed to triple the return of its associated index worked well enough on a daily basis but not over longer periods. Over the most recent five years, it returned –25%, versus 10.5% for the S&P 500 Index. Early in 2012, an ETF designed to magnify volatility surged when the sponsor stopped creating new units, then plunged 50% over two days in a sideways market.

Bogle has been diligent in his research, leaving only minor imperfections in the finished text. He dutifully credits the originators of the aphorisms he sprinkles throughout the book, yet in one case he neglects to identify Hillel as the source. Along with countless other authors, Bogle maintains that John Maynard Keynes said, "When conditions change, I change my mind. What do you do?" There is but thin evidence that the eminent economist ever uttered those words, and it is apparently owing to another eminent economist, Paul Samuelson, that so many people believe he did.[i] Quoting a speech in which Benjamin Graham alluded to the expulsion from Eden, Bogle mentions "Graham's reference to Original Sin." Original Sin is a uniquely Christian doctrine derived from events recounted in the book of Genesis and so presumably was not the intent of the Jewish Graham's allusion. In the same passage, Bogle refers to the "New York Society of Financial [read Security] Analysts."

These mini-flaws in no way undercut the contribution of *The Clash of the Cultures*. Bogle brings invaluable historical perspective to current issues ranging from high-frequency trading to the looming crisis in the U.S. retirement system to the use of mutual fund investors' money to promote the growth of assets under management. ("There is no evidence whatsoever," he writes, "that advertising benefits fund investors by bringing in an amount of new assets adequate to create economies of scale that offset the amount spent. On the other hand, there is considerable evidence that building assets above a certain size impinges on the manager's ability to create superior performance.") Every thoughtful investor can benefit from John Bogle's wisdom, served up with refreshing modesty by a giant in a field notorious for outsized egos.

—M.S.F.