

The Clash of the Cultures

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During the recent era, major changes have taken place in our nation's financial sector. They reflect two very different cultures that have existed in the world of capital formation and capital markets all through history. But today's model of capitalism has lost the optimal balance between these two cultures, to the detriment of the investing public—indeed to the ultimate detriment of our society—and to the benefit of financial sector participants at the direct, arguably dollar-for-dollar, expense of their clients.

As a member of the financial community, I'm concerned about these changes. I'm also concerned as a member of the community of investors, and as a citizen of this nation. The issue that concerns me is, simply put, today's ascendance of speculation over investment in our financial markets; or, if you will, the ascendance of the culture of science—of instant measurement and quantification—over the culture of the humanities—of steady reason and rationality. Hence my title, the phrase popularized by the British author C.P. Snow a half-century ago: "The Clash of the Cultures." As I see it, long-term investing reflects the culture of the intellectual, the philosopher, and the historian, and short-term speculation reflects the culture of the statistician, the technician, and the alchemist.

Such a criticism might seem to fly in the face of our ever more scientific and technological

world, overwhelmed today with innovation, information, instant communications, and competition that have brought great benefits to our society. But I see our financial system as somehow separate and distinct from the other business and commercial systems that permeate our world. There is a difference—a difference in kind—between what economists describe as "rent-seeking" activities that, on balance, subtract value from society and "value-creating" activities that add value to society, providing new and improved products and services at ever more efficient prices. But, on balance, technology has done little to improve the lot of investors during the recent era. Pressed to identify useful financial innovations, Paul Volcker, recent chairman of the President's Economic Recovery Board, singled out only "the ATM as his favorite financial innovation of the past 25 years" (*WSJ* [2009]).

When applied to the physical world, to state the obvious, scientific techniques have been successfully used to determine cause and effect, helping us to predict and control our environment. This success has encouraged the idea that scientific techniques can be productively applied to all human endeavors, including investing. But investing is not a science. It is a human activity that involves both emotional as well as rational behavior. Financial markets are far too complex to isolate any single variable with ease, and the record is utterly bereft of evidence that definitive

predictions of short-term fluctuations in stock prices can be made with consistent accuracy. The prices of common stocks are evanescent and illusory, for equity shares are themselves merely *derivatives*—think about that!—of the returns created by our publicly held corporations and the vast and productive investments in physical capital and human capital that they represent.

Intelligent investors try to separate their emotions of hope, fear, and greed that separate the volatile market of short-term expectations from the real market of long-term intrinsic value, and trust in reason to prevail over the long term. In this sense, long-term investors must be philosophers rather than technicians. This difference suggests one of the great paradoxes of the financial sector of today's U.S. economy: Even as it becomes increasingly clear that a strategy of staying the course is far more productive than market timing or the ultimate futility of hopping from one stock—or one stock fund—to another, our financial institutions, through modern information and communications technology, make it increasingly easy for their clients and shareholders to engage in frequent and rapid movement of their investment assets.

THE RISE OF SPECULATION

The extent of this step-up in speculation—a word I've chosen as a proxy for rapid trading of financial instruments of all types—can be easily measured. Let's begin with stocks. Annual turnover of U.S. stocks (trading volume as a percentage of marketable shares outstanding) was about 15% when I entered this business in 1951, right out of college. Over the next 15 years, turnover averaged about 35%. By the late 1990s, it had gradually increased to the 100% range, and hit 150% in 2005. In 2008, stock turnover soared to the remarkable level of some 280% and declined modestly to some 250% in 2010.¹

Think about the numbers. When I came into this field, stock trading volumes averaged about 2 million shares per day. Today we trade about 8½ billion shares of stock daily. Annualized, the total comes to more than 2 trillion shares—in dollar terms, I estimate some \$40 trillion. That figure, in turn, is 300% of the \$13 trillion market capitalization of U.S. stocks. To be sure, some of those purchases and sales are made by long-term investors. But even if we look at what are considered long-term investors, precious few measure up to that designation.

In the mutual fund industry, for example, the annual rate of portfolio turnover for the average actively managed equity fund runs to almost 100%, ranging from a hardly minimal 25% for the lowest turnover quintile to an astonishing 230% for the highest quintile.²

The stock market turnover numbers include enormous trading through today's high-frequency traders (HFTs), who are said to constitute some 50% of the total. These HFTs, in fairness, stand ready to provide liquidity to market participants, a valuable service offered for just pennies per share, with holding periods for their positions as short as 16 seconds. Yes, 16 seconds. (This multiple market system, however, has created significant inequities in order execution that demand a regulatory response.) The high demand for the services of HFTs comes not only from "punters"—sheer gamblers who thrive (or hope to thrive) by betting against the bookmakers—but from other diverse sources ranging from longer-term investors who value the liquidity and efficiency of HFTs, to hedge fund managers who act with great speed based on perceived stock mispricings that may last only momentarily. This aspect of "price discovery" clearly enhances market efficiency, a definite benefit even to investors with a long-term focus.

Consider now how these tens of trillions of dollars of transaction activity in the *secondary* market each year compare with transaction activity in the *primary* market. Providing fresh capital to business—let's call it capital formation—was once accepted as the principal economic mission of Wall Street. The process of allocating investment capital to the most promising industries and companies, both those that seek to provide better and better goods and services at increasingly economic prices to consumers and businesses, and innovators that seek to do the same, only faster. How large is that capital formation activity? Let's begin with stocks. Total equity IPOs have averaged about \$35 billion annually over the past decade, and secondary offerings have averaged about \$110 billion, bringing new issues of common stock to some \$145 billion.³ So today's annual stock trading volume of \$30 trillion is now some 200 times the volume of equity capital provided to businesses. *That* is a sizable imbalance.

I'm not sure where to put debt issuance in this comparison. For the record, debt issuance over the past decade averaged about \$1.7 trillion annually, fully \$1 trillion of which was accounted for by the now

virtually defunct area of asset-backed debt and mortgage-backed debt, too often based on fraudulent lending and phony figures that were willingly accepted by our rating agencies, witting co-conspirators in handing out AAA ratings to debt securities that would soon tumble in the recent debacle, their ratings finally slashed. I'm not at all sure that massive flow of mortgage-backed debt is a tribute to the sacred cow of capital formation.

