Corporate Governance and Mutual Fund Governance—Reflections at a Time of Crisis

Remarks by
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I'm deeply honored to set the keynote for this important conference, sponsored by one of the financial field's most distinguished organizations. The New York Society has been unfailing in its concern about governance issues, and its work has surely furthered the work of the Association for Investment Management and Research in building a climate of integrity, competence, and professionalism in this field. I'll take this opportunity to reflect on two distinct subjects: 1) The *appropriateness* of strong corporate governance, and its *value* as a positive force in company performance; and 2) the *potential* of mutual fund governance to become a positive force in shaping the long-term returns of individual funds.

These two fields are not as discrete as one might imagine. First, the laxity of mutual funds in observing their responsibilities of corporate citizenship played a major role in the transition from traditional *owners* capitalism to the *managers* capitalism that developed during the 1990s. Second, to state the obvious, these two fields are now linked by scandal. The collapse of Enron in October 2001 was quickly followed by one corporate scandal after another, which, like a virus in an epidemic, has now jumped over to the mutual fund industry. In both cases, of course, it's often alleged that the rottenness is attributable to "just a few bad apples." But the fact is that both the corporate barrel and the mutual fund barrel that hold all of those apples—good and bad alike—are themselves in need of some considerable repair.

There are important differences, too. While the owners of *corporate* America have almost limitless power to fix corporate governance—after all, the 100 largest financial institutions hold fully 56% of all U.S. stocks—the owners of *mutual fund* America are widely diffused among 95 million shareholders, with the 100 largest fund owners—usually trustees of pension and 401(k) plans—together holding only about 1% of all equity fund shares, bereft of any power whatsoever to fix mutual fund governance. Reflecting this difference, public policy at the corporate level should focus on giving owners both the motivation and the ability to improve governance, while at the mutual fund level policy should focus on creating a governance system that endows fund directors with both the motivation and the ability to serve the interests of fund owners.

And now a paradox. It is at least arguable that the laxity of funds in assuming any responsibility for the governance of the corporations in their portfolios is derived in part from the bizarre governance system under which they themselves operate. In the fund field, managers capitalism has been not only accepted, but institutionalized. The typical manager supplies every service that the fund requires to exist, appoints and pays its staff, initially selects its board of directors, names its own chairman as chairman of the fund's board, and essentially negotiates its own fees. Just as people who live in glass houses are well-advised not to throw stones, so mutual funds have been reluctant to demand that their portfolio companies meet standards that they fail to meet themselves.

Improving Corporate Governance

Absent the vigorous oversight of corporate shareholders, our society has relied on directors to do the job. Yet too many directors have failed to consider that their overriding responsibility was to represent, not the management, but the largely faceless, voiceless shareholders who elected them—failed, if you will, to honor the director's golden rule: "Behave as if the corporation you serve had a single absentee owner, and do your best to further his long-term interests in all proper ways." Indeed, those were the words used by Warren Buffett in his Berkshire-Hathaway Annual Report in 1993, a full decade ago. As a group, alas, our corporate directors have failed to measure up to that standard.

Two centuries ago, James Madison said, "if men were angels, government wouldn't be necessary." Today, I would echo that idea: *If chief executives were angels, corporate governance wouldn't be necessary*. Extending this analogy of political systems to corporate systems when I spoke to The Business Council earlier this year, I urged that we avoid corporate governance based on the *dictatorship* of the CEO. While *democracy* might not be possible, I suggested, at least we should establish a *republic,* with the elected representatives of the shareholders fully empowered to assure that the corporation held high their interests, above all competing claims. (The assembled group of CEOs, by and large, didn't seem to care for the analogy, and there was a rather heated response from the floor.)

The problem with corporate America, it seems increasingly clear, lies in the fact that 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, and that too many institutional intermediaries have failed to take them to task and demand that the interests of shareowners be served. I see no way to solve that problem other than by enabling shareowners to assert their obvious authority, and to have the primacy of their property interests honored. To do so, we need a governance system based on corporate democracy.

Corporate Democracy

Not everyone agrees! In a recent op-ed essay in *The Wall Street Journal*, Henry G. Manne, dean emeritus of the George Mason University School of Law, argued that "the theory of corporate democracy . . . has long been a standing joke among sophisticated finance economists." (He named no names.) "A corporation is not a small republic . . . and the board is not a legislature . . . the essence of individual shareholder participation is 'exit,' not 'voice' . . . 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. Such a "like it or lump it" rule, however—the so-called "Wall Street Rule"—must assume heavy responsibility for the corrosion of our capitalistic system. It doesn't seem a particularly enlightened approach to public policy.

