Creating Sound Governance: The Shareholder's Perspective

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At the
2004 AIMR Conference
Denver, Colorado
May 10, 2004

It all began with Enron. Or so it seemed. But ever since the Enron scandal exploded in November 2001, what we've seen has been almost like dominos falling, one after another—Tyco, WorldCom, Global Crossing, Quest, ImClone, Adelphia, Health South, Dynegy, and a host of others. Each of these scandals had its own particular dynamic, but all of them involved the failure of the multiple "gatekeepers" on which investors had depended to maintain the integrity of our Nation's financial system.

With Enron's bankruptcy, of course, came the collapse of Arthur Andersen, traditionally the "gold standard" of America's "Big Five" accounting firms, now, sadly, reduced to the "Final Four." It was said of Mr. Andersen, the firm's founder, that he would rather his firm die than compromise its noble principles. Alas, it has now done both.

But it is not enough to bemoan the failure of our corporate directors, accountants, regulators, and legislators to protect investors from the consequences of flawed oversight, audits that were anything but independent, government agencies that were starved of resources by legislators, attorneys and investment bankers whose casual indifference was rewarded with staggering fees, and congressmen who were co-opted by powerful lobbyists with deep pockets lined with seemingly infinite cash, working the will of their clients.

A Small Piece of History

As investment professionals, however, we also have the responsibility to look at ourselves. Were money managers and securities analysts adequately aware of what was going on behind the scenes? Let me relate a personal experience. In 1997, SEC Chairman Arthur Levitt commissioned the U.S. Independence Standards Board to consider the state of financial reporting, focusing on whether auditors were in fact independent of the clients for whom they were providing attestation services. That now-forgotten Board included four independent members and four members of the profession—CEOs from three of the then-Big-Five accounting firms and the president of the American Institute of Certified Public Accountants. William T. Allen, the eminent jurist and former chancellor of the Delaware Supreme Court served as Chairman, and I was privileged to serve with him.[1]

In the course of the ISB's work, we retained a respected consulting firm (Earnscliffe Research and Communications) to prepare a study assessing the perceptions of various constituencies regarding the concept of auditor independence and objectivity. The firm interviewed 133 senior executives, among

[1] The other two independent board members were Robert Denham and Manuel Johnson. We began our work in the summer of 1997, and during the ensuing three years issued a number of independence standards. Given the intractability of the issue regarding the functional separation of accounting and consulting, the SEC ultimately decided to issue its own independence rules, and the ISB was dissolved in July 2000.

constituencies that included CEOs and CFOs of SEC registrants, audit committee chairs, audit partners, institutional "sell side" analysts, and "buy-side" research analysts.

In the effort to understand the opinions of the analysts, I wrote personal notes to leaders of some of what I considered the strongest firms in the field—including Capital Research and Management, Fidelity, Morgan Stanley, Mutual Shares, T. Rowe Price, Salomon Smith Barney, and Wellington—and asked them if they'd be willing to select one of their most experienced and financially-acute securities analysts to meet with several ISB members. On April 27, 1998, we met with eight of them for about four hours.

My notes of that meeting reflect a consensus that clearly expressed comfort with the integrity of both accountants and financial statements, albeit a general willingness to accept that the auditor, paid by the client, cannot be truly independent; and the belief that the auditor's "reputational capital" would prevent fraud (leaving aside that an auditor with the reputation of refusing to compromise with management would likely not keep the engagement for very long!). Only *one* analyst among the seven expressed a serious concern: "Auditors have stopped thinking for themselves and have become clerks who are hiding behind rules (for example, post-retirement health care benefits), and putting form ahead of substance." He expressed "serious concern with the integrity of financial statements, which are sure to be revealed when the stock market collapses." [2] I couldn't help but feel that this minority of one held a view that was closer to reality than the others.

Part of the Happy Conspiracy

The survey itself, however, made it clear that this concern was not widely shared. Over all, the report gave financial reporting and auditing a clean bill of health. In its November 1999 report, Earnscliffe reported that with very few exceptions, the scores of regulators, accountants, senior corporate executives, and experienced investment analysts who were interviewed felt that "the standard of financial reporting in the U.S. was excellent." While half of the respondents felt that "earnings management efforts are more aggressive . . . the other half disputes that assertion . . Most said that the actual figures being reported were painting an accurate picture of the financial health of the company involved . . . Very few believe the auditors have much to do with aggressive earnings management." As to the provision of both audit and consulting services to the same client, "almost everyone favored disclosure over prohibition."

