The Battle for the Soul of Capitalism:
Doing Your Part to Begin the World Anew

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at

Immaculata University

Immaculata, PA

October 23, 2006

Over the years, I've done more than my fair share of speaking, but I still get my greatest joy in meeting in an academic environment, and especially when the audience includes university students who are our nation's hope for the future. While I welcome you all here this morning, I confess to the teachers—doing not only the nation's work, but the Lord's—and Immaculata's friends in the local community who have been kind enough to join us that it is the students who will be the prime focus of the latter part of my message. But I think you'll *all* find food for thought in those ideas too.

I'll speak first about the ideas in my latest book, *The Battle for the Soul of Capitalism.* Let me get right to the point by quoting from its dedication, to my twelve grandchildren and the other fine young citizens of their generation:

> "My generation has left America with much to be set right; you have the opportunity of a lifetime to fix what has been broken. Hold high your idealism and your values. Remember always that even one person can make a difference. And do your part 'to begin the world anew.'"

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

I then quickly turn to the main issue: "The business and ethical standards of corporate America, of investment America, and of mutual fund America have been gravely compromised. It is time to set out on a new course that, paradoxically enough, will lead us directly back to where we began, with the traditional values of capitalism—trusting, and being trusted."

Let's start with why you should—indeed *must*—care about our system of free-market capitalism. I argue that it is the job of every concerned citizen to "uphold the values that once made our corporate and financial enterprises so successful, fairly providing the rewards of investing to those who put up the capital and assume the risks involved. To win the battle to restore the soul of capitalism, it is these values that must prevail." Why? Because, "we require a powerful and equitable system of capital formation if our nation is to overcome the infinite, often seemingly intractable, challenges of our risk-fraught modern world. Our economic might, political freedom, military strength, social welfare, and even free religious values depend upon it."

These words, of course, raise the question as to whether a system like ours can actually have a "soul." (One reviewer decided that the title was "pretentious," but he liked the book anyway!) I define the human soul as Thomas Aquinas defined it, the "form of the body, the vital power animating, pervading and shaping an individual from the moment of conception, drawing all of the energies of life into a unity." In our temporal world, the soul of capitalism is the vital power that has animated, pervaded, and shaped our economic system, drawing *its* energies into a unity. And what a marvelous unity it has been! Just think of what capitalism has done in its 200 years of existence.

"The Birth of Plenty"

Quoting from William Bernstein's fabulous book, *The Birth of Plenty*, up until the beginning of the nineteenth century "the improvement in human well-being was of a sort so slow and unreliable that it was not noticeable during the average person's *twenty-five-year* life span . . ." While the forces that drive economic growth are complex to evaluate, and often contested in academic circles, there was a timely convergence of human and physical capital, supported by a network of modern systems: legal, financial, commercial, educational, governmental, and the like. In any event, two centuries ago the world's standard of living began inexorably to improve, and the modern world was born.

Result: global living standards rising at about 2 percent per year over two centuries have increased our worldly wealth from a mere $700 per capita to $6,000 in real terms, nearly nine times over. (Never underestimate the power of compound interest!)

Yes, capitalism has bestowed its blessings unevenly. But it has bestowed them liberally, as living standards have risen all over the industrialized world. Those blessings are now spreading through the emerging economies of South America and Southeast Asia, including India and China, whose economy, within the next two decades, will surpass even America's powerful economic engine.

Today's Capitalism

But in the recent era, capitalism has let us down. It has departed, not just in degree but in kind, from its proud traditional roots, a system that, despite its imperfections, served us with remarkable effectiveness, for the better part of the past two centuries—a free enterprise system based on open markets and private ownership, and on trusting and being trusted. *The system worked*. Or at least it *did* work. And then, as I write in *The Battle,* "Something went profoundly wrong, fundamentally and pervasively, in corporate America.

At the root of the problem, in the broadest sense, was the societal change aptly described by these words from the teacher Joseph Campbell: 'In medieval times, as you approached the city, your eye was taken by the Cathedral. Today, it's the towers of commerce. It's business, business, business.' We had become what Campbell called a 'bottom-line society.' But at least in my view, our society came to measure the *wrong* bottom line: form over substance, prestige over virtue, money over achievement, charisma over character, the ephemeral over the enduring, even mammon over God."