Dean Manne seems to assume that all of those who are interested in embracing ownership rights are "special pleaders with no real stake, activists (whose) primary interest . . . is to facilitate publicity for their own special-interest programs . . . and to interfere with the property and contractual rights of others in order to achieve their own ends," and describes corporate democracy as a "form of corporate fraud." Though I'm confident that at least some corporate activists have agendas that might not comport with the public weal, it seems absurd to use such anecdotal speculation to bar serious long-term investors from making their will felt.

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? To compel management to function in the interest of all of its shareholders? To have a voice in how the executives of their company are compensated? Aren't these 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 20% owner, 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? Where does the proverbial shovel break? And does the argument that it *might* break when no single shareholder owns a large share position justify depriving that shareholder of the same rights? *Not for me it doesn't*. For I believe, after Churchill, that corporate democracy "is the worst form of government . . . except for all those others that have been tried from time to time."

Corporate Performance and Corporate Governance

It is a curious paradox that in my analogy of the governance of corporations to the governance of nations lies one solution to the passivity of most stockholders: *Force the owners of America's corporations to realize that there is a direct relationship between sound governance and corporate performance*. Indeed, a recent Harvard/Wharton paper on "Corporate Governance and Equity Prices"[1] cast precisely the same analogy:

> "Corporations are republics. The ultimate authority rests with the voters (shareholders). These voters elect representatives (directors) who delegate most decisions to bureaucrats (managers) . . . one extreme, which tilts toward democracy, reserves little power for management and allows shareholders to quickly and easily replace directors. The other extreme, which tilts toward dictatorship, reserves extensive power for management, and places strong restrictions on shareholders' ability to replace directors."

The issue is one of *shareholder rights*, and it is a substantive issue. The paper examines in detail the relationship between the financial performance of corporations that were relatively rigorous in restricting those rights during the decade of the 1990s (the "Dictatorship Portfolio"), and corporations that were relatively liberal in their defenses (the "Democracy Portfolio").

The paper examined 28 governance provisions, including classified boards, compensation plans, golden parachutes, indemnification, cumulative voting, supermajority, anti-greenmail, pension parachutes, and, of course, poison pills, ranking 1500 companies in terms of management power and shareholder rights and creating a Governance Index with ten deciles. The 10% of firms with the lowest management power and strongest rights were designated as the Democracy Portfolio, and the bottom 10% were designated as the Dictatorship Portfolio. The largest companies in the Democracy Portfolio in 1990, for example, included IBM, Wal-Mart, DuPont, American International Group, and Berkshire-Hathaway (with governance scores ranging from 2 to 5—low is good); the largest companies in the Dictatorship Portfolio included GTE, Waste Management, Limited, Kmart, and Time Warner (with scores running in the 14 to 16 range).

[1] By Professors Paul A. Gompers, Jay L. Ishim, and Andrew Metrick.

It's difficult in brief, and in layman's terms, to do justice to this complex landmark study. Not only are the numbers arbitrary and abstract, but the differences look kind of, well, small. But it turns out that they are important. Each one-point difference in the index was negatively associated with an 11.4 percentage point difference in Tobin's Q ratio (essentially the relationship of a company's market cap to its book value). Most importantly, during the decade of the 1990s stocks in the Democracy Portfolio outperformed those in the Dictatorship Portfolio by fully 8.5% per year—a truly staggering margin.

Although there was a clear link between superior returns and corporate cultures that respected shareholder rights and managements that were self-reliant enough to believe that the best defense against takeover was good operating results, the authors of the study do not argue that the relationship they found between governance and performance was causal. However, when their paper concludes that "the long-run benefit of eliminating (restrictive) provisions would be enormous," the authors are clearly on to something important. Investors[2] would be wise to focus on eliminating such provisions.

