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November 12, 2012

Jack Bogle Walks The Talk

Fourth Quarter 2012
Corporate Board Member
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Mention the name John C. Bogle within earshot of anyone associated with the mutual fund business, or investors in a Vanguard fund, and you'll likely see an expression of respect if not pure adulation. In an industry that is often associated with volatility, risk taking, and self-serving capitalism, Bogle's name carries true gravitas. At 83, the legendary Vanguard mutual fund founder and iconoclast is known for many reasons: He created the first index fund—the Vanguard 500 Index—has authored 11 books, and has spawned a cult-like following known as Bogleheads. But Bogle is perhaps best known as an outspoken critic of his own industry, which may not have won him additional friends but has earned him respect in spades. Bogle never hesitates to say what he means, and as those who have followed his career have long known— Jack Bogle always means what he says.

Corporate Board Member recently had a chance to talk with Bogle about the release of his newest book, *The Clash of the Cultures: Investment vs. Speculation*, as well as his views on corporate governance and the ways in which boards need to step up to the plate.

Your new book spends a great deal of time on what you see as the vast difference between investment and speculation—between owners and renters of capital. You say that short-term renters of stock are not focused on the interest of the stockholder first. How have those lines become blurred?
Speculation is betting on the price of a stock, which is almost always short term in nature, whereas investment is based on betting on the value of the corporation.

So I'm not talking about the stock price here, but rather about the intrinsic value of the corporation itself. Investors should know that, in the long run, the return on stocks is the same as the return on corporate value. The way I look at it, 100% of the long-term return on the stock market has been achieved by dividend yields plus subsequent earnings growth. So broadly speaking in the U.S., you can say that if the dividend yield has averaged 4.5%, corporate earnings growth has averaged 4.5% in nominal returns, so that's where the 9% we accord to stocks comes from. At times, the stock market goes way over that 9% trendline or way under it, but in the long run, the stock market return is the same as what I call (in this book) the "fundamental return" or in [economist] Keynes' words, the "enterprise return." So enterprise or investment is basically investing for a future stream of income. And that's just as true of stocks as it [is] of bonds.

But, what goes on around that is speculation, which clearly—and I don't know why people don't get this—is just one person trading with another. It doesn't add value. It doesn't subtract value. The stock market doesn't care whether I own the stock or whether you own the stock. The problem with speculation is that the middleman makes it an uneven trade. The middleman becomes the casino, and the house takes a chair. So when I bet and you bet, and then you win and I lose, for example, that's not an even bet. It's an even bet less the cost of the casino.

I quote Benjamin Graham quite frequently, and he says that in the short run, the stock market is a voting machine; in the long run, the stock market is a weighing machine. And the voting and the weighing [will be] the same over a hundred years, but with huge differences day to day, week to week, month to month, or even decade to decade.

You write that "the stock market is a giant distraction from the business of investing." While I understand what you mean when you say we need to look at the long view, the reality is that we report performance to shareholders on a quarter-by-quarter basis, which logically sets up short-term expectations. How do we move away from short-term thinking and implement a discipline toward long-term investments?
Well, that's obviously not an easy thing to do, and I think a lot depends on changing the mindset of the investors. I think everybody would agree—and I certainly agree—that reporting earnings on a quarterly basis is an intelligent thing to do.

It probably shouldn't be any less frequent, and it probably shouldn't be any more frequent. But it depends on how investors use that information.

I mention in the book that the consummate long-term investor is the index fund.

The index fund can't get out of your stock depending on whether it likes the quarterly earnings or whether it doesn't. If you're 2% of the stock market, you stay at 2% of the stock market in the index fund. Index funds are growing. They now control 28% of all U.S. corporations, and yet they do nothing [to change this mindset]. We have this kind of circular control in which the indexes, the money managers, even the longer-term ones, are managing money for the corporations and voting stock in those same corporations. So this creates a conflict of interest. As a result, I included a somewhat cynical comment in the book that there are only two kinds of clients institutional managers don't want to offend: actual clients and potential clients. That's a lot of clients.

You also talk about the problems with the "double agency" society, where there is what you refer to as a "tacit conspiracy" among all the players to increase stock prices and please Wall Street. Yet of all the constituencies that you mention in this vein–officers, managers, auditors, lawyers, investment bankers, etc.–corporate directors are the only group that has a distinct fiduciary duty toward shareholders. So have they failed in that duty, in your opinion?

First, I think that the legal standards for directors are much too low. The word "fiduciary" does not appear, for example, in Delaware law. And I think we would have a different world, honestly, if the word fiduciary did appear there. So I think corporate law as such, and particularly Delaware law, which is where the vast majority of these corporations are headquartered, just has too low a bar.

