Capitalism, Entrepreneurship, and Investing—
The 18th Century vs. the 21st Century

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Last summer, I at last got around to reading a book that the late Neil Postman—prolific author, social critic, and professor at New York University—had autographed and given me in 1999. The central message of *Building a Bridge to the Eighteenth Century* is encapsulated in its opening epigram:

> **"*Soon we shall know everything the 18th century didn't know, and nothing it did, and it will be hard to live with us*."**

Postman's book presented an impassioned defense of the old-fashioned liberal humanitarianism that was the hallmark of the Age of Reason. His aim was to restore the balance between mind and machine, and his principal concern was our move away from an era when the values and character of Western Civilization were at the forefront of the minds of our great philosophers and leaders, and when the prevailing view was that anything that's important must have a moral authority.

In the present era of information technology, by way of contrast, numbers and scientific techniques seem to be at the forefront of our values. Metaphorically speaking, *if it can't be counted, it doesn't count*. Surely this change has been clearly reflected in the change in capitalism from a system with values like trusting and being trusted at the fore, to a system relying heavily on numbers, with the profound conviction that financial matters are rational simply because numbers, however dubious their provenance, are definitive.

While Postman made the bold assertion that truth is invulnerable to fashion and the passing of time, I'm not so sure. Indeed I would argue that we've moved away from *truth*—however one might define it—to (with due respect to Steven Colbert) *truthiness,* the presentation of ideas and numbers that convey neither more nor less than what we wish to believe in our own self-interest, and persuade others to believe it too. This change, in turn, has given us what I describe in my new book, *The Battle for the Soul of Capitalism*, as a "pathological mutation" from *owners'* capitalism to *managers'* capitalism in our business and financial systems—in corporate America, investment America, and mutual fund America alike, the three principal targets of my book.

Yet while Vanguard too has emerged as a sort of prototypical *21st century* firm—a virtual organization, enormous in size, heavily reliant on process, on real-time communications and computer technology, and managed largely by the contemporary numeric standards of modern management—its founding values remain intact. At our core, we remain a prototypical *18th century* firm, thriving on our early entrepreneurship, on our simple investment strategies, on eternal verities such as service to others before service to self, and on putting the interests of shareholders ahead of the interest of managers, doing our best to hold high the belief that ethical principles and moral values must be, finally, the basis for any enterprise worth its salt.

The opportunity to make this contrast between Vanguard and the financial field in which we ply our trade comes at an especially propitious moment. For, as everyone in this audience must be aware, we are currently celebrating the 300th anniversary of the birth of Benjamin Franklin, surely one of the most remarkable Americans of all time. While the tercentenary makes us more aware than ever of Franklin's extraordinary accomplishments as founding father, framer, statesman, diplomat, scientist, philosopher, author, master of the epigram, and fount of earthy wisdom, far less attention has been paid to his strict sense of values, his talents as an entrepreneur and inventor, and his sensible investment wisdom—the prototypical 18th century man.

So I'm delighted to be with you today, and I'm honored to be invited to speak again to the Greater Philadelphia Venture Group, as I did in 1997. Today, I'll discuss how Franklin's entrepreneurial values and inventions that focused on the common good, and his investment principles that focused on common sense can be seen as precursors to those of Vanguard in both of those areas, and to contrast this 18th century character with the very different 21st century character that now pervades in America's corporate and investment system.

I. Franklin's Entrepreneurship and Invention

Let's begin with Franklin's entrepreneurship. It was not only remarkable for his era; it was remarkable for *any* era. While in today's grandiose era of capitalism the word "entrepreneur" has come to be commonly associated with those who are motivated to create new enterprises largely by the desire for personal wealth or even greed, the fact is that *entrepreneur* simply means "one who undertakes an enterprise," a person who founds and directs an organization.

But at its best, entrepreneurship entails something far more important than mere money. Please do not take my word for it. Heed the words of the great Joseph Schumpeter, the first economist to recognize entrepreneurship as the vital force that drives economic growth. In his *Theory of Economic Development*, written nearly a century ago, Schumpeter dismissed material and monetary gain as the prime mover of the entrepreneur, finding motivations like these to be far more powerful: (1) "The joy of creating, of getting things done, of simply exercising one's energy and ingenuity," and (2) "The will to conquer: the impulse to fight, . . . to succeed for the sake, not of the fruits of success, but of success itself."