The Largest Firms in the Extreme Portfolios

"Democracy" Portfolio		"Dictatorship" Portfolio	
Firm	**Score**	**Firm**	**Score**
IBM	**5**	**GTE**	**14**
Wal-Mart	**5**	**Waste Management**	**15**
Du Pont	**5**	**General Re**	**14**
Pepsico	**4**	**Limited Inc.**	**14**
AIG	**5**	**NCR**	**14**
Southern Co.	**5**	**K Mart**	**14**
Hewlett Packard	**5**	**United Telecom.**	**14**
Berkshire Hathaway	**3**	**Time Warner**	**14**
Comm. Edison	**4**	**Rorer**	**16**
Texas Utilities	**2**	**Woolworth**	**14**

Source: "Corporate Governance and Equity Prices,"
***The Quarterly Journal of Economics*, 2/2003**

Corporate Performance—M&A and Executive Compensation

At least equally important, the record is clear that investors should take a tough and skeptical stance when companies propose mergers and acquisitions. A *Business Week* study reports that fully 61% of all mergers have been destructive of corporate value, a conclusion that comports with the consensus of the investment professionals with whom I've discussed it, as well as with a detailed study of mergers by Bernstein Research[3]:

1) Companies that have acquired other companies during the past decade turned in returns of 22.2% less than the S&P 500 Index during the first three years subsequent to the acquisition. The greatest negative returns from mergers and acquisitions accrued to companies financing them with stock. Acquisitions by growth companies were most destructive to shareholder value.

[2] I use the phase "investors" referring to all long-term shareholders. But I recognize that it is major institutional investors who have the real clout.
[3] *Bernstein Disciplined Strategies Monitor*, October 2003.

2) Based on a study of 12,023 acquisitions since 1980, public companies that paid *cash* for public companies produced returns of 5% more than the S&P Index. When they paid *stock* for public companies, their returns *lagged* by 9.6%. And when they bought private companies they did even worse, lagging the S&P by 17.8% if they paid cash, and by 34.8% when they used stock.

Suffice it to say that when mergers and acquisitions are proposed, before they decide how to vote, or whether to use their powers of moral suasion, investors who are paying attention ought to think about the lessons of history.

Performance of Acquirers vs. S&P 500

Year Before	Year After	Two Years After*	Three Years After*
+24.5%	-7.4%	-14.0%	-22.2%

Performance of Acquirers vs. S&P 500 for Following 3 years*, by Form of Payment

	Acquisition Type	
Form of Payment	Private Entity	Public Company
Equity	-34.8%	-9.6%
Cash	-17.8%	+5.0%

*Cumulative Returns
Source: Bernstein Research and NBER Working Paper No. 9523

The record is also clear that investors also have a big stake in executive compensation. A recent study[4] by Morgan Stanley's Steve Galbraith found that "one way (for CEOs) to rake in the dough has been to preside over a company with an underfunded pension plan, large layoffs, and mediocre stock performance." (While Mr. Galbraith does not argue causality, more extensive studies may well make just such a case.) Analyzing the 500 companies in the S&P Index, he found that the six companies whose CEOs who made more than $50 million(!) in 2002 provided average annualized returns in 2002-2003 YDT of *minus* 40%, compared to *plus* 1% for the remaining companies in the Index.

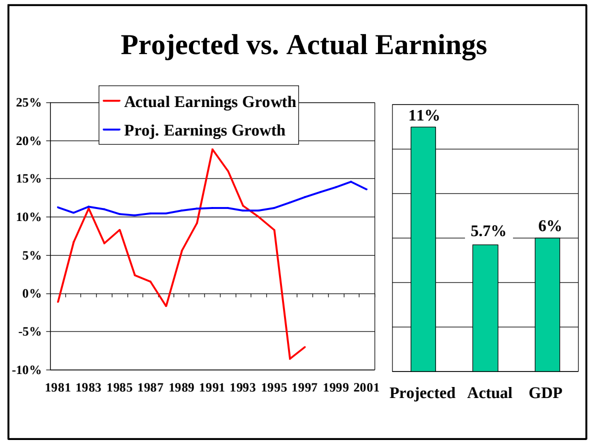
[4] "Compensatory Damage," October 20, 2003.

Mr. Galbraith argues, and I would agree, that "the root appeal of capitalism revolves around extraordinary reward potential for extraordinary performance, (but) what is less understandable are extraordinary compensation packages handed out for ordinary performance." Over the past twenty years, the average CEO projected annual earnings growth of 11% per year and delivered just 5.7%, even less than the 6% growth rate of our economy. Yet these seemingly failed executives (or terrible forecasters) were rewarded with increases that took their average annual compensation from $2 million to $11 million—an amazing failure of prudent governance by corporate directors. Again paraphrasing Churchill, "Never has so much been paid to so many for so little" in the way of accomplishment.

Paid for Performance?

