DON'T COUNT ON IT!

Reflections on INVESTMENT ILLUSIONS, CAPITALISM, "MUTUAL" FUNDS, INDEXING, ENTREPRENEURSHIP, IDEALISM, *and* HEROES

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WILEY

John Wiley & Sons, Inc.

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Chapter 31

"When a Man Comes to Himself"*

First of all, hearty congratulations to each one of you on graduation from this wonderful school. I imagine that Isaiah Vansant Williamson, the man of Scots heritage who founded your school some 120 years ago, is looking down on you from above on this bright afternoon, quietly reveling as 61 of those whom he called "his boys" are handed the diplomas that recognize that you have stayed the course; you have completed it successfully; you now begin a new course in your life.

You are no longer boys; you have become men. And somewhere along the long road of life that will follow, each of you will "come to yourself," an expression that, sadly, has fallen out of use. That is my theme today, inspired by an essay entitled, "When a Man Comes to Himself," written in 1901 by Woodrow Wilson, shortly before he became president of my own alma mater, Princeton University.† In 1912, Wilson would become the 28th president of the United States of America.

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* Based on a commencement address at The Williamson Free School of Mechanical Trades, Media, Pennsylvania, on May 28, 2009.

† Woodrow Wilson, *When a Man Comes to Himself* (New York: Harper & Brothers, 1901).

When does a man come to himself? When do you learn who you are? When do you find your place in society? There is no fixed time; we come to ourselves on our own schedule. Some of you may have gotten there already; most of you will get there before too many more years have passed; some all at once, others imperceptibly, by degrees; and, as Wilson knew, "some men never come to themselves at all," perhaps the sadness of never finding one's place in the world, perhaps the tragedy of a life cut short. But given the remarkable skills you have acquired right here on this magnificent campus, the dedicated teachers and mentors who have given of themselves to you, and your inculcation into the Isaiah Williamson Free School philosophy of service to society, I have no doubt that the world you seek will be yours.

Wilson recognized that coming to yourself is not determined by the passage of time, but by the passage of the spirit. Using Wilson's ageless words:

> It is in real truth that common life of mutual helpfulness, stimulation, and contest which gives leave and opportunity to the individual life makes coming to yourself possible, makes it full and complete. . . . In discovering your own place and force, if you seek intelligently and with eyes that see, you find more than ease of spirit and scope for your mind. You find yourself, as if mists had cleared away about you and you know at last your neighborhood among men and tasks.*

Likely it is that Isaiah Williamson came to himself well before he reached manhood, for he was a remarkable youth. According to his biographer, John Wanamaker (yes, the Philadelphia merchant prince), young Isaiah was "an apt, enthusiastic scholar, a boy who did a man's work; never tired, never absent, never idle; a lad of manly ways, of merit, integrity and industry; a lad who threw himself into the whirl of work and life." Wanamaker then goes even further, describing Williamson's "fairness, good temper, Quaker thrift and industry,

* Throughout these quotations, I have taken the liberty of substituting "you" and "your" for Wilson's "he" and "his."

modesty, and absolute trustworthiness."* Could there possibly be a better set of standards for a man who has come to himself than those eternal standards exemplified by your legendary founder?

Work . . . Trade . . . Finance

I have always been a huge admirer of the craftsman who works with his hands as well as his mind, the consummate professional who enhances our daily existence by his talents and his skills. You and your peers—those who came through these halls before you and those who shall follow you, those who study and learn their trades—add great value to our society. Indeed, you constitute the very backbone of our nation, and you should be rightfully proud of learning the trades you will soon practice. Those of us in finance are of a rather different status, for it is no longer any secret that our financial sector subtracts value from our society.

How can that be? Of course credit is central to our economy. Liquidity—enabling one person to acquire the stream of future income generated in a business, by using his capital to purchase shares from another person who wishes to withdraw his capital and relinquish his claim—is vital. And the efficient pricing of shares traded in our financial markets is essential to their functioning. But the principal function of the financial sector is to act as the middleman in a trade between a buyer and a seller, a trade that pits one investor against another, a trade that inevitably constitutes a *zero-sum* game (one side wins, the other side loses). But once the costs of the middlemen—the brokers, the bankers, the money managers, all those croupiers of finance—are extracted, speculation in stocks becomes a *loser's* game, a subtractor from social value.

An old English saying puts it well:†

> Some men wrest a living from nature and with their hands; this is called work.
> Some men wrest a living from those who wrest a living from nature and with their hands; this is called trade.

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*John Wanamaker, *The Life of Isaiah V. Williamson* (Philadelphia: J. B. Lippincott, 1928).

†I've added the phrase "with their hands" to the original quotation, the source of which is unknown.

> Some men wrest a living from those who wrest a living from those who wrest a living from nature and with their hands; this is called finance.

So, yes, I confess to you who will actually *do* the world's work, making your living "from the earth and with your hands," that your commencement speaker has earned his own living, not in that kind of real work, but in finance. But I'm embarrassed about the field in which I ply my trade. All too many of its leaders bear a heavy responsibility for running our economy into the ground, even as they made personal fortunes by playing fast and loose with the system and taking absurd risks, not with their own money (of course!) but with other people's money; even successfully lobbying for the rollback of regulations that had well-served investors for decades.

Taking on the System

But I've marched to a different drummer. I've challenged the financial system and done my best to improve it—to build a better world for investors. Vanguard, the company that I founded almost 35 years ago, was built on a firm foundation of service to our investors rather than service to ourselves, in a unique *mutual* mutual fund structure in which our fund shareholders actually *own* the funds' management company. Vanguard operates on an "at-cost" basis, and our structure and fiscal discipline have resulted in cumulative savings to our shareowners of nearly $100 billion so far, subtracting less value from society than any financial firm on the face of the globe. In short, our rise to dominance in the financial field has come simply because we are (1) structurally correct; (2) mathematically correct; and (3) strategically correct.

Our core investment strategy is the index fund—a fund that, at its best, simply owns the entire stock market (or the entire bond market). Operated at rock-bottom cost, this strategy guarantees that our shareholders receive no more and no less than their fair share of whatever long-term returns on investment that our stock and bond markets are generous enough to provide—or, on occasion, mean-spirited enough to take away. The index fund, arguably, is an exercise in the very kind of plain and simple engineering that your own careers will demand.

Think about it. In the 2005 book, *Power, Speed and Form: Engineers and the Making of the Twentieth Century*,* the best engineering is described as embodying "efficiency, economy, and elegance"†—the very kind of ingenious simplicity and effectiveness that characterize the index fund. It is the antithesis of the discredited "financial engineering," the excessive costs, the product complexity, and the rampant speculation that created the global financial crisis that Wall Street has inflicted on Main Street. And it is now arguably the largest mutual fund in the world.‡

Yet the Vanguard model has yet to be copied, and we remain a renegade in our field. We prefer to be noted for our stewardship rather than our salesmanship; for our management rather than our marketing; for our focus on long-term *investment* rather than short-term *speculation*. In this sense we parallel the career of Isaiah Williamson, who made his fortune in trade by his own efforts and straight business dealing, not by speculation.

Labor and Capital

When capital is used for speculation rather than investment, the relationship between capital and labor in our society is distorted. Of course, as Abraham Lincoln reminded us, capital has its rights, worthy of protection; and property is the fruit of labor, a positive good in the world. This philosophy resonated with Theodore Roosevelt, who in 1910 cited Lincoln's words and added:

> [We must] equalize opportunity, destroy privilege, and give to the life and citizenship of every individual the highest value both to himself and the commonwealth . . . the highest service

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* David P. Billington and David P. Billington Jr. (Oxford University Press, 2005).

† In fact, in my 1951 thesis at Princeton University, I urged that mutual funds be operated "in the most efficient, economical, and honest way possible." If honesty is understood to represent a certain kind of elegance, the ideas are identical.

‡ Assets of our 500 Index funds total $125 billion; assets of our Total Stock Market Index Funds total $95 billion, a combined total of $220 billion.

> of which he is capable. . . . We should permit fortunes to be gained only so long as the gaining represents benefit to the community . . . for every dollar received should represent a dollar's worth of service rendered—not gambling in stocks but in service rendered.*

"Not gambling in stocks but in service rendered" is a worthy standard. Yet when I look at our society today, I am appalled by our tendency to overvalue the managers of our financial sector and to undervalue those who are engaged in work and trade. A recent book entitled *The Craftsman*† makes the case for the kind of valuable work that you have been trained to do: "[*M*]*aking is thinking* . . . for the work of the hand can inform the work of the mind . . . learning to work well enables people . . . to govern themselves so as to become good citizens."‡ You newly minted Williamson graduates must already understand some of these essentials of useful knowledge cited by the author:

> How to negotiate between autonomy and authority (as one must in any workshop); how to work not against resistant forces but with them; how to complete their tasks using "minimum force"; and how to meet people and things with sympathetic imagination; and above all how to play.

And so—whether in your machine shop here, or in your masonry shop or your carpentry or paint shops, or your power plant, or even in your garden—you young craftsmen have already learned so much of what is important not only in work, but in life. And as you come to yourself, you will have learned even more.

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* Theodore Roosevelt, "The New Nationalism," speech delivered in Osawatomie, Kansas, on August 31, 1910.

† Richard Sennett, *The Craftsman* (New Haven, CT: Yale University Press, 2008).

‡ By curious coincidence, the same theme was echoed in an article in the *New York Times Magazine* only five days ago. (Google it!) In "The Case for Working with Your Hands," Matthew B. Crawford makes the point that for the craftsman, "the intrinsic satisfactions of work count—not least in the exercise of your own powers of reason."

When he wrote his essay all those years ago, Woodrow Wilson recognized the special moment that this commencement celebration represents for you graduates:

> To most men, coming to oneself is a slow process of experience, a little at each stage of life. A college man feels the first shock of it at graduation, when the boy's life has been lived out and the man's life begins. You have measured yourself with boys . . . but what the world expects of you, you have yet to find out, and it works, when you discover it, a veritable revolution in your ways of thought and action[;] your training was not for ornament or personal gratification, but to use yourself (for the greater good) and to develop faculties worth using. The man who receives and verifies the perfect secret of right living, the secret of social and of individual well-being, has discovered not only the best and only way to serve the world, but also the one happy way to satisfy himself. Then, indeed, have you come to yourself.
>
> Surely you have come to yourself only when you have found the best that is in you, and you have satisfied your heart with the highest achievement you are fit for. It is only then that you know of what you are capable and what your heart demands. . . . No thoughtful person ever came to the end of their life, and had time and a little space of calm from which to look back upon it, who did not know and acknowledge that it was what you had done unselfishly and for others, and nothing else, that satisfied you in the retrospect, and made you feel that you had played yourself as a human being.

So as your lives as men begin today, I wish each of you the power, the stamina, the determination, the wisdom, the spirit of sharing and building. And the passion to leave everything you touch better than you found it, the sheer pride in a job well done. And while you're about it, try also to leave every person whose life you touch a better person. Then, you will have come to yourself. *Then you will have come to yourself*. More than that I cannot wish you.

Part One

INVESTMENT ILLUSIONS

Many of the themes in this book are captured in Chapter 1, one of my favorite efforts, and broad enough to provide the book's title: *Don't Count on It!* In this opening chapter, subtitled "The Perils of Numeracy," my keynote speech delivered at the Princeton Center for Economic Policy Studies in 2002, I challenge the growing trend in our society to give numbers a credence that they simply don't deserve, all the while assigning far less importance to the things that can't be expressed with numbers—qualities such as wisdom, integrity, ethics, and commitment.

The consequences of this misperception are damaging. They lead to expectations that past financial market returns are prologue to the future (they most certainly are not!); to our bias toward optimism, evidenced in the failure of investors to consider real (after-inflation) returns in their retirement planning; to creative accounting (or is it "financial engineering"?) that produces corporate earnings numbers that we accept as reality when they are often far closer to illusion; and to the damaging toll it inflicts upon the real world of real human beings, who ultimately produce the real goods and services that our society relies upon.

In Chapter 2, I explore another of my favorite themes, "The Relentless Rules of Humble Arithmetic," an essay published in the *Financial Analysts Journal* in 2005. In the long-run, the reality of the inescapable mathematics of investing trumps the illusion reflected in the performance numbers provided by fund managers. For example, during the two-decade period 1983–2003, a fund emulating the S&P 500 index earned a cumulative return of 1,052 percent, and its investors earned a return of 1,012 percent. In remarkable contrast, the average equity fund reported a cumulative return of just 573 percent, and the investors in those very same funds averaged a gain of less than one-half that amount, only 239 percent. Surely using stock market returns as a proxy for equity fund returns—to say nothing of the returns actually earned by fund investors—ignores those relentless rules. The idea that fund investors in the aggregate can capture the stock market's return has proven to be yet another investment illusion.

In Chapter 3, I combat the investment illusion that the past is prologue, pointing out that the reality is far different. In "The Telltale Chart" (actually a series of 11 charts), I focus on the pervasive power of "reversion to the mean" in the financial markets—the strong tendency of both superior investment returns and inferior returns to revert to long-term norms. This pattern is documented over long historic periods among: (1) conventional sectors of the stock market, such as large versus small stocks and value versus growth stocks; (2) both past winners and past losers in the equity fund performance derby; and (3) stock market returns in general. I also show a powerful—and, I would argue, inevitable—tendency of the stock market's total return to revert to the mean of its *investment* return (dividend yields and earnings growth). *Speculative* return—generated by increases and decreases in price-to-earnings valuations—follows the same type of pattern. But since speculative return is bereft of any underlying fundamental value, it reverts to zero over the long term. Yes, the investment returns earned by our corporations over time represent reality; speculative booms and busts, however powerful in the short run, prove in the long run to be mere illusion.

Another investment illusion is that costs don't matter. The money managers who dominate our nation's investment system seem to ignore the reality that costs do indeed matter. That self-interested choice is smart, for those management fees and trading costs have resulted in soaring profitability for America's financial sector. Financial profits leaped from 8 percent of the total earnings of the firms in the S&P 500 index in 1980 to 27 percent in 2007—33 or more percent if the earnings from the financial activities of industrial companies (i.e., GE and GMAC) are included.

The enormous costs of our financial sectors represent, as the title of Chapter 4 puts it, "A Question So Important That It Should Be Hard to Think about Anything Else." Why? Because the field of money management subtracts value from investors in the amount of the costs incurred. Ironically, the financial sector seems to prosper in direct proportion to the volume of the devilishly convoluted instruments that it creates—immensely profitable to their creators, but destructive to the wealth of those who purchase them. This complexity is also destructive to the social fabric of our society, for in order to avoid financial panic, we taxpayers (a.k.a. "government") are then required to bail them out.

Finally comes the most devious investment illusion of all: confusing the creation of real corporate intrinsic value with the ephemeral illusion of value represented by stock prices. Chapter 5—"The Uncanny Ability to Recognize the Obvious"—focuses on how important it is to recognize the obvious, especially in this difficult-to-discern difference between illusion and reality. Part of that difference is the difference between the real market of business operations and the creation of value (essentially long-term cash flows) and the expectations market of trying to anticipate the future preferences of investors. Since they simply track the stock market, even index funds face the same challenges that all investment strategies face when stock prices lose touch with reality. In the recent era, it has been speculation on stock price movements that has dominated our markets, not the reality of intrinsic value. So I reiterate my long-standing conviction: When there is a gap between illusion and reality, it is only a matter of time until reality prevails.

Chapter 1

Don't Count on It! The Perils of Numeracy*

Mysterious, seemingly random, events shape our lives, and it is no exaggeration to say that without Princeton University, Vanguard never would have come into existence. And had it not, it seems altogether possible that no one else would have invented it. I'm not saying that our existence matters, for in the grand scheme of human events Vanguard would not even be a footnote. But our contributions to the world of finance—not only our unique mutual structure, but the index mutual fund, the three-tier bond fund, our simple investment philosophy, and our overweening focus on low costs—have in fact made a difference to investors. And it all began when I took my first nervous steps on the Princeton campus back in September 1947.

My introduction to economics came in my sophomore year when I opened the first edition of Paul Samuelson's *Economics: An Introductory Analysis*. A year later, as an Economics major, I was considering a topic for my senior thesis, and stumbled upon an article in *Fortune* magazine on the "tiny but contentious" mutual fund industry. Intrigued, I immediately decided it would be the topic of my thesis. The thesis in turn

*Based on my keynote speech at the "Landmines in Finance" Forum of The Center for Economic Policy Studies at Princeton University on October 18, 2002.

proved the key to my graduation with high honors, which in turn led to a job offer from Walter L. Morgan, Class of 1920, an industry pioneer and founder of Wellington Fund in 1928. Now one of 100-plus mutual funds under the Vanguard aegis, that classic balanced fund has continued to flourish to this day, the largest balanced fund in the world.

In that ancient era, Economics was heavily conceptual and traditional. Our study included both the elements of economic theory and the worldly philosophers from the 18th century on—Adam Smith, John Stuart Mill, John Maynard Keynes, and the like. Quantitative analysis was, by today's standards, conspicuous by its absence. (My recollection is that Calculus was not even a department prerequisite.) I don't know whether to credit—or blame—the electronic calculator for inaugurating the sea change in the study of how economies and markets work, but with the coming of the personal computer and the onset of the Information Age, today numeracy is in the saddle and rides economics. If you can't count it, it seems, it doesn't matter.

I disagree, and align myself with Albert Einstein's view: "Not everything that counts can be counted, and not everything that can be counted counts." Indeed, as you'll hear again in another quotation I'll cite at the conclusion, "to presume that what cannot be measured is not very important is blindness." But before I get to the pitfalls of measurement, to say nothing of trying to measure the immeasurable—things like human character, ethical values, and the heart and soul that play a profound role in all economic activity—I will address the fallacies of some of the measurements we use, and, in keeping with the theme of this forum, the pitfalls they create for economists, financiers, and investors.

My thesis is that today, in our society, in economics, and in finance, we place too much trust in numbers. *Numbers are not reality*. At best, they're a pale reflection of reality. At worst, they're a gross distortion of the truths we seek to measure. So first, I'll show that we rely too heavily on historic economic and market data. Second, I'll discuss how our optimistic bias leads us to misinterpret the data and give them credence that they rarely merit. Third, to make matters worse, we worship hard numbers and accept (or *did* accept!) the momentary precision of stock prices rather than the eternal vagueness of intrinsic corporate value as the talisman of investment reality. Fourth, by failing to avoid these pitfalls of the *numeric* economy, we have in fact undermined the *real* economy. Finally, I conclude that our best defenses against numerical illusions of certainty are the immeasurable, but nonetheless invaluable, qualities of perspective, experience, common sense, and judgment.

Peril #1: Attributing Certitude to History

The notion that common stocks were acceptable as investments—rather than merely speculative instruments—can be said to have begun in 1924 with Edgar Lawrence Smith's *Common Stocks as Long-Term Investments*. Its most recent incarnation came in 1994, in Jeremy Siegel's *Stocks for the Long Run*. Both books unabashedly state the case for equities and, arguably, both helped fuel the great bull markets that ensued. Both, of course, were then followed by great bear markets. Both books, too, were replete with data, but the seemingly infinite data presented in the Siegel tome, a product of this age of computer-driven numeracy, puts its predecessor to shame.

But it's not the panoply of information imparted in *Stocks for the Long Run* that troubles me. Who can be against knowledge? After all, "knowledge is power." My concern is too many of us make the implicit assumption that stock market history repeats itself when we know, deep down, that the only certainty about the equity returns that lie ahead is their very uncertainty. We simply do not know what the future holds, and we must accept the self-evident fact that historic stock market returns have absolutely nothing in common with actuarial tables.

John Maynard Keynes identified this pitfall in a way that makes it obvious:* "It is dangerous to apply to the future inductive arguments based on past experience [that's the bad news] unless one can distinguish the broad reasons for what it was" (that's the good news). For there are just two broad reasons that explain equity returns, and it takes only elementary addition and subtraction to see how they shape investment experience. The too-often ignored reality is that stock returns are shaped by (1) economics and (2) emotions.

*John Maynard Keynes commenting on Edgar Lawrence Smith's book (1926).

Economics and Emotions

By *economics*, I mean *investment* return (what Keynes called *enterprise**), the initial dividend yield on stocks plus the subsequent earnings growth. By *emotions*, I mean *speculative* return (Keynes's *speculation*), the return generated by changes in the valuation or discount rate that investors place on that investment return. This valuation is simply measured by the earnings yield on stocks (or its reciprocal, the price-earnings ratio).† For example, if stocks begin a decade with a dividend yield of 4 percent and experience earnings growth of 5 percent, the *investment* return would be 9 percent. If the price-earnings ratio rises from 15 times to 20 times, that 33 percent increase would translate into an additional *speculative* return of about 3 percent per year. Simply add the two returns together: Total return on stocks = 12 percent.‡

So when we analyze the experience of the Great Bull Market of the 1980s and 1990s, we discern that in each of these remarkably similar decades for stock returns, dividend yields contributed about 4 percent to the return, the earnings growth about 6 percent (for a 10 percent *investment* return), and the average *annual* increase in the price-earnings ratio was a remarkable and unprecedented 7 percent. Result: Annual stock returns of 17 percent were at the highest levels, for the longest period, in the entire 200-year history of the U.S. stock market.

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*John Maynard Keynes, *The General Theory of Employment, Interest and Money* (1936; New York: Harcourt, Brace, 1964), Chapter 12. This chapter makes as good reading today as when I first read it as a Princeton student in 1950. Interestingly, in the light of the thesis that I present in this essay, Keynes introduced these concepts with no quantification whatsoever. So I have taken the liberty of inserting the appropriate data.

†The earnings yield is also influenced by the risk-free bond yield. But because that relationship is so erratic, I have ignored it. For the record, however, the correlation between the earnings yield on stocks and the U.S. Treasury intermediate-term bond since 1926 has been 0.42. However, for the past 25 years it was 0.69, and for the past 10 years 0.53.

‡I recognize that one should actually multiply the two (i.e., $1.09 \times 1.03 = 1.123$), obviously a small difference. But such precision is hardly necessary in the uncertain world of investing, and when addressing the lay investor, simplicity is a virtue.

