Financial Reform: Investment Standards and Ethical Values

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I last addressed this Forum eleven years ago. Since then, we've all seen remarkable changes in business, commerce, and finance in our nation . . . too many of them, alas, leading us in the wrong direction. Even worse, I think, is our failure to take significant steps to deal with the challenges that I outlined in those earlier remarks, entitled "What Went Wrong in Corporate America?"

Then, my primary theme was the ascendance of a "bottom-line society" in our nation—measuring America's success by our national output, our stock market, the earnings of our corporations, the strength of our businesses, our high standard of living, and the wealth—however unevenly divided—of our citizenry. I concluded that we were measuring "the *wrong* bottom line—form over substance, prestige over virtue, money over achievement, charisma over character, the ephemeral over the enduring."

While that flawed "bottom-line society" remains dominant, tonight I'll focus on how it has affected our nation's financial sector, and distorted the interplay between the investment standards and the ethical values that now prevail in our world of finance. Both these standards and these values have deteriorated even further since last I spoke in this sanctuary.

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

Investment Standards

Let's begin with investment standards. In that earlier talk, I spoke with hope: "At last we are beginning a wave of reform, and are undertaking the task of turning America's capital development away from speculation and toward enterprise." Alas, that hope has been dashed, and our investment system is now more overwhelmed than ever before by short-term speculation. The concept of *long-term* investment is becoming little more than a footnote in the long narrative of U.S. financial history.

Look, I'm not exaggerating. Last year, the amount of trading in the U.S. stock market reached an all-time high of some $56 *trillion* dollars. Day after day, professional investors duke it out with one another to see who is the smartest. They trade with one another at a staggering rate. But they can't *all* win. For in aggregate, *they are the market*. As a group, they inevitably achieve average returns. (How could it be otherwise?)

But after deducting the trading costs incurred by that huge turnover of stocks, their returns will fall below the returns generated by the stock market itself. So, the returns that they earn *for their clients as a group*, will inevitably fall short of the stock market by the amount of those trading costs. Like the "handle" at the race track, the "take" of the state lotteries, the grift demanded by the croupiers of Las Vegas, the tolls taken by the croupiers of the Wall Street Casino[1] continue on. Indeed, our croupiers are making more money than ever before.

The Zero-Sum Game

But the croupiers in the Wall Street Casino are not the only drag on the financial wealth of investors. For there is yet another toll taken by yet another set of croupiers who are beneficiaries of our nation's financial system. The vast majority of investors retain professional money managers to do their investing for them. Pension funds of corporations and state and local governments retain outside investment advisers. So do we individuals, most likely through our ownership of mutual funds, whose shares are now held by some 90 million American investors.

[1] In 1999, *The New York Times* published my op-ed piece entitled "The Wall Street Casino." Little did I know these problems would get worse and worse. Since then, trading volume has increased *six* times over, and Wall Street's "take" is many times what it was in those ancient days.

Each year, we pay these advisers staggering sums of money—perhaps $600 billion or more—for their presumed ability to add value for their investors. But in the stock market, the *average* money manager earns, yes, *average* returns before all of their costs. What else is new? But after their advisory fees, the trading commissions that they generate, the excess taxes to which their shareholders are subjected, and all their marketing expenses and operating costs, the "zero-sum game" they play becomes a "loser's game," a game that, in the aggregate, inevitably *subtracts* value from their clients' wealth.

But wait a minute. Isn't it Wall Street that amasses investors' capital, providing the wherewithal for capital formation—the grease, if you will, that lubricates the great engine of capitalism? And don't new businesses need funding to organize, to innovate, to create the new products and services that benefit us consumers? And don't existing businesses need capital for new plants and equipment, and to fund their own innovations?

Yes, yes, and yes. And Wall Street has been an effective agent for providing fresh capital to new and existing businesses alike. Indeed, in recent years the investment bankers of Wall Street have underwritten some $100 billion per year of equity capital in initial public offerings (IPOs) and an additional $170 billion in additional equity capital for existing corporations. In fact, the amount of capital formation that Wall Street finances has totaled some $270 billion per year.