It's all too easy for you in our younger generation to look at capitalism as a money-grubbing system in which greedy businessmen, investment bankers, and money managers of hedge funds and mutual funds alike garner unfathomable wealth at the expense of the average citizen who does the nation's work and does it with neither complaint nor the hope of outsized rewards. And while there is some truth to that—indeed, in the book I express great concern about our two-tier society divided (and hardly evenly) between "haves" and "have nots"—let us not forget that it was the flourishing of true capitalism two centuries ago that has been importantly responsible for the plenty we enjoy in the modern era.

"A Pathological Mutation"

But something *has* gone wrong in the capitalist system itself. It is well-described by journalist William Pfaff as a "pathological mutation" from the classic system, *owners'* capitalism—based on 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, Pfaff wrote, "the corporation came to be run to profit its managers, in complicity if not conspiracy with accountants and the managers of other corporations." Why did it happen? "Because the markets had so diffused corporate ownership *that no responsible owner exists*. This is morally unacceptable, but also a corruption of capitalism itself." And so it is.

Once an "ownership society" in which direct owners of stock held voting control over corporate America, we have become an "agency society," and we are not going back. For direct ownership has given way to ownership by financial institutions, largely mutual funds and pension funds. But the managers of these giant investment pools—agents, whose duty is to represent the interest of the pension beneficiaries and owners of mutual fund shares who are their principals—have too often put their own interests first, consuming far too large a portion of whatever returns our corporations and our financial markets were generous enough to provide, with far too small a portion of these returns delivered to the last-line investors who put up all of the capital and assumed all of the risks.

An Ancient Thesis

It is a curious fact that my new book echoes in so many ways the principles that I set forth in my senior thesis at Princeton University in 1951. That thesis—and all that followed—depended on an incredible stroke of luck. In December 1949, in Princeton's Firestone Library, I happened upon the year-end issue of *Fortune* magazine and learned for the first time that something called "the mutual fund industry" existed. When I saw the industry described in the article as "tiny but contentious," I knew immediately that I had found my thesis topic. Completed in the early spring of 1951, it was entitled "The Economic Role of the Investment Company."

Read today, my thesis would probably impress you as no more than workmanlike, perhaps a bit callow, but above all, shamelessly idealistic. On page after page, my youthful idealism speaks out, calling again and again for the primacy of the interests of the owner of mutual fund shares. "*The prime responsibility (of fund managers) must always be to their shareholders.*" And the deal must be fair: "there is some indication that costs are too high," and that "future industry growth can be maximized by concentration on a reduction of sales charges and management fees."

After analyzing fund performance, I concluded that "*funds can make no claim to superiority over the market averages*," perhaps an early harbinger of my decision to create, nearly a quarter-century later, the world's first index mutual fund. And in my conclusion, I powerfully reaffirmed the ideals that I hold to this day: The role of the mutual fund is to *serve*—"to serve the needs of both individual and institutional investors . . . to serve them in the most *efficient, honest*, and *economical* way possible . . . *The principal function of investment companies is the management of their investment portfolios. Everything else is incidental.*"

While all of this gratuitous advice from a callow college senior was, alas, largely ignored by the fund industry, the creation of Vanguard as a truly *mutual* mutual fund group—operated on an "at-cost" basis for the benefit of its owners rather than its managers—was my attempt to walk the walk that I talked the talk about all those years ago. Today, I assure you that my youthful idealism remains intact. Indeed, it is shamelessly reflected not only in Vanguard, but in my *Battle* book, an expression of my concern about our American society today, my conviction that our system of capital formation is essential to our economic growth and world leadership, and my acknowledgement that much has gone wrong in that system.

Let's consider just nine quick examples—three each from corporate America, investment America, and mutual fund America—that reflect the negative consequences of this change in capitalism.

In Corporate America:

- **One is the staggering increase in managers' compensation**. CEO pay has risen from 42 times the compensation of the average worker in 1980 to 340 times currently, a 756 percent rise after inflation, while the real income of the average worker has barely kept pace with the cost of living. Long ago, Herbert Hoover, one of our few businessmen to serve as president, put it well: "The only trouble with capitalism is capitalists. They're too darn greedy." Imagine what he'd say today.

- **Two, the rise of financial engineering**. Today, corporate earnings are too often managed to meet the "guidance" that our corporate executives give to Wall Street, quarter by quarter. Two of the worst examples: (1) mergers that are made, not with a sound business rationale, but because of the consequent opportunity to create a veritable "cookie jar" of reserves, to be drawn on at will in order to present a rosy, but false, picture of corporate growth; and (2) arbitrarily raising the assumptions for *future* returns on corporate pension plans, even as prospective returns eroded. That's actually legal; the problem in our system isn't what's illegal, it's what's legal. In any event, we now have a dramatic shortfall between pension plan assets and the future liabilities to provide promised benefits to our retirees—our next national financial scandal.