The Pension "Experts"

Who, you may wonder, would be so foolish as to project future returns at past historical rates? Surely many individuals, even those expert in investing, do exactly that. Even sophisticated corporate financial officers and their pension consultants follow the same course. Indeed, a typical corporate annual report expressly states, "Our asset return assumption is derived from a detailed study conducted by our actuaries and our asset management group, and *is based on long-term historical returns*." Astonishingly, but naturally, this policy leads corporations to raise their future expectations with each increase in past returns. At the outset of the bull market in the early 1980s, for example, major corporations assumed a future return on pension assets of 7 percent. By the end of 2000, just before the great bear market took hold, most firms had sharply raised their assumptions, some to 10 percent or even more. Since pension portfolios are balanced between equities and bonds, they had implicitly raised the expected annual return on the *stocks* in the portfolio to as much as 15 percent. *Don't count on it!*

As the new decade began on January 1, 2000, two things should have been obvious: First, with dividend yields having tumbled to 1 percent, even if that earlier 6 percent earnings growth were to continue (no mean challenge!), the investment return in the subsequent 10 years would be not 10 percent, but 7 percent. Second, speculative returns cannot rise forever. (Now he tells us!) And if price-earnings ratios, then at 31 times, had simply followed their seemingly universal pattern of reversion to the mean of 15 times, the total investment return over the coming decade would be reduced by seven percentage points per year. As the year 2000 began, then, reasonable expectations suggested that annual stock returns might just be zero over the coming decade.*

If at the start of 2000 we were persuaded by history that the then-long-term annual return on stocks of 11.3 percent would continue, all would be well in the stock market. But if we listened to Keynes and simply thought about the broad reasons behind those prior returns on stock—investment versus speculation—we pretty much knew *what*

*Update: As it turned out, the annual return on stocks for the 1999–2009 decade came to −0.2 percent.

was going to happen: The bubble created by all of those emotions—optimism, exuberance, greed, all wrapped in the excitement of the turn of the millennium, the fantastic promise of the Information Age, and the "New Economy"—had to burst. While rational expectations can tell us *what* will happen, however, they can never tell us *when*. The day of reckoning came within three months, and in late March 2000 the bear market began. Clearly, investors would have been wise to set their expectations for future returns on the basis of current conditions, rather than fall into the trap of looking to the history of total stock market returns to set their course. Is it wise, or even reasonable, to rely on the stock market to deliver in the future the returns it has delivered in the past? *Don't count on it!*

Peril #2: The Bias toward Optimism

The peril of relying on stock market history rather than current circumstances to make investment policy decisions is apt to be costly. But that is hardly the only problem. Equally harmful is our bias toward optimism. *The fact is that the stock market returns I've just presented are themselves an illusion.* Whether investors are appraising the past or looking to the future, they are wearing rose-colored glasses. For by focusing on theoretical *market* returns rather than actual *investor* returns, we grossly overstate the returns that equity investing can provide.

First, of course, we usually do our counting in *nominal* dollars rather than *real* dollars—a difference that, compounded over time, creates a staggering dichotomy. Over the past 50 years, the return on stocks has averaged 11.3 percent per year, so $1,000 invested in stocks at the outset would today have a value of $212,000. But the 4.2 percent inflation rate for that era reduced the return to 7.1 percent and the value to just $31,000 in real terms—truly a staggering reduction. Then we compound the problem by in effect assuming that somewhere, somehow, investors as a group actually *earn* the returns the stock market provides. Nothing could be further from the truth. They *don't* because they *can't*. The reality inevitably always falls short of the illusion. Yes, if the stock market annual return is 10 percent, investors as a group obviously enjoy a *gross* return of 10 percent. But their *net* return is reduced by the *costs* of our system of financial intermediation—brokerage commissions, management fees, administrative expenses—and by the *taxes* on income and capital gains.

A reasonable assumption is that intermediation costs come to at least 2 percent per year, and for taxable investment accounts, taxes could *easily* take another 2 percent. Result: In a 10 percent market, the *net* return of investors would be no more than 8 percent before taxes, and 6 percent after taxes. Reality: Such costs would consume 40 percent of the market's nominal return. But there's more. Costs and taxes are taken out each year in *nominal* dollars, but final values reflect *real*, spendable dollars. In an environment of 3 percent annual inflation, a nominal stock return of 10 percent would be reduced to a real return of just 7 percent. When intermediation costs and taxes of 4 percent are deducted, the investor's real return tumbles to 3 percent per year. Costs and taxes have consumed, not 40 percent, but 57 percent of the market's real return.

Taken over the long-term, this bias toward optimism—presenting theoretical returns that are far higher than those available in the real world—creates staggering differences. Remember that $31,000 real 50-year return on a $1,000 investment? Well, when we take out assumed investment expenses of 2 percent, the final value drops to $11,600. And if we assume as little as 2 percent for taxes for taxable accounts, that initial $1,000 investment is worth, not that illusory nominal $212,000 we saw a few moments ago—the amazing productive power of compounding *returns*—but just $4,300 in real, after-cost terms—the amazing destructive power of compounding *costs*. *Some 98 percent of what we thought we would have has vanished into thin air*. Will you earn the market's return? *Don't count on it!*

Escaping Costs and Taxes

It goes without saying that few Wall Street stockbrokers, financial advisers, or mutual funds present this kind of real-world comparison. (In fairness, *Stocks for the Long Run* does show historic returns on both a real and nominal basis, although it ignores costs and taxes.) We not only pander to, but reinforce, the optimistic bias of investors. Yet while there's no escaping inflation, it is easily possible to reduce both investment costs and taxes almost to the vanishing point. With only the will to do so, equity investors can count on (virtually) matching the market's gross return: *owning the stock market through a low-cost, low-turnover index fund*—the ultimate strategy for earning nearly 100 percent rather than 60 percent of the market's nominal annual return. *You can count on it!*

The bias toward optimism also permeates the world of commerce. Corporate managers consistently place the most optimistic possible face on their firms' prospects for growth—and are usually proven wrong. With the earnings guidance from the corporations they cover, Wall Street security analysts have, over that past two decades, regularly estimated average future five-year earnings growth. On average, the projections were for growth at an annual rate of 11.5 percent. But as a group, these firms met their earnings targets in only 3 of the 20 five-year periods that followed. And the actual earnings growth of these corporations has averaged only about one-half of the original projection—just 6 percent.

But how could we be surprised by this gap between guidance and delivery? The fact is that the aggregate profits of our corporations are closely linked, indeed almost in lockstep, with the growth of our economy. It's been a rare year when after-tax corporate profits accounted for less than 4 percent of U.S. gross domestic product, and they rarely account for much more than 8 percent. Indeed, since 1929, after-tax profits have grown at 5.6 percent annually, actually lagging the 6.6 percent growth rate of the GDP. In a dog-eat-dog capitalistic economy where the competition is vigorous and largely unfettered and where the consumer is king—more than ever in this Information Age—how could the profits of corporate America *possibly* grow faster than our GDP? *Don't count on it!*

Earnings: Reported, Operating, Pro Forma, *or Restated*

Our optimistic bias has also led to another serious weakness. In a trend that has attracted too little notice, we've changed the very definition of earnings. While *reported* earnings had been the, well, standard since Standard & Poor's first began to collect the data all those years ago, in recent years the standard has changed to *operating* earnings. Operating earnings, essentially, are reported earnings bereft of all those messy charges like capital write-offs, often the result of unwise investments and mergers of earlier years. They're considered "non-recurring," though for corporations as a group they recur with remarkable consistency.

During the past 20 years, *operating* earnings of the companies in the S&P index totaled $567. After paying $229 in dividends, there should have been $338 remaining to reinvest in the business. But largely a result of the huge "non-recurring" write-offs of the era, cumulative reported earnings came to just $507. So in fact there was just $278 to invest—20 percent less—mostly because of those bad business decisions. But it is *reported* earnings, rather than *operating* earnings, that reflect the ultimate reality of corporate achievement.

Pro forma earnings—that ghastly formulation that makes new use (or abuse) of a once-respectable term—that report corporate results net of unpleasant developments, is simply a further step in the wrong direction. What is more, even auditor-certified earnings have come under doubt, as the number of corporate earnings restatements has soared. During the past four years, 632 corporations have restated their earnings, nearly *five times* the 139 restatements in the comparable period a decade earlier. Do you believe that corporate financial reporting is punctilious? *Don't count on it!*

"Creative" Accounting

Loose accounting standards have made it possible to create, out of thin air, what passes for earnings. One popular method is making an acquisition and then taking giant charges described as "non-recurring," only to be reversed in later years when needed to bolster sagging operating results. But the breakdown in our accounting standards goes far beyond that: cavalierly classifying large items as "immaterial"; hyping the assumed future returns of pension plans; counting as sales those made to customers who borrowed the money from the seller to make the purchases; making special deals to force out extra sales at quarter's end; and so on. If you can't merge your way into meeting the numbers, in effect, just change the numbers. But what we loosely describe as *creative* accounting is only a small step removed from *dishonest* accounting. Can a company make it work forever? *Don't count on it!*

That said, I suppose it does little harm to calculate the stock market's price-earnings ratio on the basis of anticipated *operating* earnings.

The net result of using the higher (albeit less realistic) number is to make price-earnings ratios appear more reasonable (i.e., to make stocks seem cheaper). By doing so, the present p/e ratio for the S&P 500 index (based on 2002 estimates) comes to a perhaps mildly reassuring 18 times based on *operating* earnings, rather than a far more concerning 25 times based on *reported* earnings. But our financial intermediation system has far too much optimism embedded in it to promulgate the higher p/e number.

Nonetheless, it is folly to rely on the higher earnings figure (and resultant lower p/e) without recognizing the reality that in the long run corporate value is determined, not only by the results of the firm's current operations, but by the entire amalgam of investment decisions and mergers and combinations it has made. *And they don't usually work.* A recent *BusinessWeek* study of the $4 trillion of mergers that took place amid the mania of the late bubble indicated that fully 61 percent of them destroyed shareholder wealth. It's high time to recognize the fallacy that these investment decisions, largely driven to improve the *numbers*, actually improve the *business*. *Don't count on it!*

Peril #3: The Worship of Hard Numbers

Our financial market system is a vital part of the process of investing, and of the task of raising the capital to fund the nation's economic growth. We require active, liquid markets and ask of them neither more nor less than to provide liquidity for stocks in return for the promise of future cash flows. In this way, investors are enabled to realize the present value of a future stream of income at any time. But in return for that advantage there is the disadvantage of the moment-by-moment valuation of corporate shares. We demand hard numbers to measure investment accomplishments. *And we want them now!* Markets being what they are, of course, we get them.

But the consequences are not necessarily good. Keynes saw this relationship clearly, noting that "the organization of the capital markets required for the holders of *quoted* equities requires much more nerve, patience, and fortitude than for the holders of wealth in other forms . . . some (investors) will buy without a tremor unmarketable investments which, if they had (continuous) quotations available, would turn their hair gray." Translation: It's easier on the psyche to own investments that don't often trade.

This wisdom has been often repeated. It is what Benjamin Graham meant when he warned about the hazard faced by investors when "Mr. Market" comes by every day and offers to buy your stocks at the current price. Heeding the importuning of Mr. Market allows the emotions of the moment to take precedence over the economics of the long term, as transitory shifts in prices get the investor thinking about the wrong things. As this wise investor pointed out, "In the short-run, the stock market is a *voting* machine; in the long-run it is a *weighing* machine."*

Momentary Precision versus Eternal Imprecision

Yet the Information Age that is part of this generation's lot in life has led us to the belief that the momentary *precision* reflected in the price of a stock is more important than the eternal *imprecision* in measuring the intrinsic value of a corporation. Put another way, investors seem to be perfectly happy to take the risk of being precisely wrong rather than roughly right. This triumph of perception over reality was reflected—and magnified!—in the recent bubble. The painful stock market decline that we are now enduring simply represents the return to reality. Is the price of a stock truly a consistent and reliable measure of the value of the corporation? *Don't count on it!*

Among the principal beneficiaries of the focus on stock prices were corporate chief executives. Holding huge numbers of stock options, they were eager to "make their numbers," by fair means or foul, or something in between. As the numbers materialized, their stock prices soared, and they sold their shares at the moment their options vested, as we know now, often in "cashless" transactions with bridge loans provided by the company. But unlike all other compensation, compensation from fixed-price options was not considered a corporate expense.

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*Benjamin Graham and David Dodd, *Security Analysis* (1934, 1940; New York: McGraw-Hill, 2008), 70.

Such options came to be considered as "free," although, to avoid dilution, most corporations simply bought compensatory shares of stock (at prices far above the option prices) in the public market. It is not only that shares acquired through options were sold by executives almost as soon as they were exercised, nor that they were unencumbered by a capital charge nor indexed to the level of stock prices, that makes such options fundamentally flawed. It is that compensation based on raising the price of the stock rather than enhancing the value of the corporation flies in the face of common sense. Do stock options link the interests of management with the interests of long-term shareholders? *Don't count on it!*

Ignorant Individuals Lead Expert Professionals into Trouble

Years ago, Keynes worried about the implications for our society when "the conventional valuation of stocks is established [by] the mass psychology of a large number of ignorant individuals." The result, he suggested, would lead to violent changes in prices, a trend intensified as even expert professionals, who, one might have supposed, would correct these vagaries, follow the mass psychology, and try to foresee changes in the public valuation. As a result, he described the stock market as "a battle of wits to anticipate the basis of conventional values a few months hence rather than the prospective yield of an investment over a long term of years."*

A half-century ago, I cited those words in my senior thesis—and had the temerity to disagree. Portfolio managers in a far larger mutual fund industry, I suggested, would "supply the market with a demand for securities that is steady, sophisticated, enlightened, and analytic, 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." Well, 50 years later, it is fair to say that the worldly wise Keynes has won, and that the callowly idealistic Bogle has lost.

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*John Maynard Keynes, *The General Theory of Employment, Interest and Money* (1936; New York: Harcourt, Brace, 1964), 155.

And the contest wasn't even close! Has the move of institutions from the wisdom of long-term investment to the folly of short-term speculation enhanced their performance? *Don't count on it!*

Economics Trumps Emotion—Finally

In those ancient days when I wrote my thesis, investment committees (that's how the fund management game was then largely played) turned over their fund portfolios at about 15 percent per year. Today, portfolio managers (that's how the game is now played) turn over their fund portfolios at an annual rate exceeding 110 percent—for the average stock in the average fund, an average holding period of just 11 months. Using Keynes's formulation, "enterprise" (call it "investment fundamentals") has become "a mere bubble on a whirlpool of speculation." It is the triumph of emotions over economics.

But it is an irrefutable fact that in the long run it is economics that triumphs over emotion. Since 1872, the average annual real stock market return (after inflation but before intermediation costs) has been 6.5 percent. The real investment return generated by dividends and earnings growth has come to 6.6 percent. Yes, speculative return slashed investment return by more than one-half during the 1970s and then tripled(!) it during the 1980s and 1990s. But measured today, after this year's staggering drop in stock prices, speculative return, with a net negative annual return of −0.1 percent during the entire 130-year period, on balance neither contributed to nor materially detracted from investment return. Is it wise to rely on future market returns to be enhanced by a healthy dollop of speculative return? *Don't count on it!*

The fact is that when perception—interim stock prices—vastly departs from reality—intrinsic corporate values—the gap can be reconciled only in favor of reality. It is simply impossible to raise reality to perception in any short timeframe; the tough and demanding task of building corporate value in a competitive world is a long-term proposition. Nonetheless, when stock prices lost touch with corporate values in the recent bubble, too many market participants seemed to anticipate that values would soon rise to justify prices. Investors learned, too late, the lesson: *Don't count on it!*

Peril #4: The Adverse Real-World Consequences of Counting

When we attribute certitude to history, when we constantly bias our numbers to the positive side, and when we worship the pleasing precision of momentary stock prices above the messy imprecision of intrinsic corporate values, the consequences go far beyond unfortunate numeric abstractions. These perils have societal implications, and most of them are negative.

For example, when investors accept stock market returns as being derived from a type of actuarial table, they won't be prepared for the risks that arise from the inevitable uncertainty of investment returns and the even greater uncertainty of speculative returns. As a result, they are apt to make unwise asset allocation decisions under the duress—or exuberance—of the moment. Pension plans that make this mistake will have to step up their funding when reality intervenes. And when investors base their retirement planning on actually achieving whatever returns the financial markets are generous enough to give us and tacitly ignore the staggering toll taken by intermediation costs and taxes, they save a pathetically small portion of what they ought to be saving in order to assure a comfortable retirement. Nonetheless, wise investors can totally avoid both the Scylla of costs and the Charybdis of taxes by educating themselves, by heeding the counsel of experienced professionals, or by attending the wisdom of academe.

An Ill-Done System of Capital Formation

But the peril of our preference for looking to stock prices—so easy to measure by the moment—rather than to corporate values—so hard to measure with precision—as our talisman is less easily overcome. Lord Keynes was surely right when he wrote, "when enterprise becomes a mere bubble on a whirlpool of speculation, the job [of capital formation] is likely to be ill-done." In the post-bubble environment, the job *has* been ill-done. But while some of the speculation has now been driven from the system and the day-trader may be conspicuous by his absence, the mutual fund industry still needs to get its high-wire act together and at last go back to the future by returning long-term investment policy to its earlier primacy over short-term speculation.

It is not just our capital markets that have been corrupted by the perils of relying so heavily on the apparent certitude of numbers. It is our whole society. The economic consequences of managing corporations by the numbers are both extensive and profound. Our financial system has, in substance, challenged our corporations to produce earnings growth that has not been and cannot be sustained. When corporations fail to meet their numeric targets the hard way—over the long-term, by raising productivity, improving old products and creating new ones, providing services on a more friendly, more timely, and more efficient basis, challenging the people of the organization to work more effectively together (and those are the ways that our best corporations achieve success)—they are compelled to do it in other ways.

One of these ways, of course, is the aggressive merger-and-acquisition strategy I've earlier noted. Even leaving aside the commonplace that most mergers fail to achieve their goals, the companies that followed these strategies were well-described in a recent *New York Times* op-ed essay as "serial acquirers [whose] dazzling number of deals makes an absence of long-term management success easy to hide."* Tyco International, for example, acquired 700(!) companies before the day of reckoning came. But the final outcome of the strategy, as the *Times* piece explained, was almost preordained: "Their empires of [numbers] hype can be undone very quickly by market discipline." Are such strategies a formula for long-run success? *Don't count on it!*

In this context, it's amazing how much of companies' returns today are based on financial factors rather than operating factors. The pension plan assets of the 30 companies in the Dow-Jones Industrial average now total $400 billion, not far from the corporations' collective book value of $700 billion. Off–balance sheet financial schemes proliferate (or *did*!). Selling put-options to reduce the cost of repurchasing shares and avoid the potential dilution of stock options helped prevent earnings penalties in the boom, but has come back to deplete corporate coffers in the bust. And lending by major corporations to enable consumers to buy their wares has skyrocketed. Perhaps unsurprisingly, it isn't looking so good in today's economic environment.

*Jeffrey Sonnenfeld, *New York Times*, June 5, 2002.

When Paper Covers Rock, What Comes Next?

Too many so-called industrial companies have become financial companies—companies that *count* rather than *make*. (Witness the fact that the senior aide to the CEO is almost invariably the chief financial officer, often viewed by the investment community as the *eminence gris*.) Such companies, again quoting the *New York Times* article, "base their strategies not on understanding the businesses they go into, but assume that by scavenging about for good deals, they can better allocate their financial resources than can existing financial markets." As we now observe the consequences of this strategy, we come to a painful realization. *Don't count on it!*

You may remember the children's game in which rock breaks scissors, scissors cut paper, and paper covers rock. In manias, as prices lose touch with values, paper indeed covers rock. "Paper" companies that *count* have acquired "rock" companies that *make*, and the results have been devastating. When I mention AOL/Time Warner, Qwest/U.S. West, and WorldCom/MCI, I don't have to tell you which is paper and which is rock. These are among the most poignant examples of a phenomenon in whose aftermath hundreds of thousands of loyal long-term employees have lost their jobs, and their retirement savings have been slashed unmercifully.

That the penalties for our financial mania are borne by our society was well-stated in a perceptive op-ed piece in the *Wall Street Journal*: "Stock prices are not simply abstract numbers. [They] affect the nature of the strategies the firm adopts and hence its prospects for success, the company's cost of capital, its borrowing ability, and its ability to make acquisitions. *A valuation unhinged by the underlying realities of the business can rob investors of savings, cost people far more innocent than senior management their jobs, and undermine the viability of suppliers and communities*."* Yes, the human consequences of excessive reliance on numbers, as we now know, can be remarkably harsh.

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*Joseph Fuller and Michael C. Jensen, *Wall Street Journal*, December 31, 2001.

Counting at the Firm Level

The perils of excessive numeracy don't end there. Even otherwise sound companies dwell too heavily on what can be measured—market share, productivity, efficiency, product quality, costs—and set internal goals to achieve them. But when *measures* become *objectives*, they are often counterproductive and self-defeating. Most measurements are inherently short-term in nature, but far more durable qualities drive a corporation's success over the long-term. While they cannot be measured, character, integrity, enthusiasm, conviction, and passion are every bit as important to a firm's success as precise measurements. (Call it the six-sigma syndrome.) It is *human beings* who are the prime instrument for implementing a corporation's strategy. If they are inspired, motivated, cooperative, diligent, and creative, the stockholders will be well served.

Yet recent years have shown us that when ambitious chief executives set aggressive financial objectives, they place the achievement of those objectives above all else—even above proper accounting principles and a sound balance sheet, even above their corporate character. Far too often, all means available—again, fair or foul—are harnessed to justify the ends. As good practices are driven out by bad, and the rule of the day becomes "everyone else is doing it, so I will too," a sort of Gresham's law comes to prevail in corporate standards.

"Management by measurement" is easily taken too far. I recently read of a chief executive who called for earnings growth from $6.15 per share in 2001 to a nice round $10 per share in 2005*—an earnings increase of almost 15 percent per year—but without a word about how it would be accomplished. I don't believe that the greater good of shareholders is served by such a precise yet abstract numeric goal. Indeed what *worries* me is not that it *won't* be achieved, but that it *will*. In an uncertain world, the company may get there only by manipulating the numbers or, even worse, relying on cutbacks and false economies, and shaping everything that moves (including the human beings who will have to bend to the task) to achieve the goal. *But at what cost?* The sooner companies cease their aggressive "guidance," the better.

*2010 update: Earnings topped the $10 per share target in 2009.