This huge wave of speculation in the financial markets is not limited to individual stocks. Trading in derivatives (whose values are derived from the prices of the underlying securities) has also soared. For example, trading in S&P 500-linked futures totaled more than \$33 trillion in 2010, three times the total market capitalization of \$11 trillion for the S&P 500 Index.⁴ We also have billions of frequently traded credit default swaps (essentially bets on whether a corporation can meet the interest payments on its bonds) and a slew of other derivatives, whose notional value on June 30, 2010, totaled a cool \$580 trillion.⁵ By contrast, for what it's worth, the aggregate capitalization of the world's stock and bond markets is about \$150 trillion, only about one-fourth as much. Is this a great financial system ... or what!

While much of the trading in derivatives that is represented by stock index futures, credit default swaps, and commodities reflects hedging (risk aversion), a substantial portion—perhaps one-half or more—reflects rank speculation (risk enhancing), another component of the whirling dervish of trading. Most of this excessive speculation is built on a foundation of sand, an unsound basis for our financial well-being. Sooner or later—as the great speculative manias of the past such as Tulipmania and the South Sea Bubble remind us—speculation will return to its proper and far more modest role in our financial markets. I'm not sure just when or how, but the population of investors will one day come to recognize the self-defeating nature of speculation.

THE WALL STREET CASINO

Way back in 1999, I wrote an op-ed for *The New York Times* entitled “The Wall Street Casino.” It called attention to the negative impact of the “feverish trading activity in stocks” at a time when daily trading averaged 1½ billion shares, tiny by today's standards. In 2010, the *Times* revisited the issue with an editorial with virtually the same title, “Wall Street Casino.” It called attention

to the even higher levels of speculation that had come to distort our markets and ill-serve our investors.

To understand why speculation is a drain on the resources of investors as a group, one need only understand the tautological nature of the markets: Investors, as a group, inevitably *earn* the gross return of, say, the stock market, but only before the deduction of the costs of financial intermediation are taken into account. If beating the market is a zero-sum game *before* costs, it is a loser's game *after* costs are deducted. How often we forget the power of these “relentless rules of humble arithmetic” (a phrase used by Justice Brandeis a century ago in another context) when we bet against one another, day after day—inevitably, to no avail—in the stock market.

Over time, the drain of those costs is astonishing. Yet far too few investors seem to understand the impact of that simple math, which ultimately causes investors to relinquish a huge portion of the long-term returns that our stock market delivers. Even if the cost of financial market activity—transaction costs, advisory fees, sales loads, and administrative costs—totals as little as 2% a year, its long-term impact is huge. Over a 50-year investment lifetime, for example, a 7% market return would produce an aggregate gain of 2,800%. But after those costs, the return would drop to 5% and the gain to 1,000%—barely one-third as much.

The reality of the investment business is that we investors (as a group) not only don't get what we pay for (the returns earned by our corporations), we get precisely what we *don't* pay for. So the less we pay (as a group), the more we get. And if we pay nothing (or almost nothing, as in an all-stock-market index fund), we get everything (the market return). There's simply no way 'round these mathematics of the markets. This financial math, of course, is the very same model for the casino math on which the so-called gaming industry relies. It's not just Las Vegas, and Foxwoods, and Atlantic City, but it's also our pervasive state lotteries (think Megamillions and Powerball), except that in these giant lotteries, the croupier's take, relative to the amount wagered, is even higher than on Wall Street.

Calling Wall Street a casino, of course, is not entirely fair. Wall Street is more than that. It provides the liquidity on which long-term investors as well as short-term speculators rely. Wall Street also facilitates the capital formation mentioned earlier, however small relative to today's stock market volumes, but every once

in a while even a market insider acknowledges the similarity. Late in 2010, a senior executive of Wall Street powerhouse Cantor Fitzgerald owned up to the obvious, stating, "I don't see any difference between Las Vegas Boulevard and Wall Street: Over time we can't lose, but there will be games when we take a hit" (Craig [2010]).

He is explaining why Cantor Fitzgerald, one of the largest brokers in super-safe (so far!) U.S. government securities, is now running sports bookmaking at a new casino in Las Vegas. "There's big money in ... moving onto the strip," another Cantor executive added, especially through a new license allowing sports betting, roulette, and slot machines (so far, only in Nevada) on mobile devices (Craig [2010]). Can Wall Street be far behind? Indeed, with all the computers, the technology, the quantification, and the algorithms we have today—and the enormous size of financial gambling relative to casino gaming—isn't Wall Street already far ahead?

HOW DID WE GET HERE?

The domination of the loser's game of speculation over the winner's game of investment is no accident. It has been fostered by critical changes in the elements of investing. First in my list of causes is the decline of the old ownership society—in 1950 individual investors held 92% of U.S. stocks and institutional investors held 8%—in favor of a new agency society where the tables are turned so that institutions now hold 70% and individuals 30%. Simply put, these agents collectively now hold firm voting control over corporate America.

Originally largely managers of mutual funds and pension funds, and later joined by hedge funds, these new investor/agents were hardly unaware of their own financial interests. As a group—with far too few exceptions—they took advantage of their agency in charging high advisory fees and in adopting investment policies that focused on the short-term (in part in recognition that that's how their clients would judge their performance). Mutual fund managers capitalized on the reality that hot short-term performance—even though it couldn't last—would enrich them with higher fees. In order to reduce pension contributions and enhance short-term earnings, corporate pension executives projected totally unrealistic high future returns. State and local government officials, pressed by labor unions for

higher wages and pensions, failed to provide financial disclosure that revealed—or even hinted at—the dire long-term financial consequences that are already beginning to emerge.

Most of the returns earned by these now-dominant, powerful investment institutions were in accounts managed for tax-deferred investors such as pension plans and thrift plans, and in tax-exempt accounts such as endowment funds. For their taxable clients, these investor/agents simply ignored the tax impact and passed the tax liability through to largely unsuspecting fund shareholders. So over time, these agents came to ignore income taxes and capital gains taxes, essentially eliminating them as a major frictional cost in executing portfolio transactions, a cost that had helped to deter rapid stock trading in an earlier era.