- **Three, the failure of our traditional gatekeepers.** Our once-independent auditors, providing highly profitable consulting activities—a serious conflict of interest—became partners of management, and relaxed traditional professional standards. Lobbied intensively (and expensively!) by our corporations, regulators and legislators also ignored the public interest. And corporate directors failed to provide the necessary "adult supervision of these geniuses" who managed the firms.

In Investment America:

- **One, the vanishing ownership society.** Almost unobserved, direct holdings of stocks by individual investors have plummeted from 92 percent of all stocks in 1950 to only 32 percent today, as corporate control fell into the hands of giant financial institutions—largely pension funds and mutual funds—whose share soared to 68 percent of all stocks, a virtual revolution in ownership. An agency society has replaced our old ownership society, which is never going to return. But the new agency society is failing us. Beset by conflicts of interest, our agents have placed their own interests ahead of—the interests of their principals—our pension beneficiaries and fund owners passively ignoring the need for good corporate governance and allowing the managers to look primarily to their own interests.

- **Two, the rise of short-termism**. Part of this failure came because institutional money management, once an *own-a-stock* industry (holding an average stock for six years during my first 15 years in this field) became a *rent-a-stock* industry, now holding a typical stock for but a single year, or even less. While as *investors*, owners *must* honor the rights and exercise the responsibilities of corporate governance responsibilities. But *speculators*, renters who merely trade stocks, could hardly care less. If the owners of corporate America don't give a darn about the triumph of managers' capitalism, who on earth should?

- **Three, the triumph of illusion over reality.** Our professional security analysts came to focus far more heavily on *illusion*—the momentary precision of the price of the stock—and increasingly ignored the *reality*—that what really matters is the inevitably vague, but eternally transcendent, intrinsic value of the corporation. Measuring up, unfortunately, to Oscar Wilde's wonderful description of the cynic, our money managers came "to know the price of *everything*, but the value of *nothing*." When there is a gap between perception—illusion—and reality, it is, to state the obvious, only a matter of time until the gap is reconciled—inevitably, in favor of reality.

In Mutual Fund America:

- **One, the industry changed**. Mutual funds, once a profession with elements of a business, gradually became a business with elements of a profession. Our traditional guiding star of *stewardship* was replaced by a new star—*salesmanship*. Largely focused on *management* when I wrote my Princeton thesis about the industry, our predominant focus today is on *marketing*—increasing fee revenues by building up assets under management, often by creating, promoting, and advertising speculative funds that meet the fads and fashions of the day, at great cost to our fund investors.

- **Two, the conglomerates take over**. When I entered this field all those years ago, virtually 100 percent of mutual fund management companies were *privately*-held firms, relatively small, and managed by investment professionals. Since then, they have experienced their own pathological mutation. Today, the vast majority of our largest fund management companies are owned by giant financial conglomerates, managed by businessmen bereft of professional investment training. These conglomerates are in the fund business to earn a return on *their* capital, not a return on *your* (the fund investor's) capital. They cannot do justice to both, for the record is clear that the more the managers *take*, the less the investors *make.*

- **Three, mutual fund returns fall drastically short of market returns,** by almost exactly the amount of the costs they incurred—all those management fees, operating expenses, sales charges, and hidden portfolio transaction costs. How could it be otherwise? Over the past two decades, for example, the annual return of the average equity *fund* (10 percent) has lagged the return of the S&P 500 Index (13 percent) by three percentage points per year, largely because of those pesky fund costs.

  A return of 10% in a 13% market is a shocking gap, but the reality is far worse. When compounded over this grand 20-year era for investing, and adjusted for inflation and taxes, the average investor has captured only 34 percent of the market's compounded real profit. I'm not kidding! $1,000 initially invested in a simple index fund mimicking the Standard & Poor's 500 Stock Index produced a net profit, after inflation, of $4,500. (Hooray for the *magic* of compounding *returns*!) But for the average fund investor, the real profit came to just $1,550, one-third as much. (Boo for the *tyranny* of compounding *costs*!) No wonder that David Swensen, the integrity-laden and remarkably successful manager of the Yale endowment fund, characterizes such a shortfall as "the colossal failure of the mutual fund industry." Jack Meyer of Harvard puts it even more strongly. "The investment business is a giant scam."

