Ethical Principles and Ethical Principals

Remarks by

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I'm so pleased to return to Cornell and the Johnson School, and honored to have the opportunity to give the inaugural David BenDaniel Lecture Series in Business Ethics. I've reviewed the impressive reading list for the Business Ethics course, and was especially struck by the short essay by Professor Radcliffe and by the longer essay by Steven Pinker. Professor Radcliffe reminds us of the obligations that we in business and finance owe to our colleagues, our employees, our companies, our communities, and indeed to our nation. Dr. Pinker makes a strong case that "moral goodness is what gives each of us the sense that we are worthy human beings," and identifies what he calls "the five spheres" of morality—avoidance of harming others, fairness, community (or group loyalty), authority, and purity. I loved his prophetic concluding quote from Chekov: "Man will become better when you show him what he is like."

This afternoon, I'll talk about three subjects: (1) why we need not only ethical principles to guide us, but ethical principals to assure their observance; (2) the consequences to our society when traditional professional standards focused on service to the community are superseded by business standards focused on profit-seeking and ultimately, service to self; and (3) the story of Vanguard and the role played by our structure, our strategies, and our values, from which I'll try to persuade you that "good ethics is good business."

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

I. Principals and Principles

The first of these three subjects focuses on the title I have chosen for my remarks this afternoon—"Ethical Principles and Ethical Principals." That talk was inspired by, of all things, a typographical error. A mailing I received a few years ago announced that General Electric would receive an award for long-term excellence in corporate governance; GE President Jeffrey Immelt was quoted as focusing on the importance of "sound principals of corporate governance." But while the quotation spelled *principals* with the concluding *a-l-s,* Mr. Immelt clearly meant *principles*, with the concluding *l-e-s*.

But, at least in this instance, that is distinction without a difference. After all, no matter how strong the ethical *principles* of the world of business may be, of what use are they without ethical *principals* to honor them, especially ethical *leaders* who have the responsibility to assure that these ethical principles permeate and dominate the culture of our corporate world?[1] I describe these classic ethical principles of our society in words very similar to those of Steven Pinker—integrity, honesty, and trustworthiness; fairness and justice; doing good and preventing harm; concern for the well-being of others and respect for their autonomy, and so on. But applying these societal principles to business principals is far easier said than done.

Honoring Ethical Principles in Business

No one can be more aware than I am that in the dog-eat-dog competition that has always been inherent in our capitalist system, these ethical principles are often difficult to honor. Dealing with this fierce competition without compromising one's character is no mean challenge! For example, while it seems that 100 percent of our business leaders—those principals of our corporations—describe integrity and honesty as the essential elements of leadership, it's also clear that less than 100 percent of them deliver on those two essentials. Among our large publicly held corporations, having a clear set of standards and an ethical code is now a commonplace, yet we've seen too many examples where these standards have been ignored, often to meet ambitious—perhaps overly ambitious—goals for growth in corporate revenues and earnings.

[1] This difference leaped out at me just two nights ago, when I stumbled upon a television rerun of the movie about the collapse of Enron—"The Smartest Guys in the Room." Enron's principles were solid: "Communication; Respect; Excellence; and Integrity—open, honest, and sincere." But every one of those principles was violated by the Enron principals, and the company failed. At least some of the principals went to jail for their misdeeds.

Our corporate directors pay lip service to the responsibility of stewardship. But preserving, protecting, and defending the corporation's resources with the interests of its owners as the highest priority seems the exception rather than the rule today. We know that the CEO is the senior employee of the corporation, responsible, through the board of directors, to the owners. Yet we live in a world with many imperial CEOs who seem to view themselves as solely responsible for the creation of "shareholder value" (more about that later) and, worse, are paid accordingly. Indeed, with the abject failure of the stockholders of our corporations to aggressively demand their rights of ownership and equally aggressively assume their responsibilities of ownership, why should we expect our corporate managers to honor the responsibilities they so clearly owe to their owners?