There is a difference, then, between an entrepreneur and a capitalist. Had Franklin possessed the soul of a true capitalist, "he would have devoted the time he saved from printing to making money somewhere else."[1] But he did not. For Franklin, the getting of money was always a means to an end, not an end in itself. The other enterprises he created, as well as his inventions, were designed for the public weal, not for his personal profit. Even today, Dr. Franklin's idealistic eighteenth-century version of entrepreneurship is inspirational. When he reminded us that "energy and persistence conquer all things," Franklin was likely describing his own motivations to create and to succeed, using Schumpeter's formulation, for the joy of creating, of exercising one's energy and ingenuity, the will to conquer, and the joy of a good battle.

Franklin's creation of a mutual fund insurance company was the classic example of his community-minded approach to entrepreneurship. In the eighteenth century, fire was a major and ever-present threat to cities. In 1736, when barely 30 years of age, Franklin responded to that threat by founding the Union Fire Company, literally a bucket brigade that protected the homes of its subscribers. In a short time, Philadelphia's fire companies joined in a common cause, making it possible to insure the

[1] *Benjamin Franklin – The First American*, H.W. Brands, Doubleday, 2000.

homes under their aegis against loss by fire. So on April 13, 1752, Franklin joined with his colleagues in founding The Philadelphia Contributionship.

The name of the new enterprise was inspired by the Amicable Contributionship of London, founded in 1696. Its name, in turn, was derived from the contemporary definition of contribution—"that which is given by several hands for a common purpose," an apt name for a mutual company owned by its policyholders. This combination of ownership and service—creating a true mutuality of interest between the owners of a firm and its managers—was not then, nor is it now, the common mode of business organization. But it was an inspired idea for its day and for its purpose. And it has endured. The Philadelphia Contributionship survives today, the oldest property insurance company in the United States. And while Franklin's selfless idea of mutuality has met the test of time, that was only part of his creativity. He also founded a library, an academy and college, a hospital, and a learned society, all for the benefit of his—now *our*—community. Not bad!

Like many entrepreneurs, Franklin was also an inventor. And once again, his goal was to improve the community's quality of life. Among other devices, he created the lightning rod and the Franklin stove (to say nothing of bifocals and swim fins). He made no attempt to patent the lightning rod for his own profit; and he declined the offer by the Governor of the Commonwealth for a patent on his Franklin stove, the "Pennsylvania fireplace" that he invented in 1744, revolutionizing the efficiency of home heating with great benefit to the public at large. Benjamin Franklin believed that, "knowledge is not the personal property of its discoverer, but the common property of all. As we enjoy great advantages from the inventions of others," he wrote, "we should be glad of an opportunity to serve others by any invention of ours, and this we should do freely and generously."

II. Vanguard's Entrepreneurship and Invention

If it crosses your mind that Franklin's concepts of service for the greater good of the community rather than for personal gain, and of creativity and innovation designed to improve the quality of life, are rarer than they should be in today's personal-wealth-driven, often greedy, version of entrepreneurship, you have strong powers of observation. But however rare, examples do exist. I'm very familiar with one example, for the creation of the Vanguard Group in September 1974 reflects the very same values of entrepreneurship and innovation that Franklin held high.

Just as Franklin founded the Philadelphia Contributionship on the rock of true mutuality in 1752, so mutuality was the rock on which I founded Vanguard two centuries later, in 1974. Vanguard, however, did not begin spontaneously; it sprang, Phoenix-like, from a troubled existing enterprise. We trace our lineage to 1928, when another remarkable Philadelphian, financial entrepreneur and fund pioneer Walter L. Morgan, founded Wellington Fund, one of the nation's oldest mutual funds that thrives to this day. His company, Wellington Management Company, operated and managed the fund, building its own profits from the growing advisory and distribution fees the fund generated.