Next, in a wonderful example of the law of unintended consequences, commissions on stock trading were slashed, virtually removing a second cost of transactions. Fixed commissions of about 25 cents per share that had pretty much prevailed up until 1974 (without volume discounts!) were eliminated in favor of commissions set in a free market. Wall Street, otherwise a bastion of free market capitalism, fought the change, but finally lost. And the decimalization of stock prices, begun in 2001, also took its toll as commissions fell to pennies per share as *unit costs* of stock trading were reduced to bare-bones minimums. Nonetheless, with soaring trading volumes, Wall Street's *total revenues* appear to have doubled in the past decade.⁶

It may be only to state the obvious to note that great bull markets often foster speculative activity. After all, how much *relative* harm could the earlier drag of taxes and commissions inflict on returns when the S&P 500 rose tenfold from 140 in 1982 to 1,520 at the 2000 high. What's more, when such a culture of high volume trading becomes imbedded in the system, even a bear market that took the S&P 500 to a low of 680 in the spring of 2009 didn't seem to break the trend toward high trading activity. In some respects, the events of the past few years seem to have actually enhanced the rate of speculation.

The development of this culture of speculation was accelerated by a new breed of institutional investor—hedge funds, which typically turn over their portfolios at a 300%–400% annual rate. From a single U.S. hedge fund in 1949, the field has burgeoned to some 4,600 hedge funds today with assets under management of some

\$2 trillion, down from \$2.5 trillion at their peak a few years ago. While some hedge funds have had remarkably good performance, the failure rate (funds that go out of business) is large. On average, they seem to be no better than, well, average. For example, over the last 10 years the average hedge fund produced an annual return after fees (but before taxes) of 5.5%, compared to 6.2% for a pioneering, stodgy, low-risk, conservative balanced mutual fund named Wellington.⁷ Since the traditional “2 and 20” management fee structure—2% of assets annually, plus the “carry” of 20% of realized and unrealized profits—likely consumed as many as 3 percentage points a year of the *gross* returns of the average hedge fund, small wonder that the *net* returns have been, at best, undistinguished.

While hedge funds may have led the speculative wave, many pension funds and mutual funds also moved toward the new, quantitatively oriented strategies, as ever more sophisticated computer hardware and software made data almost universally available. Analysts and academics alike massaged the seemingly infinite data on stock prices that became available, often using complex techniques—relative valuations, classes of stock (growth versus value, large versus small), momentum, changes in earnings estimates, and many others. Each of these models was designed to provide *positive alpha* (excess return over a market benchmark), which came to be seen as the Holy Grail of consistent performance superiority. But too few in the profession asked the philosopher’s question: Does that Holy Grail actually exist?

Another great fomentor of this new rapid trading environment was, of course, *money*. Not only big money for hedge fund managers, but big money for brokers and investment bankers, big money for mutual fund managers, and, collectively at least, big money for all those lawyers, marketers, record-keepers, accountants, prime brokers, and bankers who are part of the extraordinarily well-paid constituency of our casino society. Inevitably, as noted earlier, every dollar of this big money comes directly out of the pockets of the industry’s clients.

In fairness, the rise of speculation seems to reflect a broader change in our national culture. All across American life, trusted professions—traditionally focused on service to the community—have increasingly taken on the characteristics of businesses—focused on maximizing profits to providers, too often at the expense of the moral values of an earlier age. What’s more, the gambling culture, always part of our society, seemed to strengthen, a diversion from the hard times in which so many of

our families exist, giving them an opportunity—against staggering odds—to prosper at last. And even without cash on hand, we Americans like to buy things—in abundance—before we have the means to pay for them. We focus on today rather than tomorrow, and even among the wealthiest of us, we never seem to have *enough*. We compare ourselves with our neighbors and, since the realities of life can be so hard to overcome, we look to speculation—even at long odds—to lift us out of the everydayness of our lives.

THE PRESCIENCE OF BENJAMIN GRAHAM

Long ago, the possibility that speculation would come to play a far larger role in finance concerned the legendary Benjamin Graham. Way back in 1958, in his address to the New York Society of Financial Analysts, he described what he saw as the coming change in culture “in some contrasting relationships between the present and the past in our underlying attitudes toward investment and speculation in common stocks.” Graham professed:

In the past, the speculative elements of a common stock resided almost exclusively in the company itself; they were due to uncertainties, or fluctuating elements, or downright weaknesses in the industry, or the corporation’s individual setup ... But in recent years a new and major element of speculation has been introduced into the common-stock arena from outside the companies. It comes from the attitude and viewpoint of the stock-buying public and their advisers—chiefly us security analysts. This attitude may be described in a phrase: primary emphasis upon future expectations ...

The concept of future prospects and particularly of continued growth in the future invites the application of formulas out of higher mathematics to establish the present value of the favored issues. But the combination of precise formulas with highly imprecise assumptions can be used to establish, or rather to justify, practically any value one wished, however high ...

Given the three ingredients of a) optimistic assumptions as to the rate of earnings growth, b) a sufficiently long projection of this growth into the future, and c) the miraculous workings

of compound interest—lo! The security analyst is supplied with a new kind of philosopher's stone which can produce or justify any desired valuation for a really 'good stock ...'

Mathematics is ordinarily considered as producing precise and dependable results; but in the stock market the more elaborate and abstruse the mathematics the more uncertain and speculative are the conclusions we draw there—from ... Whenever calculus is brought in, or higher algebra, you could take it as a warning signal that the operator was trying to substitute theory for experience, and usually also to give to speculation the deceptive guise of investment ...

Have not investors and security analysts eaten of the tree of knowledge of good and evil prospects? By so doing have they not permanently expelled themselves from that Eden where promising common stocks at reasonable prices could be plucked off the bushes (Zweig and Sullivan [2010] pp. 79–90)?

Graham's reference to Original Sin reflected his deep concern about quantifying the unquantifiable (and doing so with false precision). When Graham spoke these words in 1958, the implications of that bite into the apple of quantitative investing were barely visible, but by the late 1990s this new form of investment behavior had become a dominant force that continues to be a major driver of the speculation that has overwhelmed our financial markets.

THE CHANGE IN THE "MUTUAL" FUND CULTURE

The general clash of the cultures in finance is well illustrated by a specific example, which happens to be an industry in which I'll soon celebrate my 60th anniversary. The mutual fund industry is a very different industry than the one that I entered all those years ago. While I'm not pleased with the change, please understand: I love the mutual fund industry. I merely want it to live up to its potential to serve investors. In that sense, I have a "lover's quarrel" with the industry to which my long career has been dedicated.⁸

There are many reasons for the changes in the industry's culture. First, there has been the sea-change in the structure of fund investment management from largely

a group approach—committees with a conservative culture of investment—to an individual approach—portfolio managers with a culture of aggressive speculation. This change has helped foster the leap in fund portfolio turnover from the 15%–20% range of the 1950s and early 1960s to the 100% range of recent years.