As I pored over the report, I was especially stuck by its reading of the responses of the buy-side securities analysts, including those whom we had interviewed. Perhaps unsurprisingly, while they tended to be more skeptical than the other respondents about the independence of auditors, the analysts were generally of the view that "most financial reporting could be trusted," a somewhat stronger appraisal than I'd sensed at my earlier meeting. While some believed that the quality of financial disclosure had improved over time, others suggested the reverse, citing restructuring charges as one area of abuse. While they expressed concern about earnings management, they believed that "the SEC had overstated the problem of auditor independence, and worry that over-regulation would drive good people out of the (auditing) profession."

Nor did the AICPA interpretation reflect my concerns. "We share the Earnscliffe report's view," they proudly proclaimed, "that the state of financial reporting in the United States is *extremely strong*. . . and agree that the media have created a perception that there is a serious problem where *none* exists." (Italics added.)

[2] Trevor Harris of Morgan Stanley.

Do tell! Four years and one great bear market later, we now know that the sunny but naive conventional wisdom of that earlier era—not only CEOs and CFOs, but audit committee chairmen and auditors, and security analysts as well—has been turned upside down. I have little doubt that most of us here today (I include myself) were participants—perhaps unwitting, perhaps not—in "the happy conspiracy" that, as the stock market soared to its hitherto unimaginable peak in early 2000, finally encompassed almost the entire investment community.

1. What Happened to Our System of Corporate Governance?

Owners' Capitalism Becomes Managers' Capitalism

Apres moi, le deluge! What followed is now history—a black-eye for corporate executives, board members, and accountants, and for so many institutional investors as well. We're a long, long way from the glory of capitalism as its great modern era was about to unfold. Some 240 years ago, Adam Smith, its patron saint, described capitalism with these wonderful words: "The pleasures of wealth and greatness strike the imagination as something grand and beautiful and noble, well worth the toil and anxiety . . . [they] keep in continual motion the industry of mankind, to build houses; to found cities and commonwealths, to invent and improve all the sciences and arts, which enoble and embellish human life; which have entirely changed the whole face of the globe, and pave the great high road of communication to the different nations of the earth."

So what happened? Why did it happen? How did stockholders let it happen? And what's to be done? I'll discuss each of these four issues, going back to the beginning. At its outset two centuries ago, the road to modern capitalism was paved with noble intentions . . . and noble actions as well. For as any successful market system must, the system began with trust and integrity, reliance on the word of those with whom we do business. Adam Smith's "invisible hand" of self-interest demanded virtue, and good ethics was good business. As people recognized the benefit of trusting and being trustworthy, and as the need for capital in manufacturing and commerce grew, as education came to be seen as a right of citizenship, as the fount of innovation sprang forth, we came to witness a truly amazing sea change in economic development.

During the past two extraordinary centuries, the global economy has experienced increasing productivity and economic growth at rates never witnessed before—*never!*—in all human history.[3] This unprecedented two-century-long boom did *not*, I assure you, come about because capitalists are naturally good people. How could *that* be? It came because the benefits of trust—of trusting and of being trustworthy—are immense, and because a successful market system teaches people to recognize those benefits . . . a *virtuous circle* in which an everyday level of trustworthiness breeds an everyday level of trust. *The system worked!*

And then something went wrong. The system changed—"a pathological mutation in capitalism," as an essay by William Pfaff in the *International Herald Tribune* described it—from the classic system—*owners'* capitalism, a dedication to serving the interests of the corporation's *owners* in maximizing the return on their capital investment—to a new system—*managers'* capitalism, in which the corporation came to be run to profit its managers. How could it happen? "Because the markets had so diffused corporate ownership *that no responsible owner exists*. This is morally and ethically unacceptable," the essay concluded, "but also a corruption of capitalism itself."

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[3] For a marvelous exposition of this great era—as well as a compelling and delightful experience—I urge you to read William Bernstein's fine new book, *The Birth of Plenty*.