We see corporations preach "the balanced scorecard" that calls for fair dealing with the corporation's other constituencies—customers, employees, suppliers, the local community, government, and the public. But the record suggests, for one example, that too many companies demand loyalty from their employees even as they fail to reciprocate by demonstrating loyalty to their employees.

And how about the integrity of the firm's financial statements, let alone the true independence of the independent auditor who attests to their conformity with generally accepted accounting principles (GAAP)? With the looseness that prevails among the myriad detailed standards developed to implement those accounting principles, small wonder that the engineering wonder of our age is *financial* engineering.

I am not necessarily arguing that our business principals are less ethical then their predecessors. But I am arguing that our business principles have been diluted. It seems to me there are far fewer *absolute* standards in the conduct of business—*There are some things that one just doesn't do*—and much greater acceptance of *relative* standards—*Everyone else is doing it, so I can do it, too.* (Think about executive compensation, stock options, and the multiple facets of financial engineering.) As moral relativism comes to supersede moral absolutism, our society is moving in the wrong direction.

What Went Wrong in Corporate America and Investment America?

So why did all these things go wrong? Simply put—and this is the main thesis of my 2005 book, *The Battle for the Soul of Capitalism*—what went wrong in corporate America, aided and abetted by investment America, was a pathological mutation in capitalism—from traditional *owners*' capitalism, where the rewards of investing went primarily to those who put up the capital and took the risks—to a new and virulent *managers*' capitalism, where a grossly excessive share of the rewards of capital investment went to corporate managers and financial intermediaries.

As I see it, there were two major reasons for this baneful change: First, the "ownership society"—in which the shares of our corporations were held almost entirely by direct stockholders—gradually lost its heft and its effectiveness. It is not going to return. In its stead, a new "agency society" has developed, with financial intermediaries controlling the overwhelming majority of shares. (Since 1950, institutional ownership has risen from 8 percent of U.S. stocks to 70 percent; individual ownership has dropped from 92 to 30 percent.) But those agents haven't behaved as owners. They have put their own interests ahead of the interest of their *principals*, largely those 100 million families who are the owners of our mutual funds and the beneficiaries of our pension plans. The whole notion of stewardship seemed to get lost in the shuffle. If the owners of corporate America don't give a damn about corporate governance, I ask you, who on earth should?

The second reason is that our new investor agents not only seemed to forget the interests of their principals, but also seemed to forget their own investment *principles*. (There's a somewhat different distinction between *a-l-s* and *l-e-s*.) In recent decades, the predominant focus of institutional investment strategy turned from the wisdom of long-term investing to the folly of short-term speculation. We entered the age of expectations investing, where growth in corporate earnings—especially earnings guidance and its achievement—became the watchword of investors. Corporate managers and corporate stockholders—now no longer true owners of stocks, but renters of stocks—came to accept that whatever earnings were reported were, well, "true." In effect, as a corporate Humpty Dumpty might have told institutional investor Alice in Wonderland: "When I report my earnings it means just what I choose it to mean, neither more nor less . . . the question is who is to be the master—that's all." And Alice said, "aye, aye, sir."

Managements—those corporate principals— became the masters of the numbers, and our public accountants too often went along. In what I've called "the happy conspiracy" between corporate managers, directors, accountants, investment bankers, and institutional owners and renters of stocks, all kinds of bizarre financial engineering took place. The reported numbers met the demands of the expectations market, but often had little to do with the realities of the business market. Loose accounting standards made it possible to create, often out of thin air, what passes for earnings, even under GAAP standards.

Under GAAP, these practices are all, well, legal. Surely it can be said, then, that the problem in such creative financial engineering isn't what's *illegal*. The problem is what's *legal*. (Indeed, when accounted for properly, even the back-dating of options—a recent example of the malfeasance of corporate managers—is legal.) And so the management consultant's ghastly bromide—"If you can measure it, you can manage it"—became the mantra of the chief executive.