In this new era, the relative volatility of individual funds has increased, and the old industry model of blue-chip stocks in market-like portfolios—and commensurately market-like performance (before costs, of course!)—evolved into a new model. It began during The Go-Go Years of the late 1960s, when "hot" managers were treated like Hollywood stars and marketed in the same fashion, and has largely continued ever since. (The index fund is a rare exception.) But as the inevitable reversion to the mean in fund performance came into play, these stars proved more akin to comets—speculators who too often seemed to focus on changes in short-term corporate earnings expectations and price momentum, and to forget about due diligence, research, balance sheet strength, and notions of intrinsic value and long-term investing.

Perhaps inevitably, this speculation by managers was soon emulated by fund investors, and the holding period for fund shares by their shareholders shrank from an average of 12 years when I joined the industry to about 3 years currently.⁹ Broadly stated, the fund industry evolved from its original and primary focus on prudent investment management to a new focus on aggressive product marketing, a shift from *stewardship* to *salesmanship*.

How different it was in the industry's early days! I'm one of the rare (if not unique) persons to have observed firsthand the change in the industry's business model. At the outset, fund management companies engaged *solely* in portfolio supervision, research, and, yes, management. They did *not* engage in marketing or the distribution of fund shares. For good reason, the marketing of fund shares was kept at arm's length, with independent, separately owned and operated distributors handling that function. The first mutual fund, Massachusetts Investors Trust, relied on a totally separate wholesale distributor from its inception in 1924 until 1969, nearly a half-century later. The second mutual fund (State Street Investment Corporation) followed essentially the same model until 1989. A separate, independently owned distribution corporation also handled the marketing function for today's giant Capital Group (American Funds) from

its inception in 1933 until 1974, when the management company and the marketing company were merged and became one.

When gathering assets becomes the name of the game, marketing and investment go hand in hand. Hot performance produces lots of sales. (No surprise there!) Sales incentives to brokers rise. The soaring volume of trading activity by mutual funds is used to grease the wheels of distribution. “Pay to play” provides enormous trading commissions to brokers who sell the fund’s shares—costs that are paid by the *funds* even as all the benefits go to the fund’s *manager*—and generate even more sales. And advertising (funded by the fund shareholders through the management fees that they pay) becomes both more pervasive and more strident (advertising short-term returns, for example, but only when they are superior), in recent years running at an estimated range of \$250 million annually.

PUBLIC OWNERSHIP AND PRODUCT PROLIFERATION

A major force that aided and abetted the change in the fund industry’s culture was the metamorphosis from private ownership of fund management companies (usually by their trustees and investment executives) to public ownership. This baneful development was fostered by an unfortunate district court decision in California in 1958 that overruled the SEC position that such transfers were a violation of fiduciary duty. This seminal—and today rarely even recognized—event changed the rules of the game. It opened the theretofore closed floodgates of public ownership to huge rewards of entrepreneurship by fund managers, inevitably at the expense of fund shareholders.

Soon after the court decision, most of the large mutual fund management companies went public.¹⁰ It was only a matter of time until many were acquired by U.S. and international financial conglomerates. These firms, obviously, are in business to earn a high return on *their* capital, even at the expense of the capital they supervise for fund investors. Today, among the 40 largest fund complexes, 33 are publicly held (including 25 held by conglomerates), with only 7 remaining private.¹¹ Nonetheless, today’s three largest fund complexes remain essentially privately held, owned either by their executives (Capital Group and Fidelity) or, uniquely, by their fund shareholders. (Yes, Vanguard is the only

mutual mutual fund group. Hence, the quotation marks around my use of the word “mutual” at the beginning of this section.)

Along with the other trends I’ve outlined, this change in industry structure has had profound implications for the fund industry’s change from a culture of investment to a culture of speculation. Asset gathering has become the name of the game, as competition for cash flow, asset size, and earnings growth drive ambitious fund executives to make their marks, eager to test their mettle on the fields of combat for the great god Market Share. Even the firms under private ownership were hardly exempt from this drive. Remarkably, as mutual fund assets soared, expenses soared even higher, with managers arrogating to themselves the enormous economies of scale in investment management. As a result, the average equity fund expense ratio, weighted by fund assets, rose from 0.5% for that tiny industry in 1960 to 0.99% for that giant industry component in 2010—a stunning increase of almost 100%.¹²

Few statistics better describe the change in this industry from a culture of management to a culture of speculation and marketing than measuring the waves of creation of new mutual funds that we have witnessed over the years. New funds—too often of the “hot” variety—are created to meet the perceived demands of the marketplace (or marketplaces—not only investors, but distributors and brokers). The product proliferation fostered by these spates of marketing creativity is usually followed by the disappearance of the funds that fail to meet durable investment needs or fail to provide market-competitive performance.

These waves of faddish creation are easy to spot. For example, in The Go-Go Years of the late 1960s, some 350 new equity funds—largely highly volatile and risky “performance” funds—were formed, more than doubling the number of funds, from 240 in 1965 to 535 in 1972. With the ensuing collapse of that bubble and the subsequent 50% decline in the overall stock market, only 7 or 8 new funds were formed in each year of the decade that followed. In the next marketing bubble, Internet and high-tech stocks led the way, and the fund industry responded by creating an astonishing total of 3,800 (!) new equity funds, mostly aggressive growth funds focused on technology and the so-called new economy. While some 1,200 funds went out of business during this period, the equity fund population

more than doubled, from 2,100 funds at the start of 1996 to 4,700 in 2001.¹³

After each wave of creation, of course, investment reality quickly intruded on speculative illusion, and the fund failure rates that followed virtually matched the earlier creation rates. Back in the 1960s, about 1% of funds disappeared each year and about 10% over the decade. When the frothy decade of the 1990s turned to the dispiriting decade of the 2000s, the failure rate leaped to an average of almost 6% a year. Some 55% of the funds in existence at the start of each decade had vanished by its conclusion. In the coming decade, assuming that rate persists, some 2,500 of today's 4,600 equity funds will no longer exist—an average of almost one fund death on every business day for the next 10 years. And this is an industry that insists that its member funds are designed for *long-term* investors.

