Values, Ethics, and Structure in Finance

Remarks by John C. Bogle, Vanguard Founder

Keynote Speech

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I’m delighted to have this opportunity to address this symposium on “Structuring Public-Private Partnerships for Asset Management and Co-Investment,” focused on values and ethics. As I review the impressive backgrounds of each of you participants, I’m honored by your presence here today.

I’m familiar with—and I applaud—the incipient development of P3s, but have little first-hand experience in that area. But I have more than 63 years of experience in our nation’s financial sector, and have a strong foundation of beliefs about its values, ethics, and structure that are also applicable to public-private partnerships.

As some of you may know, much of my recent work has focused on the flaws that have developed in the American financial system in general, and specifically in the field of institutional money management. No mean problem, since our institutional managers collectively hold some $13 trillion of U.S. stocks—65% of the shares of virtually every publicly held corporation. These managers—largely mutual funds (the major holder), public and private defined benefit (DB) pension plans, and private defined contribution (DC) thrift and savings plans—have the power to change corporate behavior for the better. So far, however, their massive collective power remains largely unexercised.

The ethics, the conduct, and the integrity of the participants in our financial systems are the foundation upon which investor confidence rests. When confidence in our financial system deteriorates and trust erodes, our society pays a steep price.

At its best, our financial system provides the grease that keeps the wheels of capitalism turning, by directing fresh equity capital to growing businesses that innovate and develop ever-improving goods
and services at lower prices, creating new jobs in the process. But raising new equity capital accounts for only about 0.6% of all equity transactions, with trading (largely of the short-term variety) in our markets accounting for 99.4% of the dollar value of the activities of our financial system.

At its worst, then, our financial system is driven by speculation, “new products” of dubious value, risk-oriented strategies, and massive trading dominated by market speculators. The confidence of investors in our markets has deteriorated, their trust has eroded, and our societal values have diminished. This deterioration has been, as it were, well earned: Think of the “time zone” trading scandals in the mutual fund industry, uncovered by New York Attorney General Eliot Spitzer in 2003—a conspiracy between fund managers and sharp-penciled speculators to defraud the long-term holders of mutual fund shares. Think of Bernie Madoff’s Ponzi scheme, and the institutional investment advisers who, driven by greed and eschewing due diligence, jumped on the illusory Madoff gravy train, making hundreds of millions of dollars in fees before his train lurched off the rails.

Think of money laundering by too many large banks. Think of the LIBOR rate-rigging scandal. Think of the assets long hidden in Swiss banks by many wealthy Americans to escape U.S. taxes. Think of stock trading based on inside information, exemplified by hedge fund manager Raj Rajaratnam of the Galleon Group, and then-Goldman Sachs director Rajat Gupta, once respected head of McKinsey, both of whom are now behind bars. Think of the now-notorious collateralized debt obligations (specifically, “CDO-squareds”), which collapsed during the 2008-2009 financial crisis. When mortgages and other debt securities are bundled into collateralized debt obligations which are themselves bundled into a second layer of securitizations, it becomes difficult, if not impossible, for investors to determine who is bearing the risk. (Hint: they were.) Think of our investment banking firms, with leverage that soared as they moved from private partnerships subject to unlimited liability, to public corporations protected by limited liability.

Have I made my point? Our financial system appears to be (I really mean “is”) deeply flawed. Why? Largely because of its underlying structure. It is a system where huge financial rewards are reaped by money managers (especially hedge fund managers) for short-term investment success. Where long-term investment takes a back seat to short-term speculation. Where innovation in “new products” is designed to benefit the producers of investment services (“Wall Street”) rather than its clients, the
consumers (“Main Street”). Asset managers such as Vanguard ought to be, not in the *business* of selling products, but in the *profession* of managing other people’s money.

