The Battle for the Soul of Capitalism

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Thank you very much for this special invitation to discuss my newest book, *The Battle for the Soul of Capitalism,* published in November by Yale University Press. It is indeed a pleasure to be with you all today.

My book minces no words. Right at the outset, I turn to the main issue: "The business and ethical standards of corporate America, of investment America, and of mutual fund America have been gravely compromised. It is time to set out on a new course that, paradoxically enough, will lead us directly back to where we began, with the traditional values of capitalism. In the recent era, capitalism has let us down. It has departed, not just in degree but in kind, from its proud traditional roots, a system that served us, despite its imperfections, with remarkable effectiveness, for the better part of the past two centuries—a free enterprise system based on open markets and private ownership, and on trusting and being trusted. *The system worked*. Or at least it *did* work." And then, as I write in *Battle,* "Something went profoundly wrong, fundamentally and pervasively, in corporate America."

At the root of the problem, in the broadest sense, was the societal change aptly described by these 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 had become what Campbell called a 'bottom-line society.' But, at least in my view, 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."

Let's start with why you should—indeed *must*—care about our system of free-market capitalism. I argue that it is the job of every concerned citizen to "uphold the values that once made our corporate and financial enterprises so successful, fairly providing the rewards of investing to those who put up the capital and assume the risks involved. To win the battle to restore the soul of capitalism, it is these values that must prevail." Why? Because, as I explain, "we require a powerful and equitable system of capital formation if our nation is to overcome the infinite, often seemingly intractable, challenges of our risk-fraught modern world. Our economic might, political freedom, military strength, social welfare, and even free religious values depend upon it."

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

It is a curious fact that my new book echoes in so many ways the principles that I set forth in my senior thesis. That thesis—and all that followed—depended on an incredible stroke of luck. In Princeton's Firestone Library, almost 56 years ago, I happened upon the December 1949 issue of *Fortune* magazine and learned for the first time that something called "the mutual fund industry" existed. When I saw the industry described in the article as "tiny but contentious," I knew immediately that I had found my thesis topic. Completed in the early spring of 1951, it was entitled "The Economic Role of the Investment Company."

Read today, my thesis would probably impress you as no more than workmanlike, perhaps a bit callow, but above all, shamelessly idealistic. On page after page, my youthful idealism speaks out, calling again and again for the primacy of the interests of the owner of mutual fund shares. *The prime responsibility (of fund managers) must always be to their shareholders.*" And the deal must be fair: "there is some indication that costs are too high," and that "future industry growth can be maximized by concentration on a reduction of sales charges and management fees."

After analyzing fund performance, I concluded that "*funds can make no claim to superiority over the market averages*," perhaps an early harbinger of my decision to create, nearly a quarter-century later, that world's first index mutual fund. And in my conclusion, I powerfully reaffirmed the ideals that I hold to this day: The role of the mutual fund is to *serve*—"to serve the needs of both individual and institutional investors . . . to serve them in the most *efficient*, *honest*, and *economical* way possible . . . *The principal function of investment companies is the management of their investment portfolios. Everything else is incidental.*"

While all of this gratuitous advice from a callow college senior was, alas, largely ignored by the fund industry, the creation of Vanguard as a truly *mutual* mutual fund group—operated on an "at cost" basis for the benefit of its owners rather than its managers—was my attempt to walk the walk that I talked the talk about all those years ago. Today, I assure you that my youthful idealism remains intact. Indeed, it is shamelessly reflected not only in Vanguard, but in my new book, an expression of my concern about our American society today, my conviction that our system of capital formation is essential to our economic growth and world leadership, and my acknowledgement that much has gone wrong in that system.

There is much that needs to be fixed, for "the business and ethical standards of corporate America, of investment America, and of mutual fund America (the three principal elements of the book) have been gravely compromised." In each arena, I discuss not only *what* went wrong, but *why* it went wrong, and *how* to go about fixing it. Right at the outset I warn the reader that mine is a tough message, bluntly delivered, opening with this epigram from St. Paul: "If the sound of the trumpet shall be uncertain, who shall prepare himself to the battle?", in this case; the battle for the soul of our capitalistic system.

Today's Capitalism

Today's capitalism has departed, not just in degree but in kind, from its proud traditional roots, a system that served us, admittedly imperfectly, but with remarkable effectiveness, for the better part of the past two centuries—a free enterprise system based on open markets and private ownership, and on trusting and being trusted.

The system worked. Or at least it *did* work. And then, late in the twentieth century, something went wrong, a "pathological mutation in capitalism," in the words of journalist William Pfaff. 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, Pfaff wrote, "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 markets had so diffused corporate ownership *that no responsible owner exists*. This is morally unacceptable, but also a corruption of capitalism itself." And so it is.

Once an "ownership society" in which direct owners of stock held voting control over corporate America, we have become an "agency society," and we are not going back. But the agents—largely mutual fund managers and pension fund trustees—have failed to represent, first and foremost, their principals—pension beneficiaries and owners of mutual fund shares. These intermediaries have consumed far too large a portion of whatever returns our corporations and our financial markets were generous enough to provide, with far too small a portion of these returns delivered to the last-line investors who have put up all of the capital and assumed all of the risks.