2. What Caused It to Happen?

This corruption is both far more subtle and far more pervasive than the scandals I cited at the outset. The failure of our capitalistic system had a whole variety of root causes that, as the second millennium turned to the third, simultaneously interacted and reinforced one another: "Victory," if that's the way we viewed the great bull market in early 2000, "had a thousand fathers," including the technology revolution; the information age; the stock market mania; the notion that our corporations were trees that could grow not only to the sky but beyond; the rise of the imperial chief executive officer; the failure of our auditors and boards of directors to remember to whom they owed their loyalty; and our regulators and legislators, who actually made things *worse.*

Add to that litany the disingenuous hype of Wall Street's stock promoters; the frenzied excitement of the media; the change in our financial institutions from being stock *owners* to being stock *traders;* the gradual blurring of the skeptical eye of the security analysts; and the eager and sometimes greedy members of nearly *all* of us in the investing public, reveling in the easy wealth that seemed like a cornucopia, and sitting back and enjoying the ride, at least while it lasted. A perfect storm! But as it drove stock prices *up*, this happy conspiracy among all of the interested parties drove business ethics *down*. The resultant market crash was inevitable.

Executive Compensation Gets Out Of Hand

If the bubble had a thousand fathers, however, I don't think we need a DNA test to identify its *real* father: management compensation. It is here that we see the most egregious example of how *owners'* capitalism has been superceded by *managers'* capitalism. As stock option grants were far too liberally bestowed, chief executive pay ratcheted steadily upward, rising from 42 times the compensation of the average worker in 1980 to an astonishing 531 (!) times in 2001, when the *average* CEO earned $11 million—lavish paychecks to managers who were rarely leaders, to bureaucrats who were rarely creators.

These self-styled lions of capitalism typically demanded compensation that suggested that they alone controlled the fates of their companies. (How silly is *that*!) But how much difference did they really make? While so many of our business managers took the credit, (and the cash!) for themselves, it was our booming national economy that made them look good. During that two-decade period, these CEOs predicted earnings growth for their firms averaging 11½% annually, and then delivered only about *half* of that amount, just 6%—even *less* than the 6½% annual growth of our economy. The reality: While our CEOs had failed to create extra wealth for their shareowners, they created enormous wealth for themselves. And when the stock market values melted away, they had long since sold hundreds of billions of dollars worth of their own stock to the public (and even to their own companies!), leaving the new owners holding the bag.

Part of the problem is that we came to accept a governance structure in which the CEO was not only boss of the business, but boss of the board. Most CEOs also serve as board chairmen, controlling the agenda, the information, the hiring of the compensation consultant, and the appointment of the audit committee. As a result of that power and an insane compensation system in which the bar is set, *not by the creation of economic value, but by how much other CEOs are paid*, their compensation rose to levels that can only be described as outrageous.

Much of that compensation increase was fueled by executive stock options. While options are almost universally described as "linking the interests of management to the interests of shareholders," the fact is that they do no such thing. They are a lottery-like give-away that focuses on easily-manipulated *stock prices*, not hard-to-come-by *corporate values*. They ignore dividends and reflect no cost of capital. Rather than holding onto their shares, executives typically sell them at the earliest moment; until recently, without putting up a penny of their own money ("cashless exercise"). The very structure of the fixed-price stock option was fatally flawed, used to the exclusion of more rational option forms because—unbelievably!—they did not appear as a cost in the company's income statement. (Indeed, compensation consultants described stock options as "free.")

In far too many cases, corporate directors failed to consider that their overriding responsibility was to represent, not the management, but the largely faceless, voiceless shareholders who elected them. They failed—*failed*—to ensure that the enterprise's resources were used in the faithful service of its owners—to be good stewards of the corporate property entrusted to them.

More than two centuries ago, James Madison said, "if men were angels, no government would be necessary." Today, I echo that idea: *If chief executives were angels, no corporate governance would be necessary*. Extending this analogy of political systems to corporate systems when I spoke to The Business Council last year, I warned against a corporate governance structure based on the *dictatorship* of the CEO. Rather, the structure should resemble a *republic*, with the directors—the elected representatives of the shareholders—fully empowered to assure that the corporation held high their interests, above all competing claims. And if those representatives don't do that job, well, the owners should vote them out, and elect a new slate. It's called, of course, *democracy*.