Today: 99.5% Speculation, 0.5% Investment

But capital formation has become, well, the tail of the Wall Street dog. The numbers tell the story. $56 *trillion* per year in trading volume, as investors buy from and sell to one another, minute after minute, day after day, year after year. That $56 trillion of trading volume dwarfs the capital formation total of $270 *billion*. Result: short-term trading in the Wall Street Casino represents 99.5 percent of the market's activity; long-term capital formation 0.5 percent. But it is only capital formation that *adds* value to our society. Trading, by definition, *subtracts* value. Indeed, the casino mentality remains in the catbird seat of finance.

Is that good or bad for investors and for our society? As Nobel Laureate in Economic Sciences and *New York Times* columnist Paul Krugman recently put it, "society is devoting an ever-growing share of its resources to financial wheeling and dealing, while getting little or nothing in return." I might go even further, and suggest that we are getting *less than nothing* in return. More broadly, be warned by these words of wisdom from the great British economist John Maynard Keynes in 1936: "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."

First Principles

So let me sum up my first point: Eroded by the dominance of short-term speculation, our *Investment Standards* are deteriorating. Part of the reason is that investors focus far too much attention on the momentary rises and falls of the stock market, which are in so many respects just noise—in Shakespearian terms, "a tale told by an idiot, full of sound and fury, signifying nothing." The stock market is in fact a *derivative*, a collection of the current market prices of some 3,500 publicly-held corporations. Those stock prices *derive* their value from the dividend yields and earnings growth that these corporations collectively generate.

Intrinsic value (investment return) is one phrase we use to describe this phenomenon. Intrinsic value is reflected in the *real market*—essentially, what U.S. businesses actually accomplish. *Real* companies, with *real* strategies, managed and operated by *real* people, producing *real* products and *real* services ever more efficiently, with *real* returns earned for *real* owners, and *real* dividends distributed to those owners.

The intrinsic value reflected in the real market is the expected future cash flows generated by all of those corporations, discounted over time. For any individual corporation, those future flows are uncertain. But the cash flows for all corporations in aggregate generally track the growth of our U.S. economy, which has moved forward, despite interruptions, at a steady pace of about 2 ½% per year (in inflation adjusted dollars) over the past century. When the stock market leaps up and plunges down—second-by-second, day-by-day, year-by-year—it reflects nothing more than those transitory emotions—hope, and greed, and fear—that have affected investors (or, I should say, speculators) forever. These emotions represent investors' reactions to momentary events, or their expectations of future events, or their expectations of how other investors might perceive these events. That's why we call it the *expectations market*, with speculative sentiment often raising or lowering stock prices far above or below their intrinsic value. In other words, speculative return reflects the change in price investors are willing to pay for each dollar of earnings.

Over the long run, however, *speculative return* has played *no role whatsoever* in shaping the market's total returns. Rather, it is *investment* return that has accounted for virtually *all* of the long-run returns generated by stocks. Over the entire history of the U.S. stock market, the investment return has averaged 9%—4 ½% from dividend yields, and 4 ½ % from earnings growth.[2] Speculative return, over the long term, has accounted for zero—*nothing*. That's why I describe the stock market as "a giant distraction from the business of investing."

Ethical Values

The great Bull Market of the 1980s and 1990s led to a focus on stock prices over intrinsic values. Paraphrasing Oscar Wilde's definition of the cynic, the "security analyst became one who knows the price of everything, but the value of nothing." We reveled in our *greed* when markets were good. We suffered in our *fear* when they were bad. And during the two 50% Bear Market declines we've experienced since 1980, we relied on the *hope* that things would get better. (They did!) During two consecutive decades of strong returns for stocks, Wall Street was all too likely to overreach, and investors seem to accept with equanimity the idea that the costs of all those croupiers didn't matter much. After 20 years of earning above-average returns of, say, 9% each year, most investors wouldn't pay much attention to the fact that the market itself earned 11% per year.

During the rising stock market, it shouldn't be surprising that the field of finance has flourished. Despite (or perhaps, because of) the dominance of (value-reducing) speculation over (value-enhancing) investment—a net minus for our society—the financial industry's claim on the resources of our society has steadily increased—from 5% of our gross domestic product (GDP) in 1980, to 6% in 1990, to 7 ½% in 2000, and to an estimated 10% last year. That's real money—some $1.6 trillion dollars.