The Real Market and the Expectations Market

Consider with me now how the erosion in the conduct and values of business has been fostered by the profound—and largely unnoticed—change in the nature of our financial markets. That change reflects two radically different views of what investing is all about, two distinct markets. One is the *real* market of intrinsic business value. The other is the *expectations* market of momentary stock prices.

This distinction between the *Real Market* and the *Expectations Market* was nicely expressed by Roger Martin, dean of the Rotman School of Business at the University of Toronto. Just think about it: In the Real Market of business, real companies spend real money and hire real people and invest in real capital equipment, to make real products and provide real services. If they compete with real skill, they earn real profits, out of which they pay real dividends. But to do so demands real strategy, real determination, and real capital expenditures, to say nothing of requiring real innovation and real foresight.

Loosely linked to this Real Market is the Expectations Market. Here, market prices are set, not by the realities of business that I have just described, but by the expectations of investors. Crucially, these expectations are set by numbers, numbers that are to an important extent the product of what our managements want them to be, too easily managed, manipulated, and defined in multiple ways. What is more, we not only allow but seemingly encourage the chief executive, whose real job is to build real corporate value, to bet in the expectations market, where his stock options are priced and exercised. That practice should be explicitly illegal, just as it is illegal in say, pro football (i.e., National Football League quarterbacks are not allowed to bet on the pre-game spreads). Today, stock option compensation, even in its present form, creates huge distortions in our financial system.

But I don't want to tar all business leaders with that dark brush. One exception is Bill George, former chief executive of Medtronic and one of our nation's most respected business leaders, now teaching at Harvard. In his wonderful book, *Authentic Leadership*, Mr. George describes his business principles and how he implemented them.

> Authentic leaders genuinely desire to serve others through their leadership. They are more interested in empowering the people they lead to make a difference than they are in power, money, or prestige for themselves. They are as guided by qualities of the heart, by passion and compassion, as they are by qualities of the mind . . . Authentic leaders lead with purpose, meaning, and values. They build enduring relationships with people. They are consistent and self-disciplined. When their principles are tested, they refuse to compromise.

> Their authentic companies create performance. [Dare I say *real* performance?] Values begin with telling the truth, internally and externally. Integrity must run deep in the fabric of an organization's culture. It guides the everyday actions of employees and is central to its business conduct. Transparency is an integral part of integrity. The truth, both successes and failures, must be shared openly with the outside world. Authentic companies [dare I say *real* companies?] value the importance of stewardship to the people they serve—customers, employees, shareholders, and communities.

> Stock price is not the best measure [of shareholder value] because it is so heavily influenced by . . . investor expectations, market psychology, and the overall trend of the market. Sustained growth in revenues and earnings per share, cash flow, and return on investment are still the best measures of how well a company is performing. The best path to long-term growth in shareholder value comes from having a well-articulated mission that inspires employee commitment and the confidence and trust of clients.

Focusing on a mission that calls on leaders of character and courage to develop commitment, confidence, and trust is simply another reflection of Adam Smith's *Impartial Spectator* who, as I'll quote at length later on, calls on each of us to be "honorable and noble, to live up to the grandeur and dignity and superiority of our own character." No, this goal will never be totally achieved. I know that. But if we all strive for a more perfect system of capitalism that honors society as a whole, even as it holds as its highest priority serving the interests of the stock owners who invest and risk their own capital, we can make meaningful progress toward achieving these noble ideals for our citizens and our nation. Only if we hold high the ethical principles that must be the foundation of any business worthy of our trust, and then demand that they be honored by ethical principals who are authentic leaders, can we fully measure up to the promise of capitalism.