CEO 2002 Compensation	# of CEO's	Median Tot. Return 2002 - 2003
>$50mm	6	-41.3%
$20 - $50mm	22	-2.0
$10 - $20mm	62	3.3
$5 - $10mm	92	6.4
$1 - $5mm	265	2.2
< $1mm	52	9.4

Source: The Board Analyst, Morgan Stanley Research



The weight of evidence demands that owners carefully consider the findings of these studies on shareholder rights, on mergers and acquisitions, and on executive compensation. Indeed, it's reasonable to ask: If the owners of corporations don't give a damn about corporate governance, who on earth should? I have no illusions about the limited utility of institutional owners getting involved in corporate *management* issues (we have hardly covered ourselves with glory running our own businesses!), but we owe it to our own fund investors and pension beneficiaries to get involved in corporate *governance* issues. It is high time institutional owners step up to the governance plate and begin to swing their potent bats.

Where are the Owners?

Why aren't we more active participants in corporate areas that are at once in our vital interest, within our competence, and surely within our mandate as owners? Answer, in Mr. Galbraith's words: "Corporate governance issues seem to be a direct by-product of the rent-a-stock culture that has taken over the U.S. equity market . . . Until investors act like owners rather than renters (or worse, squatters) the pay-for-performance debate"—and, I would add, the shareholder rights debate and the M&A debate—"will remain just that—a debate." As Benjamin Graham wrote years ago, "Stockholders are king . . . (but) the leading investment funds (are) missing a great opportunity for rendering service to the investing public . . . they can bend managements completely to their will . . . but unless prodded violently into action, they show neither intelligence nor alertness." Is it really too much to ask fund managers to be alert to governance issues, to use their intelligence, and to take action whenever the opportunity and need to act arises?

Alas, most mutual fund managers seem far more alert to improving their own financial welfare than the financial welfare of those who have entrusted them with their hard earned assets. They use far more energy, creativity and intelligence—and infinitely more resources!—in the development of clever and opportunistic marketing schemes than on fulfilling their duties as responsible corporate citizens. Gathering assets and maximizing advisory fees are the *sine qua non* of most management companies, and it is their quest for higher profits that must bear heavy responsibility for the illegal late-trading scandals, the unethical time-zone trading scandals, and (though it has received almost no attention) the heavy waste of investor resources engendered simply by creating opportunities for garden-variety market timing—too many investors moving too much money among too many funds at too fast a rate.

In 1949, when I first became involved (as it were) in this industry, its focus was on offering middle-of-the-road equity funds with broad diversification and low-cost to long-term investors. The idea was to *invest* for long-term *value*, and the average holding for a portfolio company was six-plus years. Today's industry is different. It is dominated by a new group of funds whose focus on narrow groups of stocks with particular investment characteristics (large companies or small, growth companies or value) and narrow market sectors (technology, energy, telecommunications, gold), and whose expense ratios, despite the industry's quantum growth, have more than *doubled*. Today, the idea is to *speculate* on short-term *price*—an eleven month holding period for the average stock. Partly as a result, corporate governance, an important activity for fund trustees in 1949, has almost vanished from our agenda.

Mutual Funds as Proxy Voters

Indeed, earlier this year the fund industry brought out its biggest guns to battle against a Securities & Exchange Commission proposal that had the temerity to require funds (the "agents") to tell their owners (the "principals") how *their* shares were voted in corporate proxies. Long-time rivals Fidelity and Vanguard joined together in expressing their opposition in a *Wall Street Journal* op-ed piece signed by their chairmen. ("Politics makes strange bedfellows.") Despite the opposition, the SEC stood its ground, and next year we'll know how each mutual fund voted each proxy.

I've often said that the requirement to disclose proxy votes will begin the process of giving mutual funds the *motivation* to become better corporate citizens. To its great credit, The Vanguard Group's management, following policies that it established in 2002, recently escalated the voting activity of its member funds. Press reports note that while the firm had previously "rubber-stamped" 90% of director slates, this year it ratified only 29% of the slates, "withholding votes from at least one nominee in an eye-popping 71% of the cases," and voting in favor of auditors for just 79% of firms, and in favor of only 36% of stock option plans.