Today, the goals and values of those powerful institutional asset managers are shaped by a structure in which their owners—private and public stockholders, now, regrettably, dominated by financial conglomerates—seek to earn returns on *their own capital*, rather than the capital that has been entrusted to their care by *their clients*. In such a structure, conflicts of interest abound. Stewardship is too often trumped by salesmanship, and management is trumped by marketing. In the mutual fund field, the interests of the managers’ stockholders conflict with the interests of the managers’ *fund* shareholders, and it is the manager who is the master that wins. As it is said in the Bible, “no man can serve two masters.” Today, our financial sector wantonly ignores that ancient precept.

**Going Back in History**

Speaking out against such an obvious structural flaw is hardly new territory for me. Way back in 1971, almost a half-century ago, in remarks before Wellington Management’s partners, I despaired over the trend toward public ownership of investment institutions:

> *It is hard to see what unique contribution public investors bring to the enterprise. They do not, as a rule, add capital; they do not add expertise; they do not contribute to the well-being of our clients. Indeed, it is possible to envision circumstances in which the pressure for earnings and earnings growth engendered by public ownership is antithetical to the responsible operation of a professional organization.*

Honestly, I could hardly say it better today.

In his foreword to the first edition of my book *Common Sense on Mutual Funds* (1999), now 15 years ago, legendary financial economist Peter L. Bernstein shared my concern:

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1 When I was running Vanguard, I banned the use of the word “product.” In my view, it is businesses such as toothpaste, beer, and cars that are in business to sell their products.

2 Wellington Management had itself “gone public” in 1960.
“... What happens to the wealth of individual investors cannot be separated from the structure of the industry that manages those assets. Bogle’s insight into what that structure means to the fortunes of the individuals whose welfare concerns him so deeply is what makes this book most rewarding.”

The flawed structures of financial firms—varied though they may be—can easily be seen as largely responsible for the ills that I described earlier. Think for a moment about the evidence that I presented about the multi-faceted structural flaws in finance, and how better structures might have helped our society:

- Had they been structured to honor a federal standard of fiduciary duty, the institutional asset managers who collectively control our nation’s corporations would have demanded that our corporation’s act solely in the interest of their shareholders. These manager/owners would have been tough in their evaluations of executive compensation; tough about the excessive use (and “free-rider” structure) of stock options; and tough about allowing corporations to throw around vast sums of their shareholders’ money, undisclosed, on political contributions. And that list only begins a long litany.

- Had fund managers never been allowed to go public, and had the fund industry’s traditional private ownership structure remained intact, many of the obvious conflicts of interest that managers face in trying to serve both their mutual fund shareowners and their conglomerate (or other public) shareholders would have been mitigated. Giving fund investors (and pension beneficiaries) a fair shake, and a fair participation in the staggering economies of scale that are available in managing the growing pools of other people’s money (OPM), would have come to characterize this now-giant ($15 trillion) industry. But in fact, fund managers arrogated the lion’s share of these economies of scale to themselves.

- If we had built a formal structure of international cooperation and information-sharing on money flows (and a structure of enforcement as well), wouldn’t money laundering and tax dodging have been greatly reduced?

- If today’s structure of electronic communication (e-mails seem to last forever!) and judicially approved federal wiretaps had been prevalent in an earlier age, wouldn’t the cheaters who traded on inside information have been discovered—and punished—far earlier? If so, wouldn’t there
have been better compliance with existing insider trading regulations and with the “full disclosure” requirements of SEC regulation FD? (Look, I know a bit about human nature, and fully understand that the illegal and unethical practices that arise from greed will be impossible to eliminate—mitigate, yes; eliminate, no.)

- Wouldn’t a requirement that banks retain on their own books a portion of the mortgage loans they were divesting through securitizations in the form of CDOs have precluded their disinterest in evaluating the creditworthiness of the homeowners for whom they underwrote mortgages? (Remember the NINJAs—home buyers with No Income, No Job, and No Assets?) Alas, the most recent news from the Dodd-Frank front is the elimination of the requirement that mortgage originators retain some of the risk of their mortgages. How could that happen? (Clue: powerful lobbyists.) On this occasion, I’ll ignore the structure and incentives of our rating agencies, paid huge sums by issuers seeking that coveted AAA rating!