What a counter-productive progression for our society as a whole! Rather than participating in the "real" economy, far too many of our nation's best and brightest have been attracted to the lottery-like payouts garnered by the croupiers of the Wall Street Casino. Instead of focusing on building wealth through the real long-term growth of corporate intrinsic value, Wall Street concentrates on the quick payoffs from short-term speculation. But this short-termism is not sustainable. As Economics Nobel Laureate Joseph E. Stiglitz says, "successful growth has to be based on long-term investment."

It is in this very prosperity—for investors, yes, but even more for the financial system—that we find much of the reason for the decline in the ethical standards of finance. Money, like power, corrupts. And absolute money corrupts absolutely. This is not just hearsay. During my long career, I've witnessed great deterioration in our standards of conduct. The traditional industry standard, "There are some things

[2] With dividend yields at only 2% today, it would be unwise to anticipate a 9% return in the years ahead.

that one simply does not do," has changed to a new standard: "If everyone else is doing it, I can do it too." In short, our ethical foundation has changed from moral *absolutism* to moral *relativism*. That change has taken our society a long way from the principal attribute of professional conduct—a commitment to the interests of clients, a commitment to serve responsibly, selflessly, and wisely . . . and to establish an inherently ethical relationship between the professional and the general society.[3]

"No Man Can Serve Two Masters"

We see this change of course, not only in our burgeoning financial sector, but in many other segments of our society as well. Professional relationships with clients have been increasingly recast as business relationships with customers. Think about trends in medicine; in journalism; in law; in accounting; in architecture; and, yes, in the mutual fund industry—a gradual shift away from trusted professionals serving the interests of the community toward commercial enterprises seeking competitive advantage and maximizing their own wealth, with the human beings who rely on these services being the losers. In a world where every user of services is seen as a customer, every provider of services became a seller, and the broader perspective of the professional falls by the wayside. As it is said, "When the provider becomes a hammer, every customer is seen as a nail."

Such a trend has been reflected in the sea-change in finance and money management—from a *profession* of fiduciary duty and trusteeship to a *business* of marketing and salesmanship. The mutual fund industry itself has much to answer for. Its enormous growth—from $2 ½ billion when I started in the industry in 1951 to $15 *trillion* today—led to the expansion of what was mostly a small profession into a giant business. Its investment focus moved from the long term to the short term, with annual portfolio turnover soaring from 22% when I entered the field to 85% currently—a five-year average holding period for a portfolio stock has fallen to a holding period of only fourteen *months*. Product proliferation—a fund for every imaginable purpose—has crowded out the fund industry's traditional focus on portfolios dominated by "blue-chip" stocks—a "complete investment program in one security."

In the most baneful change of all, the small private fund management companies of yore have been largely replaced by giant public companies. Today, 40 of the 50 largest mutual fund firms are owned and controlled by financial conglomerates or other outside shareholders. As this new set of masters sought

[3] These ideas were inspired by articles in the Summer, 2005 issue of *Daedalus*, the Journal of the American Academy of Arts & Sciences, including "The Professions in America Today: Crucial but Fragile" by Howard Gardner and Lee Schulman.

first *the return on their own capital,* and only second the return on the *capital invested by the funds' shareholders,* we forgot the Biblical admonition that "no man can serve two masters" (Matthew 6:24).[4] In 1776, the great Scottish economist and philosopher Adam Smith warned investors to be careful, for ". . . the managers of other people's money [rarely] watch over it with the same anxious vigilance with which . . . they watch over their own. . . . Like the stewards of a rich man, they very easily give themselves a dispensation. Negligence and profusion therefore must always prevail."

And there's more bad news, highlighted by these three examples: One, despite the industry's huge growth, the expense ratios of the major funds[5] have risen from 0.62% in 1951 and 1.15% in 2013—almost *double*!—meaning that the huge economies of scale available in the management of other people's money has been arrogated by the managers to themselves, rather than being enjoyed by the shareholders. Two, the "time-zone" trading scandals unearthed by then-New York Attorney General Eliot Spitzer revealed a conspiracy between many giant mutual fund managers and hedge fund managers to defraud the long-term shareholders of the mutual funds. Third, the purported oversight of the funds by their so-called "independent" directors has accomplished little, as the fund chairman (usually also the chairman of the fund's manager) dominates board decisions. He too is serving "two masters!"

