Ethical Principles and Ethical Principals

Remarks by
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from
The Center for Corporate Excellence
at
The "Charging the Game" Forum
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I'm deeply honored to receive your award. During my now 55-year career in the mutual fund industry I've done my best to meet your standard of "consistent ethical leadership." But I freely confess that, perhaps like all of us, I could have provided even more leadership toward a better corporate and investment America. In whatever years may remain, I pledge to you this evening that I will "press on, regardless" in this quest.[1]

The title of my remarks this evening arises from, of all things, a typographical error. In a mailing sent out by the Center for Corporate Excellence earlier this year to announce that General Electric would receive your Long Term Excellence in Corporate Governance award, you quoted GE President Jeffrey Immelt on the importance of "sound principals of corporate governance." But while the quotation said, yes, *principals*, it clearly meant *principles*.

I can't help myself from noticing that sort of stuff (query whether it's a strength or a weakness!), and as I did, it occurred to me that there might be a speech in that distinction. 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

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

[1] For the record, this motto of my family has always been taken to mean, press on, regardless of *how tough the going*, but regardless *of how easy the going* as well.

responsibility to assure that these ethical principles permeate and dominate the culture of our corporate world?

We're all familiar, I'm sure, with the classic ethical principles of our society—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 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 I'm sure that 100 percent of our business leaders 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.

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, and paid accordingly. Indeed, with the abject failure of the owners 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 honor in return the loyalty to their employees that would seem a quid pro quo of that demand.

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—things that one just doesn't *do*—and much more reliance on *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.)

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 latest 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 an excessive share of the rewards of capital investment went to corporate managers and financial intermediaries.

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 68 percent; individual ownership has dropped from 92 to 32 percent.) But those agents haven't behaved as owners. They failed to honor 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. 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 forget the interests of their principals, but also seemed to forget their own investment *principles*. (There's that distinction again.) The predominant focus of institutional investment strategy turned from the wisdom of long-term investing to the folly of short-term speculation. During the recent era, 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, but renters—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."

Management became the master 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.

My favorites, as it were, include hyping the assumed future returns earned by the pension plan, even as rational expectations for future returns deteriorated; post-merger accounting that creates a veritable "cookie jar" of reserves to be drawn on to create illusory earnings growth later on, even as we learn that some 61 percent of corporate mergers actually destroy shareholder value; failing to include the cost of stock options as a compensation expense (a practice now, happily, prohibited); and the concealment of debt by forming special-purpose entities, abused most notably by Enron.

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*. It's what's *legal*. (Indeed, even the back-dating of options—the most recent example of the malfeasance of corporate managers—when accounted for properly—is legal.) And so the management consultant's bromide—"If you can measure it, you can manage it"—became the mantra of the chief executive.

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.

Enterprise vs. Speculation

It's a curious fact that I've been concerned about this sharp dichotomy for my entire adult life. Really! In my senior thesis at Princeton University, completed way back in 1951, I cited the words of the great British economist John Maynard Keynes, in his wonderful Chapter 13 of *The General Theory*. There, Keynes drew the classic distinction between *enterprise* ("forecasting the prospective yield of assets over their whole life") and *speculation* ("forecasting the psychology of the markets").

Keynes 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, since there will be no strong roots of conviction to hold it steady. . . resulting in unreasoning waves of optimistic and pessimistic sentiment."

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, who, one might have supposed, would correct these vagaries . . . would be 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." 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."

In my thesis, I cited those very words, and then had the temerity to disagree. 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."

Alas, the steady sophisticated, enlightened, and analytic demand I had predicted from our expert professional investors is 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." Portfolio turnover of equity mutual funds, then running steadily about 15 percent, year after year—a six-year average holding period for the average stock in a fund's portfolio—actually soared skyward. In recent years, fund turnover has averaged above 100 percent—an average holding period of less than one year. So, a half-century after I wrote those words in my thesis, I must reluctantly concede the obvious: the worldly-wise Keynes was right, and that the callously idealistic Bogle was wrong. Call the score, Keynes 1, Bogle 0. It wasn't even a close fight!

"The Job of Capitalism is Likely to be Ill-Done"

During the recent era, we have paid a high price for the shift that Keynes so accurately predicted. As professional institutional investors moved their focus from the wisdom of long-term investment to the folly of short-term speculation, "the capital development of the country [became] a by-product of the activities of a casino." Just as he warned, "when enterprise becomes a mere bubble on a whirlpool of speculation, the job of capitalism is likely to be ill-done."

In the recent era, its job has indeed been ill-done. The triumph of emotions over economics that has been reflected in the casino mentality of so many institutional investors has had harsh consequences. Yet when perception—the precise but momentary price of the stock—vastly departs from reality—the hard-to-measure but enduring intrinsic value of the corporation—the gap can be reconciled only in favor of reality.

The fact is that given all of the remarkable flexibility permitted under the rules that enable our corporate leaders to guide the market's expectations of quarterly earnings and then manage their achievement, it's relatively easy for a firm to raise the short-term price of its stock and meet the demands of the expectations market. But the job of building intrinsic value in the real business market over the long term is a tough, demanding task, accomplished only by the superior corporation. This focus on stock prices and speculation holds dire consequences for our society (but not, of course, for our stock brokers, investment bankers, and money managers), even as any economically-strong society depends on the continuing creation of intrinsic value in our corporate world.