But *motivation* in voting proxies is not enough. Institutional investors need both the *opportunity* and the *ability* to take action. Public policy should move in the direction of faciliting investor "access" to corporate proxies—allowing submission of proposals to eliminate governance restrictions, to accept or reject mergers, to set standards for executive compensation and stock options, and, for that matter, to establish dividend policy—legitimate issues all for substantial investors interested in enhancing the intrinsic value of the corporation. I would also add a federal preemption of state law, and take steps to preclude the obvious kinds of trouble-making foolishness by limiting such access to groups of investors who have held, say, at least 10% of shares outstanding for at least two years. I'd also allow director nominations on a similar basis, albeit bereft of the overbearing limitations proposed in the recent SEC release. "Power to the Long-Term Owners!" is a reform whose time has come.

But engaging in good corporate citizenship is hardly the only reform we need in order to force the mutual fund industry to measure up to its duty to its owners. Funds must measure up not only by *voting* their owners' interests, but also by *operating*, at all times and in every way, in those interests. If that sounds radical to you, I would remind you that the Investment Company Act of 1940 states that the national public interest requires that a mutual fund be "organized, operated, and managed" in the interests of its shareholders, rather than in the interests of its "directors, officers, investment advisors, and underwriters (distributors)."

Church and State

I'm not sure that *anyone* would argue that the industry's present *modus operandi* hasn't reversed those priorities. Again after Madison, "*if fund managers were angels, fund governance wouldn't be necessary*." The mutual fund industry has both a professional side (the fiduciary obligation to place the client first) and a business side (the managers' zeal to make money for themselves). In journalism, this distinction is called "church" and "state," and a similar distinction exists in medicine (patient care vs. profits), in auditing (consulting is "state"), and in the law. In each of these areas, the *state* hierarchy seems to gradually become more and more powerful, the *church* hierarchy less so. Public policy must seek to reverse that baneful trend.

The problem with mutual fund governance is that the fiduciary side of the business has *never* had a firm foundation upon which to rest, and has had to rely upon honorable intentions and a spirit of trusteeship. The relatively small group of professional managers of yore, operating *via* small corporations and private partnerships, has long since been supplanted by large management companies that are largely owned and controlled by giant global financial conglomerates. *Businesses?* You bet they are! And their goal is to maximize, to the last possible cent, the return on their investment in the management companies that they organize (or acquire), manage, and operate. If that isn't the diametrical opposite of the language of what the 1940 Act calls for, someone will have to tell me what is.

Restructuring the Industry

So, the management process of the fund management industry must change; indeed, perhaps the structure of the funds themselves must change. This is not a new subject for me. Hear these words from Chapter 19 ("On Structure") of *Common Sense on Mutual Funds*, which I wrote five years ago. If the fund industry's focus is to return to serving its shareholders as productively as humanly possible, "its future evolution will take one of two critical turns: a revision of the status quo that puts more power in the hands of shareholders, or a radical restructuring . . .

> "Putting power in the hands of fund shareholders will require . . . independent board members to become ferocious advocates for the rights and interests of those whom they represent . . . negotiating aggressively with the mutual fund adviser, allowing the management company to earn a fair profit, but recognizing that the interests of the mutual fund shareholders must always come first . . . insuring that fees paid for advisory services are no longer funneled into the adviser's marketing budget . . . demanding performance-related fees that enrich managers only as fund investors are themselves enriched by superior returns . . . challenging the use of 12b-1 distribution fees. Independent directors would no longer rubber-stamp gimmick funds that have been cooked up by marketing executives to attract attention in an increasingly crowed marketplace. In short, the independent directors would become the fiduciaries they are supposed to be under the law, and would aggressively represent the interests of the mutual fund shareholders. It would be quite an imposing bundle of improvements.
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> "A radical restructuring, on the other hand, would be the mutualization of at least part of the American mutual fund industry. Large fund families would run themselves . . . no longer

> contracting with external management companies to operate and manage the portfolios, but performing those functions in-house. Mutual fund shareholders would, in effect, own the management companies that oversee the fund. They would have their own officers and staff, and the huge profits now earned by external managers would be diverted to the shareholders. They wouldn't waste money on costly marketing campaigns designed to bring in new investors at the expense of existing investors. With lower costs, they would produce higher returns and/or assume lower risks . . . They might even see the merit of market index funds.
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> "Regardless of the exact structure, conventional or mutual, an arrangement in which fund shareholders and their directors are in working control of a fund—as distinct from one in which fund managers are in control—will lead to funds that truly serve the needs of their shareholders. Under either structure, the industry will enhance economic value for fund shareholders . . . seeking to provide investors with a higher share of the rewards of investing, reasonable prices, enhanced services, greater risk control, sensible product development, more index funds, and disciplined marketing efforts. (But) whatever the precise *modus operandi* of the mutual fund industry, strategy will follow structure. Function will follow form."