Flash Boys

But no, the temptation to speculate will never be stamped out. During the second century B.C.(!) the Roman orator Cato warned about speculation by investors, but it remains with us to this day . . . only far more widespread. You're doubtless familiar with the most recent and surely the most prominent example of the problem, presented in Michael Lewis's new best-seller *Flash Boys,* with its powerful public- relations onslaught. The book's remarkable success reaffirms that well-written polemics by proven authors fly off the shelves, while balanced studies of controversial subjects rarely sell books. Despite *Flash Boy's* scathing (and partially accurate) criticisms, high frequency trading (HFT) of stocks is not going away.

To be sure, much is required to ensure that HFT operates fairly and in the public interest—timely and full reporting of all stock trades; regular financial statements from those new HFT exchanges; regulatory enforcement against insider trading and front-running, new rules against playing games by entering transaction orders and quickly cancelling them. But HFT is not *all* bad. It has helped shrink

[4] Please forgive my mixing of the sacred and the profane. In this talk, I'll cite the Bible three more times.
[5] Here I exclude the Vanguard funds, whose expense ratios plummeted from 0.55% to 0.17%, *down* almost 70%.

transaction costs to a bare minimum; produced greater liquidity, and improved (perhaps only slightly) price discovery and greater market efficiency for professional investors. That's all to the good. But the huge risks of a technology breakdown in our increasingly computerized stock market remains hidden out there, beyond the horizon. In our data-intensive, speed-driven society, yes, HFT is here to stay.

ETF Toys

I find it both astonishing and deeply discouraging that index funds have become one more example of the apparently irresistible impulse of investors to speculate. Imagine! In 1975, Vanguard created the world's first index mutual fund, following this elemental strategy: (1) buy and hold all of the stocks in the Standard & Poor's 500 Index; (2) operate at rock-bottom cost; and (3) attract long-term investors who wish to hold the stock market portfolio, well, forever.

Those original sensible strategies of indexing have reshaped investing in a highly positive way for long-term investors. But the exchange-traded index fund (ETF) is the antithesis of that third key to index success—holding the market *forever*. Formed in 1991,[6] the first ETF was also based on the S&P 500, but with the added "feature"—embodied in its advertising slogan—that its shares could be "traded all day long, in real time." (I'm not making this up!) With $160 billion of assets, the so-called "SPY" is now the world's largest ETF. It is also the most widely traded stock in the world, averaging more than $20 billion of trading volume *every day*!

Compared to 290 traditional index funds (TIFs),[7] there are now 1,500 ETF index funds. With $2.1 trillion of assets, U.S. ETFs are now actually a tad larger than their TIF progenitors, and more of these new toys for investor speculation are created every week. The lesson: Never underestimate the power of a hot new marketing innovation (or, here, one-half an innovation). Paraphrasing H. L. Mencken, "no fund marketer ever went broke by underestimating the intelligence of the American investor." You will hardly be surprised to know that when index funds are designed and used for short-term speculation, I am not amused.

[6] The late Nathan Most was the creator of the first ETF. In 1991, he came to my office with an offer to partner with Vanguard in implementing his new concept. I declined the offer. Despite the SPY's remarkable growth, I have zero regrets about that decision.

[7] I created this acronym to simplify the distinction between the two types of index funds.

Let’s Hear From Some Other Critics

Let me be clear here. While my voice may be strident, and my criticism of the field in which I’ve plied my long career is a distinct rarity among my colleagues in finance, I am not quite alone. Indeed, one of the most respected voices in finance, William C. Dudley, now president of the Federal Reserve Bank of New York, shares my concern. “There is evidence of deep-seated cultural and ethical failures at many large financial institutions.” Dudley added, “the trust issue faced by our nation’s giant banks, is one of their own doing—they have done it to themselves.” As a partner of Goldman Sachs before he became Fed president, Mr. Dudley would seem singularly qualified to comment on the ethical failures in finance that have been so rife.