Yet our nation's shareholders seem not to care much about assuring that their ownership claims are honored. While far too many corporate executives and directors have been placed in positions of great power and authority without an adequate understanding of their fiduciary duties, far too many institutional investors have failed to take them to task and demand that the interests of shareowners be served. Heaven knows, we have the power to do exactly that. Our 100 largest financial institutions—managers of mutual funds, pension funds, and endowment funds—alone hold some 56% of all U.S. stocks outstanding, absolute control over corporate America. It's a scary thought. "But not to worry." By and large, all we have heard from these owners is the sound of silence. *If the owners don't give a damn about the triumph of manager's capitalism, it is far to ask, who on earth should?*

3. Why Did These Owners Allow Capitalism to Change?

As we turn to an examination of the behavior of our institutional investor investment managers to get some sense of why this passivity exists, I want to emphasize that this is not only a mutual fund issue. For our nation's 100 giant institutions are overwhelmingly engaged in providing their services to *both* mutual funds *and* pension funds. Of the $7.4 trillion of U.S. equities overseen by our top 100 managers, more than $6.9 trillion (93%) is managed by 78 firms that serve both types of clients. The remaining nine private firms operate in only one of those two arenas and manage $250 billion, and 13 giant state and local government funds hold the remaining $250 billion.

One major reason for our failure to act as good corporate citizens is the short-term investment horizons that have, over the past several decades, come to dominate the field of institutional money management. Unlike the *long-term* investor, however, corporate governance doesn't seem to concern the *short-term speculator*. As the portfolio turnover of mutual funds for example leaped from a remarkably stable 15% annual rate during the 1950s and early 1960s to 100%—or more!—in the late 1990s (and ever since), interest in governance faded accordingly. If the six-year average holding period for a common stock in a fund portfolio once marked mutual funds as an *own-a-stock* industry, surely the eleven-month average holding period of today marks us as a *rent-a-stock* industry. Given the hyper-short-term trading activity that now characterizes institutional investing, the forbearance of portfolio managers from governance issues actually reflects a perverse common sense. Why spend money on evaluating a company's governance when you likely won't even be holding your shares when the next proxy season rolls around?

Ignorant Individuals Lead Expert Professionals . . . into Trouble

Six decades ago, John Maynard Keynes worried about the implications of such short-term speculation for our society. "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." The resulting "waves of optimistic and pessimistic sentiment are unreasoning, and yet in a sense legitimate where no solid base exists for a reasonable calculation."

Then he added, prophetically, 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."

I cited those words in my 1951 Princeton senior thesis on the mutual fund industry . . . and then had the temerity to disagree. Portfolio managers in a far larger mutual fund industry, I suggested, would "supply the market with a demand for securities that is *steady, sophisticated, enlightened*, and *analytic*, a demand that is based essentially on the (intrinsic) performance of a corporation rather than the public appraisal of the value of a share, that is, its price." Well, 53 years later, it is fair to say that the worldly-wise Keynes has won, and that the callowly-idealistic Bogle has lost. And the contest wasn't even close!

But we are paying a price for the shift that Keynes accurately predicted. As professional institutional investors move their focus from the wisdom of long-term investment—what Keynes' called "a steady stream of enterprise"—to the folly of short-term speculation, "the capital development of a country becomes 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."

The casino mentality that reflects the triumph of emotions over economics has harsh consequences. 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 *only* be reconciled in favor of reality. It is virtually impossible to raise (or, for that matter, lower) reality to perception in any short timeframe, for the tough and demanding task of building value in a corporation in a competitive world is a long-term proposition. During the recent great bubble, as our institutions lost their bearings, capitalism's job *was* ill-done.

Fund Managers' Conflicts of Interest

But there's more than short-termism that accounts for the near-absence of institutional managers from the governance scene. For example, index funds, by definition hewing to buy-and-hold strategies—comprise about one-quarter of the assets of the Institutional Investor 100. Yet even the voices of these consummate long-term investors have been, if not totally silent, at least seriously muted. And even the few large active managers engaging in what passes for low turnover in the current environment (say, below 35% annually) have generally refrained from participation in the affairs of the corporations in which they invest.

One obvious reason for this passivity is the desire to avoid controversy. In the asset-gathering business that money management has become, a high profile on a divisive issue is more liability than asset. Another reason for such forbearance is conflict of interest. While the managers deny that such conflicts affect their proxy voting policies, it is easy to imagine that private institutional investors would be reluctant to vote against the entrenched corporate managements that have hired them to manage most of the more-than-$2 trillion of equities in their pension plans and 401(k) thrift plans.

But that's only the beginning of the problem. While the proxies of shares held by mutual funds in a given company's thrift plan cannot be voted to meet the wishes of each shareholder, the shares held in its pension plan could be independently voted. The corporation itself could direct its pension managers to vote the shares of the corporations it holds in any way it wished. But it doesn't take a lot of imagination to realize that corporations, too, are unlikely candidates for aggressively voting the shares their pension plans hold in other corporations. Why be known as a trouble-maker among your Business Council colleagues, when they might reciprocate in kind?