II. Profession vs. Business

My second theme focuses on the gradual but substantial mutation of our professional associations into business enterprises. This baneful trend is among the most obvious, and troubling, manifestations of the change from the stern traditional values of yore to the flexible values of our modern age—today's "bottom line" society. Consider this sea change in values. It was a mere 45 years ago that *Daedalus*, the Journal of the American Academy of Arts and Sciences, proudly declared: *Everywhere in American life, the professions are triumphant.* But today, the contrary proposition tells the story. Driven by the pressures of new technologies and the growing importance of making money, the new reality is clear: *Everywhere in American life, business standards are superseding professional standards.*

Let's consider for a moment what we mean when we talk about professions and professionals. The *Daedalus* article defined a profession as having these commonplace characteristics:

1. A commitment to the interest of clients in particular, and the welfare of society in general.

2. A body of theory or special knowledge, requiring a specialized set of skills, practices, and performances unique to the profession.

3. The capacity to render judgments with integrity under conditions of ethical uncertainty, overseen by a professional community responsible for the monitoring of quality in both practice and professional education.

The article then added these wonderful words: *"The primary feature of any profession [is] to serve responsibly, selflessly, and wisely . . . and to establish [an] inherently ethical relationship between the professional and the general society."*

When we think of professionals, most of us would probably start with physicians, lawyers, teachers, engineers, architects, accountants, and clergy. I think we could also find agreement that both journalists and trustees of other people's money are—or at least should be—professionals as well. And yet, profession by profession, the old values are clearly being undermined. The driving force is what we have come to call "the bottom line society." Unchecked market forces not only constitute a strong challenge to our professions; they pose a significant threat to traditional standards of professional conduct, developed over centuries.

In most of our professions, these standards, in sad reality, have already been undermined. And with that change has come a serious erosion in the idea that professionals must accomplish their good works with a commitment to use their mastery to fulfill a "mission that inspires passion, a mission that gives beyond the self." Of course we're all aware, as yet another more recent article in *Daedalus* expressed it, "that pursuing a noble mission is often painful . . . and that not letting the mission get out of hand is possible only for those who truly believe in the mission and have enough self-perspective to remain wary of dangers such as arrogance, megalomania, misguided beliefs, and distorted judgments."

Recent examples of the harsh consequences of this change are easy to come by. In public accounting, our once "Big Eight" (now "Final Four") firms gradually came to provide hugely profitable consulting services to their audit clients, making them business partners of management rather than independent and professional evaluators of generally accepted (if loose) accounting principles. Think too about the increasing dominance of "state" (publishing) over "church" (editorial) in journalism, and the scandals that reached the most respected echelons of the press—the *New York Times,* the *Los Angeles Times,* the *Washington Post.* A similar transition has taken place in the medical profession, where the human concerns of the caregiver and the human needs of the patient have been overwhelmed by the financial interests of commerce—our giant medical care complex of hospitals, insurance companies, drug manufacturers and marketers, and health maintenance organizations (HMOs).

In all, professional relationships with clients have been increasingly recast as business relationships with customers. In a world where every user of services is seen as a customer, every provider of services becomes a seller. Put another way, when the provider becomes a hammer, the customer is seen as a nail. Please don't think me naive. I'm fully aware that every profession has elements of a business. Indeed, if revenues fail to exceed expenses, no organization—even the most noble of faith-based institutions—will long exist. But as so many of our nation's proudest professions—of which accounting, journalism, and medicine are hardly the only examples—gradually shift their traditional balance away from that of trusted profession serving the interests of the community and toward that of commercial enterprises seeking competitive advantage, the human beings who rely on those services are the losers.