Another objective observer of the financial world is *New York Times* columnist David Brooks (my favorite opinion page writer). Here’s his overview, from a column that he wrote in 2008 entitled “The Great Seduction”:

> *“The people who created this country built a moral structure around money. The Puritan legacy inhibited luxury and self-indulgence. Benjamin Franklin spread a practical gospel that emphasized hard work, temperance, and frugality. Millions of parents, preachers, newspaper editors, and teachers expounded the message. The result was quite remarkable.*
>
> *The United States has been an affluent nation since its founding. But the country was, by and large, not corrupted by wealth. For centuries, it remained industrious, ambitious, and frugal . . . Over the past 30 years, much of that has been shredded. The social norms and institutions that encouraged frugality and spending what you earn have been undermined. The country’s moral guardians are forever looking for decadence out of Hollywood and reality TV. But the most rampant decadence today is financial decadence, the trampling of decent norms about how to use and harness money.”*

You can see this change all through finance. We focus on numbers, numbers, numbers—all easily manipulated—and lose sight of our fiduciary responsibility to serve investors, (as I have so long said) “honest-to-God, down-to-earth human beings, each with their own hopes, fears, and financial goals.” A sign in Albert Einstein’s office read: “*Not everything that counts can be counted, and not everything that can be counted counts.”* Yet today the traditional investment standards and ethical values that truly count have been overwhelmed by the dominance of our, yes, “bottom-line” society.

Whatever else these trends may mean, the interest of *consumers*—the fund shareholders who entrust their hard-earned dollars to our industry's care—have too often been given short shrift by the *producers* of investment services—the fund industry's managers and marketers. This orientation flies in the face of some more wisdom from Adam Smith, who summed it up in his *Wealth of Nations* in 1776:

> *The interest of the producer ought to be attended to, only so far as it may be necessary for promoting that of the consumer. The maxim is so perfectly self-evident, that it would be absurd to attempt to prove it . . . The interest of the consumer . . . must be the ultimate end and object of all industry and commerce.*

In the long-run, faithful service to investors is good ethics, and good ethics is good business. That's a lesson that today's stock traders and fund managers should take to heart.

If you find yourself a tad depressed by the trends I've described this evening, so am I. But all this speculation, truth told, only matters to short-term speculators. It should have little impact—indeed *no* impact—on long-term investors. For, I repeat, the entire long-term return earned in the stock market is derived, not from short-term speculation, but from long-term investment. Further, for the long-term investor who wakes up and smells the roses, there are options among mutual funds that have themselves defied these baneful trends toward excessive portfolio turnover and investment advisory fees and other mutual fund marketing and operating costs that have reached confiscatory levels.

A Few Words About Vanguard

Vanguard was created way back in 1974 —long before the ascendance of the trends I have described—and decried—this evening. Vanguard was designed *to serve the consumer*, just as Adam Smith demanded. Now, with some reluctance on my part, I'll now "talk my own book," as the saying goes, with a few comments on Vanguard's role in our financial system.

In every line of endeavor, I believe, we need at least one firm that says, in effect, "we see what you're doing, and we think that we can do it better, and serve the customer with better products and better services, at lower prices, and with greater efficiency." The net result is that our shockingly disruptive innovations—Quaker-like in their *Thrift* and *Simplicity*—revolutionized the field of finance, to the benefit of investors.

We became the first client-owned, truly *mutual* mutual fund firm, with our non-traditional structure—a structure yet to be copied by our rivals. Why *mutual*? While I didn't come across this biblical message in John 10 until many years after we began, it sets forth our defining principle: *the shepherd takes better care of the sheep that he owns than the hired hand*. Paraphrasing John: "when the hired hand sees the wolf coming and flees, the wolf snatches the sheep, for he cares nothing for them." Similarly, Vanguard's shareholders actually *own* their fund management company, rather than hiring an outside firm and ceding control of their assets. Therein lies a world of difference. (No, the Vanguard structure is not perfect—just the best I could do at the time.)