- Finally, the new capital structure of our investment banking firms—from private partnerships to public corporations, from unlimited liability (“Be cautious and be conservative”) to limited liability (“Don’t worry much about leveraging the balance sheet. A 25-to-1 debt-to-equity ratio is just dandy.”) Under that new structure, it was all too easy to disregard, even to ignore, the risks of high leverage. But grossly excessive risk and superficial quality standards, finally, came home to roost. (See: Bear Stearns and Lehman Brothers, both now gone.)

Yes, structural flaws in finance have been a major contributing factor to the deterioration of the industry’s values, ethics, and professional conduct. When we think of professionals, we usually think of physicians, lawyers, engineers, architects, and—at least in the ideal—the trustees of other people’s money. Yet, profession by profession, the traditional values of serving clients and the broader society responsibly, selflessly, and wisely have been undermined by what I’ve called our now-dominant “bottom-line society.” Unchecked market forces have, in too many cases, substantially crowded out the original values of professionalism.

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3 I have no solution to the Madoff structure built on bare-faced lies. As long as investors are blind and greedy, and fund “managers-of-managers” utterly fail to exercise due diligence, Ponzis schemes and Madoff schemes will arise to capitalize on the base instincts of investors to “get rich quick.”
When our proudest professions shift their balance away from trustworthy service to the community and toward becoming commercial enterprises that seek competitive advantage and aimed at making money, the human beings in our society who rely on those services are the losers.

**Vanguard – The Story of a New Structure**

Ironically, while my concerns about our financial system began early in my career, I was able to resolve my dilemma by departing from the flawed structure that developed in the mutual fund industry. It all began in the mid-1960s, now a half-century ago.

Then, the public ownership structure of institutional money managers that would come to overwhelm the earlier private ownership structure was just beginning. At the same time, the so-called “Go-Go Era” in the stock market was also just beginning. That dynamic (in the worst sense) combination changed the once-sound character of the mutual fund industry—then largely composed of middle-of-the-road equity funds investing for the long-term, holding portfolios of “blue chip” stocks. (Total fund assets in 1965 were but $35 billion.)

Those near-contemporaneous changes in fund management structure and in fund investment strategy combined to seriously erode the industry’s founding values and traditional ethics of trusteeship. As one prominent observer of the Go-Go Era put it, “short-term investing may actually be safer than long-term investing sometimes, and the price action of the stocks may be more important than the ‘fundamentals’ on which most research is based … portfolio managers buy stocks, they do not ‘invest’ in corporations.” (Ugh!) Traditional “investment quality” was out. “Modern concepts, imagination, creativity, flexibility, and aggressively seeking rewards” were in.⁴

Entrepreneurs, speculators, even financial buccaneers came roaring into an industry that had previously been dominated by experienced, fairly staid, cautious, and conservative investors. I saw it all happen. For I was the new, young leader of Wellington Management Company and Chairman of the Investment Company Institute during 1969 and 1970. It’s fair to say that I was then considered the consummate mutual fund “insider,” the new face of the new industry.

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⁴ Alas, these were the words used in Wellington Fund’s 1967 Annual Report, penned by a new portfolio manager to describe the “modern concepts and opportunities” on which the fund’s future investment strategy would be based.
Yes, events—perhaps even wisdom—were soon to reinforce my view of the appropriate structure for the fund industry, and to do something about it. First, I jumped on the Go-Go bandwagon, merging Philadelphia’s Wellington Management with a hot new fund manager from Boston. That horrible misjudgment was a monument to my sheer stupidity; to my naiveté; to my eagerness, even willingness, to ignore the lessons of financial history; to my (now-long-gone) focus on marketing; and in candor, to my interest in increasing the earnings and market value of then publicly held Wellington Management Company—largely owned by founder Walter Morgan, who had named me his successor in 1967. I was the Fund’s chief executive, and I had made an awful mistake . . . and paid for it. On January 23, 1974, I was fired by my new Go-Go partners of Wellington Management Company, adviser to the mutual funds we had ostensibly controlled.