Let's consider just nine quick examples—three each from corporate America, investment America, and mutual fund America—that reflect the negative consequences of this change in capitalism.

In Corporate America:

- One is the staggering increase in managers' compensation. CEO pay has risen from 42 times the compensation of the average worker in 1980 to 340 times currently, a 756 percent rise after inflation, while the real income of the average worker has barely kept pace with the cost of living. Long ago, Herbert Hoover, one of our few businessmen to serve as president, put it well: "The only trouble with capitalism is capitalists. They're too darn greedy." Imagine what he'd say today.

- Two, the rise of financial engineering. In a remarkable manipulation of financial statements, corporate earnings are managed to meet the "guidance" that these executives give to Wall Street, quarter by quarter. Two of the prize tools for earnings shenanigans: (1) mergers that are made, not with a sound business rationale, but because of the consequent opportunity to manage "pro forma" earnings by creating a veritable "cookie jar" of reserves, to be drawn on at will in order to present a rosy, but false, picture of corporate growth; and (2) arbitrarily raising the assumptions for future returns on corporate pension plans, even as prospective returns eroded. Just think of it: In 1981, when the long-term U.S. Treasury bond yielded 13.9 percent, corporations projected pension plan returns at 7 percent per year—only *half* as much. Currently, with bond yields at 4.7 percent—65 percent *lower*—the projected return averages about 8.5 percent—20 percent *higher*. That return is simply not going to happen, and the inadequacy of pension plan assets to meet their payout liabilities to retirees is well on the way to becoming our next financial scandal.

- Three, the failure of our traditional gatekeepers. In the recent era, auditors, through their provision of highly profitable consulting activities, became partners, if not co-conspirators, with managements, and relaxed traditional professional standards. Regulators and legislators (who in 1993 forced the SEC to back down on requiring that option costs to be treated as—of all things!—corporate expenses) also ignored the public interest. And corporate directors failed to provide the necessary "adult supervision of these geniuses" who managed the firms. (You'll find that quote in my book.) Put more harshly, in an unattributed quotation that I came across a few years ago, "When we have strong managers, weak directors, and passive owners, don't be surprised when the looting begins." And that's, of course, what we've seen at Enron, WorldCom, and too many others.

In Investment America:

- One, the vanishing ownership society. Almost unobserved, direct holdings of stocks by individual investors have plummeted from 92 percent of all stocks in 1950 to only 32 percent today, as corporate control fell into the hands of giant financial institutions—largely pension funds and mutual funds—whose share soared commensurately, from 8 percent to 68 percent, a virtual revolution in ownership. But these agents, beset by conflicts of interest, have failed to place front and center the interests of their principals, passively ignoring the need for good governance and allowing corporate managers to look primarily to their own interests.

- Two, the rise of short-termism. Part of this failure came because institutional money management, once an *own-a-stock* industry (holding an average stock for six years during my first 15 years in this field) became a *rent-a-stock* industry, now holding a typical stock for but a single year, or even less. While as *investors*, owners *must* care, and care deeply, about the rights and responsibilities of corporate governance, and must exercise those rights and honor those responsibilities. But as *speculators*, renters who merely trade stocks could hardly care less. Simply put, as I ask in the book, "If the owners of corporate America don't give a damn about the triumph of managers' capitalism, who on earth should?" Yet our new agent/owners remain passive to a fault on governance issues.

- Three, the triumph of illusion over reality. As our professional security analysts came to focus far more heavily on *illusion*—the momentary precision of the price of the stock—they increasingly ignored the *reality*—that what really matters is the inevitably vague, but eternally transcendent, intrinsic value of the corporation. Measuring up, unfortunately, to Oscar Wilde's wonderful description of the cynic, our money managers came "to know the price of *everything*, but the value of *nothing*." When there is a gap between perception—illusion—and reality, it is, to state the obvious, only a matter of time until the gap is reconciled—inevitably, in favor of reality.

In Mutual Fund America:

- One, the industry changed. Mutual funds, once a profession with elements of a business, gradually became a business with elements of a profession. Our traditional guiding star of *stewardship* was transmogrified into a new star—*salesmanship*. Largely focused on management when I wrote my Princeton thesis about the industry, our predominant focus today is on marketing—increasing fee revenues by building up assets under management, often by creating, promoting, and advertising speculative funds that meet the fads and fashions of the day. As you will soon learn, our fund investors have paid a terrible price.