Quaker Values

Our very structure led to the obvious: a primary focus on the principles of *thrift* and *simplicity*, designed to reduce to the practical minimum the costs of investing for our shareholders. As to thrift, we soon became *the low-cost provider in an industry in which cost is everything.* (Our 1977 decision to eliminate all sales loads and brokerage commissions—which allowed those who sought "a better mousetrap" to beat a path to our doors—was a product of that same thrift-oriented attitude.)

As to simplicity, our creation of the world's first stock-market-index mutual fund in 1975, and the first defined-maturity series of bond mutual funds in 1977 (long-term, short-term, intermediate-term . . . investors choose whichever meets their needs) reflect not only *Thrift*, but *Simplicity*. We built into our structure the priceless value of Thoreau-like *simplicity*: the broadest possible diversification, the lowest possible portfolio turnover, and (of course) a minimum of financial complexity. We recognized even then, well before its time, the reality that in the mutual fund industry, investors as a group do not get what they pay for; they get *precisely what they don't pay for*. Therefore, if they pay (almost) *nothing,* they get (almost) *everything*.

Despite that obvious (and winning) strategy, it took a decade of disappointments, setbacks, and failures to fully engage the trust—and attract the assets—of investors. Not until the late 1980s did the turn finally come. The increasing momentum that followed would, by 2009, make Vanguard the largest firm in our field. (That is hardly bragging on my part. I remain nervous about our giant size and the challenges of managing $2 ½ trillion of Other People's Money.) Driven largely by our index funds and funds with index-like investment strategies, our growth still leads the field. While about 20 percent of mutual fund investors hold Vanguard fund shares, in recent years we have accounted for some 40 percent of the total net cash flows into the entire mutual fund industry.

I'll make one final comment about indexing, and yet one more biblical reference. In her sermon several weeks ago, Bryn Mawr Presbyterian Church pastor Dr. Agnes Norfleet cited one of my favorite Biblical passages, from Psalm 118 (repeated in Matthew 21, Mark 12, and Luke 20). *"The stone which the builders rejected has become the chief cornerstone."* Similarly, in the field of finance, the index fund—originally scorned, derogated, and rejected by Wall Street as "un-American" and worse (try "Bogle's Folly")—has become our industry's chief cornerstone. Index funds now account for *more than one-third(!)* of the assets of all U.S. equity mutual funds.

The triumph of the index fund has even broader implications for corporate governance, at least as profound as their implications for investing. Today, the dominance of index funds belies the old "Wall Street Rule"—"if you don't like the management, sell the stock." A new "Index Fund Rule" is emerging. Since index funds *can't* sell the stock (if it's in the index, it stays in the fund, no matter what), the new mantra must become, "if you don't like the management, fix the management." This is a truism for *permanent* investors in each corporation's shares. While it is yet to be honored, that sound principle will, sooner or later, alter profoundly the relationship between Financial America and Corporate America, and ultimately, I fervently hope, re-establish a proper relationship between business and our society.

Financial America and Corporate America

With the growth in finance and investment, our institutional managers now hold absolute voting control over the corporations in their clients' portfolios. The mutual fund industry alone holds some 32 percent of all U.S. stocks. Their pension-manager affiliates hold another 20 percent of the total. All told, 52 percent of all U.S. equity shares are held by these money management giants. Yes, that is absolute voting control.

Since our institutional money managers now hold the controlling interest in U.S. corporations, we are living in a new and different world. The relationship between Corporate America and Financial America is deeper than ever before. As the interdependence of finance and business grows closer, the times demand that the money managers play an ever more active role in corporate governance. This new factor in governance will ultimately change our ideas about the role of the corporation in our society . . . for the better.

To be sure, a tacit link between financial firms and corporate businesses has always existed. As noted economist Hyman Minsky pointed out, "financial markets not only respond to profit-driven demands of business leaders and individual investors, but also as a result of the profit-seeking entrepreneurial spirit of financial firms . . . Since finance and industrial development are in a symbiotic relationship, financial evolution plays a crucial role in the dynamic patterns of the economy." But today that link has gotten even more potent. Why? Simply because, as noted earlier, Financial America controls (or holds potential control) over Corporate America.