So, whether tacit or explicit, a system has emerged in which "let he who is without sin cast the first stone" has become the watchword of behavior for the mutual funds and pension plans that control trillions of dollars worth of shares of other corporations—an abandonment of responsible corporate citizenship that, while it is easily *explainable*, is hardly *excusable*. (I should note that TIAA-CREF and our state and local pension plans, and now a few far-sighted fund managers, are notable exceptions to this reluctance to participate in corporate governance.)

What's to be Done?

Corporate America and Democracy

We need to take control of corporate America and return it to its owners. It's easy enough to do, if only the owners assert their obvious authority. The corporation is the property of its owners, and it is utterly logical that they should be put in a position to have their ownership interests honored. Put another way, I urge a return to corporate democracy.

Not everyone agrees! Logical or not, it has been authoritatively argued that the exercise of ownership rights by nominating directors and making proxy proposals could disrupt the proper functioning of the board and limit the ability of the directors to fulfill their fiduciary duties. In an op-ed essay in *The Wall Street Journal*, Henry G. Manne, dean emeritus of the George Mason University School of Law, argues that "the theory of corporate democracy . . . has long been a standing joke among sophisticated finance economists." (He names no names.) "A corporation is not a small republic . . . and the board is not a legislature . . . a vote attached to a share is totally different from a political vote . . . the essence of individual shareholder participation is 'exit,' not 'voice' . . . and they can exit their corporate `citizenship' for the cost of a stockbroker's commission." In other words, if you don't like the way your company is being run, just get out—sell to the first bidder, whether or not the price reflects the corporation's intrinsic value. "*Like it or dump it*," however, doesn't seem a particularly enlightened approach to public policy, nor does describing corporate democracy as a "form of corporate fraud" really shed much light on the subject.

My own position is simple; *Owners should be allowed to behave as owners*. If ownership rights are not placed front and center, where should they be placed? Who would *dare* to suggest that barriers should be placed in the way of the right of shareholders to elect as a director anyone they wish to serve as their agent? That owners cannot compel their managers to be responsive to their demands? That owners have no right to determine the compensation that executives receive from their company? Aren't these among the essential rights of ownership?

Clearly, they are the rights of the 100% owner, who brooks no interference with his will. And any manager who flatly refused to consider the views of a 50% owner, or even a 25% owner (think Wal-Mart) would soon be looking for another line of work. What about a dozen institutions, each holding a 3% interest and sharing a particular viewpoint, or wishing to nominate a director? Or 30 owners, each with a ½ of 1% stake? Where does the proverbial shovel break? And does the argument that it *might* break when no single shareholder owns more than, say, 0.10% of the shares justify depriving these shareholders of the same rights? *Not for me it doesn't.* Of course activism by owners can be disruptive, but I believe, after Churchill, that corporate democracy "is the worst form of governance . . . except for all those others that have been tried from time to time." (Including, I hasten to add, those that have been tried in the recent era.)

Yet corporate democracy is currently conspicuous by its absence from the governance scene. As the legendary Benjamin Graham put it, "in legal rights and machinery, the stockholders as a class are king . . . they can hire and fire managements and bend them completely to their will. But the assertion of their rights in practice is almost a complete washout. Unless prodded violently into action, they show neither intelligence nor alertness. They vote in sheep-like fashion for whatever management recommends, no matter how poor the record of accomplishment may be. . . The leading investment funds could contribute mightily to the improvement of corporate managements . . . but have shied away . . . missing a great opportunity for rendering service to the investing public." And so it remains today.

But it wasn't always so. Way back in 1949, *Fortune* suggested that, "the mutual fund is the ideal champion of . . . the small stockholder in conversations with corporate management, needling corporations on dividend policies, blocking mergers, and pitching in on proxy fights." And in my 1951 thesis that examined the economic role of mutual funds, I devoted a full chapter to their role "as an influence on corporate management," noting with approval the SEC's 1940 call on mutual funds to serve as "the useful role of representatives of the great number of inarticulate and ineffective individual investors in corporations in which funds are interested."