- Two, the conglomerates take over. When I entered this field all those years ago, virtually 100 percent of mutual fund management companies were *privately*-held firms, relatively small, and managed by investment professionals. Since then, they have experienced their own pathological mutation. Today, 41 of the 50 largest fund management companies are *publicly*-held, including 35 that are owned by giant U.S. and global financial conglomerates, largely managed by businessmen bereft of professional investment training. It shouldn't surprise you to learn that these conglomerates are in the fund business to earn a return on *their* capital, not a return on *your* (the fund investor's) capital. They cannot do justice to both, for the record is clear that the more the managers *take*, the less the investors *make*. Alas, in the fund industry in the aggregate, you not only *don't* get what you pay for, *you get precisely what you don't pay for.*

- Three, mutual fund returns fall drastically short of market returns. And they fall short by almost exactly the amount of the costs they incurred—all those management fees, operating expenses, sales charges, and hidden portfolio transaction costs. How could it be otherwise? Over the past two decades, for example, the annual return of the average equity *fund* (10 percent) has lagged the return of the S&P 500 Index (13 percent) by three percentage points per year, largely because of those pesky fund costs. To make matters worse, largely because of poor timing and poor fund selection, the return actually earned by the average fund *investor* has lagged the return of the average fund by *another* 3 percentage points, reducing it to just 7 percent per year—roughly 50% of the market's annual return. Warren Buffett accurately describes the problem: "the principal enemies of the equity investor are *expenses* and *emotions.*" The fund industry has failed investors on both counts.

  A return of 7% in a 13% market is a shocking gap, but the reality is far worse. When compounded over this grand 20-year era for investing, and adjusted for inflation, the average investor has captured but 16 percent of the market's compounded real profit. (I'm not kidding! $1,000 invested in a simple index fund mimicking the Standard & Poor's 500 Stock Index in 1984 and held today produced a profit of $5,490 after inflation; for the average fund investor, the real profit came to just $910.) No wonder that David Swensen, the integrity-laden and remarkably successful manager of the Yale endowment fund, characterizes such a shortfall as "the colossal failure of the mutual fund industry."

Where is the Public Discourse?

It seems obvious that there is an urgent need to face up to these and other failures in the changing world of capitalism. But despite the contentious nature of the issues I've just described—broadly reflecting the triumph of the powerful economic interests of the oligarchs of American business and finance over the interests of our nation's 100 million investors—it is remarkable that so little public discourse has been in evidence. In the investment community, I have seen no defense of the inadequate returns delivered by mutual funds to investors, nor of the industry's truly bizarre, counterproductive ownership structure; no attempt by institutions to explain why the rights of ownership that one would think are implicit in holding shares of stock remain largely unexercised; no serious criticism of the virtually unrecognized turn away from the once-conventional and pervasive investment strategies that relied on the wisdom of long-term investing, toward strategies that increasingly rely on the folly of short-term speculation; and, until recent weeks, almost no discussion of the profound problems we are facing in our systems of retirement plan funding. If my book helps to open the door to the introspection by our corporate and financial leaders that is so long overdue, and then corrective action, perhaps the needed changes will be hastened.

This process must begin with a return to the original values of capitalism, to that virtuous circle of integrity—"trusting and being trusted"—as I mentioned at the outset. When ethical values go out the window and service to those whom we are duty-bound to serve is superseded by service to self, the whole idea of the capitalism that has been a moving force in the creation of our society's abundance is soured. In the era that lies ahead, the trusted businessman, the prudent fiduciary, and the honest steward must again be the paradigms of our great American enterprises. It won't be easy, but if we all work long enough and hard enough at the task, we can build, out of a long-gone ownership society and a failed agency society a "fiduciary society," one in which the citizen-investors of America will at last receive the fair shake they have always deserved from our corporations, our investment system, and our mutual fund industry.

Fixing the system is not a task for the faint of heart, for it will not be easy. My overarching recommendations are two: (1) A call for the formation of a federal commission to (a) recommend policies that respond to the failure of our agency society in which direct stockowners have become an endangered species, and (b) to take the steps necessary to ultimately eliminate the frightening shortfall—recently estimated at $1.2 trillion—in the expected future wealth of the vastly underfunded public, private, and individual retirement plans that are the foundation of our national savings. These two problems are directly related, and best solved by the creation of a federal statutory standard of fiduciary duty which will require our intermediaries to truly represent—first, last, and only—the interests of those they serve.

But even if that recommendation of a federal approach doesn't come to pass for a decade or more, Adam Smith's legendary "invisible hand"—each investor acting in his or her own enlightened self-interest—will gradually bring about these changes. So my second recommendation is to speed-up that process by an intense focus on investor education. If we investors simply have the wisdom to understand how the financial system works, and to move our own money where our own common sense dictates, then the system of financial intermediation that has failed so many investors in the modern era will change. One way or another then,—whether by government fiat or by invisible hand—the soul of capitalism—that traditional owners' capitalism that served us so well, for so long—will be reclaimed.

Fixing today's CEO-centered corporate world, the excesses of the financial system, and the faltering mutual fund industry—returning control from managers to owners in a new fiduciary society—is on the way. I hope my book will help. But whether forced to do so by law or regulation, or by the wisdom finally acquired by crowds of investors making intelligent investment decisions as they simply seek to further their own economic interests, so it will be. That's my ideal, and that's my idealism.

Thank you.