One major event of the past decade illustrates the falsity of that assertion. The emergence of the exchange-traded fund is surely the industry's greatest *marketing* success of the first decade of the new century. I'm not sure why an ETF—an index fund whose shares can be traded all day long—would be preferable to a regular index mutual fund whose shares can be bought and sold “only” once a day, but that is what the market seems to be saying. Only time will tell whether this new model—index funds used more by speculators than by investors—is just another marketing fad. Whether the ETF will prove to be a great *investment* success is quite another matter. So far, it seems unlikely. During the five years ended June 2010, ETF investors earned far less than the ETFs in which they invested by a truly remarkable cumulative total of 28 percentage points (average ETF, +15%; average ETF investor –13%),¹⁴ reaffirming an apparently enduring principle of mutual fund performance: *Fund investors can be their own worst enemies.*

AN EXAMPLE THAT MAKES THE POINT

There can be, I think, little room for debate about this change in the industry's culture and character. It is well summed up in a single recent example that encompasses the trafficking in management company stocks that the Securities and Exchange Commission tried—but failed—to prevent back in 1958, as well as bluntly explaining the rationale behind a giant mutual fund manager's decision to acquire an almost equally

large rival. The acquirer was Ameriprise Financial, which traces its roots back to 1894 and entered the fund field in 1940. The firm was acquired by American Express in 1984, only to be spun off in a public offering after which the funds were rebranded as RiverSource in 2005. Another management company, Seligman, was then acquired along the way.

On May 3, 2010, Ameriprise completed the acquisition of Columbia Management from Bank of America for approximately \$1 billion in cash; adding the Ameriprise fund assets of \$462 billion to the Columbia fund assets of \$190 billion created a \$652 billion colossus.¹⁵ Proudly announcing the acquisition, the chief of Ameriprise was surprisingly candid about the motivation for the merger, which was that the “acquisition transforms our asset management capabilities and provides a platform to accelerate our growth [in assets under management]. It enhances our scale, broadens our distribution and strengthens our [fund] lineup ... [and] allows us [Ameriprise] to capture essential expense synergies that will drive improved returns [in our asset management business] and [profit] margins [for Ameriprise] over time” (Ameriprise (2010)).

The acquisition announcement said little about what's in it for the shareholders of the funds now run by Columbia, the name adopted for the entire group. (Gone is RiverSource.) But a lengthy paragraph in the announcement does include a claim by the head of Ameriprise's asset management business that “we now offer clients strong-performing funds in every style category.” That statement seems to be true: 31 Columbia funds are rated as earning 4 stars or 5 stars, the top two of the five rating categories under Morningstar's rating system. But the allegation conceals more than it reveals. Fully 59 Columbia funds—nearly twice as many—carry the *lowest* ratings (1 star or 2 stars). The remaining 75 funds garner an “average” 3-star rating. The official statement by the fund's management company simply ignores this overall mediocrity (at best). The mutual funds, of course, had no way to speak for themselves.

THE QUESTION OF FIDUCIARY DUTY

No better example of how the fund industry's new salesmanship culture—focused on maximizing profits to management companies—has overwhelmed its original stewardship culture exists than the disgraceful “late

trading” scandals uncovered by New York Attorney General Eliot Spitzer in 2003. In brief, a whole range of fund managers conspired with hedge fund managers essentially to defraud long-term fund investors by trading on easily perceived (and often well-known) gaps in fund pricing procedures. The frauds were widespread. Some 23 firms participated in the conspiracy, enriching fund management companies at the measurable expense of their shareholders. These firms—some of them among the industry’s largest—were managing fully one-fourth of all assets of long-term mutual funds. Since significant asset size was required to accommodate such rapid trading, I venture to assert that the vast majority of firms that had the capability to handle such transactions proved unable to resist the temptation to feather their own nests. (For the record, not all of the industry’s giants were involved in the scandals. To their credit, Capital Group, Fidelity, T. Rowe Price, and Vanguard all resisted the temptation.)

Few insiders seem concerned about erosion of the industry’s culture. One surprising exception is Matthew Fink, industry advocate and president of the Investment Company Institute (the industry’s trade association and lobbying arm) from 1991 to 2004, who wrote: “Industry participants [must] understand that they are engaged in an endeavor where success depends on adherence to high standards of fiduciary behaviors If directors [and managers] believe that ensuring fiduciary standards is not their number one priority, the industry is in for some very rough times” (Fink [2008] p. 260).

The idea that fund officials, in Fink’s [2008] words, “act as fiduciaries, with an eye single on the best interests of fund shareholders” (p. 258) has now been totally discredited. Ever since its provisions were enacted into law more than 70 years ago, the federal Investment Company Act of 1940 has demanded that funds be “organized, operated, and managed” in the interest of shareholders rather than fund managers and distributors. But those provisions have been ignored, lost in the dustbin of history. Paradoxically, it was only a short time after the 1940 Act became law that the industry’s culture, balanced in favor of stewardship before that standard was enacted, began to shift soon thereafter toward a balance in favor of salesmanship. In the decades that followed, the interests of fund shareholders became subservient to the interests of fund managers, and the fund industry largely became just another consumer products marketing business.

THE WISDOM OF JOHN MAYNARD KEYNES

The change in culture of the mutual fund industry has helped to facilitate the broad trend toward the dominance of speculation over investment in the financial markets. This erosion that I have described in the conduct, values, and ethics of so many fund leaders has been fostered by the profound—and largely unnoticed—change that has taken place in the nature of our financial markets. That change reflects two radically different views of what investing is all about, two distinct markets, if you will. One is the *real* market of intrinsic business value. The other is the *expectations* market of momentary stock prices.

It’s a curious coincidence that I’ve been concerned about this sharp dichotomy ever since I first encountered it in my study of economics at Princeton University. Really! In my 1951 senior thesis, inspired by a 1949 article in *Fortune* on the then “tiny but contentious” mutual fund industry, I cited the distinction made by the great British economist John Maynard Keynes between *enterprise* investment—Keynes called it “forecasting the prospective yield of the asset over its whole life”—and *speculation*—“forecasting the psychology of the markets.”