The result is our unprecedented "Double-Agency Society"—corporate CEOs and directors are agents who too often place their own interests ahead of the interests of their shareholders, coupled with CEOs and directors of institutional money managers, who, similarly, are agents who too often place their own interests ahead of the fund shareholders (or pension beneficiaries) whom they are duty bound to serve. Economists have been concerned about this "agency problem" that has permeated our society, well, forever. But to have two sets of powerful agents whose financial interests are so often at odds with the fiduciary duty that both sets of managements owe to their principals is indeed "something new under the sun."

The Failure of the Corporate Governance System

Let's not kid ourselves. There are fundamental ways in which our mutual funds and other institutional money managers—our "producers"—have failed to serve the interests of fund shareholders and pension beneficiaries—our "consumers." Question: how do these fund managers actually use their power? Answer: very sparingly. Fund managers have demonstrated little appetite for action on corporate governance issues. Indeed, the mutual fund industry fought a proposed SEC regulation that would require fund managers to even disclose to their fund shareholders how their corporate proxy votes were cast. (The good news: their effort failed.)

Let me touch briefly on some of the vital corporate governance issues on which mutual funds have been largely silent:

- **Executive compensation.** One word: *Appalling*. Seemingly limitless amounts are paid to corporate CEOs. An important contributing factor is that compensation consultants that recommend pay cuts aren't long in business. A recent *New York Times* article entitled "Executive Pay: Invasion of the Supersalaries" pointed out that the median compensation for CEOs of major corporations in 2013 was $13.9 million(!), a nine percent increase over 2012. In his new book, *Capital in the 21st Century*, French economist Thomas Piketty states that two-thirds of the staggering increase in America's income inequality over the past four decades was the result of the skyrocketing “supersalaries” bestowed upon “supermanagers” (who as a group, of course, prove to be average).

- **Accounting standards.** As corporate profit and loss statements become increasingly self-serving and opaque, the gap between *reported* earnings of the companies in the S&P 500 Index—before taking into account the negative impact of failed business ventures and management errors (euphemistically called “non-recurring events)—have been fully 20% higher than *reported* earnings under GAAP accounting principles. That amazing improvement over fiscal reality has been created by illusion, financial legerdemain, and “window dressing.”

- **Corporate political contributions.** Don’t get me going on this one! In the wake of the ghastly 2011 Supreme Court decision in the *Citizens United* case, corporate money has poured into our nation’s political campaigns—*money that belongs to the shareholders*, but is handed-out to politicians by Corporate America. Those shareholders should have a say in how their assets are expended. In 2011, I wrote an op-ed for the *New York Times* arguing that corporate proxy statements should include a resolution precluding political contributions unless at least 75 percent of shares voted to approve such a policy.[8]

- **The looming retirement crisis.** Beginning in the 1980s, there has been a massive transfer of the investment risk and longevity risk associated with retirement planning from employers to employees. In order to reduce their pension costs, companies have increasingly replaced traditional Defined Benefit (DB) retirement plans with Defined Contribution (DC) thrift plans, which are now the dominant form of retirement planning in the U.S. But most workers lack the specialized knowledge and experience needed to successfully manage their own investments. In 2012, *New York Times* columnist Joe Nocera wrote a piece in which he described how the losses in his high-risk-oriented retirement plan, plus his later divorce, depleted his retirement account to the point where there is no way he can retire. He concluded, “most human beings lack the skill and emotional wherewithal to be good investors. Linking investing and retirement has turned out to be a recipe for disaster.”

[8] My longtime friend and neighbor, James Mackie, read my op-ed and, without any assistance, took it upon himself to have that resolution inserted into the proxy statement of Johnson & Johnson. Management opposed, and the resolution failed to pass. But Jim continues his work again this year. I believe that this harbinger of shareholder democracy has great potential to serve society.

- **Nomination of directors.** Even if our money manager/agents wanted to do the right thing in honoring the needs of the shareholders they represent by striking a blow at excessive compensation, retirement plans, corporate accounting standards, and political contributions, they rarely have the proxy access they need to do so. Yes, mutual funds have the latent power to nominate directors to corporate boards. But they do essentially *nothing*. I know of no significant example of a mutual fund nominating director candidates. To put a spin on an old idiom, "the flesh is strong, but the spirit is unwilling."