Crime and Punishment

I reserve some of my harshest criticism for the financial world, including the mutual fund sector in which I've spent my entire career. The traditional notion of the trustee was as a financial or legal professional whose overriding duty as a fiduciary was to serve the interests of those whose assets were entrusted to his care. Yet, with the dominance of the agency world of institutional money management that I described earlier, the trustees of "Other People's Money" (OPM) seem to have turned away from stewardship in favor of building assets under management, increasing fee revenues, carefully controlling costs (even investment management costs), marketing, and taking advantage of any short-cuts available to achieve these goals, carefully avoiding breaking the *letter* of the law but hardly its *spirit.*

My 2008 book *Enough. True Measures of Money, Business, and Life* has ten chapters (called "the Ten Commandments" by management guru and author Tom Peters), each with a common cadence—too much cost, not enough value; too much speculation, not enough investment; too much complexity, not enough simplicity, too much counting, not enough trust; too much salesmanship, not enough stewardship, and so on. These trends clearly reflect the triumph of business standards over professional values. However, given the horrific events in the financial field during the past decade, I should have added an eleventh chapter (though that would have killed the Ten Commandments metaphor!) entitled "too much crime, and not enough punishment."

I'm not sure which bothers me more—the rampant spread of criminal conduct (that is, violations of law) during the recent era, or the disappointing lack of serious punishment of those individuals, the decision-making principals of the firms involved. The number of firms found in violation of securities laws is little short of staggering. I understand that in the academic community "Wikipedia" is not accepted as a valid source, but its "Timeline" on financial scandals covers seven full pages, with 42 separate cases. It reads like a "Who's Who" of the nation's largest financial and business firms—including Goldman Sachs, Merrill Lynch, American International Group, Citigroup, Xerox, KPMG, and Marsh and McLennan. Let me give just three examples:

1. The Fund Timing Scandals. The mutual fund market timing scandals were uncovered by New York attorney general Eliot Spitzer in 2003. A dozen or more major fund managers were involved in allowing scores of hedge funds to make what were essentially risk-free short-term trades, diluting the returns of the other investors in the funds. Putnam, Merrill Lynch, Massachusetts Financial Services. Alliance Capital, Janus, and Prudential only begin the list. What we had, simply put, was a conspiracy between hedge fund managers and mutual fund managers to defraud the long-term shareholders of the mutual funds involved. No individuals (as far as I know) were imprisoned for these crimes. And while many fines were assessed on the fund *companies*, most of the individual perpetrators paid little or nothing. (In a related case, Putnam president Lawrence Lasser was fined $25,000. Modest punishment indeed, when related to his compensation as Putnam chief, a total of more than $160 million during 1998-2002 alone.)

2. "Pay-to-Play." Another mutual fund case was equally shocking. Capital Group of Los Angeles, manager of the giant American Funds complex, was regarded as one of the most ethical and professional firms in the industry. In 2005, the National Association of Securities Dealers (NASD) brought an enforcement case against the firm. According to the NASD, the written record showed that the fund distributor had worked out a business plan with its leading broker-dealers that guaranteed these retailers financial support in the form of "revenue sharing" based on the sales volume in shares of Capital's mutual funds. This so-called "pay to play" bargain was said to be a violation of the 1981 rule that prohibited NASD members from promising or arranging "a specific amount or percentage of brokerage commissions conditioned upon . . . [the] sales of [fund shares]." In its report, the hearing panel noted that the firm's employees (including its president) "repeatedly testified that the damaging documents did not really mean what they plainly said," and found this testimony "disingenuous, to say the least." The NASD Enforcement Division calculated that the excess commissions paid by the funds totaled more than $98 million, and imposed a fine of that amount on the firm. An NASD Hearing Panel, however, reduced the penalty to $5 million, since such payments to the brokers were "consistent with practices that had arisen in the fund industry over a number of years." In effect "if everyone else is getting away with it, I should be allowed to get away with it too." Some reasoning! And the $5 million penalty was but small potatoes relative to the $15 *billion* in management fees received by Capital Group and its affiliates during 2001-2007 alone. Some punishment!

3. The New York State Pension Plan. The final outcome of my third example—another "pay to play" scandal, this time in New York State's pension plan—has yet to be determined. The disgraceful crimes that were uncovered at the highest levels of state government began with former state controller Alan G. Hevesi, and include noted political consultant Hank Morris and financier Steven L. Rattner. According to court documents, one-half of the state pension fund's $10 billion of assets reserved for hedge funds would be handled by firms that paid off Mr. Morris and his associates; firms that refused to pay these intermediaries were typically rejected by the pension fund. Mr.

