

# **A Tale of Two Markets**

**Keynote Speech by  
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I am profoundly honored by the prestigious award for Distinguished Contributions to Financial Reporting that you bestow on me this afternoon. Of course I am deeply humbled, but I'm also somewhat stunned, for I am not a trained financial professional. But I do care, and care deeply, about integrity in financial reporting.

In this latest decade of my now 55-year career in investing, I've studied this subject with attention and concern, delivered lectures that were a combination of sermon and jeremiad, and written a fiery book—*The Battle for the Soul of Capitalism*—that demands that we address the remarkable erosion in the conduct and values of our business leaders, our accountants, our investment bankers, and our money managers that has taken place over the past two decades.

This change in the conduct of capitalism is hardly a parochial issue. For quoting, if I may, from my book, “If our nation is to overcome the infinite, often seemingly intractable, challenges of our risk-fraught modern world, we require a powerful and equitable system of capital formation. Our economic might, our political freedom, our military strength, our social welfare, and even our free religious values depend upon it.” There is a lot at stake in your work as financial professionals.

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

One major contributor to the erosion of that conduct and those values has been the change in the nature of our financial markets that reflects radically different views of what investing is all about, and the role of our nation's accounting system in defining them. One is the *real* market of intrinsic business value. The other is the *expectations* market of momentary stock prices. This is why I have chosen "A Tale of Two Markets" as the title of my remarks today.

### **The Real Market and the Expectations Market**

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 manipulated and defined in multiple ways. We have *pro-forma* earnings (reflecting the magical earnings growth that can be created by merging two firms, as well as a certain dissembling). We have *operating* earnings (absent all those write-offs of previous bad investment decisions, bad debts, and bad operations that were discontinued). And we have *reported* earnings, conforming to Generally Accepted Accounting Principles, GAAP accounting which itself is riddled with its own substantial gaps in logic and implementation that permit all sorts of financial shenanigans by those who are so inclined.

I first encountered the compelling formulation of the distinction between the Real Market and the Expectations Market only last spring, in the writings of Roger Martin, dean of the Rotman School of Business at the University of Toronto. I was particularly impressed by the distinction he drew, for I've been focused on the very same dichotomy with different words, for a long time. I most recently raised the distinction 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 *Battle for the Soul of Capitalism*, published last year by Yale University Press.

The thesis of that speech—“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 . . . (As a result), we worship hard numbers and accept the momentary precision of stock prices as the talisman of investment reality rather than the eternal vagueness of intrinsic corporate value.”

### **Enterprise vs. Speculation**

These ideas, in turn, were in fact the product of yet another thesis—a real one, written a half-century earlier—my senior thesis at Princeton University, completed in 1951. There, I cited the words of the great British economist John Maynard Keynes, in his wonderful Chapter 13 of *The General Theory*, where he 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 simply didn’t happen. Quite the contrary! Portfolio turnover of equity mutual funds, then running steadily about 15 percent, year after year—a 6-year average holding period for the average stock in the portfolios—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 acknowledge the obvious: the worldly-wise Keynes was right, and that the callously idealistic Bogle was wrong. Call the score, Keynes 1, Bogle 0.

### **“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. The expectations market of prices has trumped the real market of business at every turn. 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 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 exceptional corporation.

## What Went Wrong in Corporate America and Investment America?

Simply put—and this is the main thesis of my book—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.

How could this have happened? There were two principal reasons. First, the “ownership society”—in which the shares of our corporations were held almost entirely by direct stockholders—was gradually transformed into a new “agency society,” 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 didn't behave 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.

The second reason is that the predominant focus of institutional investment strategy turned from long-term investment in the business market to short-term speculation in the expectations market. During the past few decades, 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, out of thin air, what passes for earnings, even under GAAP standards. For example:

- Cavalierly classifying large charges against revenues as “immaterial.”
- Hyping the assumed future returns of pension plans, even as rational expectations for future returns deteriorated.
- Counting as revenues sales made by lending corporate monies to the purchasers.
- Merger adjustments involving huge write-offs of accounts receivable, only to collect them later on; and write-offs of perfectly good plant and equipment, eliminating future depreciation charges.
- Excluding the cost of stock option compensation from corporate expenses. (This practice has now, happily, been prohibited.)
- And, lest I forget, timing differences between GAAP and tax accounting.

And I haven’t even touched on the concealment of debt in special-purpose entities, abused most notably by Enron.

Under GAAP, these practices are all, well, legal. Surely it can be said 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.

### **Reality Falls Short**

But hyping the expectations market by managing earnings can only continue to the extent that the real business market delivers the goods, and of course it couldn’t. During 1980-2004, public corporations had projected their growth at an annualized rate averaging 11 ½ percent. But they actually delivered earning growth of 6 percent—only about half of their goal, and even slightly less than our GDP growth of 6.2 percent per year. (It will hardly surprise this audience to learn that over the long term, corporate earnings growth is closely linked to the growth of the economy.) During the great bubble, the expectations market—illusion—soared above the business market—reality. And then, inevitably, the stock market bubble finally burst.