Fixing the System

It's high time professional investors lived up to their responsibility to be good corporate citizens. Such shareholder democracy *does not* require radical change in the existing institutional *structure.* But we must muster the courage to address the two principal issues involved in what has come to be called "shareholder access" to the ballot—the company's proxy statement. One is the ability to nominate directors. Yet because of today's tortuous, time-consuming, and expensive process, during the entire 1996-2002 period, there were but *ten* challenges to incumbent directors of companies with market capitalizations of as little as $200 million or more.

Corporate managers, not surprisingly, strongly object to changing the system to facilitate challenges to their slate. The Business Roundtable warns that shareholder participation in the nominating process "has the potential to turn every director election into a divisive proxy contest," involving heavy cost and the diversion of management effort. But even if that could happen, there is no reason that a well-designed access proposal couldn't resolve most of the difficulties. Managers also argue that potential directors would be deterred from serving, but that seems a specious, even self-serving, reason for allowing those at the top of the business pyramid to have complete protection from challenge and possible removal from office. Of course a board constantly engaged in civil war would hardly serve the owners' interests. But it is not at all clear that those interests aren't equally ill-served when harmony is so embedded that no dissent can be brooked. Surely we can all think of individual cases in which shareholders have paid a high price for collegiality so deep-seated that it stifles dissent.

As I was writing these remarks, I happened upon an editorial in *The Economist* entitled "American Corporate Governance: No Democracy Please, We're Shareholders." It not only echoed the views I've expressed here, but reinforced them. Perhaps my citing the editorial's conclusion will add some intellectual heft to my position:

> *In the face of hysterical opposition from corporate bosses, who can think of nothing worse than being humiliated in a genuine election, . . . The Securities and Exchange Commission summoned up enough spirit to propose a small step in the direction of genuine shareholder democracy. Yet the proposal is, if anything, too timid . . .The SEC should implement this modest rule-change forthwith. It might then consider adopting another quite modest proposal, a rule long observed in more shareholder-friendly places such as Britain: if, by withholding support, shareholders cast more votes against a candidate then in favor, he should not be elected to the board. How daringly democratic.*

Beyond the Board Slate

The second issue regarding shareholder access to the corporate ballot is the ability of owners to make proposals regarding corporate activities. In an earlier era, the Securities and Exchange Commission allowed most such shareholder proposals to be excluded from the proxy because they were related to the "ordinary business" of the corporation. In recent years, however, proposals to limit excessive compensation have often been ruled not subject to the "ordinary business exclusion," and have been included in proxies. It is high time that owners began to demand that executive compensation be related to the *real* business achievements of executives in *building long-term corporate value.*

The short-term price of a stock, as we must have learned by now, is an absurd basis for compensation. We ought to be demanding such benchmarks as a company's five-year return on total capital relative to peers and to American industry in total, and its growth in cash flow. How *much* extra return on capital, or how *much* cash flow growth should be required for our CEOs to earn box-car bonuses, I do not know. But I wonder how many companies would dare to follow the threshold set by General Electric for the compensation of CEO Jeffrey Immelt: annual cash flow growth averaging at least 10% for five years. Now *that* strikes me as a shareholder-friendly approach! It's high time for us to pay our CEOs, not on the basis of *peer pressure*, but on *performance*.

The compensation issue only begins the list of where owners should get involved. No, I don't think our giant institutions have the talent and ability to manage the businesses they effectively own. But we ought to demand the right to nominate directors; to approve large mergers and acquisitions; to eliminate anti-takeover provisions, staggered boards, and poison pills; and to say grace over dividend policy; indeed the right to submit to a vote of shareholders *any* proposal that is designed to assure that a company is managed in the interests of its shareowners.

These changes will require SEC approval, and I confess to being disappointed in the Commission's recent proposals regarding shareholder access to the proxy process. They are technically complex, and raise the bar against proposals by active investors to an almost insurmountable level. Sure, mischief might be created by shareholder blocs—large or small—if the bar were lowered too far. *But let us never forget that vesting among owners the power to exercise their corporate franchise will only alter* *the state of corporate affairs if a majority of shares are voted in favor of a given proposal or a particular director*. So what's wrong with letting corporate democracy flourish? Doesn't the whole underpinning of our capitalistic system depend on the notion that the will of the shareholder be done?