"Capitalism without Owners Will Fail"

America's institutional money managers must focus on owning companies that create long-term intrinsic value for the *owners* of their shares, rather than short-term market prices for the *renters* of their shares. Only then can Corporate America remain the prime engine of our nation's growth and prosperity. But too many of our money managers have abdicated their responsibilities to long-term investors.

Robert A. G. Monks, founder of Institutional Shareholder Services, writes in his 2011 essay *Capture* that "corporations have effectively *captured* the United States: its judiciary, its political system, and its national wealth, without assuming any of the responsibilities of domination." He too cites executive compensation, describing it as "the smoking gun . . . an expression of concentrated power—of enterprise power concentrated in the chief executive and of national power concentrated in corporations." That power must be curbed, and the fair balance between the corporation and the government must be re-established. That is an uphill battle that will take a great deal of time and effort.

A Federal Standard of Fiduciary Duty

My preferred solution to this issue is the creation of a federal standard of fiduciary duty for all of those who manage Other People's Money. (Since our corporations are chartered by the states, we also need a model standard of fiduciary duty shared by those states.) Yes, there is an implied standard of fiduciary duty in the Investment Company Act of 1940—to paraphrase, "mutual funds must place the interests of their shareholders ahead of the interests of their officers, directors, investment advisers, and distributors." But that's just not happening. Today fiduciary duty and corporate governance issues are near the bottom of the priority list for most fund managers.[9]

Surely passivity by the financial institutions that control Corporate America is unacceptable. Distinguished NYU professors Ralph Gomory and Richard Sylla agree, "There is a need to find ways of inducing corporations to act in ways that produce better social outcomes . . . [this] is not the first time in history that people have wondered whether ours is a government of the people, or of, by, and for the corporations."[10] They cite Theodore Roosevelt's first annual message to Congress in 1901:

> *"Great corporations exist only because they are created and safeguarded by our institutions; and it is therefore our right and our duty to see that they work in harmony with those institutions."*

Roosevelt spoke those words more than a century ago, yet those kinds of challenges still plague our society today. What's to be done? The first step is building public awareness. That's what I'm striving to do—to shine light on these issues in my books and speeches, including my words to you this evening. And, while I may one day slow down my busy pace, now is not the moment to slacken my efforts nor to vitiate my passion for building a better financial system. I'm no hero in my own industry, but, as I was long ago warned, "a prophet is without honor in his own country." (Yes, Mark 6 and Matthew 13, my final biblical reference!) It's a lonely task, but I find common cause with many independent thinkers, including many, if not most, of our nation's leading academics.

So that's what *I* do. What can *you* do? The answer does not come easily, for if you own individual stocks, you are among a definite minority, being dwarfed by the voting power of those giant money managers. But if you own mutual funds, get out your pen and paper, and write to their CEOs and their independent directors, demanding that they step up to the plate on corporate governance issues. It is with our huge mutual funds that battle of bringing the spirit of fiduciary duty to today's double-agency society must begin.

Paraphrasing Doris Kearns Goodwin's words in her recent best-seller *The Bully Pulpit*: *Theodore Roosevelt, William Howard Taft, and the Golden Age of Journalism*, I hope that my remarks this evening

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[9] In a sign of impending change, Laurence D. Fink, the Chairman and CEO of BlackRock (the nation's largest holder of corporate stock—about 7% of every company—recently wrote to the CEOs of all 500 companies in the S&P 500 Index, condemning the focus on short-term stock prices. "[Our] mission," Fink writes, "is to earn the trust of our clients by helping them meet their long-term investment goals. . . . We share those concerns [about the short-term demands of the capital markets], and believe it is our collective role to challenge that trend."

[10] "The American Corporation," *Daedalus*, 142 (2), Spring 2013.

“will guide you through your own process of discovery toward a better understanding of what it takes to summon investors to demand the actions necessary to bringing the financial system of our nation closer to its ancient ideals.”

> Margaret Mead said it even more simply:
> *“Never doubt that a small group of thoughtful, committed citizens can change the world. Indeed, it is the only thing that ever has.”*

Thank you for your attention, and for coming out this evening.