For I believe that a quarter-century from now the companies that will be leading the way in their industries will be those that make their earnings growth, not the *objective* of their strategy, but the *consequence* of their corporate performance. Will the numbers *counters* outpace the product *makers*? *Don't count on it!*

An Individual Perspective

Lest I be accused of *innumeracy*, however, please be clear that I'm not saying that numbers don't matter. Measurement standards—*counting*, if you will—is essential to the communication of financial goals and achievements. *I know that.* But for the past 28 years I've been engaged in building an enterprise—and a *financial* institution at that—based far more on the sound implementation of a few commonsense investment ideas and an enlightened sense of human values and ethical standards than on the search for quantitative goals and statistical achievements. Vanguard's market share, as I've said countless times, must be a *measure*, not an *objective*; it must be *earned*, not *bought*. Yet the fact is that our market share of fund industry assets has risen, without interruption, for the past 22 years. (We did benefit, greatly, by being a *mutual* company, with neither private nor public shareholders.)

Our strategy arose from a conviction that the best corporate growth comes from putting the horse of doing things for clients ahead of the cart of earnings targets. *Growth must be organic, rather than forced.* And I've believed it for a long time. Indeed, here is how I closed in my 1972 annual message to the employees of Wellington Management Company (which I then headed) about giving too much credence to the counting of numbers:*

> The first step is to measure what can be easily measured. This is okay as far as it goes. The second step is to disregard that which cannot be measured, or give it an arbitrary quantitative value. This is artificial and misleading. The third step is to presume that what cannot be measured really is not very

* Quoting pollster Daniel Yankelovich.

> important. This is blindness. The fourth step is to say that what cannot be measured does not really exist. This is suicide.

There is, then, a futility in excessive reliance on numbers, and a perversity in trying to measure the immeasurable in our uncertain world. So when *counting* becomes the name of the game, our financial markets, our corporations, and our society pay the price. *So don't count on it!*

Numbers are a necessary tool and a vital one. But they are a *means* and not an end, a condition *necessary* to measure corporate success, but not a condition *sufficient*. To believe that numbers—in the absence of the more valuable albeit immeasurable qualities of experience, judgment, and character—are all that illuminate the truth is one of the great failings of our contemporary financial and economic system. Wise financial professionals and academics alike should be out there searching for a higher, more enlightened set of values. So, having begun this essay by describing how my career in the academy began, I'll close with a two-centuries-old quotation from the Roman poet Horace about the proper role of the academy:

> Good Athens gave my art another theme
> To sort what is from what is merely seen
> And search for truth in groves of academe.

Part Two

THE FAILURE OF CAPITALISM

After the egregious financial speculation, the stock market crash, and the deep economic recession of 2007–2009, even the most articulate and powerful believers in the ability of free markets to regulate themselves came to recognize that modern-day capitalism has failed our society. In a stunning admission, Alan Greenspan, former chairman of the Federal Reserve Board, conceded that he had found "a flaw in the model that I perceived as the critical functioning structure that defines how the world works." An equally surprising concession came in a 2009 book from widely respected federal judge Richard Posner, a leader in the "Chicago School" of *laissez-faire* economics. Its title gets right to the point: *A Failure of Capitalism*.

I begin Part Two seeking to answer the question, "What Went Wrong in Corporate America?" In 2003, when I delivered this lecture at the Community Forum of the Bryn Mawr (PA) Presbyterian Church, the handwriting was on the wall: "stock market mania . . . the rise of the imperial chief executive officer . . . the failure of our (corporate) gatekeepers . . . the change in our financial institutions from being stock *owners* to stock *traders*. . . ." It turns out that the burst in the stock market bubble that I described in those remarks would, but five years later, be echoed in the burst of a real estate bubble that would lead to an even larger stock market collapse and the worst recession in the U.S. economy since the Great Depression. While I was belatedly aware of the mortgage mess, it was of a piece with the financial manipulation of corporate America that I describe toward the close of Chapter 6.

From the perspective of 2009, I examine the after-effects of the numerous failures in our system of free-market capitalism in Chapter 7, "Fixing a Broken Financial System." I illustrate my main points with three examples: Alan Greenspan and his apologia; Bernard Madoff and his Ponzi scheme; and President Barack Obama's articulate response to this failure in his inaugural speech, calling for "a new era of responsibility." Despite the awesome question facing our society—whether we have enough character, virtue, and courage to reform the system—I strike an optimistic note on the financial crisis that America has endured: "This, too, shall pass away."

The failure of capitalism is in large measure a failure of personal and professional values. When I was asked in 2007 to present a lecture at Princeton University on the subject of "vanishing treasures" in our society, I chose to illustrate the subject with the loss of "Business Values and Investment Values," which is the title of Chapter 8. The main points are: (1) Modern-day business standards have come to overwhelm traditional professional standards; and (2) our once-triumphant *ownership* society has been supplanted by a new *agency* society in which our institutional investor/agents have placed their own interests ahead of those of their principals, whom they are duty-bound to serve. Unless we build a new *fiduciary* society that demands virtuous conduct and a return to traditional values, I conclude that the treasures that made American business the dominant force in our nation's growth will indeed vanish. My 2009 op-ed essay in the *Wall Street Journal*—"A Crisis of Ethic Proportions"—concisely summarizes these views (Chapter 9).

In Chapter 10, I explain the failure of capitalism in part by the inevitable failure of the laws of probability when applied to the financial markets. As I examine the role of risk in the financial markets, I rely on the famous "Black Swan" formulation of the British philosopher Sir Karl Popper (1902–1994) to describe surprising events that are "outliers," beyond the realm of our regular expectations. In "Black Monday and Black Swans," published in the *Financial Analysts Journal* in early 2008, I draw the distinction between risk (an event with *measurable* distributions, such as a roll of the dice, even our mortality) and uncertainty (which is, simply put, *immeasurable*). The American economist Hyman Minsky (1919–1996) was right on the mark when he pointed out that rampant speculation in our financial sector inevitably flows over into our productive economy. In accord with his finding, I close by noting that "some surprising event . . . will surely come to pass . . . when it comes, [it] will be just one more Black Swan." That view was promptly validated by the market crash that followed.

That we cannot seem to learn from our historical experience in market crashes is illustrated in Chapter 11. In "The Go-Go Years," I go way back in time to describe the boom and bust in the wild and crazy era that began in the mid-1960s and essentially continued until the stock market collapse of 1973–1974. In this essay for a new edition of "Adam Smith's" *Supermoney* in 2006, I described my role as a witness to, and a participant in, this era. My own involvement with go-go investing proved to be a personal and professional disaster, but ultimately led to the creation of the Vanguard Group as an antidote to the insanity. While I paid a heavy price in terms of my career, I learned from it, and gained the perspective that helped me anticipate, first, the market crash of 2000–2003, and then the market crash of 2007–2009. Investors will, I pray, learn from these painful lessons of financial history that have recurred over and over again for centuries.

Chapter 6

What Went Wrong in Corporate America?*

As so many of us have read in the gospel of Matthew: "A prophet is not without honor, save in his own country." Yet by your invitation to speak to you this evening you honor me, even as I stand here in my own country! I live right down the road from this great church, and for the better part of a half-century have regularly attended Sunday worship services in the thrall of such extraordinary preachers as David Watermulder and Eugene Bay, who have helped me beyond measure in gaining enlightenment, inspiration, and faith.

While my remarks center on what went wrong in corporate America, being in this sanctuary compels me to begin with some 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 have become what Campbell calls "a bottom-line society." But our society, I think, is measuring the *wrong* bottom line: form over substance, prestige over virtue, money over achievement, charisma over character, the ephemeral over the enduring.

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*Based on a lecture as part of the Community Forum Distinguished Speaker Series at the Bryn Mawr (PA) Presbyterian Church, February 24, 2003.

†Quoted in Warren G. Bennis, "Will the Legacy Live On?" *Harvard Business Review* (February 1, 2002), 95.

I'm sure it does not escape you that Joseph Campbell's analogy proved to be ominous. We have now witnessed the total destruction of the proudest of all America's towers of commerce, at New York's World Trade Center. We have seen a $7 trillion collapse of the aggregate market value of America's corporations—from $17 trillion to $10 trillion, in the worst stock market crash since 1929–1933. And we've seen the reputations of business leaders transmogrified from mighty lions of corporate success to self-serving and less-than-trustworthy executives, with several even doing "perp walks" for the television cameras.

Our bottom-line society has a good bit to answer for. As United Kingdom's Chief Rabbi Jonathan Sacks put it: "When everything that matters can be bought and sold, when commitments can be broken because they are no longer to our advantage, when shopping becomes salvation and advertising slogans become our litany, when our worth is measured by how much we earn and spend, then the market is destroying the very virtues on which in the long run it depends."*

So let's think about what went wrong in our capitalistic system, about what's now beginning to go right, and about what investors can do as a part-owner of corporate America. Whether you own a common stock or a share in a mutual fund, or participate in a private retirement plan, you have a personal interest in bringing about reform. Both as shareholders and as citizens, each of us must accept the responsibility to build a better corporate world.

Capitalism—A Brief Review

Capitalism, *Webster's Third International Dictionary* tells us, is "an economic system based on corporate ownership of capital goods, with investment determined by private decision, and with prices, production, and the distribution of goods and services determined mainly in a free market." Importantly, I would add, "a system founded on honesty, decency, and trust," for these attributes, too, have been clearly established in its history.

As the world moved from an agrarian society to an industrial society during the 18th and 19th centuries, capitalism came to flourish. Local

*Jonathan Sacks, "Markets and Morals," the 1998 Hayek Lecture (London: Institute of Economic Affairs, 1998).

communities became part of national (and then international) commerce, trading expanded, and large accumulations of capital were required to build the factories, transportation systems, and banks on which the new economy would depend. Surprising as it may seem, at the heart of this development, according to an article in *Forbes*' recent 85th Anniversary issue,* were the Quakers. In the 1700s and early 1800s, probably because their legendary simplicity and thrift endowed them with the capital to invest, they dominated the British economy, owners of more than half of the country's ironworks and key players in banking, consumer goods, and transatlantic trading. Their emphasis on reliability, absolute honesty, and rigorous record-keeping gave them trust as they dealt with one another, and other observant merchants came to see that being trustworthy went hand-in-hand with business success. Self-interest, in short, demanded virtue.

This evolution, of course, is exactly what the great Scottish economist/philosopher Adam Smith expected. Writing in *The Wealth of Nations* in 1776, he famously said, "The uniform and uninterrupted effort to better his condition, the principle from which (both) public and private opulence is originally derived, is frequently powerful enough to maintain the natural progress of things toward improvement. . . . Each individual neither intends to promote the public interest, nor knows how much he is promoting it . . . [but] by directing his industry in such a matter as its produce may be of the greatest value, *he is led by an invisible hand to promote an end which was no part of his intention*."

And so it was to be, the *Forbes* essay continued, that "the evolution of capitalism has been in the direction of more trust and transparency and less self-serving behavior. Not coincidentally, this evolution has brought with it greater productivity and economic growth. Not because capitalists are naturally good people, [but] because, the benefits of trust—of being trusting and of being trustworthy—are potentially immense, and because a successful market system teaches people to recognize those benefits . . . a virtuous circle in which an everyday level of trustworthiness breeds an everyday level of trust." The system *works!*

Or at least it *did* work. And then something went wrong. The system changed—"a pathological mutation in capitalism," as an essay in

*James Surowiecki, *Forbes*, December 23, 2002.

the *International Herald Tribune** described it. The classic system—*owners*' capitalism—had been based on a dedication to serving the interests of the corporation's *owners* in 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," the author says, "the markets had so diffused corporate ownership *that no responsible owner exists*. This is morally unacceptable, but also a corruption of capitalism itself."

The Broken Circle

What caused the mutation from virtuous circle to vicious circle? It's easy to call it a failure of character, a triumph of hubris and greed over honesty and integrity. And it's even easier to lay it all to "just a few bad apples." But while only a tiny minority of our business and financial leaders have been implicated in criminal behavior, I'm afraid that the barrel itself—the very structure that holds all those apples—is bad. While that may seem a harsh indictment, I believe it is a fair one. Consider that *Predators and Profits*, a 2003 book by Reuters editor Martin Howell, lists fully 176(!) "red flags," each of which describes a particular shortcoming in our recent business, financial, and investment practices, many of which I've witnessed with my own eyes.

It is now crystal-clear that our capitalistic system—as all systems sometimes do—has experienced a profound failure, a failure with a whole variety of root causes, each interacting and reinforcing the other: the stock market mania, driven by the idea that we were in a New Era; the notion that our corporations were trees that could grow not only to the sky but beyond; the rise of the imperial chief executive officer; the failure of our gatekeepers—those auditors, regulators, legislators, and boards of directors who forgot to whom they owed their loyalty—the change in our financial institutions from being stock *owners* to being stock *traders*; the hype of Wall Street's stock promoters;

*William Pfaff, September 9, 2002.

the frenzied excitement of the media; and, of course, the eager and sometimes greedy members of the investing public, reveling in the easy wealth that seemed like a cornucopia, at least while it lasted. There is plenty of blame to go around. But even as it drove stock prices *up*, this happy conspiracy among all of the interested parties drove business standards *down*. Yes, the victory of investors in the Great Bull Market had a thousand fathers. But the defeat in the Great Bear Market that followed seems to be an orphan.

If we had to name a *single* father of the bubble, we would hardly need a DNA test to do so. *That father is executive compensation, made manifest in the fixed-price stock option.* When executives are paid for raising the price of their company's stock rather than for increasing their company's value, they don't need to be told what to do: Achieve strong, steady earnings growth and tell Wall Street about it. Set "guidance" targets with public pronouncements of your expectations, and then meet your targets—and do it consistently, without fail. First, do it the old-fashioned way, by increasing volumes, cutting costs, raising productivity, bringing in technology, and developing new products and services. Then, when *making it and doing it* isn't enough, meet your goals by *counting it*, pushing accounting principles to their very edge. And when that isn't enough, *cheat*. As we now know, too many firms did exactly that.

The stated rationale for fixed-price stock options is that they "link the interests of management with the interest of shareholders." That turns out to be a falsehood. For managers don't *hold* the shares they acquire. They *sell* them, and promptly. Academic studies indicate that nearly *all* stock options are exercised as soon as they vest, and the stock is sold *immediately*. Indeed, the term "cashless exercise"—where the firm purchases the stock for the executive, sells it, and is repaid when the proceeds of the sale are delivered—became commonplace. (Happily, it is no longer legal.) We have rewarded our executives, not for long-term economic reality, but for short-term market perception.

Creating Wealth—for Management

Even if executives were required to hold their stock for an extended period, however, stock options are fundamentally flawed. They are not adjusted for the cost of capital, providing a free ride even for executives who produce only humdrum returns. They do not take into account dividends, so there is a perverse incentive to avoid paying them. Stock options reward the *absolute* performance of a stock rather than performance *relative* to peers or to a stock market index, so executive compensation tends to be like a lottery, creating unworthy centimillionaires in bull markets and eliminating rewards even for worthy performers in bear markets.

While these issues could be resolved by the use of restricted stock, or by raising the option price each year, or by linking the stock performance with a market index, such sensible programs were almost never used. Why? Because those alternative schemes require corporations to count the cost as an *expense*. (Heaven forbid!) The cost of fixed-price options alone is conspicuous by its absence on the company's expense statement. As the compensation consultants are wont to say, these stock options are "free."

The net result of the granting of huge options to corporate managers, all the while overstating earnings by ignoring them as an expense, is that total executive compensation went through the roof. In the early 1980s, the compensation of the average chief executive officer was 42 times that of the average worker; by the year 2000, the ratio had soared to 531(!) times. The rationale was that these executives had "created wealth" for their shareholders. But if we actually *measure* the success of corporate America, it's hard to see how that could be the case. During that two-decade period, while corporations had *projected* their earnings growth at an average annual rate of 11.5 percent, they actually *delivered* growth of 6 percent per year—only half of their goal, and even less than the 6.5 percent growth rate of our economy. How that lag can be the stuff to drive *average* CEO compensation to a cool $11 million in 2001 is one of the great anomalies of the age.

The fact is that the executives had "created wealth" for themselves, but not for their shareowners. And when the stock market values melted away, they had long since sold much of their stock. Let me give you a few examples:

- **AOL Time Warner**. In an extraordinary example of the delusions of grandeur that characterized the Information Age, the news of this marriage of the "New Economy" and the "Old Economy" as

2000 began sent the price of Time Warner soaring to a then-all-time high of $90 per share. But AOL's revenues began to tumble almost immediately, and the company recently reported losses totaling *$98 billion*(!). But in the first three years, the founder of AOL (and the chairman of the merged company) sold nearly *one-half-billion-dollars*' worth of his shares, mostly at boom-level prices. Today, the stock languishes at $10, down almost 90 percent from the high.

- **Sprint**. When they agreed to merge with WorldCom in October 1999, the directors accelerated the vesting of its executives' stock options. Although the merger scheme quickly fell apart, two senior executives quickly sold $290 million of their optioned shares at prices apparently in the $60 range. They also paid the firm's auditors $5.8 million(!) for a clever plan to circumvent the tax laws, and pay not a penny of tax on these gains. (Yet! The IRS is now challenging the tax-evasion device.) Today, Sprint sells at about $13 per share, down 83 percent from its high.
- **General Electric**. While clearly a blue-chip company, the price of its shares has dropped from $60 to $23 per share since August 2000, a cool $370 billion reduction in its market value. Amid growing investor concern about its tendency to smooth its reported earnings by "creative accounting" practices, its once-legendary leader, Jack Welch, is not looking so good lately. Yet his total compensation from 1997 through 2000 came to nearly $550 million, plus another $200 million from the sale of option shares, some at prices of $55 or more. Now retired, he is still well-paid: a pension of $357,000, plus another $377,000 for consulting services, a total of $734,000—*per month*! (He must enjoy an expensive lifestyle that leaves little to spare, for a recent report placed his monthly charitable giving at just $614.) Such is the world of executive compensation in corporate America today.

Clearly, *owners*' capitalism had been superseded by *managers*' capitalism, and managers' capitalism has created great distortions in our society. And chief executives, with all their fame, their jet planes, their perquisites, their pension plans, their club dues, and their Park Avenue apartments, seem to forget that they are employees of the corporation's owners, and the owners apparently have forgotten it, too. But their behavior has not gone unnoticed. They are now close to the bottom of the barrel in public trust. A recent survey showed that while 75 percent of the general public trust shopkeepers, 73 percent trust the military, and 60 percent trust doctors, only 25 percent trust corporate executives, slightly above the 23 percent that trust used-car dealers.

The Failure of the Gatekeepers

What happened? How did it all come to pass? Basically, we have had a failure of just about every gatekeeper we've traditionally relied on to make sure that corporations would be operated with honesty and integrity, and in the interests of their owners. Independent auditors became business partners of management. Government regulations were relaxed, and our elected officials not only didn't care, but actually aided and abetted the malfeasance. The elected representatives of the owners—the Boards of Directors—looked on the proceedings with benign neglect, apparently unmindful of the impending storm.

Let's begin with our public accountants. It would seem obvious that they should have constituted the first line of defense against pushing accounting standards to the edge and beyond, and, hard as it may be to discover, at least some defense against fraud. But the accounting standards themselves had gradually become debased. "Cookie jar" reserves were created after corporate mergers, and off–balance sheet special-purpose enterprises flourished, creating debt invisible to the public eye and giving "financial engineering" a whole new meaning. Of course the pressure has always been on accountants to agree with the corporate clients who pay them for their services. But over the past decade, to that seemingly unavoidable conflict of interest has been added the conflict of being business partners with their clients, providing management consulting services whose revenues often dwarf their audit fees. In the year 2000, for example, U.S. corporations paid their auditors nearly $3 billion for auditing services, only one-half of the $6 billion paid for consulting.

This added pressure on accountants to accede to management's demands, coming as managers promised quarterly earnings growth that was impossible to deliver, led to a company's *numbers* becoming more important than a company's *business*—a direct contradiction to the advice given to his colleagues by James Anyon, America's first accountant, way back in 1912: "Think and act upon facts, truths, and principles, and regard figures only as things to express them . . . so proceeding, [you will be] a credit to one of the truest and finest professions in the land."* The "creative accounting" of the recent era has taken us a long, long way from the wisdom of relying on figures to present facts.

On the regulatory and legislative front, our public servants were also pressed into relaxing existing regulations for accounting standards and disclosure. When proposals for reform came—for example, requiring that stock options *actually be counted* as a compensation expense, or prohibiting accountants from providing consulting services to the firms they audit—the outrage of our legislators, inspired (if that's the right word) both by political contributions and by the fierce lobbying efforts of both corporate America and the accounting profession, thwarted these long-overdue changes. Too many of our elected officials ought to be ashamed of themselves for their "play-for-pay" morality. Two centuries ago, Thomas Jefferson said, "I hope we shall crush in its birth the aristocracy of our monied corporations which dare already to challenge our government in a trial of strength, and bid defiance to the laws of our country." We didn't, of course, do so. But rather than defying our laws in this recent era of managers' capitalism, our monied corporations thwarted remedial legislation (it's a lot easier!), and compromised the highest interests of their investors.

The Role of the Board

That brings us to the board of directors. It is their job to be good stewards of the corporate property entrusted to them. In medieval England, the common use of the word "stewardship" meant the responsible use of a congregation's resources *in the faithful service of God*. In the corporate sense, the word has come to mean the use of the enterprise's resources in the faithful service of its owners. But somehow the system let us

*As quoted in David Boyle, *The Tyranny of Numbers* (London: Harper-Collins, 2000), 8.

down. As boards of directors far too often turned over to the company's managers the virtually unfettered power to place their own interests first, both the word and the concept of stewardship became conspicuous by their absence from corporate America's values.

Serving as rubber-stamps for management, company directors have been responsible for approving option plans that are grossly excessive; audits in which the auditors are not independent appraisers of financial statements but partners of management; and mergers based on forcing the numbers rather than on improving the business. (As it turned out, according to *BusinessWeek*, 63 percent of all mergers have destroyed corporate value.) Directors also approved ethical codes in which words like "integrity," "trust," and "vision" were the order of the day, but corporate actions were another story. Some 60 percent of corporate employees, for example, report that they have observed violations of law or company policy at their firms, and 207 of 300 "whistleblowers" report they have lost their jobs as a result.