Keynes [1964] was deeply concerned about the societal implications of the growing role of short-term speculation on stock prices; “A conventional valuation [of stocks] which is established [by] the mass psychology of a large number of ignorant individuals,” he wrote, “is liable to change violently as the result of a sudden fluctuation of opinion due to factors which do not really matter much to the prospective yield . . . resulting in unreasoning waves of optimistic and pessimistic sentiment” (p. 154).

Then, prophetically, Lord Keynes predicted that this trend would intensify, as even “expert professionals, possessing judgment and knowledge beyond that of the average private investor, would become concerned, not with making superior long-term forecasts of the probable yield on an investment over its entire life, but with forecasting changes in the conventional valuation a short time ahead of the general public” (p. 155). As a result, Keynes warned, the stock market would become “a battle of wits to anticipate the basis of conventional valuation a few months hence, rather than the prospective yield of an investment over a long term of years” (p. 155).

In my thesis, I cited those very words, and then had the temerity to disagree with the great man. Portfolio managers, in what I predicted—accurately, as it turned out—would become a far larger mutual fund industry, would “supply the market with a demand for securities that is *steady, sophisticated, enlightened, and analytic* [italics added], a demand that is based essentially on the [intrinsic] performance of a corporation [Keynes *enterprise*], rather than the public appraisal of the value of a share, that is, its price [Keynes *speculation*].”

Alas, the steady, sophisticated, enlightened, and analytic demand that I had predicted from our expert professional investors is now nowhere to be seen. Quite the contrary! Our money managers, following Oscar Wilde’s definition of the cynic, seem to know “the price of everything but the value of nothing.” As the infant fund industry matured, the steady, sophisticated, enlightened, and analytic demand that I had predicted utterly failed to materialize. So, six decades after I wrote those words in my thesis, I must reluctantly concede the obvious: Keynes sophisticated cynicism was right, and Bogle’s callow idealism was wrong. Call it Keynes 1–Bogle 0, but that doesn’t mean we should let that system prevail forever.

FIXING THE SOCIAL CONTRACT

Today’s dominance of a culture of short-term speculation over a culture of long-term investment has implications that go far beyond our provincial financial sector. It distorts our markets and ultimately distorts the way our businesses are run. If market participants demand short-term results and predictable earnings (even in an unpredictable world), corporations respond accordingly. When they do, there is heavy pressure to reduce the work force, to cut corners, to rethink expenditures on research and development, and to undertake mergers in order to “make the numbers” (and to muddy the accounting waters).

When companies are compelled by short-term speculators to earn a return on their *capital as it is valued in the marketplace*, rather than the *capital provided to them by their shareholders*, the task can become nigh on impossible. Indeed, it may lead to dire consequences for their employees, for their communities, for the integrity of the products and services they provide, and even for their long-term viability. When a corporation’s focus on meeting Wall Street’s expectations (or demands) takes

precedence over providing products and services that meet the ever more demanding needs of its customers, it is unlikely to serve our society as it should, which is the ultimate goal of free market capitalism.

Perhaps even more importantly, we’ve largely lost the essential link between corporate managers and corporate owners. Ownership has its privileges—one of the most important of which is to assure that the interests of shareholders are served before the interests of management. But most short-term *renters* of stocks are not particularly interested in assuring that corporate governance is focused on placing the interests of the stockholder first. Even long-term *owners* of stocks have not seemed to care very much about exercising their rights—and indeed their responsibilities—of stock ownership.

Despite the growing importance of index funds—which, because they can’t and don’t sell stocks of companies whose managements are deemed to have produced inadequate returns on the capital they oversee ought to be in the vanguard of serious reforms—the agency society I’ve described earlier has too often failed to lend itself to significant involvement in corporate governance, let alone a more muscular activism, including proxy proposals, director nominations, executive compensation (now absurdly excessive, but generally ignored by the shareowners), and vigorous advocacy. Part of the challenge is that our institutional investors too often have a different agenda from that of the fund shareholders and pension beneficiaries they represent. Like the corporate managers they oversee, these money managers are too often inclined to put their own interests first, taking advantage of their agency position.

It is surely one of the great paradoxes of the day that the largest financial rewards in our nation are received by an investment community that *subtracts* value from its clients, with far smaller rewards received by a business community that *adds* value to society. Ultimately, such a system is all too likely to bring social discord to our society and engender a harsh public reaction to today’s record disparity between the tiny top echelon of income recipients and the great mass of families at the base. The highest-earning 0.01% of U.S. families (150,000 in number), for example, now receives 10% of all of the income earned by the remaining 150 million families, three *times* the 3%–4% share that prevailed from 1945 to 1980.¹⁶

In yet another distortion aided and abetted by our financial system, too many of the best and brightest

young people in our land, instead of becoming scientists, physicians, educators, or public servants, are attracted by the staggering financial incentives offered in the investment industry. These massive rewards serve to divert vital human resources from other, often more productive and socially useful, pursuits. Even in the field of engineering, “financial” engineering (essentially *rent seeking* in nature) holds sway over “real” engineering—electrical, mechanical, aeronautical, and so on (essentially *value creating*). The long-term consequences of these trends simply cannot be favorable to our nation’s growth, productivity, and global competitiveness.

Finally, the dominance of speculation in our financial affairs shifts our society’s focus from the enduring reality of corporate value creation on which our nation ultimately depends to the momentary illusion of stock prices. We spend far too much of the (roughly) \$600 billion annual cost of our investment sector on what is, in fact, gambling—intelligent and informed gambling perhaps, but gambling that one firm’s wit and wisdom and algorithms can capture an enduring advantage over another’s. (Evidence supporting the systematic achievement of sustained superiority simply does not exist.) So perhaps we should listen carefully when Lord Adair Turner, chairman of Britain’s Financial Service Authority, describes much of what happens in the world’s financial centers as “socially useless activity” (Cassidy[2010]). Or, as I have often pointed out—the stock market is a giant distraction to the business of investing.

THE WISDOM OF HENRY KAUFMAN

Once again, I’m not alone in my concern about this obvious dominance of the culture of speculation over the culture of investment in our financial markets. Indeed, I’m proud to associate my philosophy with that of legendary financial economist Henry Kaufman, whose wisdom places him in the top echelon of the worthy mentors of my long career. Consider his words:

The United States has not sustained a proper balance between financial conservatism and financial entrepreneurship—the fundamental and long-standing tension between two broad financial groups. At one end of the spectrum are financial conservatives, who favor preserving the status quo in the marketplace and hold in high esteem the traditional values of prudence, stability, safety,

and soundness. At the opposite end are financial entrepreneurs—risk takers restlessly searching to exploit anomalies and imperfections in the market for profitable advantage. They consider existing laws and regulations to be fair game, ripe to be tested and challenged . . .