Latent Power

Yet while we need important structural changes if we are to enhance corporate democracy, financial institutions should not underestimate our existing ability to affect change. As the recent dust-up over CEO Michael Eisner's re-election as a director of Walt Disney shows, institutional owners are not without power to be a major force for change, if only we summon the courage to exercise the franchise that exists today. Investors already can—and I think should—

- Withhold votes for board chairmen who are also CEOs. (Remember the difference between "boss of the business" and "boss of the board"?)
- Vote against auditors who are also providing consulting services (or consulting service fees that are disproportionate to their audit fees).
- Withhold votes for board members who serve on audit committees, compensation committees, and governance committees when their qualifications seem doubtful or their independence seems questionable.
- Vote *against* proposals that limit open governance (i.e., staggered boards) and proposals that excessively protect companies from takeovers (i.e., poison pills).
- Perhaps most meaningful of all, vote against overly-dilutive stock option plans.

As the most pronounced vestige of managers' capitalism, stock option plans are a vital battleground on which to fight for a return of owners' capitalism. Owners must demand severe limits not only when excessive share dilution is proposed by management, but when the *cumulative* share dilution—actual and potential—over time exceeds reasonable limits. Now that the costs of fixed-price stock options likely will soon be required to be accounted for as an expense (of all things!), owners should also demand better forms of options with owner-oriented terms. Be tough!

For example, a threshold return on corporate capital might be required for exercise; an exercise at a significant premium over the current market value; an exercise price indexed to peer companies and/or the Fortune 500, based on relative stock market returns and/or return on investment; long-term incentives that include fewer stock options and more restricted stock, rather than all options. Or requiring the *retention*, during the executive's tenure with the company, of a substantial portion of shares acquired; or "claw back" provisions if corporate earnings are later restated. This list of improvements in the system that executives and compensation consultants have described as "free"—but in fact has carried huge costs—is but a superficial litany of steps that must be taken to restore a fair and equitable balance between the interest of owners and of managers. Please don't underestimate the power of institutional investors—and your own power as security analysts, researchers, and portfolio managers—to bring about these long-overdue changes.

Corporate Managers and Money Managers

But we also need to improve our own behavior as *money* managers. For how we behave cannot be divorced from how *corporate* managers behave (and vice versa). If the money manager is focused on the price of the stock rather than the intrinsic value of the corporation, then we should not be surprised when the corporate manager does the same in an attempt to "game" the system. We are not without responsibility for the fact that the list of companies managed for the long-term and without "earnings guidance" is depressingly small, in part because so few investment managers buy and hold for the long-term, bereft of excessive concern about the changing valuations that Benjamin Graham's metaphorical "Mr. Market" offers each day.

Berkshire Hathaway's Warren Buffett, of course, is the most pristine of such corporate managers, and he regularly hammers home the message that he "prefers Berkshire stock to trade at or around its intrinsic value—neither materially higher nor lower," noting that, "intrinsic value is the discounted value of the cash that can be taken out of the business during its remaining life. When the stock temporarily overperforms or underperforms the business, a limited number of shareholders—either sellers or buyers—receive out-sized benefits at the expense of those they trade with. *(But) over time, the aggregate gains made by Berkshire shareholders must of necessity match the business gains of the company."* What a refreshing perspective. And it's true!

Equally obvious is Benjamin Graham's formulation. "In the short run the stock market is a voting machine," indeed one that too often seems to measure only extraordinary popular delusions and the madness of crowds. "But in the long-run," he assures us, "it is a weighing machine." I would suggest to you that corporations that are managed with a view toward enhancing long-term intrinsic value will gain *extra* weight *vis a vis* those that seek extra votes by focusing on selecting short-term earnings guidance.

Learning From the Past

At the same time, investment professionals ought to develop a healthy skepticism about financial reporting, especially, as I noted at the outset, after the way we were burned during the bubble. Analysts should return to analyzing, and even encourage companies to stop all that "earnings guidance" and "meeting expectations"—even better, exceeding expectations, and never, never falling short—that create pressure on management to deliver—first by fair ways, then only by financial engineering. Small wonder it is so often the chief financial officer—not the chief operating officer, not the head of manufacturing, not the head of research and development—who accompanies the chief executive officer to meetings with security analysts. If we have learned anything from the great bubble, it must be that the manipulation of numbers is within the province, not only of the "bad apples" that I cited at the start of my remarks, but the province, of well-meaning but often self-serving chief executives and their financial officers, for whom the price of a share of their stock—not the intrinsic value of their corporation—is the ultimate measure of success.

It is not enough, then, for the investment community to gain the even greater *ability* to exercise its ownership rights. If owners' capitalism is to return to its historic preeminence, we have to develop the *will* to participate in corporate governance. That will require a sea change in our investment attitudes—our objectives, our strategies, the way we manage our equity securities, indeed the way we analyze the stocks in our portfolios.