Yet our society has lionized our boards of directors nearly as much as our vaunted CEOs. Early in 2001, for example, *Chief Executive* magazine told us that "dramatic improvements in corporate governance have swept through the American economic system, [thanks to] enlightened CEOs and directors who voluntarily put through so many [changes] designed to make the operations of boards more effective." In particular, the magazine praised a certain "New Economy" company, "with a board that works hard to keep up with things . . . and working committees with functional responsibilities where disinterested oversight is required," a company whose four highest values were stated as, "Communication; Respect; Excellence; and Integrity—open, honest, and sincere. . . . We continue to raise the bar for everyone [because] the great fun here will be for all of us to discover just how good we can really be."* As it happens, we *do* now know just how good it could be: The company, so good that its board was named the third best among all of the thousands of boards in corporate America for 2000, is *bankrupt*. While its executives reaped billions in compensation, its employees are jobless, their retirement savings obliterated. Its reputation is shredded beyond repair. It was, of course, Enron.

*Robert W. Lear and Boris Yaritz, "Boards on Trial," *Chief Executive*, October 2000, 40.

The board of directors is the ultimate governing body of the corporation, and the directors are stewards charged with the responsibility of preserving and building the company over the long term. Yet the directors of corporate America couldn't have been unaware of the management's aggressive "earnings guidance"; nor of the focus on raising the price of the stock, never mind at what cost to the value of the corporation; nor of the fact that the lower the dividend the more capital the company retains; nor that it was management that hired the consultants who recommended to the compensation committee higher compensation for that very same management, year after year, even when its actual accomplishments in building the business were hardly out of the ordinary. Surely it is fair to say that it is our corporate directors who should bear the ultimate responsibility for what went wrong with corporate America.

Oh, No They Shouldn't!

Or should they? Why should the board bear the ultimate responsibility when it doesn't *have* the ultimate responsibility? Of course the directors' responsibility is large, indeed, but it is the stockholders themselves who bear the *ultimate* responsibility for corporate governance. And as investing has become institutionalized, stockholders have gained the *real*—as compared with the *theoretical*—power to exercise their will. Once owned largely by a diffuse and inchoate group of individual investors, each one with relatively modest holdings, today the ownership of stocks is concentrated—for better or worse—among a remarkably small group of institutions whose potential power is truly awesome. The 100 largest managers of pension funds and mutual funds alone now represent the ownership of one-half of all U.S. equities: *absolute control over corporate America.* Together, these 100 large institutional investors constitute the great 800-pound gorilla who can sit wherever he wants to sit at the board table.

But with all that power has come little interest in corporate governance. That amazing disconnection between the potential and the reality—awesome power, yet largely unexercised—reminds me of the original version of the motion picture *Mighty Joe Young.* In the film, the protagonist was a fierce gorilla who destroyed every object in his path. But whenever he heard the strains of "Beautiful Dreamer" he became serene and compliant. Not to push this analogy too far—especially for those who have not seen the film!—but I fear that, as institutional managers consider their responsibility for good corporate citizenship, they are hearing the sweet strains of "Beautiful Dreamer" playing in the background.

Yet mutual fund managers could hardly have been ignorant of what was going on in corporate America. Even before the stock market bubble burst, the industry's well-educated, highly trained, experienced professional analysts and portfolio managers *must* have been poring over company fiscal statements; evaluating corporate plans; and measuring the extent to which long-term corporate goals were being achieved, how cash flow compared with reported earnings, and the extent to which those ever-fallacious "pro-forma" earnings diverged from the reality. Yet few, if any, voices were raised. Somehow, our professional investors either didn't understand, or understood but ignored, the house of cards that the stock market had become. We have worshiped at the altar of the precise but ephemeral price of the stock, forgetting that the eternal sovereign is the intrinsic value of the corporation—simply the discounted value of its future cash flow.

We have yet to accept our responsibility for our abject failure, for the fact is that we have become, not an *own-a-stock* industry, but a *rent-a-stock* industry. During the past year, for example, the *average* equity fund turned over its portfolio at a 110 percent rate—meaning that the average stock was held for just *11 months.* When a company's stock may not even remain in a fund's portfolio by the time the company's next annual meeting rolls around, proxy voting and responsible corporate citizenship will rarely be found on the fund manager's agenda. What is more, money managers may avoid confrontation because even valid corporate activism could hurt the manager's ability to attract the assets of a corporation's pension account and 401(k) thrift plan, or limit its analysts' access to corporate information. Further, despite convincing information to the contrary, fund managers generally perceive only tenuous linkage between governance and stock price. But for whatever reason, the record clearly shows that the stockowners themselves—and especially the mutual fund industry—pay only sparse attention to corporate governance issues. "We have met the enemy, and he is us."

Actions and Reactions

As Sir Isaac Newton said, "for every action there is an equal and opposite reaction," and the reaction to the stock market boom and the mismanagement of so many of our corporations, to state the obvious, is already upon us. The first reaction to the bull market, of course, was the bear market that holds us in its throes to this day. The stock market, having quickly doubled from the start of 1997 to the high in March 2000, then dropped by half through mid-October 2002. That combination of percentages—plus 100 percent, then minus 50 percent—of course produces a net gain of *zero*. (Think about it!) But with the modest recovery that then ensued, stocks are just 10 percent higher than their levels were when 1997 began.

The sharp decline, it seems to me, has brought us "back to (or at least toward) normalcy" in valuation. And even *after* the Great Bear Market, the return on stocks during 1982 through 2002 averaged 13 percent per year, surely an attractive outcome for long-term stock owners. Through the miracle of compounding, those who owned stocks in 1982 and still held them in 2002 had multiplied that capital *10 times* over. So for all of the stock market's wild and wooly extremes, *owners* who bought and held common stocks have been well-compensated for the risks they assumed. For such investors, the coming of the bubble and then its going—the *boom* and then the *bust*—simply did not matter.

But that doesn't mean there weren't winners and losers during the mania—and lots of both. Simply put, the winners were those who *sold* their stocks in the throes of the halcyon era that is now history. The losers were those who bought them. Let's think first about the winners. A large proportion of these shares that were sold were those of corporate executives who had acquired vast holdings of their companies' stocks through options, and those of entrepreneurs whose companies had gone newly public as Wall Street investment banking firms underwrote huge volumes of initial stock offerings, many already defunct. *Fortune* magazine recently identified a group of executives in just 25 corporations in those categories, whose total share of sales came to $23 billion—nearly a billion dollars each.

Winners and Losers

Other winners included the financial intermediaries—investment bankers and brokers who sold the high-flying stocks to their clients, and mutual fund managers who sold more than *half a trillion*(!) dollars in speculative funds to the public. Why were they winners? Because the investment banking, brokerage, and management fees for their activities reached staggering levels. More than a few individual investment bankers saw their annual compensation reach well into the tens of millions, and at least a half-dozen owners of fund management companies accumulated personal wealth in the billion-dollar range, including one family said to be at the $30 billion level.

The losers, of course, were those who *bought* the stocks. "Greater fools?" Perhaps. But paradoxically, in order to avoid the dilution in their earnings that would otherwise have resulted from issuing those billions of optioned shares, the very corporations that issued those shares at dirt-cheap prices bought them back at the inflated prices of the day. But most of the buying came from the great American public—often in their personal accounts, and often through ever more popular 401(k) thrift plans—sometimes *directly*, by buying individual stocks; sometimes *indirectly*, through mutual funds. Greed, naiveté, the absence of common sense, and aggressive salesmanship all played a role in the rush to buy speculative stocks—technology, the Internet, telecommunications—that were part of the "new economy." During the peak two years of the bubble, $425 billion of investor capital flowed into mutual funds favoring those types of speculative growth stocks and $40 billion actually flowed *out* of those stodgy "old economy" value funds.

Clearly there was a massive transfer of wealth—a transfer, I believe, of as much as $2 trillion—during the late bubble, from public investors to corporate insiders and financial intermediaries. Such transfers, of course, are not without parallel all through human history. For whenever *speculation* takes precedence over *investment*, there is always a day of reckoning for the investors in the financial markets.

Fixing the Governance System

It's important to understand this history of what went wrong in corporate America and its impact on our financial markets, because only if we understand the root causes can we consider how to remedy them. So as I promised at the outset, I'm going to discuss the progress that is being made to right those wrongs. Newton's law holds here as well, for the reaction to the failures of our capitalistic system was swift in coming. Surprisingly, however, it was not the generalized problems of pushy earnings, faulty accounting, hyped expectations, imperial executives, loose governance, excessive speculation, and even the Great Bear Market that were the catalysts for reform. Rather, it was a handful of scandals—those few "bad apples," including Enron, Adelphia, WorldCom, Global Crossing—that galvanized the public's attention and generated the powerful reaction that, at long last, will help to bring the reform we need in our financial markets.

This pervasive reaction to the unacceptable actions of those we trusted to be our corporate stewards came swiftly.

- Last July, Congress passed the Sarbanes-Oxley bill, requiring senior corporate managers to attest to the validity of their companies' financial statements, providing for disgorgement of profits by executives who sell stocks and later restate earnings, and replacing self-regulation of accountants with a new federal Public Company Accounting Oversight Board, as well as other salutary provisions.
- In August, the New York Stock Exchange approved a powerful set of corporate governance rules for its listed companies—most of the major corporations in America—including substantially greater director independence, and new standards for audit committees and compensation committees. It even contemplated a "lead director" who is independent of corporate management. These changes should at long last lead to a separation of the powers of *governance* from the powers of *management*, and help us to return to a system of *owners*' capitalism.
- Just last month, The Conference Board Blue-Ribbon Commission on Public Trust and Private Enterprise—on which I was privileged to serve—completed its recommendations of a powerful set of "best practices" for public corporations. Our report on executive compensation included a recommendation that *all* types of stock options be treated as corporate expense, at last making it clear that fixed-price options are not "free." On corporate governance, we recommended an *independent* nominating/governance committee; the

establishment and enforcement of codes of ethics; and the separation of the chairman and CEO roles, making clear the distinction between ownership and management. On accounting standards, our Commission's recommendations include further strengthening of audit committees and auditor rotation, and a challenge to the remaining Big Four (also known as "the Final Four") accounting firms to focus on quality audits, and to eliminate *all* consulting and tax services that involve advocacy positions, including those grotesque tax-shelters designed so executives can circumvent the law.

Two centuries ago, James Madison said, "If men were angels, we wouldn't need *government*." Today, I say to our corporate leaders, "If chief executives were angels, we wouldn't need *corporate governance*." Through the reactions of Congress, the New York Stock Exchange, and the Conference Board Commission, to say nothing of the media, we're on our way to getting better governance right now.

Astonishingly, however, the reaction of institutional investors to the failings of our system has yet to occur. Even after the bear market that devastated the value of our clients' equity holdings, the only response we've heard from the mutual fund industry is the sound of silence. The reason for that silence seems to be that the overwhelming majority of mutual funds continue to engage, not in the process of long-term investing on the basis of intrinsic corporate *values*, but in the process of short-term speculation based on momentary stock *prices*. The typical fund manager has lots of interest in a company's price momentum—its quarterly earnings and whether or not they are meeting the guidance given to Wall Street. But when it comes to what a company is actually worth—its fundamental earning power, its balance sheet, its long-term strategy, its intrinsic value—there seems to be far less interest. When Oscar Wilde described the cynic as "a man who knows the price of everything but the value of nothing," he could have as easily been talking about fund managers.

Fixing the Investment System

It must be clear that we need not only good *managers* of corporate America, but good *owners*. That goal will *not* be easy to accomplish. For it will require shareholders—especially institutional shareholders—to abandon the focus on short-term speculation that has characterized the recent era and return at last to a focus on long-term investment. We need to return to behaving as *owners* rather than as *traders*, to return to principles of prudence and trusteeship rather than of speculation and salesmanship, and to return to acting as good stewards of the assets entrusted to our care. For example:

- Institutions and individual investors must begin to act as responsible corporate citizens, voting our proxies thoughtfully and communicating our views to corporate managements. We should be prepared to nominate directors and make business proposals in proxies, and regulators should facilitate these actions. The SEC's recent decision to require mutual funds to disclose how we vote our proxies is a long-overdue first step in this process.
- Shareowners must demand that corporations focus the information provided to the investment community on long-term financial goals, cash flows, intrinsic values, and strategic direction. Quarterly "earnings guidance," so omnipresent today, should be *eliminated*. So should efforts to meet financial targets through creative accounting techniques.
- Given the enormous latitude accorded by "Generally Accepted Accounting Principles," owners must demand full disclosure of the impact of significant accounting policy decisions. Indeed, we ought to consider requiring that corporations report earnings both on a "most aggressive" basis (presumably what they are reporting today), and on a "most conservative" basis as well.
- Mutual funds must report to their owners not only the *direct* costs of mutual fund investing (such as management fees and sales loads), but the *indirect* costs, including the costs of past and expected portfolio turnover and its attendant tax impact. Funds must also desist from advertising short-term investment performance (and perhaps from *any* performance advertising at all).
- Policymakers must develop differential tax strategies aimed at stemming excessive speculation. Some years ago, for example, Warren Buffett suggested a 100 percent tax on short-term capital gains, paid not only by taxable investors, *but also by tax-exempt pension funds*. While that tax rate *might* seem a tad extreme, perhaps a 50 percent tax on very short-term gains on trading stocks would force investors to come to their senses.

- Perhaps most important of all, investor/owners must demand that corporations step up their dividend payouts. Despite the absence of evidence that earnings retention leads to sound capital allocations, the payout rate has been declining for years. Yet history tells us that higher dividend payouts are actually associated with *higher* future returns on stocks. Investing for income is a *long-term* strategy, and investing for capital gains is a *short-term* strategy; the turnover of dividend-paying stocks is at but one-half of the rate for non-dividend-paying stocks.

Back to the Future

Calling for a return to the eternal principles of long-term investing is more than mere moralizing. Our very society depends on it, for our economic growth depends upon capital formation. Way back in 1936, Lord Keynes warned us, "When enterprise becomes a mere bubble on a whirlpool of speculation, the position is serious. *For when the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done.*"* As a nation we can't afford to let that happen. The fact is that we need a whole new mindset for institutional investors, one in which *speculation* becomes a mere bubble on a whirlpool of *investment*. In the mutual fund industry, we need to go "back to the future," to return to our traditional focus on stewardship and abandon the focus on salesmanship that has dominated our recent history.

While the changes I have suggested will help return us to our roots, however, the fact remains that there is more profit potential for financial service firms in marketing (generating huge assets to manage) than in management. For, as both simple mathematics and the investment record of the past clearly indicate, beating the market is a loser's game, simply because of the staggering toll taken by the costs of financial intermediation. When fund investors realize that fact, they will

*John Maynard Keynes, *The General Theory of Employment, Interest and Money* (1936; New York: Harcourt, Brace, 1964), 159.

vote with their feet, and send their hard-earned dollars to funds that get the message. By doing so, using Adam Smith's metaphor, "it is the individual who acts in his own interests to better his financial condition who will promote the natural progress of things toward improvement." Similarly, when an investor puts his money into mutual funds that invest rather than speculate, he earns the highest possible proportion of whatever returns the financial markets are generous enough to provide (of course, we know them to be low-cost market index funds), promoting the public interest without intending to, or even knowing he is doing so.

That doesn't mean, however, that the trusted fiduciary, the honest businessman, or the good merchant should behave in an ethical way only because their clients have dragged them, kicking and screaming, into doing what's right. The fact is, as I noted at the outset, that in the long run *good ethics are good business, part of that virtuous circle that builds our society*. When in recent years our rule of conduct became "I can get away with it," or, more charitably, "I can do it because everyone else is doing it," integrity and ethics go out the window and the whole idea of capitalism is soured.

Man's Better Nature

If my appeal to man's better nature seems hopelessly out of tune with the discouraging era I've described this evening, I can only remind you that Adam Smith, that patron saint of capitalism, would be on my side. Even before *The Wealth of Nation*s, he wrote *The Theory of Moral Sentiments*, reminding us of the better nature that

> has lighted up the human heart, capable of counteracting the strongest impulses of self-love. . . . It is reason, principle, conscience, the inhabitant of the breast, the man within, the great judge and arbitrator of our conduct who calls to us with a voice capable of astonishing the most presumptuous of our passions that we are of the multitude, in no respect better than any other in it . . . he who shows us the propriety of reining in the greatest interests of our own for the yet greater interests of others, the

love of what is honorable and noble, of the grandeur, and dignity, and superiority of our characters.*

At last we are beginning a wave of reform in corporate governance and are undertaking the task of turning America's capital development process away from speculation and toward enterprise. It will be no mean task. For there's even more at stake than improving the *practices* of governance and investing. We must also establish a higher set of *principles*. This nation's founding fathers believed in high moral standards, in a just society, and in the virtuous conduct of our affairs. Those beliefs shaped the very character of our nation. If *character counts*—and I have absolutely no doubt that character *does* count—the ethical failings of today's business and financial model, the financial manipulation of corporate America, the willingness of those of us in the field of investment management to accept practices that we know are wrong, the conformity that keeps us silent, the selfishness that lets our greed overwhelm our reason, all erode the character we'll require in the years ahead, more than ever in the wake of this Great Bear Market and the investor disenchantment it reflects. The motivations of those who seek the rewards earned by engaging in commerce and finance struck the imagination of no less a man than Adam Smith as "something grand and beautiful and noble, well worth the toil and anxiety." I can't imagine that the vast majority of our citizenry would use those words to describe what capitalism is about today. The sooner the better when we can again apply those words to our business and financial leaders—*and mean them.*

A Call for Virtue

So there is much work to be done. But it's about much more than assuring that the "bottom line" of business is not only stated with probity, but focused on investing based on long-term corporate value rather than speculating on short-term stock prices. It is the enduring reality of

* Adam Smith, *The Theory of Moral Sentiments* (1759; Cambridge, England: Cambridge University Press, 2002), 158.

intrinsic value—make no mistake, the worth of a corporation *is* neither more nor less than the discounted value of its future cash flows—*not* the ephemeral perception of the price of a stock that carries the day. And the enterprises that will endure are those that generate the most profits for their owners, something they do best when they take into account the interests of their customers, their employees, their communities, and indeed the interests of our society. *Please don't think of the ideals merely as foolish idealism.* They are the ideals that capitalism has depended upon from the very outset. Again, hear Adam Smith: "He is certainly not a good citizen who does not wish to promote, by every means of his power, the welfare of the whole society of his fellow citizens." So it's up to each one of us to speak up, to speak out, and to demand that our corporations and our fund managers represent our interests rather than their own—the owners first, not the managers. Please don't think that your voice doesn't matter. In the words of the motto I've tried to ingrain in the minds of our Vanguard crewmembers, "Even one person can make a difference."

While a call for virtue in the conduct of the affairs of corporate America—and investment America, too—may sound like a hollow "do-good" platitude, the fact is that in the long run the high road is the only possible road to national achievement and prosperity, to making the most of those priceless assets with which America has been endowed by her Creator. On this point, I am unable to find more compelling wisdom than some splendid words attributed, perhaps apocryphally, to Alexis de Tocqueville. I hope these words will resound far beyond the parochial issues I've addressed here into the larger world around us, troubled as it is:

> I sought for the greatness and genius of America in her harbors and her rivers, in her fertile fields and boundless forests, and it was not there.
>
> I sought for the greatness and genius of America in her rich mines and her vast world commerce, and in her institutions of learning, and it was not there.
>
> I sought for the greatness and genius of America in her democratic Congress and her matchless Constitution, and it was not there.

> Not until I went into the churches of America and heard her pulpits flame with righteousness did I understand the secret of her genius and power.
>
> America is great because America is good, and if America ever ceases to be good, America will cease to be great.

And so it is with corporate America and investment America, too. If we return to goodness, we can again strive for greatness. Let's all of us together make sure that happens.

Chapter 8

Vanishing Treasures: Business Values and Investment Values*

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 present my perspective.

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*Based on remarks at the Maclean House 2007 Lecture Series at Princeton University on March 15, 2007.

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." *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

*Edward Gibbon, *The Decline and Fall of the Roman Empire* (1776–88; New York: Random House, 2003); John C. Bogle, *The Battle for the Soul of Capitalism* (New Haven: Yale University Press, 2005).

> 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 the book's first chapter ("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 I've so often quoted 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*.

Profession versus 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,* 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."

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*"The Professions in America Today: Crucial but Fragile," *Daedalus*, Summer 2005, 13–18.

When we think of professionals, most of us would probably start with physicians, lawyers, teachers, engineers, architects, accountants, and clergy. 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.* 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.

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*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."* "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).

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

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.*

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 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

*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.

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, "[M]anagers 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.

"The Happy Conspiracy"

Way back in 1999, I described the shared focus on the price of a corporation's stock over all else as "the happy conspiracy" between our business sector and our investment sector, mutually reinforcing one another, in which traditional values and longstanding 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 irrational exuberance. Finally, the eternal truth reemerges: *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 percent, nearly *twice* the 6.3 percent *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 relatively 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" 12 firms, but among them were 8 of the 9 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 & McClennan, 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.

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 had 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. (Assets 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 past 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 16 years. Today, it has shrunk but 4 years, admittedly, up from only 2 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.* 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"—not only have *not* been realized, but have been violated. Accordingly, the earlier business values and investment values of our industry became vanishing treasures.

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:

> 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.

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

> 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]

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*Henry Kaufman, *On Money and Markets* (New York: McGraw-Hill, 2001).
†Felix Rohatyn, "Free, Wealthy and Fair," *Wall Street Journal*, November 11, 2003.

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 at Princeton in 1948–1949—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—*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 his or her 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,

*Paul A. Samuelson, *Economics: An Introductory Analysis* (New York: McGraw-Hill, 1948).

drives this message home: *The Little Book of Common Sense Investing—The Only Way to Guarantee Your Fair Share of Stock Market Returns*.)

"The Impartial Spectator"

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 of 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, it is 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 11th(!) 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.

Chapter 13

A New Order of Things: Bringing Mutuality to the "Mutual" Fund*

I'm profoundly honored by the privilege of delivering the Manuel F. Cohen Memorial Lecture for 2008 here at the National Law Center of the George Washington University. Part of my pleasure comes from the fact that, during the latter time of his 27-year tenure at the Securities and Exchange Commission, I came to know Chairman Cohen (universally known as "Manny"). He had served on the staff from 1942 until 1961 and as a member of the Commission from 1961 until 1969, serving as its chairman during the final five years of his tenure. I remember him as being wise, smart, blunt, tough, intolerant of beating around the bush, and a pillar of personal rectitude and professional integrity. It should go without saying that I had the highest admiration for this consummate public servant.