The modern quantitative and econometric techniques developed in the last generation have given investors and portfolio managers a new sense of confidence in the ability to forecast financial trends and behaviors. By compiling and analyzing historical data, and by building models that take into account current variables, econometricians often try to predict the movement of interest rates, stock prices, inflation, unemployment, and so on. During times of financial euphoria and investor panic, however, these techniques become virtually worthless. The reason is fairly simple: The vast majority of models rest on assumptions about normal and rational financial behavior. But during market manias, logical and analytical minds do not prevail. Such markets are driven more by hubris, elation, fear, pessimism, and the like—emotions that the current models do not, and perhaps cannot, compute . . .

People in finance are entrusted with an extraordinary responsibility: other people’s money. This basic fiduciary duty too often has been forgotten in the high-voltage, high-velocity financial environment that has emerged in recent decades. With the absorbing excitement of the trading floor—which for some becomes a sort of game, an end in itself—the notion of financial trusteeship is frequently lost in the shuffle. In the final analysis, the tilt toward unbridled financial entrepreneurship has exacted economic costs that often far outweigh their economic benefits. 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 . . .

Today’s financial community is suffering from a bad case of amnesia. Most Wall Streeters are unaware of or have forgotten about the damaging effects of irresponsible behavior in their rush to ‘innovate’ and profit. Business majors at most colleges and universities were once required

to take courses in business and financial history, while the history of economics and economic thought was a staple in economics programs. This is no longer the case. In their entrancement with new quantitative methods, most business schools long ago abandoned their historically oriented courses. Anything having to do with the qualitative side of business practice—ethics, business culture, history, and the like—was subordinated or eliminated as being too ‘soft’ and ‘impractical.’ Yet only a long historical perspective can help us sort out what is lasting and salient from what is ephemeral and faddish. In finance, as in all human endeavors, history has valuable lessons to teach (Kaufman [2001], pp. 303–325).¹⁷

Dr. Kaufman’s book was published in 2000. Ten years later, following the financial crisis that has slammed our economy, our society, and our communities, it is high time that we take his wisdom to heart.

RESTORING BALANCE IN OUR INVESTMENT SECTOR

Although our financial sector in many ways functions in a different fashion from our productive economy, the two are hardly independent. As the economist Hyman Minsky has pointed out, “Since finance and industrial development are in a symbiotic relationship, financial evolution plays a crucial role in the dynamic patterns of our economy” (Martin Capital Management [2006] p. 66). So, the dominance of today’s counterproductive speculative orientation requires not only thought but action. In the effort to restore a sounder balance between investment and speculation in our investment sector, there are many actions that we should consider. While each has much to recommend it, any action must withstand rigorous intellectual analysis of its consequences as well as the resistance of strong detractors with a vested interest in the status quo. So now let’s consider the possibilities, as well as the benefits to society, if we can better rebalance the two cultures of investors.

First, taxes can be brought back into play, restoring some of the frictional costs of investing that served to moderate the speculation that prevailed in an earlier era. Years ago, Warren Buffett suggested (he says it was spoken “tongue in cheek”) a tax on very short-term capital gains realized by both taxable and tax-deferred

investors. Alternatively, taxes on transactions, as suggested by professor James Tobin years ago, should be considered—perhaps in the range of one to five basis points (0.01%–0.05% of the value of the transaction). This kind of Pigouvian tax (essentially a “sin” tax designed to elicit appropriate behavior) is generally unpopular not only with investment managers, but with economists as well. But it deserves a fair hearing. Less radically, disallowance of the tax deduction for short-term losses is also an idea worth pursuing. Yes, the lower trading volumes that would likely result from tax changes such as these could negatively impact liquidity in our markets, but do we really need today’s staggering levels of turnover, quantum amounts above the norms of a half-century ago?

Taxes on earnings from stock trading should also be considered. A century ago, President Theodore Roosevelt distinguished between activities with positive utility that add value to our society and activities with negative utility that subtract value from our society. If trading pieces of paper is akin to gambling (remember the earlier “casino” example), why should trading profits *not* be subject to higher rates? Yet we live in an Alice-in-Wonderland world in which that hedge fund “carry” mentioned earlier is subject to much *lower* rates. Such income is subject only to the minimal taxes applicable to long-term capital gains rather than the higher taxes on ordinary earned income. I can’t imagine how our legislators can continue to allow such an absurd and unfair tax subsidy, one that favors highly paid stock traders over the modestly paid workers who provide the valuable products and services that give our nation the living standards that are the envy of the world.

Second, we need stronger, smarter, and wiser regulation, principles-based where possible, otherwise rules-based. No, I do not believe that our government should run our financial sector. But I would be willing to accept the cost of its inevitable bureaucratic drag on the system (after all, most government activity itself is also rent seeking rather than value adding) in order to 1) establish sterner limits, as appropriate, on leverage and portfolio quality; 2) bring the opacity of today’s derivatives trading into the bright sunlight of transparency and openness; and 3) develop much stronger rules that would preclude—or at least minimize—obvious malfeasance such as insider trading, conflicts of interest, and the remarkably widespread Ponzi schemes that we’ve recently witnessed. We’ve had too much crime and not

enough punishment in our financial sector. I'd like to see far stronger penalties for white-collar criminals who abuse their clients' trust. We also need far better data on most of the issues I've raised in this article. Sound regulation can compel such transparency.

While we need regulation about the rules of the game and the appropriate behavior of its players, however, I hold as a general principle that government should, under nearly all circumstances, keep its hands off the free functioning of the marketplace. I wince when the Federal Reserve states its intention to raise asset prices—including “higher stock prices”—apparently irrespective of the level of underlying intrinsic stock values. Substantive limits on short selling is another nonstarter. The overriding principle should be: *Let the markets clear*, at whatever prices well-informed buyers are willing to pay to equally well-informed (but not better-informed) sellers.