Vanguard changed the operation of Wellington Fund—originally a profit-making entity for its *managers*—to an entity that sought to optimize the returns earned by its *shareholders*. Flying in the face of industry tradition and practice, the fund shareholders, not outside investors, actually owned the new management company, operating it on an "at-cost basis." Under Vanguard's aegis, Wellington Fund and its sister funds took the unprecedented step of becoming a truly *mutual* mutual fund group. When the change was made, the assets of the then-Wellington fund group were $1.4 billion. We knew that this new venture was not without risk, for in the wake of the 1973-74 market crash, fund assets were being withdrawn by shareholders at a fearsome rate. In fact, we would endure 78 consecutive months of capital outflow that did not end until June 1981. And then the Vanguard era began.

When operations began, we were a tiny company with just 28 *crewmembers* (I never cared for the term *employees*). Today our crewmembers number nearly 12,000, our seven mutual funds (I never cared much for the use of the word *product* to describe a mutual fund, either) now number 130, and our assets exceed $900 billion. The fastest growing firm in our field, we are now one of the two largest fund complexes in the world.

Our true mutuality—and the low costs and "shareholder first" values that it engendered—has been the single most important factor in the firm's astonishing growth. Why was mutuality so important? Simply because of the central reality of investing: *costs matter*. Since equity mutual funds are simply diversified investment portfolios that invest in the securities traded on America's stock market, as a group they earn *gross* returns on their portfolios that are roughly equal to the returns generated in the stock market. *But only before fund costs are deducted.* The *net* returns that funds actually *deliver* to their investors fall short of those *gross* returns by the amount of their costs—all of those management fees, operating expenses, portfolio transaction costs, and sales commissions that funds incur.

Just as gambling becomes a loser's game after the croupier's rake descends, so beating the market becomes a loser's game after the costs of our financial intermediaries are deducted. The fund business, arguably, is the only business in which "*you get what you don't pay for*." In fact, for fund investors as a group, "you get *precisely* what you don't pay for." (Later, I'll give you a powerful example of the long-term impact of fund costs.)

But while our mutuality has been the central factor in Vanguard's growth, the concept is hardly winning any popularity contests. Part of the reason for my choice of the name *Vanguard* for our new firm was to suggest that our structure would establish a new trend, one in which we would be the *leader*. Alas, despite the passage of more than three decades, our mutualized structure has yet to attract its first *follower.*

The reason that mutuality has so far failed to rule the financial seas, I fear, is that the Schumpeterian *entrepreneurs* who originally created mutual fund enterprises—"for the joy of creating . . . for success itself, *not* for the fruits of success"—are in the ordinary course of events succeeded by *businessmen* who are more susceptible to temptation by the fruits of success for themselves and the greater personal wealth that results from building their empires. And so it has been in the mutual fund field. The small, privately-held organizations managed by investment professionals that were the foundation of this industry when I joined it in 1951 have been replaced, largely by giant publicly-owned financial conglomerates that are in the business to earn a return on *their* capital, not a return on *yours* (as a mutual fund shareholder). Just as my book points out, mutual funds are the paradigm of the triumph of managers' capitalism over owners' capitalism. Yet the winning strategy ultimately is held by the firm that provides a *community* advantage that serves shareholders and owners, simply by taking the lion's share of those oppressive costs out of the investment equation. It is hard to imagine that Dr. Franklin, reborn in our age, wouldn't have sought to serve, not himself, but the community in exactly the same way.

Our innovative structure and the low costs it engendered, in turn, were our springboard for a wide range of inventions, largely new funds designed to capitalize—both in concept and in substance—on making the importance of those low costs most meaningful and obvious. The first invention took place only months after we began, when a simple thought, indeed one that had first occurred to me when I wrote my senior thesis at Princeton University in 1949-51, began nagging at my mind. *If mutual funds as a group fail to deliver stock market returns by the amount of their heavy costs, why not own the entire market at the minimal cost we were prepared to deliver?* Then, investors could capture almost 100% of that annual return, rather than the 70%-80% fraction that would likely be achieved by our peers. This banally obvious insight quickly led to the simple invention that has been the most powerful manifestation

of Vanguard's philosophy—the first index mutual fund in history. Today, "Bogle's Folly"—now Vanguard 500 Index Fund—is the largest mutual fund in the world.