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* Based on an essay in the Winter 2008 *Wake Forest Law Review*, which in turn was based on the 27th Annual Manuel F. Cohen Memorial Lecture that I delivered at the George Washington University Law School in Washington, D.C., on February 19, 2008.

He left the Commission in 1969 to enter the private practice of law at Wilmer, Cutler and Pickering, but continued to speak out on issues affecting the securities field, lecturing here at the George Washington School of Law. One of his speeches, given when he was SEC Chairman, sets the theme for my own lecture this afternoon. That speech, delivered at the 1968 Federal Bar Conference on Mutual Funds, was entitled simply "The 'Mutual' Fund."* And, yes, he put quotation marks around the word *mutual*. The title—and the theme—of my remarks today follows that same formulation: "A New Order of Things—Bringing Mutuality to the 'Mutual' Fund." Please note that the word *mutual* is again bracketed by quotation marks.

The fact is that "mutual" remains an inappropriate adjective to apply to our business. The operation of virtually all mutual funds is about as far from the concept of mutuality as one can possibly imagine. Hear Chairman Cohen on this point in that 1968 speech: "The basic idea of a 'mutual' fund is deceptively simple," he said, "[but its] salient characteristics raise a serious question whether the word 'mutual' is an appropriate description." While the policyholders of mutual insurance companies and the depositors in mutual savings banks were at least putatively sharing in the profit of their institutions, mutual funds, he said, were different, noting that fund shareholders paid fees to their external managers, corporations in business to earn profits for their own shareholders, with a completely different, and often opposed, set of interests.

Chairman Cohen pointedly observed that "the [external] fee structure has provided a real opportunity for the exercise of the ingenuity for which fund managers have established an enviable reputation. After all," he said in his speech, "that is where the money is, and despite the common use of the word 'mutual,' the principal reason these funds are created and sold is to make money for the people who sell them and those who manage them."

Of course he was right. Virtually all mutual funds are organized, operated, and managed, *not* in the interests of their shareholders, but in the interest of their managers and distributors. Is there something improper, or wrong, or unethical about having funds operated with

*"The 'Mutual' Fund," an address by Manuel F. Cohen before the 1968 Conference on Mutual Funds, Palm Springs, California, March 1, 1968.

this purpose? Perhaps not. But if this structure is not illegal *per se*, there seems to be something about the way in which the industry has evolved that flies directly in the face of the provisions in the Investment Company Act of 1940 that require that investment companies be "organized, operated, and managed"* in the interests of their shareholders, "rather than in the interest of their managers and distributors."† (Interestingly, the phrase *mutual funds* does not appear in the statute.)

A Lone Exception to the Conventional Structure

Now, when I said that *virtually* all funds operate under this external management structure, please note that I did not say *all*. The creation of Vanguard in 1974 marked my attempt to create a family of mutual funds that was truly mutual, doing away with the conflict of interest that exists between funds and their advisers, by returning the enormous profits that accrue to external managers directly to the fund shareholders themselves. The now-150 funds in our group actually *own* our manager, The Vanguard Group, Inc., roughly in proportion to their share of the Group's aggregate assets, and share in the total expenses incurred by the funds in their operations in approximately the same proportion. (That is, if a given Vanguard fund represents 1 percent of our assets, it would own 1 percent of Vanguard's shares and assume 1 percent of Vanguard's operating expenses.)

The directors of the funds and their management company are identical. Eight of our nine directors are otherwise unaffiliated with the company, and only one (the chief executive) serves as an officer. No director is permitted to be affiliated with any of the funds' external advisors.‡ Our funds essentially operate and manage themselves on an

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*Investment Company Act of 1940, 15 U.S.C. § 80a-1(b)(2) (2000), available at www.sec.gov/aboutlaws/ica40.pdf.

†*In re: The Vanguard Group, Inc.*, Investment Company Act Release No. 11,645, 22 SEC Docket 238 (Feb. 25, 1981).

‡The investment advice for approximately 70 percent of Vanguard's fund assets—largely index, bond, and money market funds—is provided internally by Vanguard itself. The remaining 30 percent is advised under contracts held by a score of external advisers.

"at-cost" basis, enabling our shareowners to garner the extraordinary economies of scale that characterize investment management (i.e., the costs of managing $10 billion of assets is nowhere near 10 times the cost of managing $1 billion). It is fair to describe Vanguard as the only truly "mutual" mutual fund complex.

This shareholder-first structure has produced enormous savings for investors in the Vanguard funds. For example, in 2007, our composite expense ratio of 0.21 percent (21 "basis points") was 76 basis points below the 0.97 percent (97-basis-point) composite weighted average expense ratio of our largest competitors. That saving, applied to our average assets of $1.2 trillion during the year, came to almost $10 billion for 2007 alone. By 2009, cumulative savings for our mutual fund owners will have crossed the $100 billion mark.

Whence "Mutual"?

The Vanguard structure is unique in industry annals. While the first mutual fund (Massachusetts Investors Trust, formed in 1924) was managed by its own trustees rather than by an external company—a structure it abandoned in favor of the external structure in 1969—its shares were marketed and financed by a separately owned distribution company. And while the funds in the Tri-Continental (now Seligman) group were for many years operated at cost by their management company, the manager reaped substantial (if undisclosed) profits by serving as the broker-dealer for the funds' portfolio transactions.* In 1978, this structure, too, was converted into an external manager structure.

Since the word "mutual" did not appear in the Investment Company Act of 1940, whence did it arise? I've looked through those old *Investment Companies* manuals published by Arthur Weisenberger & Company

*While the funds operated by TIAA-CREF and USAA have a shareholder-oriented structure that is similar in philosophy to Vanguard's, they differ by being managed, in effect, by insurance/annuity providers that are themselves mutual, owned by their policyholders. While the funds pay fees to the manager in the same way as in the conventional external model, those fees are far below industry norms.

all the way back to the 1945 edition, and it is not until that 1949 edition, a quarter-century after the industry began, that I find the first mention of *mutual* funds. But while the derivation of the term remains a mystery, the paradoxical fact is that it first appears only a short time before the industry began to abandon its early mutual values.

History confirms that from the inception of the first U.S. mutual fund in 1924 until the late 1940s, the predominant focus of mutual fund management was on portfolio selection and investment advice, rather than on distribution and marketing. In fact, the managers who founded not only Massachusetts Investors Trust, but State Street Investment Corporation and Incorporated Investors, the original "Big Three" of the fund industry, put themselves forth as "the twentieth-century embodiment of the old Boston trustee."*

During the industry's early years, sales of fund shares were often the responsibility of separate underwriting firms financed by distribution revenues from sales loads, and predominately unaffiliated with fund managers. For example, "the primary concern of the State Street [Research and Management Company] partners was that they not be distracted by the sales effort. As they wrote to investors in 1933, 'it is our intention to turn over the active selling and the commissions to dealers . . . thereby leaving us free to devote . . . our entire time and effort to research and the study of the problems of investment.'" (The partners were even better than their word; in 1944 the fund entirely ceased the sale of its shares.)

The same spirit was echoed by Judge Robert F. Healy, the SEC Commissioner primarily responsible for the development of the legislation leading to the Investment Company Act of 1940. Here's how he opened his testimony at the hearings for the Act in 1939: "The solution (to the industry's) shocking record of malfeasance . . . was a group of expert trust managers who do not make their profits . . . distributing trust securities, styled principally for their sales appeal, but from wise, careful management of the funds entrusted to them." The SEC Commissioners, Judge Healy said, "were anxious to protect the fund

*This and the quotations that follow over the next pages are from Michael Yogg's ~~find~~ book "Passion for Reality," *Xlibris* (2006).

investor from the distorting impact of sales. *Products* [Italics added] designed for their appeal to the market did not, and do not, necessarily make the best investments."

Legendary industry pioneer Paul Cabot, one of State Street's founders and a major force in the drafting of the 1940 Act, agreed with the SEC on this point. Earlier, in 1928, he had described the abuses in the investment-trust movement of the day as "(1) dishonesty; (2) inattention and inability; (3) greed, by which he meant simply charging too much for the services rendered. 'Even if a fund is honestly and ably run, it may be inadvisable to own it simply because there is nothing in it for you. *All the profits go to the promoters and managers*'" (emphasis added).

While the derivation of the term *mutual* remains obscure, the prudent idealism that undergirded the spirit of the industry when the 1940 Act was drafted arguably justified the use of the term. Yet *mutual fund* actually came into being just as the industry began to turn away from its original spirit of mutuality, from its early mission of stewardship of investor assets to its modern-day mission of salesmanship, a mission, as Chairman Cohen seemed to be suggesting, that would make the use of the term "mutual" something of a joke.

The Straw That Broke the Camel's Back

As with any transformation, multiple, doubtless innumerable, factors were responsible for the sea change that gradually subverted the fund industry's mission. Operating for decades as an industry composed of a group of small firms, entirely privately owned by the professional managers who were actually providing the advisory services, and focused on earning a return on the capital that investors had entrusted to them, the industry gradually morphed into a group of giant firms, largely publicly owned and controlled by corporate executives whose mission was asset gathering, and focused on earning a return on the capital of the owners of the management company. But the proverbial "straw that broke the camel's back" of the traditional industry was when the owners of privately held management companies gained the right to sell their ownership positions to outsiders, and then to the public, and finally to giant financial conglomerates.

Paul Cabot did not approve of that change. For him, the private ownership of fund managers was essential. Indeed it represented a moral imperative for him, and he sharply criticized firms that would sell out to insurance companies and other financial institutions. In 1971, he recalled the negotiations over the Investment Company Act of 1940: "Both the SEC and our industry committee agreed that the management contract between the fund and the management group was something that belonged . . . to the fund . . . and therefore the management group had no right to hypothecate it, to sell it, to transfer it, or to make money on the disposition of this contract . . . the fiduciary does not have the right to sell his job to somebody else at a profit."

Yet, ironically, in 1982, Paul Cabot's successors did exactly that: The partners of State Street Research and Management Company sold the firm to the (paradoxically, then-mutual) Metropolitan Life Insurance Company for an astonishing (in those ancient days) profit of $100 million. The stated reasoning of the Fund's board: "[T]he affiliation of State Street with an organization having the financial and marketing resources of Metropolitan Life will result in the development of new products and services which the fund may determine would be beneficial to its [the fund's] shareholders." (Mr. Cabot, still a partner, was apparently enriched to the tune of $20 million, in 1982 dollars.)

It is hard to imagine how such "new products and services would be beneficial" to the *fund's* shareholders, even as they would likely benefit the *management company*, which became a subsidiary of the insurance behemoth. In fact, the merger hurt the fund shareholders. "Performance lagged, and the manager's position in the industry declined from tops to average." By 2002, Metropolitan Life abandoned the fund business, selling State Street Management and Research Company to Blackrock Financial for an estimated $375 million. Among Blackrock's first moves was to put State Street Investment Corporation out of its misery, merging the industry's third-oldest fund into another Blackrock fund. I still refer to this event as "a death in the family."

The Floodgates Open

The sale and resale of State Street exemplified what might be called the "trafficking" in fund advisory contacts that greatly concerned the Commission during the drafting of the 1940 Act. But while the SEC and the industry agreed that the management contract was an asset of the fund, the 1940 Act failed explicitly to articulate this sound principle. It would be only a matter of time until a sale would take place. That sale opened the floodgates to public ownership of fund management companies.

The date was April 7, 1958, when the United States Court of Appeals for the Ninth Circuit ruled that the 1956 sale of shares in Insurance Securities, Incorporated (ISI), at a price equal to nearly 15 times its book value, did not constitute "gross misconduct" or "gross abuse of trust" under Section 36 of the 1940 Act. The SEC had gone to court to oppose the sale, on the grounds that the excess price represented a payment for succession to the adviser's fiduciary office.

The Court agreed with the Commission that "the well-established principles of equity barred a trustee standing in a fiduciary relationship with another from either transfer of the office or exploiting such a relationship for personal gain." But it weighed even more heavily the fact that the value of the contract, rather than representing an asset of the trust fund, represented the reality that the manager receives a profit for rendering its services in return for stipulated fees that the fund had contracted to pay.

Well-decided or ill-decided by the Ninth Circuit (I believe the latter*), the U.S. Supreme Court refused *certiorari*. And that was that. That narrow legal decision, now almost exactly a half-century ago, played a definitive role in setting the industry on a new course

*A note in the *Harvard Law Review* of April 1959 (vol. 72, no. 6) agreed with me, taking issue with the Ninth Circuit's decision: "If [the Act] is construed to incorporate the basic principle that a fiduciary owes individual loyalty to the beneficiary and must avoid any conflict of interest, then a seller should not be allowed to transfer his fiduciary office for personal gain . . ." (p. 180).

in which manager entrepreneurship in the search for personal profit would supersede manager stewardship in the search for prudent investment returns for fund shareholders.

Within a decade, many of the major firms in the fund industry joined the public ownership bandwagon, including Vance Sanders (now Eaton Vance), Dreyfus, Franklin, Putnam, and even Wellington (the firm I had joined in 1951, right out of college). Over the next decade, T. Rowe Price and Keystone (now Evergreen) also went public. In the era that followed, financial conglomerates acquired industry giants such as Massachusetts Financial Services (adviser to the fund complex of which MIT had become a part), Putnam, State Street, American Century, Oppenheimer, Alliance, AIM, Delaware, and many others. The trickle became a river, and then an ocean.

Today (continuing that somewhat stretched analogy), the tide of public ownership of fund management companies has come in, and the tide of private ownership is at an all-time low. Among the 50 largest mutual fund management complexes, only 8 have maintained their original private structure—including Fidelity, Capital Group (American Funds), Dodge & Cox, and TIAA-CREF, plus Vanguard, owned by its fund shareholders. Of the remaining 41 firms on the list, 9 are publicly held (including T. Rowe Price, Eaton Vance, Franklin, and Janus) and 32 are owned by banks, giant brokerage firms, and U.S. and international conglomerates. As we shall soon see, this seemingly irresistible tide of public—largely conglomerate—ownership has ill-served mutual fund shareholders.

Vanguard Goes the Other Way

Only a single firm resisted this epic tide. In the context of my theme this evening, the story of its creation is a story worth telling. As you may recall, in 1960, my employer, Wellington Management Company, was among the firms to ride that early wave of industry IPOs. In 1965, when I was given the responsibility of leading the firm, I recognized the challenge involved in serving those two demanding masters whose interests were so often in direct conflict. To state the obvious, we had a fiduciary duty *both* to our fund shareholders *and* to our management company shareholders as well. However, when a privately held management company becomes publicly held, this conflict is exacerbated.

In September 1971, I went public with my concerns. Speaking at the annual meeting of my Wellington partners, I began my remarks with a 1934 quotation from Justice Harlan Fiske Stone: "Most of the mistakes and major faults of the financial era that has just drawn to a close will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that 'a man cannot serve two masters'. . . . Those who serve nominally as trustees but consider only last the interests of those who funds they command suggest how far we have ignored the necessary implications of that principle." It is high time, I added, that any conflicts between the profession of finance and the business of finance must be reconciled in favor of the client. It is a matter of fiduciary principle.

I then explored some ideas about how such a reconciliation might be achieved, including, "a mutualization, whereby the funds acquire the management company . . . or internalization, whereby the active executives own the management company, with contracts negotiated on a 'cost-plus' basis, with incentives for both performance and efficiency, but without the ability to capitalize earnings through public sale."

Within three years, a situation developed in which I was put in a position in which I would not only *talk the talk* about mutualization, but would *walk the walk*.* Even before the 1973–1974 bear market began, the investment returns of the Wellington funds had begun to deteriorate (both on an absolute and on a relative basis) and the large cash *inflows* they had enjoyed had turned to huge cash *outflows*. Assets of our flagship, the conservative Wellington Fund, had tumbled from $2 billion in 1965 to less than $1 billion, on the way to a low of $480 million. Wellington Management Company's earnings plummeted, and its stock price followed suit. This concatenation of dire events was enough to destroy the happy partnership formed by an unfortunate

*An expanded version of this transaction can be found in Chapter 12.

merger I implemented in 1966, and I got the axe as Wellington Management Company's CEO on January 23, 1974. But—here's the catch—I remained as chairman of the mutual funds, with their largely separate (and largely independent) board of directors.

Shortly before the firing, seeing the handwriting on the wall, I submitted a proposal to the *mutual fund* board of directors under which the Wellington Group of mutual funds would acquire Wellington Management Company and its business assets. The company would become a wholly owned subsidiary of the funds and serve as investment adviser and distributor on an "at-cost" basis. I openly acknowledged that my mutualization proposal was "unprecedented in the mutual fund industry." The cautious fund board nonetheless asked me to expand the scope of my proposal and undertake "a comprehensive review of the best means by which the funds could obtain advisory, management, and administrative services at the lowest reasonable costs to the fund shareholders."

My first report, completed on March 11, 1974, was entitled "The Future Structure of the Wellington Group of Investment Companies." It spelled out the ultimate objective for the fund shareholders: *independence*. The goal was "to give the funds an appropriate amount of corporate, business, and economic independence," under a mutual structure that was clearly contemplated by the Investment Company Act of 1940. But, I added, such independence had proved to be an illusion in the industry, with "funds being little more than corporate shells . . . with no ability to conduct their own affairs. . . . This structure has been the accepted norm for the mutual fund industry for more than fifty years."

On June 11, 1974, perhaps unsurprisingly, the board rejected my proposal to have the funds acquire the manager, and chose a different option, the least disruptive of the seven options that I had offered. We established the funds' own administrative staff under the direction of its operating officers, with my continuing as their chairman and president. We would also be responsible, as the board's counsel, former SEC Commissioner Richard B. Smith wrote, "for monitoring and evaluating the external (investment advisory and distribution) services provided" by Wellington Management. The decision, the counselor added, "was *not* envisaged as a 'first step' to internalize additional functions, but as a structure that . . . can be expected to be continued into the future."

Since the Board agreed that Wellington Management Company would retain its name (and Wellington Fund would also retain *its* name), a new name would have to be found for the administrative company. I proposed to name the new company "Vanguard" and the Board approved, albeit somewhat reluctantly. The Vanguard Group, Inc. was incorporated on September 24, 1974. Without apparent difficulty, the SEC soon cleared the funds' proxy statements proposing the change, which the fund shareholders promptly approved. Vanguard began operations on May 1, 1975.

No sooner than the ink was dry on the various agreements, the situation began to change. The creation of Vanguard, as I've written, "was a victory of sorts, but, I feared, a Pyrrhic victory . . . and the narrow mandate that precluded our engaging in portfolio management and distribution services would give Vanguard insufficient power to control its destiny. Why? Because success in the fund field was not then, and is not now, driven by how well the funds are *administered*. Though their affairs must be supervised and controlled with dedication, skill, and precision, success [will be] determined by what kinds of funds are created, by how they are managed, by whether superior investment returns are attained, and by how—and how effectively—the funds are marketed and distributed."

We first determined to start a new fund that we would manage internally. Paradoxically (if not disingenuously), it would be a fund that arguably didn't conflict with our limited mandate, for, technically speaking, it wasn't *managed*. It was the world's first index mutual fund, modeled on the Standard & Poor's 500 Stock Index. Incorporated late in 1975, its initial public offering was completed in August 1976. While the offering raised a puny $11 million, despite that unhappy start, Vanguard 500 Index Fund is now among the largest mutual funds in the world.

Our control over fund marketing came only shortly thereafter. On February 9, 1977, after yet another contentious debate, the fund board accepted my recommendation that the funds terminate their distribution agreements with Wellington Management, eliminate all sales charges, and abandon the broker-dealer network that had distributed

Wellington shares since its inception in 1929. (I argued that we weren't violating the memorandum of understanding by *internalizing* distribution. Rather we were *eliminating* distribution.) While the board approval was by the narrowest of margins, Vanguard moved, literally overnight, from a seller-driven, load-fund channel we had relied upon for almost a half-century to the buyer-driven, no-load channel we maintain to this day. Only 21 months after Vanguard began operations, the fledgling organization had become a fully functioning fund complex. What we called "the Vanguard Experiment" in fund governance was about to begin in earnest.

Let's See How It All Worked Out

It will soon be 34 years since Vanguard began operating under its unique mutual structure, and almost exactly 50 years since that ghastly Ninth Circuit decision opened the door of public ownership to fund managers and led to the age of conglomeration that has now overwhelmed the industry. Surely it must occur to you that the philosophies underlying these two events are diametrically opposite. Outside ownership, in effect, demands that investment funds be viewed as *products* of their management companies, manufactured (in the current grotesque parlance) and distributed to earn a profit for the company. Mutual ownership, on the other hand, views mutual funds—yes, *mutual* funds—as trust accounts, managed under the direction of prudent fiduciaries.* It's high time to look at the record, and compare the results achieved by the firms following these opposing philosophies.

As I'm fond of saying, over our three-plus decades of our existence, Vanguard has proven to be both a *commercial* success and an *artistic* success—a commercial success, because our structure has been proven to be a superb business model. The assets we manage for investors have grown from $1.4 billion at our 1974 founding to some *$1.2 trillion* today. At this moment, in fact, we may well be the largest firm in our industry. (In fairness, Vanguard, American Funds, and Fidelity have

*I intensely dislike the use of the word "product" to describe an investment company, and, early in Vanguard's history, banned its use at the firm.

gone back and forth in the lead position for several years now. Each of these giants manages about *three times* the fund assets of the next largest firms, Franklin Templeton and Barclays Global.)

Of course, the stock market boomed during that period (at least through early 2000), and the fund industry could hardly help but flourish. Nonetheless, Vanguard's market share of industry assets has soared from a mere 1.8 percent in 1980 to 10.6 percent currently, *without a single year of decline*. Let me illustrate the impact of that rise in share: If it had remained at 1.8 percent, assets of the Vanguard funds today would be $220 billion. Thus, fully $1 trillion of our growth—80 percent of it—has come from our increased market share; that is, out of the pockets of our competitors. (Not bad, dare I say, for a firm in which I consistently drummed home this philosophy: "Market share is a measure, *not* an objective; market share must be earned, *not* bought.")

How did we earn that commercial success? By our artistic success, which I define as providing superior investment returns to our shareholders. The data indicate that the performance of the Vanguard funds was indeed superior. To the contrary, the financial conglomerates that now dominate this industry generally produced performance returns that were distinctly inferior.