**Strategy Follows Structure**

But the separate and largely independent boards of the Wellington mutual funds decided to keep me on as their chief. After a bitter struggle that lasted for eight months, the funds declared their independence from Wellington Management, and Vanguard was created.

As I’ve often said, “strategy follows structure.” Vanguard’s unique, client-owned, truly mutual structure naturally led to—even demanded—a strategy that held the costs of investing to the bare minimum and allowed investors to keep their fair share of the market’s return. Here, of course, I’m speaking of the world’s first index mutual fund—Vanguard’s disruptive innovation that would ultimately reshape the mutual fund industry.

We had tough going at first. Vanguard suffered huge net cash outflows in each of our first four years of existence, and the IPO of that first index fund was virtually ignored—not even raising enough money to buy round lots of each stock in the S&P 500. But investors eventually took notice and came around to the Vanguard way of investing. Today, our asset base is dominated by index funds (71% , but another 25% is composed of virtual index funds) which, while “actively managed,” are designed to deliver returns that are closely linked to their relevant market sectors. (Together, that’s 96% of our asset base.)

When Vanguard was founded in 1974, we supervised just $1.4 billion of OPM. Today, we manage over $3 trillion worldwide. Our initial market share of long-term (stock and bond fund) assets in
the U.S. was less than 6% at the outset. It has now grown to over 18% today—a dominant level, one without precedent in the industry.

**Introspection, the Crucial Ingredient**

I lack many of the talents (and resources!) of today’s financial leaders. They are often sharp businessmen, focused, laser-like, to produce ever higher revenues and profits; driven to achieve dominant market shares in the products and services that they offer; stereotypically desperate to be rewarded with higher compensation than their peer chief executives; too often imperious and demanding; extroverted and self-confident. (I’m sure that most of you here have observed this paradigmatic model of the “CEO.”)

That just isn’t me. Pity! Yes, when I led Vanguard, I led with an iron hand (sometimes with, sometimes without, a velvet glove). But I knew that I had “ENOUGH!” (the title of my sixth book). I don’t like to spend money (especially our shareholders’ money!). I revel in being with our crew (up from 28 in 1974 to 16,000 forty years later), and find no greater reward then when we roll up our sleeves together, work like blazes, and celebrate our achievements with joy.

But I have—or believe that I have—one quality that my peers may lack, or at least keep deeply hidden: *Introspection*. According to the definition in Volume VIII of the Oxford English Dictionary—all 18 volumes of which repose a few steps from my office—introspection is “the action of looking into, or under the surface of things, especially with the mind . . . self-examination . . .” In my view, introspection is looking at a business structure and thinking, shouldn’t the structure fit the business? Shouldn’t the strategy follow the structure? Shouldn’t the firm serve its clients? Shouldn’t it serve society? Isn’t there a better way to accomplish the mission? Those were among many questions that I asked myself, and Vanguard was my answer.

Few have described these issues better than Philipp Hildebrand, vice-chairman of BlackRock and former head of the Swiss National Bank. As a speaker on a distinguished panel at the “Future of Finance” conference held by the International Monetary Fund on October 12, 2014, he faulted “our collective

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5 In addition to Philipp Hildebrand, the distinguished panel included Mark Carney, Governor of the Bank of England; Christine Lagarde, Managing Director of the IMF; Kok-Song Ng, Chair of Global Investments for the Government of Singapore Investment Corporation; and Reverend Justin Welby, Archbishop of Canterbury.
failure to see the serious flaws in today’s structure of finance.” What’s to be done? Here are Mr. Hildebrand’s thoughts:

1) Incentives in finance matter a great deal, so we need to focus, not a complex regulatory system, but on getting the basic incentives right in order to get the right outcomes.
2) The personal behavior of leaders counts. We need a form of personal transformation in the leadership of finance.
3) If the financial industry does not adopt the right incentive structure, which would lead to the right business model, which would lead to personal transformation, these changes will likely be imposed on the industry by regulators in a way that is counterproductive to the creation of wealth and prosperity.