It also took no more than the obvious arithmetic in which investment cost plays the critical role in shaping returns to recognize that the implications of indexing go far beyond the simple all-stock-market index fund and the all bond-market index fund that followed. Result: we developed a second precedent-breaking invention, and then a third. The second came in the bond fund sector, when in 1977 we launched the industry's first *defined-maturity* series of bond funds, including a short-term portfolio, and an intermediate-term portfolio, and a long-term portfolio. It may not seem very imaginative—it wasn't!—but the simple concept revolutionized the bond fund sector, and virtually the entire industry quickly followed suit. The three-tier bond portfolio is now the industry standard.

That same simple arithmetic was the key to a third Vanguard invention that would also be quickly imitated (except, of course, for the low costs). In 1993, recognizing (albeit far later than we should have!) that excessive tax costs incurred by actively-managed funds were at least as much of a burden to fund owners as operating costs, management fees, loads, and turnover costs, we created the industry's first series of funds designed to minimize taxes—two equity funds and a balanced fund, all following largely passive index-oriented strategies, all delivering on their promise in the years that followed.

Following Franklin's wonderful precedent, Vanguard placed its inventions in the public domain rather than seeking private profit. We made no attempt to patent the index fund, nor the three-tiered bond fund, nor the tax-managed funds, nor for that matter, did we seek to patent any of our other inventions and innovations. Our idea was to be "in the Vanguard" by giving investors a range of intelligent choices; to provide a *community* advantage, all the while garnering a *competitive* advantage for the firm.

III. Investment Wisdom—Franklin in the 18th Century; Vanguard in the 20th.

The civic virtue that Benjamin Franklin brought to his entrepreneurship and invention has overshadowed the remarkable wisdom of this investment sage. Yet, perhaps because it is so simple that it seems unremarkable, this wisdom goes virtually unheralded amongst his other grand accomplishments. With his simple precepts, he would have realized that in this new age of investing, we have ignored the crucial lesson: *simplicity trumps complexity*. All of that shuffling of paper shares of stock that we read about in the press—in the U.S., nearly 4 billion shares of stock, are traded each day, some one *trillion* shares a year—is engaged in by speculators attempting to garner competitive advantage, even as it inevitably slashes the returns earned by investors as a community.

While investing in stocks and bonds as we know it today hardly existed in Franklin's era, his sensible advice about savings sets a high standard for today's investment books, most of which provide complex programs that promise to "beat the market," yet inevitably fail to deliver on that promise. In my own books, however, I did my best to focus on the simple principles that define investment success. These investment ideas, it turns out, are eerily similar to Franklin's ideas about savings, set forth largely in his classic, *The Way to Wealth*, first published in 1757. A comparison of the two philosophies suggests that wisdom about sound financial principles go back at least as far as Franklin's homespun formulations about savings, echoed in Vanguard's founding investment precepts.

Perhaps the best place to begin is with Franklin's acute understanding of the miracle of compound interest. According to *Philadelphia Inquirer* journalist Clark DeLeon, "in 1785, a French mathematician wrote a parody of Franklin's *Poor Richard* called *Fortunate Richard*, in which he mocked the (to him) unbearable spirit of American optimism represented by Franklin. The Frenchman wrote a

piece about Fortunate Richard leaving a small sum of money in his will to be used only after it had collected interest for 500 years."

"Franklin," DeLeon continued, "wrote back to the Frenchman, thanking him for a great idea and telling him that he had decided to leave a bequest to his native Boston and his adopted Philadelphia of 1,000 pounds to each on the condition that it be placed in a fund that would gather interest over a period of 200 years." Franklin assumed that the funds would accrue interest at the annual rate of 5%, bringing each original 1,000 pounds to 131,000 pounds ($232,000 at today's exchange rate) after 100 years, and 17,300,000 pounds ($31,000,000) in 200 years.