There are, of course, lots of ways to measure fund performance. I'll use one of the more sensible methodologies, relying largely on the Morningstar system, in which the risk-adjusted returns of each fund are compared with the risk-adjusted returns of its peers over a full decade (albeit with a heavier weighting on the recent years of the decade). For example, a given manager's large-cap growth fund is compared with other large-cap growth funds; its investment-grade intermediate-term corporate bond fund with other peers, and so on. Under this system, 10 percent of funds receive five stars (the top rating) and 10 percent one star (the bottom rating); 2.5 percent receive four stars and 2.5 percent receive two stars; the middle 35 percent receive the average grade of three stars.*

*By weighting the analysis by number of funds rather than by assets, this procedure has one strength not in evidence in other methodologies, which almost invariably ignore the impact of sales loads. My methodology captures the returns of "B" and "C" shares, usually smaller in assets but which have sales loads built into their expense ratios. This method gives a more realistic picture of the net returns actually delivered to fund shareholders in all share classes.

My deceptively simple methodology is to calculate, for each fund complex, the percentage of its funds in the four- and five-star categories, and subtract from that total the percentage of funds in the one- and two-star categories. The result: the balance between funds that provided distinctly superior returns and those that provided distinctly inferior returns. While I've never seen this done before (although there's lots of promotional bluster for funds that get four or five stars), my own view is that staying out of the one- and two-star categories is at least an equally important benefit for shareholders.

We measured the returns achieved by the 50 largest fund complexes, defined as the firms managing at least 40 individual funds, excluding money market funds. (The complex with the largest number of funds, Fidelity, includes 471 long-term funds.) Only one of these firms managed less than about $25 billion. This remarkably representative list includes more than 8,800 funds with some $7 trillion in fund assets, 80 percent of the industry's long-term asset base.

The full study is clearly too extensive to inflict on this audience, but I've presented it in the appendix of this essay (see Table 13.4). What I'll now present to you (Table 13.1) is a summary showing the scores of six of the top firms, the bottom six firms, and six fairly well-known firms that achieved roughly average performance records for their funds. The top-ranking fund complex, in terms of providing superior returns to its investors, was Vanguard. With 59 percent of our funds in the top group and less than 5 percent in the bottom group, the firm's performance rating is +54.[†]

Joining Vanguard among the top three are DFA and TIAA-CREF, both at +50. (More than coincidentally, all three firms are focused largely on index-like strategies.) At number four is T. Rowe Price (+44), followed by Janus (+38) and American Funds (+26). Honestly, I think most objective observers would agree that over the past decade, at least five of these six firms have been conspicuous in delivering superior risk-adjusted returns, a judgment that confirms the methodology. Again more

[†] Full disclosure: Two much smaller firms have higher ratings. Dodge & Cox, with 4 funds, is at +100; Royce and Associates, with 31 funds, has a score of +65.

TABLE 13.1 MAJOR MUTUAL FUND MANAGERS: FUND PERFORMANCE*

		Manager	Percent of Funds Ranked: Highest 4 or 5 Stars	Percent of Funds Ranked: Lowest 1 or 2 Stars	Highest Minus Lowest
	1	Vanguard	59%	5%	54%
	2	DFA	57	7	50
Highest	3	TIAA-CREF	54	4	50
Returns	4	T Rowe Price	53	9	44
	5	Janus	54	16	38
	6	American Funds	46	20	26
	7	Franklin Temp.	31	22	9
	8	Morgan Stanley	32	30	2
Average	9	Fidelity	31	34	−3
Returns	10	Barclays Global	27	31	−4
	11	AIM Inv.	20	34	−14
	12	Columbia Funds	23	38	−14
	13	Goldman Sachs	15	55	−40
	14	Dreyfus	12	53	−40
Lowest	15	MainStay Funds	20	60	−40
Returns	16	John Hancock	17	60	−43
	17	ING Investments	9	64	−55
	18	Putnam	4	62	−58

*Morningstar ratings as of 12/2007 (long-term funds only).

than coincidentally, this six-firm list is dominated by four management companies that are not publicly owned—Vanguard, DFA, TIAA-CREF, and American—and none are controlled by conglomerates.

On the other hand, each of the bottom six firms are units of giant brokerage firms or financial conglomerates. Their ratings range from −40 for Goldman Sachs to an astonishing −58 for Putnam, with only 4 percent of its funds in the top category and 62 percent ranking in the bottom category. Strikingly, every one of the 17 lowest-ranking firms on the 50-firm list is conglomerate-held, while only one of the firms among the top 10 can be similarly characterized.*

* The success of Neuberger Berman, ranking #8 with a score of +19, was largely achieved before its 2003 sale to Lehman Brothers.

The middle group—all producing more or less average scores (mostly less) for their funds—includes one publicly held firm (Franklin, +9), one owned by a giant investment banker (Morgan Stanley, +2), one privately held (Fidelity, −3), and three owned by conglomerates (all below par, at −4, −14, and −14). Putting the three groups—high-performing, average-performing, and low-performing—together, it seems patently obvious that the truly mutual structure (which has only a single entrant) and the other three privately held structures that dominate the top group have provided consistently superior returns for their shareholders, with an average score of plus 48—54 percent in the top group and only 6 percent at the bottom. This positive score stands in sharp contrast with the inferior scores that characterize the financial conglomerates at the bottom, with an average score of minus 46—13 percent in the top group and 59 percent in the one- and two-star categories.

Performance Evaluations from a Higher Authority

While the performance methodology I have chosen is inevitably imperfect, I believe that it is not only entirely reasonable, but a significant enhancement over most other methodologies. But, let's not rely only on the statistics to evaluate fund performance. Let's find out how the fund shareholders themselves regard the funds they actually own. Happily, thanks to a survey done in 2007 by Cogent Research LLC, we have measures of how fund shareholders feel about the mutual fund firms that manage their money. (The study focused on shareholders who have mutual fund investments of at least $100,000.)

The Cogent study, reported by the *Wall Street Journal*,* measured client loyalty, presenting investors with a scale representing the extent of their trust in their managers—10 the highest rating ("definitely recommend" to other investors), 1 the lowest ("definitely *not* recommended"). Each firm was scored by subtracting the percentage of

*The *Journal* published the ratings for only eight of the firms in the survey. The other ratings were made available for this paper. Many of the firms in the performance survey were not included in the loyalty survey.

shareholders who rated the firms at 5 or below ("detractors") from the percentage who rated the firms at 9 or 10 ("supporters"). Only 11 of the 38 firms evaluated had positive loyalty scores. The average score was −12, a message about investor confidence in the fund industry that would not seem to be much of a tribute.

Simply put, fund shareholders seem to "get it." When we juxtapose these loyalty scores for each firm with its performance scores, we see a remarkable, if by no means exact, correlation (Table 13.2). In fact, Vanguard's performance score (+54) and its loyalty score (+44), both the highest in the field, were quite similar. Putnam's scores, also similar (−58 and −54, respectively), were the lowest in the field. Of course there is a relationship between how well one has served investors and how loyal they are!

TABLE 13.2 MAJOR MUTUAL FUND MANAGERS: FUND PERFORMANCE AND SHAREHOLDER LOYALTY

		Manager	Percent of Funds Ranked Highest Minus Lowest	Client Loyalty Score
	1	Vanguard	54%	44%
	2	DFA	50	n/a
Highest Returns	3	TIAA-CREF	50	n/a
	4	T Rowe Price	44	21
	5	Janus	38	−30
	6	American Funds	26	12
	7	Franklin Temp.	9	1
	8	Morgan Stanley	2	−18
Average Returns	9	Fidelity	−3	12
	10	Barclays Global	−4	n/a
	11	AIM Inv.	−14	−48
	12	Columbia Funds	−14	−47
	13	Goldman Sachs	−40	−32
	14	Dreyfus	−40	−45
Lowest Returns	15	MainStay Funds	−40	n/a
	16	John Hancock	−43	−10
	17	ING Investments	−55	−11
	18	Putnam	−58	−54

There were also numerous significant disparities between the two scores. Most of them were explained, I think, because the performance ratings that I presented reflect the returns *reported* by mutual funds. But such reporting has a major failing. To be blunt about it, fund investors could hardly care less about reported returns when they vastly overstate the returns that they've actually earned. That's often the case in this business, for fund marketers have a seemingly irresistible impulse to promote shares of a fund only *after* the fund has achieved sterling performance, an impulse, alas, that also seems irresistible to fund investors. Following such superior performance, however, such funds seem to have an almost equally irresistible impulse to revert not only to the market mean, but even below it. What goes up, it seems, must go down.

The most glaring gap between performance rating (+38) and loyalty rating (–30) appears for the Janus funds. Let's examine their records. During the 10 years ended December 31, 2007, the five largest Janus funds turned in an average annual return of 9.3 percent, a solid margin over the annual return of 5.9 percent for the S&P 500 index. During the first three years of that period, however, the Janus returns soared far above the S&P 500 index return, and as the market soared to new heights some $50 billion of investor capital flowed into the funds. In the bear market that followed, the funds collapsed. Result: Most Janus investors actually experienced dismal returns.

To summarize the math: For the decade, these Janus funds reported *time-weighted* returns averaging 9.3 percent per year, a compound 10-year return of 157 percent. The Janus fund investors, on the other hand, earned *dollar-weighted* returns averaging but 2.7 percent per year on the money they actually invested, a compound return of only 38 percent. That is, the returns actually earned by Janus shareholders for the decade fell fully 119 percentage points behind the returns that the Janus funds reported. That truly remarkable lag doubtless accounts for the gross disparity between the funds' high scores in reported performance and their low loyalty scores based on what Janus shareholders actually experienced. Such experience also likely characterizes the lack of shareholder loyalty at Morgan Stanley, AIM, and Columbia (Bank of America).

Costs Rear Their (Ugly) Head

The data are clear, then, that truly mutual investing has not only reaped rewards for its clients but has also earned their loyalty. Equally clearly, the financial conglomerates have not only failed their investors, but have earned (if that's the right word) their opprobrium. How do we account for these differences in return? Obviously, there's a certain amount of luck, skill, and timing in performance ratings, even though much of the impact of those variations evens out over a period as long as a decade, and even more of the disparity is mitigated when the management firms run a hundred funds or more.

It turns out, however, that there is one factor that plays a major role in the relative returns of peer funds. Happily, it is a factor that persists over time: *the costs that funds incurred in delivering their returns to investors.* It must be obvious that funds with similar objectives, managed by competent and experienced professionals, and compared over an extended period of time are more likely to achieve similar (and inevitably market-like) returns—but only before the costs of investing come into play.

Fund costs come in many guises. The major costs are: (1) the expense ratio (annual percentage of asset value consumed by management fees and operating expenses); (2) sales loads, representing the cost to acquire fund shares; and (3) transaction costs, the real—but hidden—expenses incurred in the execution of the investment decisions made by the fund's portfolio managers. Since transaction costs are not publicly available, the "all-in" expense ratios I'm using—including sales loads built into the B and C share classes—are the most satisfactory measure of fund costs.

Now let's add to our previous chart a column showing the expense ratios for the equity funds in each group* (Table 13.3). The three firms with the highest performance ratings are the very same firms—in the very same order—that have the lowest annual expense ratios, averaging

*Since the largest variations in fund expense ratios come in equity funds, I have excluded bond fund expense ratios—which are generally lower—from this comparison. This practice also eliminates the distortion that would be created when firms manage different proportions of bond funds to stock funds.

TABLE 13.3 MAJOR MUTUAL FUND MANAGERS: FUND PERFORMANCE, SHAREHOLDER LOYALTY, AND COSTS

		Manager	Funds Ranked Highest Minus Lowest	Client Loyalty Score	Avg. Eq. Fund Exp. Ratio
	1	Vanguard	54%	44	0.23%
	2	DFA	50	n/a	0.33
Highest	3	TIAA-CREF	50	n/a	0.37
Returns	4	T Rowe Price	44	21	0.93
	5	Janus	38	−30	1.21
	6	American Funds	26	12	1.06
	7	Franklin Temp.	9	1	1.48
	8	Morgan Stanley	2	−18	1.23
Average	9	Fidelity	−3	12	1.31
Returns	10	Barclays Global	−4	n/a	0.41
	11	AIM Inv.	−14	−48	1.59
	12	Columbia Funds	−14	−47	1.41
	13	Goldman Sachs	−40	−32	1.59
	14	Dreyfus	−40	−45	1.65
Lowest	15	MainStay Funds	−40	n/a	1.49
Returns	16	John Hancock	−43	−10	1.40
	17	ING Investments	−55	−11	1.72
	18	Putnam	−58	−54	1.56

0.31 percent. For the top-performing group in total, the average ratio is 0.69 percent. Expense ratios for the middle group average 1.24 percent, fully 80 percent higher.[†] The bottom group of performers, on the other hand, have the highest expense ratios, averaging 1.57 percent per year, 127 percent above the top-performing group. Together, these data tell us that, when looking to the sources of mutual fund returns, yes, *costs matter.*

But please don't take my word for it. In fact, these data merely confirm what industry experts and academics have been saying for decades. Morningstar puts in unequivocally: "[E]xpense ratios are the fund

[†]The funds managed by Barclays, with a ratio of 0.41 percent, largely follow lower-cost index or index-like strategies.

world's best predictor" of performance, adding that "*all* studies show that expenses are the most powerful indicator of a fund's performance" (Italics added). Nobel laureate (in Economics) William F. Sharpe is equally unequivocal: "The smaller a fund's expense ratio, the better the results obtained by its shareholders."* He wrote those words in 1966(!), and confirmed them in 1996. "If you had to look at one thing only [in selecting a fund], I'd pick expense ratio."†

Sharpe's observations have met the test of time, nicely confirmed by the data that I have just presented. Crude data showing the relationship between expense ratios and Morningstar ratings suggests that an extra percentage point of cost means one *less* star in ratings; a percentage point reduction in cost means one *more* star. That is, if a three-star fund had an expense ratio one percentage point lower, it would be transformed into a four-star fund; if the same fund had a ratio one percent higher, it would become a two-star fund. Despite this powerful data, however, despite the opinion of experts, and despite the common sense that tells us that investment costs are the central element in determining the relative returns of mutual funds within their peer groups, price competition remains conspicuous by its absence from the mutual fund industry.

Price Competition?

Investors seem to be largely unaware of the direct and causal relationship between fund costs and fund returns. The industry's only three *very*-low-cost firms dominate the performance statistics, yet together they constitute a mere 14 percent of industry assets. How can the industry continue to maintain expense ratios that average 1.5 percent per year, *five times* as high? (Yes, along with Vanguard, T. Rowe Price, American Funds, and Fidelity—with costs that average 1.1 percent, somewhat

*"Mutual Fund Performance," *Journal of Business* (January 1966): 119.
†"In the Vanguard" (Summer 1996).

below industry norms, but many times Vanguard's costs—accounted for about one-third of all industry cash flow last year. But that still leaves two-thirds of the cash flowing largely into high-cost funds.)

The fact is that there are many "signs the mutual fund marketplace may not be performing in a way one would expect in a satisfactorily functioning competitive market." That is the opinion of the general counsel of the U.S. Securities and Exchange Commission.* One sign, he adds, is "the law of one price," the principle that, in an efficient, competitive market, nearly identical goods will sell at nearly identical prices. That's obviously because with full information "no rational buyer would pay more." Yet without such price convergence in the fund field, "American investors may be being deprived of the long-term returns they deserve."

Put another way, as a University of Washington professor† wrote, "as the information about a commodity improves, its price variability will decline." He quotes the great English economist Alfred Marshall, "[T]he more nearly perfect a market is, the stronger the tendency for the same price to be paid for the same thing at the same time in the market." Price variability, then, is a measure of our ignorance about what the makeup of a commodity is, dividing goods into what the author calls "brand-name commodities" and "caveat emptor commodities."

The fact is that some kinds of funds—money market funds, for example—are clearly commodities. So are index funds. Investment-grade bond funds and U.S. Treasury bond funds (with comparable maturities) are at least commodity-like. What about managed equity funds? When sorted by objectives (i.e., compared to their peers, as in, for example, large-cap value funds), they are also commodity-like in the short run, even more so in the long run. (And since the various equity investment styles tend to revert to the mean over time, all—or

*Speech by Brian G. Cartwright before the 2006 Securities Development Conference, December 4, 2006.

†Dr. Yoran Barzel, "Replacing the Law of One Price with the Price Convergence Law" (University of Washington Department of Economics Working Paper No. UWEC-2005-10, 2005, March 28, 2005).

nearly all—equity funds tend to be commodity-like in nature in the *very* long term.) When *brand-name* commodities have different prices, then, they quickly become *caveat emptor* commodities, a lesson fund investors have yet to learn.

Clearly, price ought to be the talisman that drives investor choice, forcing fund managers to reduce costs. But that is simply not happening. Yes, money flows (as I have noted) are increasingly directed toward the lower-cost funds, and Vanguard has been a beneficiary of, indeed a creator of, that structure. But other fund complexes are not following the lead.* In short, *if price competition is defined, not by the action of consumers, but by the actions of producers, then price competition is conspicuous by its absence in the mutual fund industry*. Why don't fund managers compete on costs? Because to do so would be antithetical to their vested financial interests.

The fund industry, of course, argues that it is characterized by vigorous competition. To a point that is true: There is competition in the marketplace. Witness the incentives offered to brokers to sell shares and the hundreds of millions spent each year on print and television advertising. There is performance competition. Witness the ongoing advertising of funds that have had superior past records, or are investing in hot market sectors. But there is little evidence to suggest that there is price competition. While the most vigorous industry advocates find "evidence of price competition clear,"† the data presented by these advocates show that while there were 1,240 fee decreases during 1998–2004, there were even more fee *increases*—1,469 per year on average. Even these advocates do not dispute "the empirical fact that mutual fund boards of directors rarely 'fire' advisers and do not put advisory contracts up for bids among advisers." Without such competition, mutual fund managers are hardly likely to reduce their fees, and hence their own profitability.

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*I'm often told that Vanguard's demonstrably low costs—increasingly recognized in the marketplace—are responsible for setting an upper limit on prices among our competitors. But that level is still far too high for my taste.

† John C. Coates IV and R. Glenn Hubbard, "Competition in the Mutual Fund Industry," *Journal of Corporation Law* 33, no. 1, University of Iowa (Autumn 2007): 173–174.

Recap of the Issues

Let me summarize here the arguments I've made so far: In its early years, the investment company industry had many characteristics that well-served fund investors. The focus was largely on private trusteeship; prudence and diversification were the watchwords of investment policy; fund trustees often were a step removed from fund distribution; expense ratios were moderate, and far below today's levels. Today, public ownership—largely by giant conglomerates—overwhelmingly dominates the fund industry, and it has ill-served fund investors. By way of contrast, the results of that "Vanguard Experiment" in mutual fund governance are now clear. It has been both a remarkable commercial success for the firm itself, and an artistic success for its shareholder/owners.

Our central idea was to create a firm honoring the industry's original values. I expected that becoming the low-cost provider in any industry where low cost (by definition) is the key to superior returns, would force our competitors to emulate our structure. Indeed, I chose the name "vanguard" in part because of its meaning: "leadership in a new trend." But I was wrong. After more than three decades—during which at least one of our industry peers has described us as "the organization against which others must measure themselves"—we have yet to find our first follower.* We remain unique.

Of course, not everyone shares my view of the positive power of the mutual structure. Hear the American Enterprise Institute (AEI), in a recent book entitled *Competitive Equity: A Better Way to Organize*

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*I had hoped that when Marsh & McClennan decided to sell its Putnam Management Company subsidiary—obviously a deeply troubled firm whose previous management ill-served its investors in so many ways—it would mutualize and internalize its organization. However, my attempts to persuade three directors of the funds (including its then-independent chairman) fell on deaf ears. The fund board approved the sale of the management to a Canadian conglomerate for $4.9 billion. For a further explanation of why and how such a conversion might have taken place, see my speech, "Corporate Governance and Mutual Fund Governance—Reflections at a Time of Crisis," November 21, 2003.

*Mutual Funds** (Hint: It doesn't consider the Vanguard way "a better way.") The authors are skeptical of our claim that we operate on an "at-cost basis," albeit without identifying the basis of that skepticism. They allege that our managers do not accept compensation substantially lower than that paid to other fund advisers, apparently unaware that we fully disclose the rates and fees we pay to the unaffiliated external advisers that manage many of our actively managed funds. For the record, the average fee paid to the advisers to Windsor Fund is 0.12 percent of fund assets; the fee paid to the adviser to our GNMA Fund is 0.01 percent. (Yes, that's one basis point.)

Despite these shortcomings in their argument, their conclusion is unequivocal: "[T]he idea that the mutual form of organization is inherently superior to the external form . . . is something of an overstatement." They also allege that conversion to a mutual form would require buying out the existing shareholders (of the management company), ignoring the fact that Vanguard, as noted earlier, did no such thing. In fact, the fund directors have the awesome power to simply terminate the manager's contract and either manage the funds internally or hire new external advisers. (I note that while this never happens in the fund field, it happens with considerable frequency among corporate pension funds.)

The Triumph of Conglomeration

In any event, the mutual model remains stuck, still used by only a single firm, and the conglomerate model has triumphed. Early on, and presciently, Chairman Cohen recognized the serious problems that would be created by this conglomeration. In a 1966 speech, he spoke of the "new and more complex relationships . . . [between] institutional managers and their beneficiaries," and sought "a more adequate scheme of regulation that ultimately will protect beneficiaries from unwarranted action by their managers, and will realize the fullest benefits of their participation" in their funds. He then noted, prophetically,

*By Peter J. Wallison and Robert E. Litan (Washington, DC: AEI Press, 2007).

his concern about "public ownership of investment advisers . . . and the beginning of a trend toward [their] acquisition by industrial companies," which makes it "increasingly difficult to define the responsibilities of institutional managers," who may "be obligated to serve the business interests of the very companies in which they invest."

The snowball that began to roll with the onset of public ownership of management companies in 1958 took a while to gather speed. But during the 1980s and 1990s it came into full flower and, as noted earlier, among the 50 largest firms in the industry only 9 remain privately held. This massive wave of conglomeration by what are essentially giant marketing firms led to a wave of, yes, "product proliferation" that carried the number of mutual funds from 560 in 1980 to 12,039 today.

It's Time for a Change

Only two weeks after that 1966 speech by Chairman Cohen, the Commission sent to Congress a massive report by its staff entitled *Public Policy Implications of Investment Company Growth* (PPI).* In that report, the SEC noted the burgeoning level of fund fees (then at an annual level of a mere $134 million vs. more than *$100 billion* today). The Commission also called attention to the effective control advisers held over their funds, and "the absence of competitive pressures, the limitations of disclosure, the ineffectiveness of shareholder voting rights, and the obstacles to more effective action by the independent directors."