Where is the Public Discourse?

It must seem obvious to you that there is an urgent need to face up to these and other failures in the changing world of capitalism. But despite the contentious nature of the issues I've just described—broadly reflecting the triumph of the powerful economic interests of the oligarchs of American business and finance over the interests of our nation's 100 million investors—it is remarkable that so little public discourse has been in evidence. In the investment community, I have seen no defense of the inadequate returns delivered by mutual funds to investors, nor of the industry's truly bizarre, counterproductive ownership structure; no attempt by institutions to explain why the rights of ownership that one would think are implicit in holding shares of stock remain largely unexercised; no serious criticism of the virtually unrecognized turn away from the once-conventional and pervasive investment strategies that relied on the wisdom of long-term investing, toward strategies that increasingly rely on the folly of short-term speculation; and, until recent weeks, almost no discussion of the profound problems we are facing in our systems of retirement plan funding. If my book helps to open the door to the introspection by our corporate and financial leaders that is so long overdue, and then corrective action, perhaps the needed changes will be hastened.

This process must begin with a return to the original values of capitalism, to that virtuous circle of integrity—"trusting and being trusted"—as I mentioned at the outset. When ethical values go out the window and service to those whom we are duty-bound to serve is superseded by service to self, the whole idea of the capitalism that has been a moving force in the creation of our society's abundance is soured. In the era that lies ahead, the trusted businessman, the prudent fiduciary, and the honest steward must again be the paradigms of our great American enterprises. It won't be easy, but if we all work long enough and hard enough at the task, we can build, out of a long-gone ownership society and a failed agency society a "fiduciary society," one in which the citizen-investors of America will at last receive the fair shake they have always deserved from our corporations, our investment system, and our mutual fund industry.

Capitalism and Values

The idea that ethical values and service to the community of investors should be intimately embedded in the practices of business, as you may recall, was also an important underlying theme of my idealistic thesis of 54 years ago. That old idealism remains with me intact—heck, it is even stronger!—today. So I'll now turn to some thoughts on what business careers should be all about, and on the meaning of success. I hope that my reflections will be especially helpful to you students as you begin to consider your role in this opportunity-rife, risk-ridden modern world, and what contribution you can make to mankind. I turn these ideas as a good preacher should, with an anecdote.

The Reverend Fred Craddock, a remarkable preacher from Georgia, may have been imagining things—the way preachers are wont to do—but he says this story really happened. Dr.

Craddock was visiting in the home of his niece. There was this old greyhound dog there, just like the ones who race around a track chasing those mechanical rabbits. His niece had taken the dog in to prevent it from being destroyed because its racing days were over.

Here's how Dr. Craddock recounts the conversation. "I said to the dog, are you still racing?" "No," he replied. "Well, what's the matter? Did you get too old to race?" "No, I still had some race in me." "Well, what then? Did you not win?" "I won over a million dollars for my owner." "Well, what was it? Bad treatment?" "Oh, no," the dog said, "they treated us royally when we were racing." "Did you get crippled?" "No." "Then why?", Craddock pressed, "Why?" The dog answered, "I quit." "You quit?" "Yes," he said, "I *quit*." "Why did you quit?" At last, the reason: "I just quit. Because after all that running and running and running, I found out that the rabbit I was chasing wasn't even real."

While I've received more accolades than I could ever deserve during these later years of my own long career, including the Honorary Degree Immaculata was kind enough to bestow on me, I must confess that even I challenge myself as to whether the rabbit *I've* been chasing is real. Like more careers than we'd like to imagine, mine has benefited from my being born at the right time; from having my education at Blair Academy and Princeton funded by the generous benefactions and job opportunities they offered me; and from receiving an amazing number of lucky breaks, including opening that *Fortune* magazine all those years ago and discovering the mutual fund industry, even opening a book of British naval history in 1974 and discovering Lord Nelson's flagship HMS Vanguard, which inspired the name of the firm I founded in 1974.

And I surely wouldn't be where I am today without the tutelage of a great mentor and father-figure (mutual fund pioneer Walter L. Morgan), and a score of other mentors in school, college, and business. What is more, through no doing of my own, I apparently inherited some genes that gave me more than my share of common sense, leading one of my detractors to comment that the only thing I've ever had going for me is "the uncanny ability to recognize the obvious."