For a variety of practical financial reasons and complex legal reasons, when Franklin's trusts expired 200 years later in 1994, those totals were not nearly reached. (Boston's funds were worth almost $5 million and Philadelphia's about $2 ¼ million.) Nonetheless, the results were an impressive display of the massive accumulation of capital that could be achieved when the explosive mix of *rate of return* and *time* are combined. We call that mix "the magic of compounding."

Similarly, for as long as I can remember, compound interest has been at the center of my own investment thinking. The opening words in the very first chapter of my very first book[2] were: "*The Magic of Compounding*. 'The greatest mathematical discovery of all time' is how Albert Einstein described compound interest . . . the value of $1,000 invested in stocks in 1872 would have grown to $27,710,000 in 1992 [when the book was published, and the historical rate of return on stocks was 8.8 percent.] . . . *the magic of compounding writ large*."

While that 8.8 percent rate of return was higher, and that 120-year period shorter, than Franklin's 200-year horizon, however, both periods seem so long as to be useless in our own personal financial planning. Since a comfortable retirement is the principal objective of nearly all U.S. families, in my new book I use a 65-year time horizon, one that assumes a 45-year working career (to age 65) and a further 20 years of life (to age 85) based on today's actuarial tables: "$1000 invested at the outset of the period, earning an assumed annual return of, say, 8 percent would have a final value of $148,780—*the magic of compounding returns*."

But I quickly warned that this total was unlikely to be achieved. Why? Because the obvious *magic of compounding returns* was all too likely to be overwhelmed by the subtle *tyranny of compounding costs*, a concept that, in a simpler age, even the great Franklin failed to contemplate. Here's what happens:

> "Assuming an annual intermediation cost (by mutual fund managers) of only 2 ½ percent, the 8 percent return would be reduced to 5 ½ percent. At that rate, the same initial $1000 would have a final value of only $32,465—*the tyranny of compounding costs*. The triumph of tyranny over magic, then, is reflected in a stunning reduction of almost 80 percent in accumulated wealth for the investor . . . consumed . . . by our financial system."

When our financial system—essentially our money managers, marketers of investment products, and stockbrokers—put up zero percent of the capital and assume zero percent of the risk yet receive fully 80 percent of the return, something has gone terribly wrong in our financial system. As I note in the book, "the shift in our system from owners' capitalism to managers' capitalism has been devastating to investors."

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[2] *Bogle on Mutual Funds*, Irwin Professional Publishing, 1993. In the book, I used a $1 initial investment rather than the $1000 in this example.

So what are investors to do? How do we plan sensibly for our financial futures and strive for a comfortable retirement? Once again, Franklin's ideas prefigure my own. Let me note a handful of his aphorisms, largely taken from *The Way to Wealth*, and compare them to the advice, which I describe as "pillars of wisdom," in my own books.

On saving for the future:
Bogle: Not investing is a surefire way to fail to accumulate the wealth necessary to ensure a sound financial future. Compound interest is a miracle. Time is your friend. Give yourself all the time you can.
Franklin: If you would be wealthy, think of Saving as well as Getting. Remember that time is money. Lost time is never found again.

On the importance of cost control:
Bogle: Basic arithmetic works. Your net return is simply the gross return of your investment portfolio, less the costs you incur. So keep your investment expenses under control.
Franklin: Beware of little Expenses; a small Leak will sink a great Ship.

On taking risks:
Bogle: Invest you must. The biggest risk is the long-term risk of not putting your money to work at a generous return, not the short-term—but nonetheless real—risk of market volatility.
Franklin: There are no Gains, without Pains. He that would catch Fish, must venture his Bait.

On understanding what's important:
Bogle: To be a successful mutual fund investor, *you need information*. If information about the past returns earned by funds—especially short-term returns—is close to meaningless, information about risks and costs is priceless.
Franklin: An investment in knowledge always pays the best interest. Learning is to the Studious, and Riches to the Careful. If a man empties his purse into his head, no man can take it away from him.

On the markets:
Bogle: Don't think you know more than the market, nor act on insights that you think are your own but are in fact shared by millions of others.
Franklin: One man may be more cunning than another, but not more cunning than everybody else.