The Commission also noted "the adviser-underwriter permeation of investment company activities to an extent that makes rupture of existing relationships a difficult and complex step . . . [rendering] arm's length bargaining between the fund's board and the managers . . . a wholly unrealistic alternative." Yet the Commission was "not prepared to recommend at this time the more drastic statutory requirement of compulsory internalization of management [i.e., mutualization]."

*U.S. Government Printing Office (December 3, 1966).

Rather, the SEC recommended the adoption of a "statutory standard of reasonableness . . . *a basic standard that would make clear that those who derive benefits from their fiduciary relationships with investment companies cannot charge more for services than if they were dealing with them at arm's length*" (emphasis added).

The SEC described *reasonableness* as a "clearly expressed and readily enforceable standard [that] would not be measured merely by the cost of comparable services to individual investors or by the fees charged by other externally managed investment companies . . . [but by] the costs of management services *to internally-managed funds* and to pension funds and other non-fund clients." If the standard of reasonableness does not "resolve the problems in management compensation that exist . . . *then more sweeping steps might deserve to be considered.*"

With vigorous lobbying by the Investment Company Institute, the self-anointed representative of fund shareholders but in fact the powerful voice of fund managers, that reasonableness standard was never adopted. Yet, even as fund fees soared and conglomeration gradually took over, transaction after transaction, unchallenged (and, arguably, unchallengeable) after that ghastly 1958 decision by the Ninth Circuit, even as Chairman Cohen's worst fears were being realized, even after PPI's warning 42 long years ago, more sweeping steps have yet to be considered by the SEC.

But some baby steps have been considered. In 2004, the Commission recommended a significant strengthening of fund boards, only to be reconsidered and likely watered down by a differently led Commission in 2008. Of course I'd prefer more sweeping steps. Indeed, as I wrote in my book *Common Sense** nearly a decade ago, "[T]he industry's further evolution must take one of two critical turns: [One is] a radical restructuring, a change in the status quo, a change that places more power in the hands of shareholders. The radical restructuring would be the mutualization of at least part of the American mutual fund industry. Rather than contracting with

*Paraphrased from my book, *Common Sense on Mutual Funds: New Imperatives for the Intelligent Investor* (Hoboken, NJ: John Wiley & Sons, 2009).

external management companies to operate and manage the portfolios, funds—or at least large fund families—would run themselves. Mutual fund shareholders would, in effect, own the management companies that oversee the fund.

"They would have their own officers and staff, and the huge profits now earned by external managers would be diverted to the shareholders. Under such a structure, the character of the industry would return to its traditional roots. Funds wouldn't waste their shareholders' money on costly marketing campaigns designed to bring in new investors at the expense of existing investors. With markedly lower costs, they would produce markedly higher returns and/or assume commensurately lower risks. They would provide full and candid disclosure to their shareholder-owners. They'd have no need to organize and market 'fund-of-the-moment' funds, and they might even see the merit of market index funds.

"The other choice would be the rise of more activist independent mutual fund directors. Independent board members would become ferocious advocates for the rights and interests of the mutual fund shareholders they represent. They would negotiate aggressively with the mutual fund adviser, allowing the management company to earn a fair profit, but recognize that the interests of the mutual fund shareholders must always come first. Independent directors would approve only portfolios that are based on sound investment principles and meet a reasonable investment need. The independent directors would at last become the fiduciaries they are supposed to be under the law. And if the creation and encouragement of activist independent directors is a more practicable solution than the wholesale mutualization of the American mutual fund industry, then perhaps it is an objective deserving of our energies and effort. And who knows? As the values of such a refocused organization move toward the values of the mutual organization, full mutualization for some firms may be only a step further away.

"Regardless of the exact structure, mutual or conventional, an arrangement in which fund shareholders and their directors are in working control of a fund—as distinct from one in which fund managers are in control—will lead to funds that truly serve the needs of their shareholders, meeting the crying need to return this industry to the traditional role of trusteeship that largely characterized its *modus* *operandi* through its first three decades. Under either structure, the industry will enhance economic value for fund shareholders."

What's to Be Done?

Given the industry's growth; its sharp turn from stewardship to salesmanship; the army of conglomerates that has swept across it, leaving only a handful of survivors; its failure to produce anything like satisfactory returns to the investors who have entrusted funds with their hard-earned dollars; and, dare I say, the success of the singular, still unique, firm that has, for nearly 34 years now, almost unequivocally demonstrated the value of that internalization that the SEC was unprepared to mandate all those years ago, not a single additional moment should elapse before those long-justified, long awaited "more sweeping steps" are not only considered, but enacted into the law.

My idealism tells me to fight for compulsory internalization,* at long last making it possible to delete those quotation marks around "mutual" fund that reflected the prescient concerns expressed by Chairman Cohen in the speech he delivered in 1968. But my pragmatism disagrees. Powerful and well-financed lobbyists—led by the Investment Company Institute, the fabulously profitable management companies and their conglomerate owners, and the U.S. Chamber of Commerce (of course!)—would take up arms against such a seemingly radical proposal. The campaign would come with unbridled enthusiasm and virtually unlimited financial firepower, K Street's dreams come true. Given the state of our nation's governance, such opposition, self-interested as it obviously is, would defeat "the national public interest and the interest of investors," the very interests that the 1940 Act was designed to protect.

But hope is not lost. There is a way—not, of course, an easy way—to honor the spirit and letter of the Act so that investment companies are organized, operated, and managed in the interests of

* But not for all fund complexes, only for complexes that exceed certain thresholds; for example, fund complexes that manage over $25 billion in assets and more than 30 mutual funds.

their shareholders rather than their managers and distributors. It would take a series of logical steps to achieve this goal, some already in the works, some proposed by an earlier Commission and now seemingly abandoned; new steps that take us even further toward that goal; one simple—if dramatic—organizational change that would create enormous momentum toward fund operational independence from their advisers; and a change in federal law.

Here's the plan I propose:

1. Require that 100 percent of fund directors be unaffiliated with the management company. There is simply no point in any longer subjecting management company officers to the profound conflicts of interest that they face when they also serve as fund directors. It's time to honor the principle that "no man can serve two masters." (As noted earlier, since the firm's inception, the Vanguard funds have prohibited representatives of any external adviser from serving on their boards. It hasn't seemed to impair the returns we earn for investors.)
2. Require that the chairman of the fund board be independent of the management company, even if, as under the Commission's 2004 proposal, only 75 percent of the board is required to be independent. Such a separation of powers, ordained for our federal government in the Constitution, is not only a fundamental principle of governance, but simple common sense.
3. Require the retention by the funds of legal counsel independent of the adviser and a chief compliance officer. Both are already mandated by the Commission, but we must require them to be responsible to the fund board, reporting to the independent fund chairman.
4. Importantly, require that the fund boards retain advisers and experts necessary to carry out their duties, in order to provide truly objective and independent information to the board. (I'm guessing that few fund boards have seen the kind of comparative performance, loyalty, and cost data that I've presented in these remarks.) The SEC recommended language "authorizing" such a staff (or consultants) in its 2004 recommendations, which now seem to have gone aborning. As I see it, this requirement would apply only to

fund complexes of a certain (large) size and scope.* It's time to face up to the fact that directors who are overseeing 100 funds or more can't do so without staff support.

5. A specific regulatory authorization that enables funds to assume responsibility for their own operations, including administration, accounting, compliance, shareholder record-keeping, etc. Such a structure would cut the Gordian knot that gives fund managers de facto control over the funds they manage.† It is this very step that was central to the creation of Vanguard, which (as noted earlier) soon enabled the fledgling firm to extend its reach to investment management and then to distribution.
6. Enact a federal standard of fiduciary duty for fund directors. The fact is that mutual fund managers, indeed pension fund managers, public and private alike, face serious conflicts of interest in carrying out their duties. In today's relatively new *agency* society, in which financial institutions control more than 70 percent of stock ownership, there has been a serious failure to serve their *principals*—largely fund shareholders and pension beneficiaries. As the Honorable Leo E. Strine, Jr., Vice Chancellor of the Delaware Court of Chancery, has noted, it would be "passing strange if professional money managers would, as a class, be less likely to exploit their agency than the managers of corporations that make products and deliver services."‡ Yes, the world has changed, and we need to redress that imbalance in favor of the principals.

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*For example, complexes meeting the standards outlined in note 33. But in my darker moments, I'd consider applying this requirement only to fund complexes in which a majority of the directors are unable to actually name all of the funds on whose boards they serve. If that requirement is too demanding, then only when directors are unable to specify the exact number of funds on whose boards they serve.

†It is a curious fact that the operational function was ignored in the 1940 Act. It refers solely to the other two functions of fund management, investment advice and share distribution (underwriting).

‡"Toward Common Sense and Common Ground," *Journal of Corporation Law (Iowa)* 33, no. 1 (Fall 2007): 1.

Two Powerful Endorsements

Once again, this critical analysis of the mutual fund industry is not mine alone. Listen to Warren Buffett: "Fund independent directors . . . have been absolutely pathetic. They follow a zombie-like process that makes a mockery of stewardship. 'Independent' directors, over more than six decades, have failed miserably." Then, hear this from another investor, one who has not only produced one of the most impressive investment records of the modern era but who has an impeccable reputation for his character and intellectual integrity, David F. Swensen, Chief Investment Officer of Yale University:

> The fundamental market failure in the mutual-fund industry involves the interaction between sophisticated, profit-seeking providers of financial services and naïve, return-seeking consumers of investment products. The drive for profits by Wall Street and the mutual-fund industry overwhelms the concept of fiduciary responsibility, leading to an all too predictable outcome . . . the powerful financial services industry exploits vulnerable individual investors . . .
>
> The ownership structure of a fund management company plays a role in determining the likelihood of investor success. Mutual-fund investors face the greatest challenge with investment management companies that provide returns to public shareholders or that funnel profits to a corporate parent—situations that place the conflict between profit generation and fiduciary responsibility in high relief. When a fund's management subsidiary reports to a multi-line financial services company, the scope for abuse of investor capital broadens dramatically . . .
>
> *Investors fare best with funds managed by not-for-profit organizations*, because the management firm focuses exclusively on serving investor interests. No profit motive conflicts with the manager's fiduciary responsibility. No profit margin interferes with investor returns. No outside corporate interest clashes with portfolio management choices. Not-for-profit firms place investor interest front and center. Ultimately, a passive index fund managed by a not-for-profit investment management

organization represents the combination most likely to satisfy investor aspirations. [Emphasis added.]

I regard these two powerful endorsements of the positions that I hold as a clarion call for action. Yes, it's time to make fund directors aware of their duty to serve the fund shareowners rather than the entrenched fund managers, and to bring independent leadership—*real* leadership—to fund boards. That is the purpose of the six changes I've delineated. And yes, I'm well aware that, for some firms, these changes may lead to the full mutualization that, in the only case study that exists, has served shareholders so well. Yes, it's also time to overturn the ghastly legacy of the Ninth Circuit's erroneous decision in 1958 that opened the floodgates first to public ownership and then to conglomerate ownership.* It's also high time for firms that now place asset-gathering at the heart of their mission to return to the industry's professional roots and again act as true fiduciaries.

So, yes, it's time for a new order of things. It's time to facilitate the development of mutualization in the mutual fund industry. It's time to go back to the future and honor the vision of trusteeship held by Paul Cabot, and the vision of SEC Commissioner Healy to protect investors from the distorting impact of fund sales. And, especially on the occasion of this 27th annual Manuel F. Cohen Memorial Lecture, it's time to honor Manny Cohen's legacy, his implicit demand that we build an industry worthy of deleting those darned quotation marks that he placed around the word "mutual," at last bringing mutuality back to the mutual fund industry. Only then will we honor the crystal-clear spirit of the 1940 Act, and protect the national public interest and the interests of investors.

*Interestingly in light of my recommendations here, the note in the *Harvard Law Review* cited in note 13 concludes with this caveat: "However, the sellers might be allowed to sell control for any consideration if the fund had an independent board of directors . . . with control of the proxy machinery and the power to select another adviser."

Appendix

TABLE 13.4 MAJOR MUTUAL FUND MANAGERS: FULL STUDY

Manager Name	Total Assets $MM (as of 11/07)	Number of Funds Rated						4/5 Star Share	1/2 Star Share	5/4 minus 1/2	Loyalty Score
		5 Stars	4 Stars	3 Stars	2 Stars	1 Star	Total				
1 Vanguard	1,089,489	31	78	67	5	4	185	58.9%	4.9%	54.1%	44
2 DFA	108,655	2	22	15	3		42	57.1%	7.1%	50.0%	
3 TIAA-CREF	17,788	3	22	19	2		46	54.3%	4.3%	50.0%	
4 T Rowe Price	230,424	7	47	38	9		101	53.5%	8.9%	44.6%	21
5 Janus	97,181	14	27	23	9	3	76	53.9%	15.8%	38.2%	−30
6 Schwab	54,203	3	16	32	2	1	54	35.2%	5.6%	29.6%	26
7 American Funds	1,157,019	63	80	106	47	16	312	45.8%	20.2%	25.6%	12
8 Neuberger Berman	26,589	4	10	15	4	3	36	38.9%	19.4%	19.4%	−1
9 PIM CO/Allianz Glbl	244,039	40	71	114	56	15	296	37.5%	24.0%	13.5%	−27
10 Franklin Templeton	331,866	20	66	131	45	17	279	30.8%	22.2%	8.6%	1
11 Oppenheimer Funds	165,845	15	61	61	42	18	197	38.6%	30.5%	8.1%	−6
12 Waddell & Reed	46,146	27	40	57	34	19	177	37.9%	29.9%	7.9%	
13 Prudential Finl	34,645	28	34	62	48	2	174	35.6%	28.7%	6.9%	
14 BlackRock	146,125	34	80	138	65	31	348	32.8%	27.6%	5.2%	−18
15 American Century	76,854	13	44	65	41	8	171	33.3%	28.7%	4.7%	−21
16 Morgan Stanley	69,075	8	61	84	60	5	218	31.7%	29.8%	1.8%	−18
17 Russell Invst Grp	36,242		11	34	6	4	55	20.0%	18.2%	1.8%	
18 Fidelity	928,528	44	102	165	116	44	471	31.0%	34.0%	−3.0%	12
19 Barclays Global	321,630	4	23	41	20	11	99	27.3%	31.3%	−4.0%	
20 Alliance Bernstein	95,286	7	37	96	38	17	194	22.7%	28.4%	−5.7%	−33
21 Principal Funds	54,435	10	50	154	72	13	299	20.1%	28.4%	−8.4%	−7
22 Nuveen	72,537	16	21	57	30	19	143	25.9%	34.3%	−8.4%	
23 GE Asset Mgmt	19,666	4	11	24	16	4	59	25.4%	33.9%	−8.5%	
24 The Hartford	49,878	10	25	52	42	8	137	25.5%	36.5%	−10.9%	−11

(*Continued*)

TABLE 13.4 (Continued)

Manager Name	Total Assets $MM (as of 11/07)	Number of Funds Rated					Total	4/5 Star Share	1/2 Star Share	5/4 minus 1/2	Loyalty Score
		5 Stars	4 Stars	3 Stars	2 Stars	1 Star					
25 Northern Trust	21,035		6	39	13		58	10.3%	22.4%	−12.1%	
26 AIM Investments	63,308	5	37	94	62	7	205	20.5%	33.7%	−13.2%	−48
27 Columbia Funds	118,967	19	50	115	73	38	295	23.4%	37.6%	−14.2%	−47
28 Federated	42,731	8	25	59	46	11	149	22.1%	38.3%	−16.1%	
29 Wells Fargo	45,270	16	52	79	82	29	258	26.4%	43.0%	−16.7%	−20
30 FAF Advisors	20,994	4	20	76	39	11	150	16.0%	33.3%	−17.3%	
31 Eaton Vance	98,196	11	27	87	63	16	204	18.6%	38.7%	−20.1%	−47
32 JPMorgan Funds	76,723	4	46	93	77	26	246	20.3%	41.9%	−21.5%	10
33 Lord Abbett	58,698	7	19	46	44	10	126	20.6%	42.9%	−22.2%	−5
34 MFS	84,708	12	36	111	88	20	267	18.0%	40.4%	−22.5%	−9
35 MassMutual Finl	23,373	3	25	67	48	18	161	17.4%	41.0%	−23.6%	
36 Delaware	27,285	7	29	71	74	8	189	19.0%	43.4%	−24.3%	
37 Evergreen Inv Mgmt	55,444	8	38	59	68	28	201	22.9%	47.8%	−24.9%	−48
38 Pioneer	38,732	8	19	35	47	13	122	22.1%	49.2%	−27.0%	
39 DWS Scudder	65,492	9	31	73	68	31	212	18.9%	46.7%	−27.8%	−41
40 Legg Mason Funds	90,049	3	30	67	59	28	187	17.6%	46.5%	−28.9%	4
41 Van Kampen	93,901	3	17	45	45	10	120	16.7%	45.8%	−29.2%	−12
42 RiverSource	56,223	12	34	63	86	34	229	20.1%	52.4%	−32.3%	2
43 State Street Glbl	42,831		5	16	8	11	40	12.35%	47.5%	−35.0%	
44 UBS Glbl Asset Mgt	23,951		15	37	38	15	105	14.3%	50.5%	−36.2%	
45 Goldman Sachs	60,131	4	21	49	79	11	164	15.2%	54.9%	−39.6%	−32
46 Dreyfus	62,997	5	37	120	133	47	342	12.3%	52.6%	−40.4%	−45
47 MainStay Funds	24,470	3	18	21	41	23	106	19.8%	60.4%	−40.6%	
48 John Hancock	59,228	8	9	24	43	18	102	16.7%	59.8%	−43.1%	−10
49 ING Investments	29,746	4	12	48	70	44	178	9.0%	64.0%	−55.1%	−11
50 Putnam	89,318	1	9	92	121	48	271	3.7%	62.4%	−58.7%	−54
Total	6,947,135	571	1,706	3,335	2,427	817	8,856	25.7%	33.6%	−7.9%	

Chapter 22

Seventeen Rules of Entrepreneurship*

A wonderful series of happy accidents—beginning with my admission to this best old place of all as a member of the great Class of 1951—led to the creation of Vanguard. Today we manage some $720 billion of investor assets, one of the two largest mutual fund complexes in the world. Like all numbers, that number, in and of itself, is not particularly important. What *is* important is that we created a unique corporate structure, a more efficient and economical way to serve investors, and a new way of managing investments that together have begun to reshape the way the financial community thinks about investing.

Of course Vanguard is a story of entrepreneurship, too. But an odd kind of entrepreneurship, involving (1) the conversion of an existing enterprise to a higher use; (2) a business that demands virtually no capital assets; (3) an innovative corporate structure that was unlikely to be—and even 50 years later has yet to be—copied; and (4) an

*Based on remarks at the Princeton Entrepreneurs' Network 5th Annual National Conference in Princeton, New Jersey, on May 28, 2004. The original title was "Vanguard—Child of Princeton."

original idea, the index mutual fund, which, simply put, is the "killer app"—an investment strategy that cannot be empirically improved upon. And if that's not enough to make Vanguard atypical, I would add: (5) a firm specifically designed to provide neither equity nor entrepreneurial reward for its creators. (More about that later!) If those five peculiarities undermine my credentials to speak authoritatively on entrepreneurship, so be it. But I'll try, anyway.

Where It All Began

The story begins with the first of the almost-infinite number of breaks I've been given during my long life. It came at Blair Academy, where, thanks to a scholarship and a job, I received a splendid college-preparatory education. That priceless advantage in turn presented me with another break. With the help of another full scholarship and a job waiting on tables in Commons, I entered Princeton University in the late summer of 1947. (It was easier to get admitted then!)

Despite my academic success at Blair, I found the early going at Princeton tough. The low point came in the autumn of 1948, when I struggled with the first edition of Paul Samuelson's *Economics: An Introductory Analysis*. It was not a happy introduction to my major field of study, and I earned a well-deserved 4+ (D+ today) as my mid-term grade. With my other grades scarcely more worthy, my scholarship—and hence my Princeton career, for I had not a *sou* of outside financial support—was in dire jeopardy. But I ended the term with a nice upsurge . . . to a hardly distinguished 3 (today, C) average.

Academic distinction continued to elude me, but a year later fate smiled down on me once again. Determined to write my senior thesis on a subject that no previous thesis had ever tackled, Adam Smith, Karl Marx, and John Maynard Keynes were hardly on my list. But what topic *should* I choose? Perusing *Fortune* magazine in the reading room of the then-brand-new Firestone library in December 1949, I paused on page 116 to read an article about a business which I had never even imagined. And when "Big Money in Boston" described the mutual fund industry as "tiny but contentious," this callow and insecure—but determined—young kid decided that mutual funds should be the topic of his thesis. I entitled it, "The Economic Role of the Investment Company." Thus, the first **Entrepreneurial Lesson** that I'll present today is: **#1: Get lucky**.

A Design for a Business?

I can't tell you that my thesis laid out the design for what Vanguard would become. But there's no question that many of the values I identified then would, 50 years later, prove to lie at the very core of our remarkable growth. "The principal function of mutual funds is the management of their investment portfolios. Everything else is incidental. . . . Future industry growth can be maximized by a reduction of sales loads and management fees," and, with a final rhetorical flourish, funds should operate "in the most efficient, honest, and economical way possible." Sophomoric idealism? A design for the enterprise that would emerge a quarter-century later? I'll leave it to you to decide. But whatever was truly in my mind all those years ago, the thesis clearly put forth the proposition that mutual fund shareholders ought to be given a fair shake.

In any event, the countless hours I spent researching and analyzing the industry in my carrel at Firestone were rewarded with a 1+, and led to a *magna cum laude* diploma—a delightful, if totally unexpected, finale for my academic career at Princeton. And it came with a fine sequel: A half-century later, Dr. Samuelson, by then a Nobel Laureate in Economics, would write the foreword to my first book! (Another turnabout: In 1999, exactly 50 years after *Fortune* introduced me to the industry, that very magazine named me one of the four Investment Giants of the 20th century.) **Entrepreneurial Lesson #2: Turn disaster into triumph**.