Third, we need our long-term investors to act as trustees of the “other people’s money” that they oversee. Investment professionals need to do a far better job of due diligence. We need to focus on investment fundamentals. We need to assume the rights and responsibilities of corporate governance, taking on an activist role in assuring that the companies whose shares our institutional managers/agents hold and control are run in the interest of the investors/principals whom they serve as fiduciary agents. A big step in the right direction would be the enactment of a federal standard of fiduciary duty for those who put themselves forth as trustees, calling for a long-term investment focus, due diligence in security selection, participation in corporate affairs, reasonable costs, and the elimination of conflicts of interest.

Fourth, investors need to wake up and, Adam Smith-like, look after their own best interests. Of course, that would involve much better, clearer, and more pointed disclosures. It would involve a campaign to educate investors about the hard realities of investing. Investors need to understand not only the miracle of compounding long-term returns, but the tyranny of compounding costs, costs that ultimately overwhelm that magic. (I presented the math earlier.) Investors need to know about sensible asset allocation and the value of diversification. Investors need to understand the huge gap that exists between the illusion of *nominal* returns and the reality of *real* (after-inflation) returns. They need to recognize that short-term trading—like casino gambling—is ultimately a loser’s game, and to understand the demonstrated costs of the behavioral flaws

that plague so many market participants. As I suggested earlier—*investments usually perform better than investors*.

Finally—and this may surprise you—we need far deeper caring about our clients’ interests to permeate our conduct and values, and we need introspection—introspection, that rarest of qualities—from today’s leaders of our financial sector as well as tomorrow’s. We need leaders with integrity and wisdom, leaders with a sense of history (what has been); a sense of the conditions, practices, and character of our present financial sector (what is); and a sense of what we want our field to look like in the decades down the road (what will be). Is today’s system what we would design if we were present at the creation of a new system, designed to serve our investors, our communities, our society at large? If we can do better, isn’t it time for those who care about the future of the financial profession to stand up and be counted? As it is said, if not we, who? If not now, when?

CONCLUSION

We must seek a financial sector of a size appropriate to its capital formation responsibilities, to its ability to provide liquidity for long-term investors as well as speculators, and to its responsibility for our nation’s 100 million individual investors. We must seek an investment sector in which a culture of stewardship and long-term perspective dominates a culture, however necessary in moderate doses, of speculation, short-term trading, salesmanship, and marketing. We must seek a culture of financial trusteeship and fiduciary duty that should play the starring role in the long saga of investment, with entrepreneurial innovation and speculation playing only a supporting role—an exact reversal of the way the system works today. In this new and better-balanced culture, our financial sector should do a far better job of earning sound returns while assuming reasonable risks and, through our financial markets, delivering to our nation’s families—who are ultimately the providers of all of the capital investment in our economy—their fair share of whatever returns our corporate businesses are able to generate over an investment lifetime.

In the course we choose, there’s a lot at stake for today’s beleaguered system of free market capitalism. Lord Keynes got it right with the warning: “When enterprise becomes the bubble on a whirlpool of speculation . . . [and] when the stock market takes on the attitude of a casino, the job [of capitalism] is likely to be ill-done”

(Keynes [1964] p. 159). That's the one thing that none of us—no matter how we may feel about the issues raised in this article—can afford to have happen.

ENDNOTES

Mr. Bogle joined Wellington Management Company in July 1951, becoming president in 1967. In 1974, he left Wellington and founded The Vanguard Group, serving as chief executive and then as senior director for the next 25 years. This article is drawn largely from his lecture at the Museum of American Finance in New York City on January 19, 2011. The opinions expressed do not necessarily represent the views of Vanguard's present management.

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¹Source: CRSP

²Source: Morningstar

³Source: Securities Industry and Financial Markets Association

⁴Source: CME Group

⁵Source: Bank for International Settlements

⁶Estimate based upon revenue data provided by the Securities Industry and Financial Markets Association. Excluding trading gains/losses and margin interest, total revenues of U.S. stock exchange members increased from \$227 billion in 2001 to \$447 billion in 2007, falling to \$337 million in 2008. This data series has been discontinued.

⁷Sources: Hedge Fund Research; Wellington Fund reports.

⁸My ideas, however, are about as welcome to my industry peers as Amy Chua's controversial recent book *Battle Hymn of the Tiger Mother* published by Penguin Press in early 2011 is to American mothers. Perhaps I should call my next book *The Battle Hymn of the Indexing Tiger*.

⁹The holding period in years is conventionally represented by the reciprocal of the shareholder redemption rate, which rose from 8% to 35%, according to my calculations based on data from the Investment Company Institute. These data exclude trading in the industry's hottest new product, exchange-traded funds. Exchange-traded funds have annual shareholder turnover rates ranging from 200% to 300% to more than 10,000%.

¹⁰In 1960, Wellington Management Company quickly joined the flight to public ownership, and I played a major role in the underwriting of its IPO. Although I wasn't then wise enough to consider its implications, by 1971 I had a change

of heart. In a statement to our Wellington staff, I warned that "public ownership is antithetical to the responsible operation of a professional organization." Three years later, striving to live up to that sound principle, I founded Vanguard.

¹¹Source: Bogle Financial Markets Research Center

¹²This 0.99% figure (calculated by the Bogle Financial Markets Research Center) excludes index funds and institutional funds, neither of which existed in 1960. Including these lower-cost funds, the 2009 asset-weighted average expense ratio of equity funds was 0.86%, or "only" 72% above the 1960 level (ICI [2010]).

¹³Source: Data from Mark Carhart and Morningstar; calculations by the author.

¹⁴Source: Author's calculation based on Morningstar data.

¹⁵The Columbia funds, originally formed in 1964, were themselves the combination of a rampant acquisition spree, controlled at one time or another by bank holding companies including Fleet Boston, NationsBank, and Bank of America. Along the way, mutual fund managers Colonial, Stein Roe and Farnham, Wanger, Crabbe Hudson, Newport Pacific, U.S. Trust Advisers, and Marsico were acquired, with Marsico then repurchased by its founder in 2007. Before its acquisition by Ameriprise, Columbia was courted by fund managers Black Rock, Franklin Resources, and Federated. The SEC's early concern about "trafficking" in management company stocks turns out to have been both prescient and wise (Syre [2009]).

¹⁶Source: Thomas Piketty and Emmanuel Saez. Available at <http://www.econ.berkeley.edu/~saez/>.

¹⁷I've paraphrased Dr. Kaufman's words without in any way distorting either the spirit or the letter of his text.

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