If we remain focused on stock prices rather than corporate values—on the folly of short-term speculation rather than the wisdom of long-term investment—we can forget about owners' capitalism. Those who *rent* stocks hardly need care about their responsibilities of corporate citizenship, while those who *own* stocks not only *must* care about governance, but can't afford *not* to care.

It's not as if high turnover is some proven strategy for success. It isn't. (After all, the stock speculator can hardly be unaware that trading is a loser's game; for each gambler who wins, there is another gambler who loses; the only certainty is that the croupier *always* wins.) The laboratory in which we measure the mutual fund industry provides compelling evidence of the large lag of equity fund returns behind the returns of the stock market, a lag that has grown apace with turnover over the years; and an astonishingly high correlation between low turnover and higher returns in all nine of the Morningstar style boxes. And anecdotal evidence suggests that "static portfolios" (based on the assumptions that a fund's portfolio on a given date is held unchanged for, say, one year) are at least as productive as the actual results achieved by the portfolio whose securities come and go. (You might want to check your own portfolios this way at each year-end. I'll bet you'll be surprised at the results!)

What Else Can We Do to Restore Owners' Capitalism?

One wonderful way to break the heavy role of stock speculation in which we all find ourselves would be the enactment of a federal tax on stock transactions, or a tax on realized short-term gains, applicable to both taxable and non-taxable investors as Warren Buffett suggested, tongue-in-cheek he tells me, some years ago. But unless our casino mentality gets even more pronounced than it is today, the chances of Congress taking such action is probably close to zero.

But there is more than one way to skin the speculative cat, however, perhaps by the payment of higher dividends to long-term shareholders. Investing for income, after all, is a long-term strategy; investing for capital gains a short-term strategy. But we ought to be thinking of everything imaginable in order to improve our market system so that *true* owners gain the upper hand.

Perhaps, too, security analysts and money managers can learn from the ingredients of the remarkable success—not only the *commercial* success, but the *artistic* success—of the index fund. (It attracts capital; it performs!) Think about it. It's not very complicated: The all-market index fund is the consummate prudent investor—vastly diversified in its portfolio holdings; infinitely patient in its long-term, buy-and- hold strategy; highly tax-efficient; and focused, not on the *emotions* of fluctuating stock prices, but on the *economics* of intrinsic value, a simple bet of the future cash flows of corporate America. Providing the stock market's total return, with only the smallest deduction for operating costs, the index fund works because it puts the client first. And as the old saw goes, *that's important too*. Indeed if there's a Golden Rule that will help us all, as investment professionals, succeed in our careers, serving the client's interests before our own is the rule I'd choose.

At least since 1998—long before the recent spate of corporate and mutual fund scandals—I've been calling for mutual funds and other private institutional investors to make their will known by taking an active, even collective, role in governance. While many of our institutions are focusing on short-term speculation, there remains a strong cadre of others; hence the working designation I have suggested for the group, "*The Federation of Long-Term Investors.*" Index funds—the consummate long-term investors, who simply buy and hold the stocks in their benchmark portfolios—now representing 12% of mutual fund assets and an estimated 25% of pension fund assets—would constitute the core of such a federation, joined by active managers that eschew a short-term focus. While most of the managers with whom I've discussed these issues are publicity-shy (neither notoriety nor controversy are good for the marketing side of the house), I press on in that mission. Alas, my combative style endears me to few, so I'm hopeful that strong leaders who share my conviction will emerge to lead this embryonic effort to restore owners' capitalism to its rightful place at the top of our corporate hierarchy.

I close by reminding you that in the course of all human events, it's up to us in the investment field—particularly those of us who take seriously the profession of investing—to work toward building, not only a better market system, but a better society. The mission to return capitalism to its proud roots begins with having the owners of our corporations stand up and be counted—not only in what they say, but in what they do. If we can restore enterprise to its pre-eminence over speculation, to its deserved position as the highest priority of our investment decisions, we will improve not only the returns of our clients, but our standing as respected investment professionals. If we reaffirm the lofty goal set forth for us by Lord Keynes, we will serve not only ourselves, but our society, too:

The social object of skilled investment should be—not "to beat the gun," to outwit the crowd, to pass the bad, or depreciating, half-crown to the other fellow—but to defeat the dark forces of time and ignorance which envelop our future.

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