> Hevesi has pleaded guilty and awaits sentencing; Mr. Morris is said to have agreed to a guilty plea to a single felony. Mr. Rattner has not yet settled with New York or Federal regulators, but it can't help his case that his former advisory firm, Quadrangle, has described his actions as "inappropriate, wrong and unethical." His punishment, if any, remains to be seen.

I've chosen these three examples out of scores—even hundreds—of examples, reluctantly leaving out that pillar of probity, Bernard Madoff. While his long jail sentence for his crimes surely is fair punishment, the hedge fund managers whose clients paid them some $500 million for the privilege of having Mr. Madoff defraud them remain scot-free. But the fact is that a disturbingly high percentage of the violations of law and of traditional ethics have occurred in the financial field, where the financial rewards are simply too tempting to ignore. The traditional emphasis on professional standards and fiduciary behavior focused on preserving and enhancing the wealth of clients has given way to business standards aimed at acquiring and accumulating wealth for agents, ethical principles be dammed.

III. Vanguard – Structure, Strategy, and Values

There is a better way. So in this third and final section of my remarks this afternoon, let me turn to some reflections on Vanguard and the structure, strategies, and values that have brought us to the pinnacle of the mutual fund industry—the largest fund manager in the world. The fact is that the Vanguard is simply different from our peers, unique in our field. We are in fact a group of truly *mutual* mutual funds, structured so that our management company is owned directly by our funds and their shareholders, operating on an at-cost basis for the benefit of our owners.

Our rivals are not "mutual" in any sense of the word. (That is why in my recently published book *Don't Count On It!,* the section on "What's Wrong with 'Mutual' Funds" includes quotation marks around the word *mutual*.) They are operated for the benefit of profit-making corporations, in business to earn a profit on their own capital. Of course, they also want to earn profits for the shareholders of their funds. But in the long run, these managers as a group are destined to produce market-like performance *before* costs. However, *after* the heavy costs they levy on their fund investors—the substantial management fees and operating expenses, huge distribution and marketing investments, administrative fees for shareholder record-keeping, and so on—the performance of their funds falls, as it must, well behind the returns provided in the stock market.

In his foreword to my 1999 book *Common Sense on Mutual Funds* (updated and republished last year), the late eminent economist and prolific author Peter Bernstein made this pungent observation: *What happens to the wealth of individual investors cannot be separated from the structure of the industry that manages those assets . . . [and] investment managers go right on earning a return on their own capital that most other industries can only envy.* In the present manager-dominant structure of institutional investing, managers garner huge rewards and their clients get second shrift.

If you doubt that, just compare the huge returns earned on the stocks of publicly-held management companies with the far more modest returns earned by even the best-performing of their funds. While we don't know the exact profitability of the management companies that are owned by giant U.S. and international banks and financial conglomerates—now the dominant structure in the fund industry—aggregate profits must run to many billions. (In 2006-2009 alone, for example, Sun Life Financial reported operating profits of $1.5 billion from its mutual fund subsidiary MFS.) I suspect that the returns are even higher for the few large management companies that remain privately-held. (Example: Fidelity Management and Research reported net operating income of $2.5 billion for 2009 alone.)

When one considers the ancient Biblical precept, "No man can serve two masters," it is clear that the master who manages the funds—by definition—feeds at the top of the food chain of investing, paid before whatever profits remain are shared by the shareholders of the funds, who feeds at the bottom of the food chain. Under Vanguard's mutual structure, our idea was to make the fund shareholder the master. It must be clear that the benefits of this mutual structure to shareholders, in financial terms, are not only larger, but mathematically certain. "The less the managers take, the more the shareholders make."