How Fund Reform Might Develop

What might prompt investors to demand a fairer shake? I asked. And answered:

> "Trial and error is one possibility. Investors who get badly burned by a long period of equity underperformance, or even (and much more memorably!) by a significant plunge in stock prices, will not soon return to the industry's fold. Investors buying hot funds, experimenting with market timing, and shopping and swapping funds with untoward frequency will one day learn, through painful experience, that these short-term approaches have been not only unproductive, but counterproductive." (Unless, of course, they could bet on the horse after the race was over!)

Whether by luck, or by grace, or by wisdom, the scenario I described in 1998 anticipated precisely what was about to happen: The market plunge; huge losses incurred by fund investors who bought hot "new economy" funds; the market timing scandals; and the corrosive effect of excessive fund costs—*all engendered by the near-absence of countervailing power held by the mutual funds vis a vis their managers*. What more do we need to convince ourselves that the time for the process of reforming fund governance is here?

At this moment, Congress is considering improving governance within the existing industry structure. I have recommended that we amend the Investment Company Act of 1940 to require an independent board chairman; to limit the fund's manager to a single board seat; to enable the board to retain its own staff to provide information that is independent and objective; and to require full disclosure of all compensation to senior executives and portfolio managers, including their participation in the management company's profits. We also need a requirement that *fund directors have a fiduciary duty* to carry out the noble purpose of the 1940 Act's preamble: Mutual funds must be "organized, operated, and managed" in the interests of fund shareholders, rather than in the interests of fund "directors, officers, investment advisers, underwriters, and distributors."

We also need legislation, as Senator Peter Fitzgerald has suggested, to facilitate the conversion of existing fund organizations to mutualized status. Of course, if mutuality had been required when the industry was born in 1924, today's industry would likely be a mere shadow of itself. While investment managers and entrepreneurs created mutual funds with the idea of serving investors, they surely sought to make money for themselves. Until 1958, the *earnings* of the companies they created were their *only* source of profit, for the SEC held that, as the sale of a fiduciary office, the sale of a management company's shares was prohibited under existing law. When the Supreme Court failed to uphold that position, the walls that precluded public ownership came tumbling down. Today, among the industry's 50 largest firms, only seven private firms remain. Seven are publicly held, and 36 are owned by giant financial conglomerates who dictate how the funds are to be run.

Of course funds cannot be born by themselves. Like babies, they require parents, who nurture them as they grow and become adults. But there is a point at which mutual funds, like children, grow up. They become perfectly able to operate on their own—for better or worse!—and to live independent lives without parental supervision. Yet while the earliest mutual funds reached their maturity in the late 1940s and 1950s, they remain (with Vanguard the sole exception) in the thrall of their parents. With the industry's oldest fund soon to celebrate its 80th birthday(!), hasn't the time for large, established fund groups to stand on their own long since arrived?

Catalysts for Change

What catalysts might be needed to create this change? One possibility is suggested by the series of events that precipitated the creation of Vanguard in the autumn of 1974: A great bear market; poor fund performance; overly-zealous marketing of overly-speculative funds; the prospect of large cost savings; and a board whose leader (in our case, the chairman of our Independent Director Group[5]) was willing to support a radical proposal by the person who had just been deposed as head of the management company, but continued to serve as chairman of the funds (that person happened to be me). And so the deed was done. "The Vanguard Experiment" in mutual fund governance has, I think, met expectations beyond the wildest dreams, not only of the skeptics, but of its advocates.

Today, which fund organizations might be facing circumstances that would call for a similar conversion? I am reluctant to name them, but I'll give some hints: Why not "Wisconsin"[6]? Why not "Wayne, PA"? Why not "Denver"? Why not "New York City"? But above all, why not "Boston," a firm whose recent circumstances reflect such remarkable parallels with those of the pre-Vanguard Vanguard funds?