On safety:
Bogle: Diversify, diversify, diversify. By owning a broadly diversified portfolio of stocks and bonds, only market risk remains.
Franklin: Great Estates may venture more, but little Boats should keep near shore.

On forecasting:
Bogle: It takes wisdom to know what we don't know.
Franklin: Tis easy to see, hard to foresee.

On looking after your own interests:
Bogle: Investors must not ignore their own economic interests.
Franklin: If you would have a faithful Servant, serve yourself.

And finally, on steadfastness:
Bogle: Stay the course. No matter what happens, stick to your program. Think long term. Patience and consistency are the most valuable assets for the intelligent investor. "Press on, regardless!"
Franklin: Industry, Perseverance, and Frugality make Fortune yield.

Surely you can learn at least these two things from this litany of sound financial advice shared, despite the nearly three centuries that separate them, by two Philadelphians: 1) 18th century Franklin had a far better way with words than 21st century Bogle; and 2) that the principles of sensible savings and investing are time-tested, perhaps even eternal. The way to wealth, it turns out, it to avoid the high cost, high turnover, opportunistic marketing modalities that characterize today's financial service system. While the interests of the *business* are served by the aphorism *"Don't just stand there. Do something!,"* the interests of investors are served by an approach that is its diametrical opposite; *"Don't do something. Just stand there!"*

IV. Virtue

It turns out that the 18th century version of entrepreneurship, mutuality, and invention have something in common: *Virtue*. While virtue is a word that tends to embarrass us today, it surely didn't embarrass Dr. Franklin. In 1728, when he was but 22 years of age, he tells us that he, "conceived the bold and arduous project of arriving at moral perfection . . . I knew, or thought I knew, what was right and wrong, and I did not see why I might not *always* do the one or avoid the other." The task, he tells us, was more difficult than he imagined, but he ultimately listed thirteen virtues—including *Temperance*, *Silence, Order*, *Frugality*, *Industry, Sincerity*, and *Justice*—even ranking them in order of importance. He began each day with "The Morning Question: What good shall I do this day," and ended with the "Evening Question: What Good have I done today?" It is hard to imagine a more ethical philosophy.

Even viewed through the lens of twenty-first century cynicism rather than eighteenth-century idealism, I confess a sense of wonder at the young Franklin's moral strength and disciplined self-improvement. While few of us in today's society would have the will to pursue a written agenda of virtue, Franklin had established, in his own words, the "character of Integrity" that would give him so much influence with his fellow citizens in the struggle for American independence. That character was also central to his dedication to the public interest, so easily observable in his entrepreneurship, in the joy he took from his creations, and from exercising his ingenuity, his energy, and his persistence. Echoing the same ideals that Schumpeter would echo more than a century later, he succeeded solely for the sake of success, exercising his talents not with a view toward personal gain and private profit, but toward serving the community. "America's first entrepreneur" may well be our finest one.

I hope you will forgive my boldness in comparing the peerless accomplishments of our nation's first entrepreneur with my own humble entrepreneurship and inventiveness, my own joy in what providence has led me to create, my own energy and persistence, and my own love of the battle to improve the lot of the American investing public. I confess that I'm proud of my career, but I console myself with Benjamin Franklin's own confession, written when he was about my age:

> "In reality, there is, perhaps, no one of our natural passions so hard to subdue as *pride*. Disguise it, struggle with it, beat it down, stifle it, mortify it as much as one pleases, it is still alive, and will every now and then peep out and show itself; you will see it perhaps often in this history; for even if I could conceive that I had completely overcome it, I should probably be proud of my humility."

So if I have allowed my own pride to peep out and show itself this afternoon, I assure you that it is with great humility with which I regale you with this chronicle of Vanguard's formation, our founding values, our inventions, and our investment principles. But I hope that, taken together, they will help you, in your own entrepreneurship and your own creativity and inventiveness, to avoid, using Franklin's timeless words, "life's tragedy—(in which) we get old too soon and wise too late." Let me sum up my hope with this revision of Neil Postman's epigram that I cited at the outset:

"While we now know nearly everything the 18th century didn't know, we still remember what it did know, and it will be easy to live with ourselves."

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

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