When I founded Vanguard in September 1974, it followed the idealistic principles that I outlined in my senior thesis at Princeton University, written in 1951 (when I was only a bit younger than most of you students here in this room today). Here are some of the values that I expressed in "The Economic Role of the Investment Company:"

> [Mutual funds] should be operated in the most efficient, honest, and economical way possible . . . Future growth can be maximized by reducing sales charges and management fees . . . Funds can make no claim to superiority over the market averages . . . the principal function of investment companies is the management of [their] investment portfolios. Everything else is incidental . . . *The principal role of the mutual fund should be to serve its shareholders*.

What should one make of these words? The idealistic ruminations of an immature college senior? An intelligent design for a new fund management structure? Something in between? I'll let you decide.

Strategy Follows Structure

Before you do decide about Vanguard's origins (and don't forget luck and determination!), let's consider the far-reaching consequences that our unique structure—simply designed to minimize the costs of investing—has on the strategies followed by such a mutually-operated firm to maximize that compelling advantage. Here they are, and how they differ from our peers.

1. **Profit.** Higher profits for investors, rather than awesome profits for managers.
2. **Pricing**. On an at-cost basis, rather than whatever traffic will bear.
3. **Service**. Treating the client as an owner, rather than as a customer.
4. **Risk.** Limiting risk without sacrificing return, an option available because of the cost advantage.
5. **"Products."** Shunning faddish new strategies focused on short-term fashions, in favor of simplicity and winning on the long-term arithmetic (*gross* return, minus cost, equals *net* return).
6. **Indexing.** Focusing on index funds, unattractive to active managers because of the minuscule fees they generate, but guaranteeing investors their fair share of whatever returns our markets generate. (As I suggested in that 1951 thesis, passive index funds must ultimately demonstrate performance superiority over their actively-managed peers.)
7. **Bonds.** Focusing on fixed-income securities, whose long-term returns are derived entirely from interest coupons, where the yield advantage will be obvious, narrowly define the maturity range for each fund.

8. **Marketing.** Instead of vainly shouting-out implied promises based on evanescent short-term performance, spend as little as possible on this activity, which inevitably subtracts from fund returns.

Yes, strategy follows structure, not only for Vanguard but for our rivals, whose vastly different structures demand very different strategies.

I don't need to turn this talk into a Vanguard commercial, but the fact is that those simple strategies are the very strategies that Vanguard has followed since its inception 36 years ago. They have served us well, not because of magic or genius, but because the "relentless rules of humble arithmetic" (Supreme Court Justice Louis Brandeis's phrase) are eternal. So I look at Vanguard as an *artistic* success. Not just because our fund performance has, with considerable consistency, outpaced our peers (largely by reason of our low costs), in virtually every sector of fund investing—money markets, bonds, and equities, ranging from large-cap growth, to small-cap value, to international, and so on. This steady performance has earned us the industry's highest scores in investor trust. Without going into the mechanics of a recent independent study, we have earned a "loyalty" rating of +44, with the #2 firm at +26, and the industry average at -12 (hardly a message that suggests that fund investors are satisfied.) The lowest-ranking firms had scores of -54, -48, and -47.

As consumers seek out better goods and services at ever lower costs, sometimes the competitive free market system works pretty well. In Vanguard's case, our solid returns, our low costs, and our shareholder loyalty (that's the *artistic* success) have resulted in *commercial* success. Our market share of industry assets has risen from 1.8 percent in 1981 to 13 percent currently, and we have become the world's largest fund manager. (Happily, our passive management strategies don't leave us muscle-bound and Gulliver-like, a challenge that our giant peers must deal with on a daily basis.) Since we are structurally sound, mathematically sound, and (I believe) ethically sound, and our strategies have followed our structure, it's easy for me to make the case that "good ethics is good business."