I raised this same issue rather more tartly in a speech I gave at Princeton University's Center for Economic Policy Studies in 2002, the core ideas of which in turn found their way to a prominent role in my *Battle* book. The theme of that speech—entitled "Don't Count On It. The Perils of Numeracy"—was that "in our society, in economics, and in finance, we place too much trust in numbers. *But numbers are not reality*. At best, they're a pale reflection of reality. At worst, they're a gross distortion of the truths we seek to measure . . . (Yet) we worship hard numbers and accept the momentary precision of stock prices rather than the eternal vagueness of intrinsic corporate value as the talisman of investment reality."

The Real Market and the Expectations Market

Perhaps this distinction between the *Real Market* and the *Expectations Market* was best 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 pregame spreads). Today, stock option compensation, even in its present form, creates huge distortions in our financial system.

These problems require a whole new way of thinking about investing. We need more investors and fewer speculators, and we need investors—institutional and individual alike—to understand three simple facts: (1) Investing for the long term—buying and holding all of the publicly-held corporations in America, for example—is a *winner's* game. In the long run—since 1900—the 9.6 percent nominal annual return on stocks was created almost entirely from the real returns earned by business. Dividend yields averaging 4.5 percent and earnings growth averaging 5 percent gave us 9.5 percentage points of that total. Only 1/10 of 1 percent came from the expectations market.

But if long term investing is a *winner's* game, as it is, consider the next fact: (2) Trading stocks with one another—as we now do to the tune of 4 billion shares—say, $100 billion!—every business day makes beating the market a *zero sum* game, but only before the deduction of the money we spend on all of that busy trading. And so, Q.E.D., Fact (3): After those costs, the lavish rewards we bestow on our financial croupiers—our stock brokers, our investment bankers, our money managers—beating the market (essentially what all those short-term speculators are trying to do) becomes a *loser's* game. (If these relentless rules of humble arithmetic are a plug for the low-cost, no-load, buy-and-hold, all-stock-market-index fund I began to design 31 years ago, well, so be it.)

The Invisible Hand

While fixing the system will not be easy, it's easy to conceptualize the two parallel paths we need to follow. One is what I call the "Adam Smith Solution," the *Invisible Hand* of competition that he described in *The Wealth of Nations*. If each individual investor out there—those who hold their stocks directly and those who hold their stocks through their mutual funds—would only look after his or her own economic interests, then great progress would be made.

Intelligent investors would move away from the costly folly of short-term speculation to the priceless (and price-less!) wisdom of long-term investing—abandoning both the emotions that betray sound investment strategy and the expenses that turn beating the market into a loser's game. When they do, and they will, our financial intermediaries will be forced to respond with a focus on long term investing in business, not short term speculation in stocks. (My next book, to be published in February 2007, drives this message home: *The Little Book of Index Investing—The Only Way to Guarantee Your Fair Share of Stock Market Returns*.)

The second path is what I call the "Societal Solution:" to create, out of our disappearing ownership society and our failed agency society, a new fiduciary society. Here, our agent/owners would be required by federal law to place the interest of their principals first—a consistently enforced public policy that places a clear requirement of fiduciary duty on our financial institutions to serve exclusively the interests of their beneficiaries, that duty would expressly require their effective and responsible participation in the governance of our publicly-owned corporations, and demand the return of our institutional agents to traditional standards of professional stewardship that is long overdue.

The Impartial Spectator

Together, these changes will compel—and perhaps even inspire—the *principals* of our corporations and our money managers to improve their own ethical *principles*. But we also need to raise our society's expectations of the proper conduct of our leaders. So, in addition to Adam Smith's almost universally-known Invisible Hand from *The Wealth of Nations*, we need to call on his almost universally-unknown Impartial Spectator, from Smith's earlier *Theory of Moral Sentiments.* Just who is this impartial spectator, the force that arouses in us principles that are often so generous and so noble? It is the man within, shaped by the society in which he exists, even the soul, who gives us our highest calling. In Smith's words, "It is reason, principle, conscience, the inhabitant of the breast, the man within, the great judge and arbiter of our conduct."

It is this impartial spectator, Smith tells us, "who 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 him only that we learn the real littleness of ourselves. It is this impartial spectator . . . who shows us the propriety of generosity and the deformity of injustice; the propriety of reining the greatest interests of our own, for the yet greater interests of others . . . in order to obtain the greatest benefit to ourselves. 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."

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. And leave it to Bill George, former chief executive of Medtronic and one of our nation's most respected business leaders, whom you honored last year with the very award with which you favor me this evening, to translate those societal principles into business principles. He describes them in his wonderful book, *Authentic Leadership.* Let me cite a few excerpts:

"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," Bill George continues, "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."

How do we develop such authentic leaders, ethical principals who honor ethical principles? Legendary law professor Tamar Frankel, who will speak to us tomorrow, agrees the answer lies in the hands of a caring and ethical society. In her impassioned recent book *Trust and Honesty: America's Business Culture at a Crossroads*, she writes: "The real test for an honest and productive society is not what a society has achieved, but what it aims to achieve. It can put honest people on a pedestal even if they do not maximize their personal benefits and preferences . . . and discard and shun as models of failure dishonest people who achieve their highest ambitions by fraud and abuse of trust."

It's all up to society, then, simply another reflection of Adam Smith's *Impartial Spectator* who 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. Yes, all of us here tonight at the Center for Corporate Excellence must work toward "changing the game," striving to 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.