Let's spend a moment on its numbers. In 2002, Boston, a wholly-owned subsidiary of a giant global insurance broker, managed $279 billion of assets—$164 billion in mutual funds and $115 million in pension and other separate accounts. During the preceding three years, its funds and clients paid the firm revenues totaling $7.7 billion. After expenses, stated as $5.6 billion, net income earned for the parent totaled $2.1 billion. Those expenses included incentive compensation paid to Boston's officers that surely totaled several hundreds of millions of dollars. (Payments to the fund firm's recently-terminated chief executive alone, including the value of option grants, totaled more than $100 million.) Clearly, that individual was highly paid because of his ability to make lots of money for the parent company. *And he did*—or at least his organization did. For the *parent's* owners, the *business* side of the firm was working beautifully..

What about the *trusteeship* side? How much value did the firm create for its *mutual fund* owners? In fact, the fund owners lost some $86 *billion*(!) during this period—not a very satisfactory

[5] The late Charles D. Root, Jr. whose remarkable service in the cause of mutualization deserves, not a mere footnote, but a full chapter, in industry history.

[6] These firms at these locations are among those whose behavior in the scandal was the most deplorable. I feel uncomfortable "naming names," although they will be obvious to even the causal observer.

return on the fund shareowners' investments of some $240 billion at the beginning of 2000, which had fallen to $139 billion by the end of 2002. To be sure, this was hardly a banner era for stocks, but only five of Boston's 55 mutual funds ranked in the first-quartile among their peers during the past three years, while 14 languished in the fourth quartile (including seven in the bottom *decile*).

Like the other four firms that I mentioned—all deeply involved in the scandals—Boston was an industry leader in the level of its costs. *High!* If its fund directors had taken the trouble to compare their expense ratios with those of "Valley Forge"—the industry's sole mutualized firm—they would have seen the Boston firm's expenses for managing $279 billion of fund and counsel assets in 2002 came to $2.17 billion, while the cost of managing Valley Forge's $551 billion in fund assets came to $1.47 billion—32% *less* cost for managing 97% *more* assets. In expense ratio terms, 1.32% for Boston, an amazing 372% higher than Valley Forge's 0.28%

If this combination of staggeringly high costs, aggressive marketing of speculative funds, large losses inflicted on fund owners, poor relative performance, immense compensation paid to executives, staggering profits channeled to Boston's absentee owners, scandalous behavior, and the opportunity for huge savings doesn't place "mutualization" at the top of the agenda for the next meeting of Boston's *fund* board, it's hard to imagine what would. And, if Boston adopts that mutual fund governance model, I'm sure others will follow. "Come on in, peers, the water's fine!"

"Boston" Management Company

	2002	2001	2000	Total
Revenue	**$2.1b**	**$2.4b**	**$3.2b**	**$7.7b**
Expenses	**1.6**	**1.8**	**2.2**	**5.6**
Op. Income	**$0.5b**	**$0.6b**	**$1.0b**	**$2.1b**

	Boston	Valley Forge	Difference
Counsel Assets	**$115b**	**- 0 -**	
Fund Assets	**164**	**$551b**	
Total Assets	**$279b**	**$551b**	**+97%**
Fees	**$2.17b**	**$1.47**	**-32%**

Wrapping Up

Sound corporate governance is one of the major issues of the day. No, it doesn't rank up there with Iraq, terrorism, and global security, nor with our fragile economy nor our burgeoning federal deficits. But make no mistake about it, governance is a vital issue not only for our business enterprises, but for our society. The system of owners capitalism that helped propel our nation to such high economic achievement has been subtly subverted by a system of managers capitalism, and it's high time we return the system to its proud roots. In *corporate* America, ownership is sufficiently concentrated among institutions to give them the real power to assure that companies will be governed in the interests of those who own them. All they need is the motivation and the ability to use that power.

In *mutual fund* America, however, ownership is so diffused that the only power that can assure that mutual funds will be governed in the interest of their owners lies in the hands of their directors. Today, however, directors possess neither the motivation nor the ability to make their impact felt. So we must either provide those directors with the independent ability and substance to carry out their fiduciary responsibilities or, at long last, foster the adoption by large, established fund groups of a truly mutual structure under which they can, of all things, organize, operate, and manage *themselves*.

In the title of my remarks, I described these governance issues as coming at a time of crisis. Well, it *is* a time of crisis. We *are* at a crossroads. We can take the risky route and move further toward *managers* capitalism. Or we can stand where we are. Or we can take the opportunity to march firmly in the direction of *owners* capitalism. The Chinese character for "crisis" is a combination of the character for *risk*, and the character for *opportunity*. If we understand only that, and act with only the common sense that the Lord gave us, we will act on this opportunity, and at last get the governance that the owners of our corporations and our mutual funds deserve.

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