Getting those simple ethical values across to a rapidly growing company is much easier when it's part of the firm's ethic since the day we began in September 1974, with $1.4 billion of fund assets (now at $1.4 trillion, 1000 times larger) and 28 crew members (now 12,000 in number, 400 times larger). Changing a firm's character and value system is infinitely more difficult than embedding the character and values established at the outset. It begins with the leaders not merely "talking the talk," but "walking the walk," every step of the way. It means communicating these values, over and over again, *ad infinitum,* in the simplest possible terms—*Put the shareholder in the driver's seat* . . . *Do what's right. If you're not sure, ask your boss* . . . *Keep Vanguard a place where judgment has at least a fighting chance to triumph over process* . . . *a company that stands for something—stewardship* . . . *Character counts.* If we can build a crew that holds high those values, and focuses not on a job, but on a lifetime career, those veterans will pass the values along to those who follow them, and the firm's character should endure for a long, long time, and with it—if we don't lose our way— our industry preeminence.

Food for Thought

Summing up: One, we still seem to have plenty of ethical principles out there, but not nearly enough ethical principals. Two, business standards (such as they may be) have, in less than a half-century, come to supersede traditional professional ethics, at great cost to society. Three, a promising new structure in money management, focused on the positive ethics of placing shareholders rather than managers at the top of the food chain of investing, has carved out a now-dominant niche in money management. At some point, if only in order to survive, other firms will have to emulate the Vanguard model.

But the task remains: to elevate the ethical behavior of we all-too-human beings. It will be no easy task, but perhaps we can find some of that hope in a new book by Princeton professor Kwame Anthony Appiah, *The Honor Code: How Moral Revolutions Happen*. He points out that honor—the respect of one's peers and one's community—is, ultimately, more important than money as a moral motivator. Whatever the case, we need to raise society's expectations of the conduct and the character of the leaders of our businesses and financial institutions.

Professor Appiah notes that his ideas echo the words in our Declaration of Independence—"a decent respect for the opinions of mankind." Knowingly or not, he is also echoing Adam Smith's philosophy of life. In his first book, *The Theory of Moral Sentiments*, written in 1773 but now more relevant than ever, Smith developed the concept of the Impartial Spectator—"the force that arouses in us values that are so often generous and noble, the inner man, shaped by the society in which he exists, who gives us our highest calling. It is reason, principle, conscience, the inhabitant of the beast, the man within, the great judge and arbiter of our conduct." This Impartial Spectator, Smith tells us,

> . . . calls to us, with a voice capable of astonishing the most presumptuous of our passions, that we are but one of the multitude, in no respect better than any other in it, and that when we prefer ourselves so shamefully and so blindly to others, we become the proper objects of resentment, abhorrence, and execration. It is from [this Impartial Spectator] only that we learn the real littleness of ourselves . . . who shows us the propriety of generosity and the deformity of injustice; the propriety of resigning the greatest interests of our own, for the yet greater interests of others . . . It is not the love of our neighbour, it is not the love of mankind, which upon many occasions prompts us to the practice of those divine virtues. It is a stronger love, a more powerful affection, the love of what is honourable and noble, the grandeur, and dignity, and superiority of our own characters . . . *in order to obtain the greatest benefit to ourselves* [Italics added.]

With these powerful words, Adam Smith—yes, Adam Smith—touches on nearly all of those traditional ethical principles of which I spoke at the outset. We need to be reading him again today. Yes, our corporate values and virtues have been greatly eroded. But there remain scores of examples—although never nearly enough—of corporations and financial institutions that have held to their traditional bearings, staunchly resisting the powerful forces that are driving our society away from them. Again, quoting from *The Honor Code*, "honor is, for us, what it has always been, an engine fueled by the dialogue between our self-conception and the regard of others that can drive us to take seriously our responsibilities in a world we share."

I close my remarks this afternoon by urging you favored members of the next generation to begin to assume responsibility for our great nation's future, and to join me in the quest to demand ethical principals in all the avenues of American life, principals who are eager to implement ethical principles. Take heart, and remember these words of the anthropologist Margaret Mead:

> *Never doubt that a small group of thoughtful committed citizens can change the world. Indeed, it is the only thing that ever has.*