Would you favor a federal statute to addresses that?
I would propose a federal statute, because it's pretty clear that if someplace such as Delaware wants to blaze a new trail in the direction of fiduciary duty, it runs the obvious risk that its corporations will relocate in a different state. So if you're going to change the proxy voting process, that would become a federal issue. I personally think it should be very broad and not specific— a little bit like the British common law, which has a standard of fiduciary duty in it.

So what else should directors be doing to better work for the long-term interests of shareholders?
Basically, the standard should be pretty much the way Warren Buffett said it, which is quoted in the book: "Fiduciaries must decide whether their job is to work for owners or managers." So a director should vote and consider issues as if he were the sole stockholder of the corporation and had no interest in anything else but his own well-being. Directors should be looking first at what is best for the shareholders. That's who elects them, even though the electoral process is a bit byzantine and sort

of like a Russian election in that there aren't a lot of choices there—or really, any. So I think they ought to look at themselves as if they owned the corporation and ask, "What would I do here?"

The ownership by directors is almost inevitably pretty small in terms of percentage of the company, and even small in terms of their own wealth, unless they're insiders, in which case their own wealth has come largely from stock options, which is a different kind of a financial commitment than if you go out and buy the stock. So [it comes back to the fact that] there's too much focus on the price of a stock and not enough focus on the intrinsic value of the corporation.

Say on pay certainly has moved the pendulum further toward shareholder rights and boards' responsibilities to their investors. What is your impression of the impact say on pay has had after two years of votes?
I think we need to move in that direction even more strongly. But the problem is that while shareholders are increasingly gathering the means of engaging more in corporate governance, they don't have the will to do so. And as I said in one of my previous books, The Battle for the Soul of Capitalism, seven or eight years ago when the SEC tried to open the door to more institutional participation, [it] got virtually no support from the large money managers. Several money managers wrote in and said they didn't want that much additional flexibility, or additional opportunity to change things. You know, it's a contentious, subtle thing as to why these institutions aren't more dedicated to the interests of their shareholders and the pension plan investors they represent. That's just a flaw in the system that we have to fix, and I don't know how to fix it.

So many of the shareholders are traders now and short-term speculators themselves that they not only don't give a damn about corporate governance, but you could argue—and I would argue—they shouldn't give a damn about corporate governance. The corporation's governance has nothing to do with the change in the stock price between 1:00 and 2:00 today—nothing! But if you're a long-term investor, corporate governance means everything. So this whole idea of too much speculation and not enough investment comes clearly into play in this area, with the great flaw being that even the long-term investors—particularly the index funds, the ultimate gatekeepers—just don't want to get into the fray. There are a whole lot of reasons for that, a whole lot of excuses for that, but we're not seeing [things change.] So you can lead a horse to water, but you can't make him drink.

If you had a corporate board member in front of you right now, what nuggets of advice would you offer as he or she looks toward 2013?
First, if I were addressing a director, I'd say you should behave as if you are the sole owner of the company. [Ask yourself:] What is good for the owner? So, personalize it.

Number two, understand what makes the corporation tick. Understand the data you get and consider that directors only have so much time, and they're obviously getting perspective from a self-interested management. That's the way the system works. Therefore, you should consider demanding an independent appraisal of the data. And that would be divisive, understand that. We also have to understand that the interest of management can diverge from the interest of shareholders in [terms of] executive compensation, and [also] with these ghastly—if I may editorialize—hefty amounts of corporation money that are now legally given away [under the Supreme Court's Citizens United decision] for political contributions.

Three, I'd say be truly independent, which is very hard to do within a board setting. Don't assume that every board vote has to be unanimous! There are ways to speak up and get your opinion across in a perfectly polite, collegial way and be able to say, "Look, I just don't think that's the right thing to do; I recognize the board's going to go ahead and pass it, but I'd like to be recorded as opposed to it." That happens very rarely in corporate America, but I think if one were to look at the number of unanimous votes out there, probably 99.5% of the votes taken by the board are unanimous.

[Along those lines,] there's a great story I used in an earlier book about Alfred Sloan, former head of General Motors. They had a major plan, a strategy, and the board approved it unanimously.

And Mr. Sloan said to the board, "You're unanimous in approving this. Something is wrong somewhere along the way. So I'd like to postpone. I'd like to forget that vote and give you another month to study it and think about it, and we'll take up the issue and have another vote at the next board meeting." And I think that's the right spirit!

A director has important responsibilities (and this is one of the problems of corporate governance—and saying this may be a bit hyperbolic but I think the spirit is right), and [in my opinion] corporate directors are substantially underpaid relative to the responsibilities they assume and substantially overpaid relative to the way they implement their roles.

topic tags: board of directors, corporate governance