Fate smiled on me yet again when a great Princetonian named Walter L. Morgan, Class of 1920 and the founder of Wellington Fund, read my thesis. In his own words: "Largely as a result of his thesis, we have added Mr. Bogle to our Wellington organization." While I agonized over the risks of going into that "tiny but contentious" business, my thesis research had persuaded me that the industry's future would be bright. So I cast my lot with this great man, my good friend until his death at age 100 in 1998, and never looked back. He had given me the opportunity of a lifetime. Bless his soul! **Entrepreneurial Lesson #3: Get a mentor**.

In the Business, Then Out

By 1965, Mr. Morgan had made it clear that I would be his successor. At that time, the Company was lagging its peers, and he told me to "do whatever it takes" to solve our problems. Young and headstrong (I was then but 36 years of age), I put together a merger with a high-flying group of four "whiz kids" who had achieved an extraordinary record of investment performance over the preceding six years. (Such an approach—believing that *past* fund performance has the power to predict *future* performance—is, of course, antithetical to everything I believe today. It was a great lesson!) Together, we five whiz kids whizzed high for a few years. And then we whizzed low. The speculative fever in the stock market during the "Go-Go Era" of the mid-1960s "went-went." Just like the recent "New Economy" bubble, it burst, and was followed by a 50 percent market decline in 1973–1974. The once-happy band of partners had a falling out, and in January 1974 I was deposed as the head of what I had considered *my* company. **Entrepreneurial Lesson #4: Get fired**.

But without both the 1951 hiring, which providentially brought me *into* this industry, and the 1974 firing, which abruptly took me *out* of it, there would be no Vanguard today. Removed from my position at Wellington Management Company, I decided to pursue an unprecedented course of action. The *company* directors who fired me composed only a minority of the board of Wellington Fund itself, so I went to the *fund* board with a novel proposal: Have the Fund, and its then-10 associated funds (today there are 100), declare their independence from their manager, and retain me as their chairman and CEO.

It wasn't *exactly* the Colonies telling King George III to get lost, as it were, in 1776. But *fund independence*—the right of a fund to operate with its own leadership, in the interest of its own shareholders, free of domination by the fund's outside manager—was at the heart of my proposal. *Mirabile dictu!* After a contentious debate lasting seven months, we won the battle to administer the funds on a truly mutual basis, under which they would be operated, at cost, by their own wholly owned subsidiary. **Entrepreneurial Lesson #5: Dare to be bold!**

With only weeks to go before our incorporation, we still had no name for the new firm. Fate, of course, smiled again. In the late summer of 1974, a dealer in antique prints came by my office with some small engravings from the Napoleonic War era, illustrating the military battles of the Duke of Wellington, for whom Mr. Morgan had named his first mutual fund 46 years earlier. When I bought them, he offered me some companion prints of the British naval battles of the same era. Ever enticed by the sea and its timeless mystery, I bought them, too. Delighted, the dealer gave me the book from which they had been removed. Even as I had browsed through *Fortune* in Firestone Library 25 years earlier, I again browsed through the text.

With my usual luck, I happened to turn to the saga of the historic Battle of the Nile, where Lord Nelson sank the French fleet and ended Napoleon's dreams of world conquest. There was Nelson's triumphant dispatch from his flagship, "*Vanguard*, off the mouth of the Nile." Together, the Wellington tie-in, the proud naval tradition embodied in HMS *Vanguard*, and the leading-edge implication of the name *vanguard* were more than I could resist. So on September 24, 1974, nearly 30 years ago, *The Vanguard Group* was born. Consider this syllogism: *No Princeton, no thesis; no thesis, no Morgan; no Morgan, no Wellington; no Wellington, no merger; no merger, no firing; no firing, no Vanguard*. Without Princeton the patriarch, Vanguard the child would never have been born. **Entrepreneurial Lesson #6: Getting lucky multiple times beats getting lucky once**.

A Narrow Mandate

Given the fiery crucible of contention out of which Vanguard was born, the Fund directors decided to allow Vanguard—owned, under its new mutual structure, by the funds themselves—only the narrowest of mandates. Our sole task was to handle the Fund's *administration*. Our crew, numbering only 28 members when we began the long voyage, was responsible only for the Fund's operating, legal, and financial affairs.

But administration comprises but one of the three sides—and arguably the least important side—of the triangle that represents mutual fund activities.

The other two, more critical, sides of the triangle—*investment management* and *share distribution*—were to remain with my rivals at Wellington Management. Yet it didn't take a genius to realize that our destiny would be determined by what kind of funds we created, by whether the funds could attain superior investment returns, and by how—and how effectively—the funds' shares were marketed. When we were prohibited from presiding over these activities, I knew that a rough road lay ahead. **Entrepreneurial Lesson #7: Never get discouraged**.

The fact that investment management was outside of Vanguard's mandate led us, within months, to an unprecedented action that today seems obvious—the fruition of an idea I had toyed with for years. Based on evidence that I had gathered in my Princeton thesis, I had written that mutual funds should "make no claim to superiority over the market averages." Was this thought the precursor of my later interest in simply *matching* the market with an index fund? Honestly, I don't know. But when I wrote those words way back in 1951, that moment may well have been when the seed was planted that germinated into my recommendation to the fund Board of Directors in September 1975: that Vanguard organize and operate the first market index mutual fund in history.

When the board reminded me that investment management was not within Vanguard's mandate, I argued that the index fund wasn't "managed"; it would simply own all 500 stocks in the Standard & Poor's 500 index. Disingenuous or not, this argument narrowly carried the day. When we organized the fund in late 1975, we had made our entry into the *second* side—the investment side—of the fund triangle. First Index Investment Trust (now named Vanguard 500 Index Fund), derided for years as "Bogle's Folly," wasn't even copied until 1984, after nearly a decade had passed. *What a great idea!* But our original index fund is now the world's largest mutual fund. **Entrepreneurial Lesson #8: Emerson was right. Build a better mousetrap and the world *will* beat a path to your door**.

Eliminating a Sales Force

How could we take over the third and final side of the triangle—share distribution? Once again, we devised a novel solution to a seemingly insurmountable challenge: We would abandon the network of brokers that had distributed Wellington shares for the previous half-century, and simply eliminate the *need* for distribution. We would rely, not on sellers to *sell* fund shares, but on buyers to *buy* them. After another divisive board battle, we took that unprecedented step in February 1977, converting overnight from the industry's traditional broker-dealer *supply-push* selling system to a sales-charge-free, no-load, *demand-pull* marketing system. In just 18 months from the day our skeleton enterprise began operations with its narrow mandate, we had become the full-fledged mutual fund firm we are today. **Entrepreneurial Lesson #: Never give up. Never. Never. Never. Never. Never**.

There was really only one further step in the evolution of Vanguard's central concept. Within six months of our no-load decision we created a series of municipal bond funds with an unprecedented structure. Even as I had come to believe that precious few stock managers could outguess the stock market, so I had come to believe that precious few bond managers could outguess the bond market by accurately forecasting the direction and level of interest rates. Yet our peers, offering "managed" tax-exempt bond funds, were implicitly promising they could do exactly that—a promise that could not be fulfilled. So why not depart from the crowd and form not a *single* tax-exempt bond fund, but a *three-tier* bond fund offering a *long-term* portfolio; a *short-term* portfolio; and—you guessed it—an *intermediate-term* portfolio? It's difficult, in truth, to imagine a more banally simple idea. *But it had never been done before*. It changed, almost overnight, the way investors thought about bond fund investing, and the industry quickly adopted the concept.

Strategy Follows Structure

All of the changes I've just cataloged may seem convoluted and even arcane, so let's think for a moment about what we had done in the design of Vanguard's structure and the determination of Vanguard's strategy.

We had created a unique mutual *structure* in which costs could be reduced to the bare-bones minimum, and a *strategy* that emphasized mutual funds in which the linkage between our costs and our investors' returns would be obvious, indeed almost causal. *Strategy follows structure*. The one great—and largely unrecognized—idea of investing is this: *Costs matter.*

Why do costs matter? Consider the analogy of the stock market as a casino, in which the investor-gamblers swap stocks with one another, a casino in which, inevitably, all investors as a group share the stock market's returns, no more, no less. *But only until the rakes of the croupiers descend*. Then, what was inevitably a *zero-sum* game—a fruitless search by investors to beat the market *before* costs—becomes a negative-sum game *after* the costs of investing are deducted. Beating the market, by definition, is then a loser's game. *Gross market return, minus intermediation costs, equals net investor return*—clearly, a highly complex arithmetic formula. **Entrepreneurial Lesson #10: Be a mathematical genius. (Only kidding!)**

Since playing the mutual fund game carries heavy costs and entails lots of croupiers, each wielding a wide rake, the losers lose lots. Sales commissions when most funds are purchased. Fund management fees and operating costs. Marketing costs, including all those expensive advertisements you see. Transaction costs paid to stockbrokers and market-makers when fund managers buy and sell the stocks in fund portfolios over and over again. The excessive tax costs to which funds unnecessarily subject their shareholders as the result of their incessant, often mindless, turnover. Taken together, these costs, roughly 3.5 to 4 percent of fund assets each year, compounded year after year, have given taxable mutual fund investors but about one-half of the market's return during the past decade and—I'm glad you're sitting down!—only a little more than one-third in the past quarter-century. The average fund investor, who put up 100 percent of the capital and assumed 100 percent of the risk, garnered something like 33 percent of the market's after-tax return. Yes, *costs matter*. **Entrepreneurial Lesson #11: Never underestimate the power of the obvious**.

Given those elementary mathematics of the market, the insight that led into a low-cost structure and an index-oriented, structured-portfolio strategy is not only obvious, but startlingly obvious. It can't have been a mystery to the other firms in our industry. All of our rivals had the same *opportunity* as Vanguard to create such a structure, but, just like the prime suspect in a murder mystery, we alone had the *motive* to act. Because of our mutual *structure*, the finger of guilt, as it were, pointed directly at Vanguard. We sought low costs to maximize the returns for our *fund* shareholders; our rivals, eager to maximize the returns for their *management company* shareholders, sought the highest returns that traffic would bear. **Entrepreneurial Lesson #12: Competition is easier if your competitors won't—and can't—compete on costs**.

Opposition from a Formidable Source

While we had struggled long and hard to establish Vanguard on a firm foundation, however, our enterprise was still built on sand. For we were operating only under a *temporary* SEC order that allowed us to operate under our unique mutual fund structure. Astonishing as it may seem today, in 1980, nearly three years after giving us that temporary approval, the SEC reversed its ruling, leaving us in a no-man's-land that I had never contemplated. Aghast, for I knew we were doing what was right for our shareholders, we mounted a vigorous appeal. Finally, in 1981, after a struggle that had lasted *four long years*, the SEC did an about-face, approving our plan with these powerful words:

> The Vanguard plan actually furthers the objectives [of the Investment Company Act of 1940] by ensuring that the Funds' directors . . . are better able to evaluate the quality of services rendered to the funds. The plan fosters improved disclosure to shareholders . . . promotes savings from economies of scale . . . clearly enhances the Funds' independence . . . provides them with conflict-free control over distribution . . . and promotes a healthy and viable fund complex within which each fund can better prosper.

Wow! The Commission's endorsement—virtually a commercial message on our behalf—made the struggle worthwhile. At last, our foundation was a rock, firmly in place. **Entrepreneurial Lesson #13: "I'm from the government and I'm here to help you."**

Sometimes.

Assets Double Every Three Years

The years in which our structure was hanging by a Damoclean thread were a challenge. But when the SEC finally gave us the green light in 1981, the stock market had begun to recover, and our assets had doubled, from $1.4 billion to $3 billion. By 1983, they'd doubled again to $6 billion; by 1985, again to $12 billion; by 1986, again to $24 billion; by 1990, *again*, to $48 billion. Assets doubled yet *again* to nearly $100 billion in 1993, then again to $200 billion in 1996, and *again* to $400 billion in 1998. No one thought that remarkable record could continue. *It didn't.* Nonetheless, despite the tough stock market since the bubble burst in 2000–2002, our assets now total $720 billion.

Our simple group of index funds, structured bond funds, and money market funds—each providing a near-causal relationship between low costs and high returns—constitute the powerful engine that has driven that amazing growth. The assets of these funds now total $520 billion, fully 75 percent of our asset base. What is more, we have also applied the principles on which they are based—an emphasis on rock-bottom operating costs, minimal portfolio turnover, no sales charges, diversified, investment-quality portfolios, and clearly defined objectives and strategies—to substantially all of the remainder of our assets, largely actively managed equity funds. In the marketplace of intelligent long-term investors—individual and institutional alike—whom we have chosen to serve, our strategies are mutually reinforcing. **Entrepreneurial Lesson #14: An internally consistent strategy is one of the keys to business success**.

Now, I recognize that creating a new company out of the framework of an existing company may not quite qualify as entrepreneurship. But I hope you'll consider as entrepreneurial the initiatives I've discussed today: (1) the creation of a new form of governance in the mutual fund industry, a *mutual* structure in which the interests of fund investors take precedence over the interests of fund managers and distributors; (2) forming the world's first index fund, a passive portfolio designed simply to provide the returns provided by the stock market, a challenge that precious few portfolio managers have bettered over time; (3) a new paradigm for bond fund management; (4) abandoning a proven distribution system in favor of a new and untried one; and (5) the sheer energy required to get it all done, in the face of a divided board of directors and the initial opposition of a federal regulatory agency. We marched to our own, different, drummer, and it worked. **Entrepreneurial Lesson #15: Take the road less traveled by. It can make all the difference**.

The Fruits of Success . . . or Success for Its Own Sake?

Let me close by considering the classic definition of the entrepreneur, "one who undertakes an enterprise," and ask *why* does a person undertake an enterprise? In his *Theory of Economic Development*, economist Joseph A. Schumpeter dismissed material and monetary gain as the prime motivation of the entrepreneur, concluding that these motives are far more powerful:

- "The joy of creating, of getting things done, of simply exercising one's energy and ingenuity," and
- "The will to conquer, the impulse to fight . . . to succeed for the sake, not of the fruits of success, but of success itself."

When Schumpeter identified entrepreneurship as a vital moving force in human economic progress, he ascribed it as a combination of those motives. Note that he downplayed *the fruits of success* as a primary motivator. Entrepreneurship, he tells us, is really about success itself, accomplishment, creativity, joy, energy, and the will to fight for one's ideas. *And so it is!*

Long before Schumpeter, a man often described as "America's first entrepreneur" also eschewed personal gain. Like many entrepreneurs, Benjamin Franklin was also an inventor, creating, among other devices, the lightning rod and the Franklin stove. He made no attempt to patent the lightning rod for his own profit, and declined an offer by the governor of the Commonwealth for a patent on his Franklin stove, the "Pennsylvania fireplace" he designed to improve the efficiency of home heating and benefit the public at large. Franklin believed that "knowledge was not the personal property of its discoverer, but the common property of all. As we enjoy great advantages from the inventions of others," he wrote, "we should be glad of an opportunity to serve others by any invention of ours, and this we should do freely and generously."

And there is yet another aspect of entrepreneurship that we should not ignore. While *ideas* are a dime a dozen, even the best of them require *implementation* to bring them to fruition. So let's all be humble enough to suppress our entrepreneurial egos and realize that the care and handling of those human beings who join us in the mission to turn an idea into a reality is an essential prerequisite of success. Helen Keller said it beautifully: "I long to accomplish a great and noble task, but it is my chief duty to accomplish humble tasks as though they were great and noble. The world is moved along, not only by the mighty shoves of its heroes, but also by the aggregate of the tiny pushes of each honest worker." **Entrepreneurial Lesson #16 (after John Donne): "No man is an island, entire of itself."**

Taking the Plunge, and Cashing In

The theme of this conference is "The Building Blocks of Entrepreneurship—From Taking the Plunge to Cashing In," and I've done my best to give you 17 lessons (one of which is still to come) that I hope will serve as building blocks that you can use as a frame of reference for your own entrepreneurship. I've tried to honor the first half of the subtitle by describing not only *the* plunge, but the *many* plunges, I've taken during my long career, at first with failure (that early merger that cost me my job), and later with what I guess passes for success—the mutual structure, the index fund, the three-tier bond fund; the gamble on a new marketing system.

Alas, I have nothing to say about the second half of the subtitle, "cashing in." The concept of a mutual structure that is the rock foundation of Vanguard simply doesn't entail cashing in for the founder, or for any one else. To do so would belie the very core of our existence—that our mutual fund shareholders are the actual owners of our firm, and their annual cost savings, estimated at something like $6 billion *per year*, are in effect an extra dividend on their fund investments.

Yet I'm a long way from sackcloth and ashes, for four major reasons: (1) I've been very well paid in salary and bonus incentives; (2) I prefer to save money rather than spend it; (3) I've been dollar-averaging—in part, in our tax-deferred savings plan—for 53 long years, and I can assure you that it works; and (4) I've been wise enough to follow my own prudent investment advice: lots of stocks in youth and middle age, lots of bonds in my later years, nearly all in our low-cost Vanguard funds with index or index-like strategies. That works, too!

Far more important than the rewards of the pocketbook—more things, more material possessions, more useless extravagance—are the rewards of the soul and spirit that come from trying to serve others rather than oneself. Whatever my entrepreneurial achievements may have been, I believe they have helped those honest-to-God, down-to-earth human beings who have invested with Vanguard in order to avoid the many, often deep, potholes on the long road to investment success, and thus capture their fair share of the returns with which our financial markets have rewarded us, and to enjoy a more comfortable retirement than most of their neighbors, just as Dr. Samuelson wrote in his foreword to my first book. I revel in that outcome. So I conclude with **Entrepreneurial Lesson #17: Our greatest rewards come when we foster economic progress, and help to build a better world**.

So that's my story. Sometimes I wonder what my life would have been like had Princeton, 57 long years ago, not opened its heavenly gates and let me in.

Foreword

Did someone say, *Don't count on it?* Or was it, don't count on *them*? As everybody knows, America's vaunted financial system let us down big-time during the raucous decade of the 2000s. The decade began with the spectacular stock market crash of 2000–2002, as corporate will-o'-the wisps, previously hyped by unscrupulous "analysts" who should have known (and did know!) better, collapsed before our eyes. That searing financial shock was followed in close order by the accounting scandals at Enron, WorldCom, and others in 2001–2002, the mutual fund scandals in 2003, and then, of course, the mother of all financial collapses: the stunning series of financial crises that started in the summer of 2007 and eventually brought the entire financial system to the brink of ruin and the world economy to its knees. With all this going on, you might have thought that America's leaders, both political and financial, would have been frequently out on the hustings giving both detailed explanations and copious apologies. But you would have been wrong. The silence has been deafening.

Enter Jack Bogle, the conscience of Wall Street, if that's not an oxymoron. More accurately, Bogle never left. His relentless voice, sharp pen, and indefatigable energy have been prodding the mutual fund industry in particular, and the financial industry more generally, to embrace higher business, fiduciary, and ethical standards for decades. Indeed, the essay that lends its name to this volume originated as a speech at Princeton University (Bogle's *alma mater* and mine) in 2002, and a few of the others are older than that. Our financial leaders and public officials had plenty of time to set things straight. Would that they had listened to Bogle more. But, too often, his was a lonely voice in the wilderness.

That fine voice is in ample evidence here, in this worthy collection of 35 essays, many of them short and pithy. The essays range widely over the usual Bogle themes: the unconscionably high costs of financial intermediation, the disgraceful failure to abide by what should have been normal fiduciary standards, the inefficient absorption of too much high-priced talent into financial manipulation rather than into useful productive activities, the dismaying triumph of emotion over cool-headed reason in so many investment decisions, and the related—and sometimes ruinous—triumph of speculation over investment. If you've heard these themes expounded by Bogle before, listen again because the lessons still haven't sunk in. If you haven't, you're in for a real treat, for Bogle writes not only with passion and conviction, but also with verve, wit, and literary flair. Where else, in a book on finance, will you find references to (in chronological order) Horace, Benjamin Franklin, Edgar Allan Poe, and Steven Colbert?

As a veteran of the mutual fund industry, and a father of low-cost index funds, it is no surprise that Bogle directs much of his ire at the high costs of financial intermediation. He never tires of reminding investors of this fundamental identity:

$$\begin{aligned}\text{Net returns to investors} = {} & \text{Gross returns on the assets} \\ & - \text{Costs of operating the financial system}\end{aligned}$$

The identity implies, among other things, that an investment adviser, or broker, or mutual fund manager earns his keep only if the gross returns he *adds* by "beating the market" exceed the costs he *subtracts*. Armed with reams of evidence to the contrary, Bogle is skeptical that this happens often. In Chapter 4, for example, he estimates that, in 2007, the costs of intermediation in securities came to a staggering $528 billion. That was 3.8 percent of GDP and, by remarkable coincidence, almost exactly the amount of money that all businesses in America spent that year on new factories, offices, and stores. Were the benefits worth the brobdingnagian costs? Bogle thinks not and he's probably right. It will not surprise you to see the virtues of indexing—principally, the reduction of transactions costs—extolled by the man who brought us Vanguard. He should know—and he does.

The duties of a fiduciary have always commanded a central place in the Bogle pantheon of virtue and vice—and so it is here, in several essays that display both his strong moral sense and his limitless backbone. After all, as Bogle reminds us in the title of Chapter 19 (and elsewhere), "No man can serve two masters." (Too bad so many Wall Streeters served more than two.) According to St. Jack, as he is sometimes called, "Fiduciary duty is the highest duty known to the law." It requires, among other things, that the fiduciary "act at all times for the sole benefit and interests of the principal" and never "put personal interests before that duty" or "be placed in a situation where his fiduciary duty to clients conflicts with a fiduciary duty to any other entity." Can you imagine how much milder the financial crisis would have been if Wall Street had adhered to those simple precepts? If not, read Bogle's essays on the subject. You'll see.

I could go on, but you've picked up this book to read Bogle, not Blinder. Let me just close with a wistful thought that sticks in my mind after reading these essays.

Once the financial cataclysm of 2007–2009 had passed its nadir, in about March 2009, policymakers, financial market experts, scholars, and others could turn their attention away from the emergency measures needed to prevent a total meltdown, and start thinking about the long-lasting structural reforms needed to build a sturdier *and fairer* financial system. It was a great national debate, which has already produced the landmark Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. And it's not over. As the debate has progressed, I must confess to a mischievous and, frankly, somewhat undemocratic thought: Wouldn't it be better just to turn the whole thing over to a small group of wise heads like Jack Bogle? When you finish this book, you'll see why.

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Princeton, NJ
May 2010