And, of course, it all worked. *It had to!* But it never would have happened without good luck, remarkable mentors, and fortuitous timing. Yet many leaders who assure me, "I did it all by myself," must have received similar breaks, a claim that rings especially hollow when nearly every one of them has also received the *ultimate* blessing: Being born in the United States of

America. Now how on earth did they arrange that? The truth is that *none* of us do it all by ourselves.

What is Success?

I have little doubt, however, that our Vanguard crew and our clients believe that the rabbit I've been chasing in my career—essentially giving investors a fair shake in their quest to accumulate assets for a secure future—is real. And of course it *is*. So what's bothering me? Perhaps it comes down to how a friend, many years ago, defined "success"—a word that should be used sparingly, if at all, when talking about a human being's career—as consisting of wealth, power and fame. But those three attributes don't represent success. They represent the *fruits* of success, and I've seen enough of life to be absolutely sure that each one is a false, mechanical rabbit.

In business, I fear, too many think of defining *wealth* in terms of dollars and cents, rather than of family, friendships and contributions to society; of defining *fame* by newspaper headlines and television appearances, rather than in reputation among colleagues and contemporaries; and of defining power as power over the corporate purse and over the corporate persons, rather than the power of the intellect and moral power. I hope each of you will define your own success in these latter terms. But for you students, there's plenty of time for that later on in your lives. The point is to ask yourself whether you want to chase the illusory rabbit of *success*—defined by wealth, fame, and power—rather than the real rabbit of *meaning*—defined by integrity, virtue, and inner strength—heck, let's call it soul—doing our best with whatever talents that the Lord has been kind enough to endow us.

Think with me for a moment about those whom we can all agree *are* chasing real rabbits—teachers and scientists, sculptors and painters, historians and musicians, authors and poets, physicians and surgeons, jurists and true public servants, ministers and priests and rabbis. Perhaps they earn our respect because they do their good work knowing that accumulating great financial wealth in their endeavors is almost out of the question, that national or worldwide fame is rare, and that power—at least *temporal* power—is conspicuous by its absence.

But don't stop there. Let's think too about the humble folk of this life who do the world's work—farmers and carpenters, soldiers and firemen, plumbers and mechanics, computer programmers and train conductors, pilots and navigators, landscapers and stone masons, all of those who help us to live our lives in comfort. People who get up with the sun and do an honest day's work, usually with neither complaint nor hope of accolade; souls who are rarely rewarded with those elusive fruits of so-called success. Yet surely few of them need worry about whether the rabbit they chase is real. *Of course it is.*

The Unexamined Life?

But I'll bet they do worry! In the quiet of the evening and the sometime loneliness of the soul, many of those who shouldn't *need* to reflect on the value of hard work and a life well-lived doubtless do exactly that. But whether *they* do or not, surely *we* who have been blessed with what passes for success, and you who are gaining the education and social graces that are often deemed important ingredients of future success—we who by the blessings of our birth, our genes, our talents, our luck, and the help others have given us—deserve no such exemption. Everyone here this afternoon ought to heed Socrates' warning, "The unexamined life is not worth living."

We're all in the human race together—those of us who earn a reputation through our careers, those who undertake the nobler missions of life, and those humble souls who do the world's hard work, to say nothing of you here today who will be required to carry the torch for a new and better generation, and are preparing yourself for the task by taking maximum advantage of the first-class education that is here for the taking. Don't miss the opportunity you have been given. For every single one of us, the job begins with getting up in the morning, going through the day trying to make the world a better place—even better by a tiny amount—and as a result, entitled to enjoy a well-earned night's rest. Then, rather than chasing after that rabbit, finding that it's fake, and quitting in dismay, like the greyhound we met, let's just make sure that we chase the *real* rabbit of life, and then keep running, and running, and running, as hard as we possibly can.

Just what *is* that real rabbit? How could anyone possibly *know*? But I think it has something to do with using whatever talents God is generous enough to bestow on us, as best we flawed human beings can, to serve our fellow man. We could do worse than honor William Penn's timeless words:

> *I expect to pass through this world but once. Any good therefore, that I can do, or any kindness I can show to any fellow creature, let me do it now. Let me not defer or neglect it, for I shall not pass this way again.*

Modern-day capitalism, alas, has strayed far from that noble creed. I trust that you in the coming generation will take on the challenge that I urged in my opening words, "To begin the world anew." So, you young citizens, please never, never lose your idealism. And, to those of you at or approaching my age, don't you dare lose yours either. And if perchance you have lost it, get inspired by our new generation and find it once again. Now.