But now think about this: if each stockholder held the same stocks throughout the boom and the bust, that difference—finally irreconcilable—simply wouldn’t have mattered. Prices

would have soared past intrinsic value and then, observing the laws of gravity, returned. So what? But it *did* matter. Why? Because an enormous transfer of wealth took place from a variety of stock sellers—largely corporate insiders exercising their stock options and entrepreneurs taking their enterprises public—to a variety of largely different stock buyers—the unsuspecting (and often, greedy public and, ironically, or corporations themselves, buying back stock in order to avoid earnings dilutions from those options.

But this was no zero-sum game. For the financial intermediaries—investment bankers and brokers who sold all those high flying stocks to their clients, and mutual fund managers who sold all those “new economy” funds to the public—turned it into a loser’s game. I calculate these croupier costs at more that \$1 trillion (!) during 1998-2002 alone.

When we have two vastly different markets, it is almost inevitable that major conflicts arise. Toronto’s Roger Martin sets up his critique using pro football as an analogy. There, the expectations market is reflected in the betting on the point spread between the scores of rival teams. When the game ends, the reality, of course, is the actual spread. In pro football, he notes, “No participant in the real market is permitted to participate in the expectations market.” That is, the star quarterbacks, as well as all the other actors in those football dramas are not allowed to bet on *any* games, even those in which they do not play. Surely few would argue that such a prohibition is not a sensible policy.

And then he drops the bomb. “But there is an even bigger game in which players in the real market are not only allowed, but strongly encouraged to play in the related expectations market: It is of course the stock market for a company’s shares. While the task of the CEO is to build the real business, he spends a lot of his time playing in the expectations market, setting expectations, controlling the numbers that will reflect whether or not they are met, and getting paid staggering amounts of stock-based compensation on the theory that such compensation aligns the interest of executives with the interest of shareholders.”

Baloney! Stock-based compensation does nothing of the sort. It encourages executives—and their chief financial officers, too often with the tacit approval of their public accountants and their directors—to manipulate the expectations market to their own benefit. Even as it is banned in pro football, it shouldn’t be allowed in executive compensation. Sometimes this manipulation is reflected in a future slowing of overstated past earnings. (General Electric, widely

regarded as one of the champions of managed earnings during the recent bubble era, reported growth in earnings per share in 1996-2000 of 15 percent per year. Since then, the growth rate has dwindled to 4 percent.) At other times, we get earnings restatements. And, in the recent era, lots of them. In 2005, there were 1195 restatements by U.S. public companies, a mere 10-fold increase over the 116 restatements in 1995.

### **When Prices Depart from Values**

But in the long-run, the numbers that are reported as earnings don't change the realities of investing. Berkshire Hathaway's legendary investor Warren Buffett, whose firm is publicly held, regularly hammers home to his shareholders the message that he prefers Berkshire stock to trade at or around its intrinsic value—neither materially higher nor lower. He explains 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 over-performs or under-performs 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.*”

If all investors were long term investors, financial probity and all that earnings management would be of less concern to us. But substantial short-term departures of stock prices from intrinsic values generate out-size benefits to a limited number of shareholders—either buyers or sellers—at the expense of those with whom they trade, just as Mr. Buffett says. When those benefits are disproportionately bestowed on corporate insiders with the tacit consent of investment bankers and fund managers whose business interests are served by these aberrations, we have a societal problem that requires—indeed demands—our attention.

Your award specifically recognizes the importance of providing financial information that is useful to investors in making investment decisions. But a serious conflict exists between the powerful motivation of top management of reporting corporations to produce favorable reports on their accomplishments and the interest of investors in receiving reliable and useful financial statements.

In his perceptive recent article in the *Journal of Business Ethics*, Berkeley Professor Emeritus George Staubus argues—persuasively, in my view—that our auditors owe their



allegiance to the owners and other users of the financial statements rather than the managements of the enterprises that they audit, and that they have failed in carrying out that mandate. He also faults academic accountants and members of accounting standards-setting bodies for the same flawed allegiance. Yet the U.S. Supreme Court has ruled (in *U.S. vs. Arthur Young*, 1984) that the auditor's "ultimate allegiance is to a corporation's stockholders, as well as the investing public."

We must work toward a system in which auditors represent, not corporate managers, but corporate owners. This is how the system actually worked back in the 19<sup>th</sup> century, when the British banks and insurers who sent their capital across the sea to finance American capital investment—our railroads and our canals—sent their own accountants to audit the books. Presumably, their standards set the stage for American auditing. James Anyon, known as America's first auditor, followed in their footsteps. In 1912, he advised his professional colleagues, "Think and act upon facts, truths, and principles, and regard figures only as things to express them." Amen!

But of course directing the allegiance of the auditors to the owners of our firms is only part of the solution to today's flawed version of American capitalism. For in our agency society, where the holders of our stocks are a conflict-ridden step removed from their principals, and where there are too few long-term owners of stocks and too many short-term renters of stocks, accomplishing that goal is not a task for the faint-hearted. But time runs out on my remarks today, and perhaps your tolerance. We'll have to solve *that* problem, well, tomorrow.

For the good of our society, we need to return to a system in which the real market of owning businesses returns to play the starring role in investment strategy, and the casino-like expectations market is consigned to a supporting role, even as we strive to provide financial reporting that makes those expectations as hard and firm and realistic as we possibly can. To do so, returning to the theme set out by Professor Solomon Darwin as he opened this morning's session, each one of us must focus our own personal human resources of integrity and character on resolving the stubborn and difficult issues that have arisen in this flawed era of capitalism.