That none of these goals will be easy to achieve is self-evident. But they should represent the major criteria on which we focus as we contemplate the future of finance.

**Public-Private Partnerships**

Now let me close with some thoughts about public-private partnerships. The basic strategy of P3s has already been fairly well established. Outside the U.S., some 1,300 are said to be operating now with present capital of $250 billion. The U.S., however, lags far behind, despite the needs of rural America, solar energy, and military housing, to say nothing of the massive rehabilitation of our nation’s deteriorating infrastructure. There it’s estimated that we need an additional investment of $1.6 trillion to do the necessary maintenance and upgrading of our roadways, bridges, railroads, ports, and airports, some of which are described as “structurally deficient or obsolete.”

As the incipient development of P3s builds in the U.S., we must give our close attention to assuring that these partnerships serve the interests of the taxpayers, the state and local governments that finance them, and the interests of the private contractors that do the work of building, maintaining, and managing these projects.

This means honest bidding, honest delivery, and honest disclosure—both by municipalities and contractors. I hardly need tell this group that giant construction projects are too often fraught with
political favoritism and contractors who submit low bids knowing full well that the inevitable changes in specifications leave the door wide open for huge increases in costs.\(^6\)

It also means that states and local governments must develop the technical capacity and expertise to enter the P3 arena, and to protect the public interest. “Hell hath no fury like a taxpayer whose interests are not placed front-and-center.”

What is the optimal structure for implementing these contractual agreements between governments and the private sector to design, build, operate, maintain, and finance the coming tsunami of essential improvements in infrastructure? As I have often said about Vanguard’s structure and strategy, “ideas are a dime a dozen; implementation is everything.” And so it is with public-private partnerships.

I would go far beyond my own experience and expertise in a field distinctly different from my own to speculate on the optimal means of implementing the complex arrangements that characterize P3s, while at the same time fully protecting the public interest. But in my earlier remarks, I’ve done my best to set forth the issues surrounding the professional ethics and values that are essential to my own area of expertise, the financial sector in which I have spent my entire career.

Here, I close by reaffirming the ideas expressed by Professor Jordan in her summary of this conference: “Values and ethics should guide these new forms of relations emerging between the public and private sector.” (I underscore that both parties have this obligation.)

Professor Jordan also asks us to be aware that “finance (being reliant on the quest for gain) concerns other people’s money, which often opens the pathway for misconduct.” She continues:

\emph{Is this a question of honesty and morality? Yes, in part, but more importantly it is a question of a structural flaw in finance which includes the compensation structure of firms, organizational pressures to engage in unethical activities, culture, incentives, and conflicts of interest. Therefore, it is not only about individual conduct, but also of organizational and systemic factors.}

Professor Jordan also shares my concern about “innovative financial products” and the perils of “complexity and opacity.” So as we consider the optimal means for organizing public-private partnerships

\(^6\) The cost of the “Big Dig” in downtown Boston was originally estimated at $2.8 billion. Final cost: $14.6 billion.
to meet our nation’s compelling infrastructure needs, and the optimal means to finance them, let’s keep
the relationship between structure and strategy on the one hand, and ethics and values on the other, at the
forefront of our thinking.

Yes, the structure and values of our financial sector have set a bad example. But the cheapest way
to learn is to learn from the mistakes of others. We must embrace the illuminating glow of sunlight that
will inspire us to realize a brighter future, rather than the flicker of light from the fire in the cave that until
now has transfixed us and dominated our values and perspectives.  

7 Build your own bank of information. Form your own opinions. Stress test all models. Calculate all risks. Challenge, well, everything. As I say at Vanguard, “for God’s sake, give judgment at least a fighting chance to triumph over process.” Think through your work with the deepest introspection that you can command.

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7 Those of you who are familiar with Plato’s “Allegory of the Cave” will know exactly what I’m talking about.