Investment Wisdom and Human Values

A Lecture by

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I'm deeply honored to return to West Point, and to have the opportunity to discuss economic principles and the investment markets, and to the challenges to human values that today's version of capitalism presents to our society. Whenever I visit your magnificent campus, and observe you young men and women of the corps of cadets, my faith in America soars. I often find myself wishing that your timeless motto—"Duty, Honor, Country"—could somehow be spread to our nation's business leaders. The fact is that I'm deeply concerned about the deterioration of business values in American commerce and finance.[1]

In my new book, *The Battle for the Soul of Capitalism*, published by Yale University Press last November, I express the view that in the recent era, "the business and ethical standards of corporate America, of investment America, and of mutual fund America (the three principal elements of the book) have been gravely compromised." In each section, I discuss not only *what* went wrong, but *why* it went wrong, and *how* to go about fixing it.

Today's capitalism, I believe, has departed, not just in degree but in kind, from its proud traditional roots, a system that served us, admittedly imperfectly but 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, late in the twentieth century, something went wrong, a "pathological mutation in capitalism," in which 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—morphed into a new system—*managers'* capitalism, in which "the corporation came to be run to profit its managers, in complicity with accountants and the managers of other corporations. The change came in large measure because the markets had so diffused corporate ownership *that no responsible owner exists*—a corruption of capitalism itself."[2]

[1] Given the conduct of too many of our CEOs, they don't deserve the PMI (sleep-in privilege) that I understand your guest speakers are allowed to bestow. But I hereby bestow PMI to each of you this coming Monday.

[2] Quoting Journalist William Pfaff.

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

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. The move to an agency society has been massive and unrelenting. In 1950, direct individual owners of American business held 92 percent of all stocks, and institutional agents but 8 percent. Today, institutions own 68 percent of all stocks, and individuals just 32 percent. Averaging as it may seem, our 100 largest financial institutions—with 56 percent of all stocks—hold effective control of our corporations. While we have revolutionized our ownership structure, we have to change the rules of the game.

As a result, these agents—largely mutual fund managers and pension fund trustees—have failed to represent, first and foremost, their principals—pension beneficiaries and owners of mutual fund shares. Our corporate CEOs and our investment managers have consumed 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 have put up all of the capital and assumed all of the risks, with dire consequences. Let me explain by turning to the simple ABCs of investing.

Corporate America and Investment America

How does the performance of corporate America relate to the performance of investment America? It's essential to recognize that in the long run, it is *investment* returns—the earnings and dividends generated by American business—that create for the returns delivered in our stock market. As the legendary investor and author of *The Intelligent Investor* Benjamin Graham pointed out, "in the short run the stock market is a *voting* machine . . . (but) in the long run it is a *weighing* machine."

What the wise Mr. Graham is saying is that while the prices we pay for stocks often lose touch with the reality of corporate values, in the long run it is reality that rules. So please place no credence in the idea that the past is prologue to the future. To understand why the past cannot foretell the future, we need only heed the words of the great British economist John Maynard Keynes, written 70 years ago: "It is dangerous . . . to apply to the future inductive arguments based on past experience, unless one can distinguish the broad reasons why past experience was what it was."

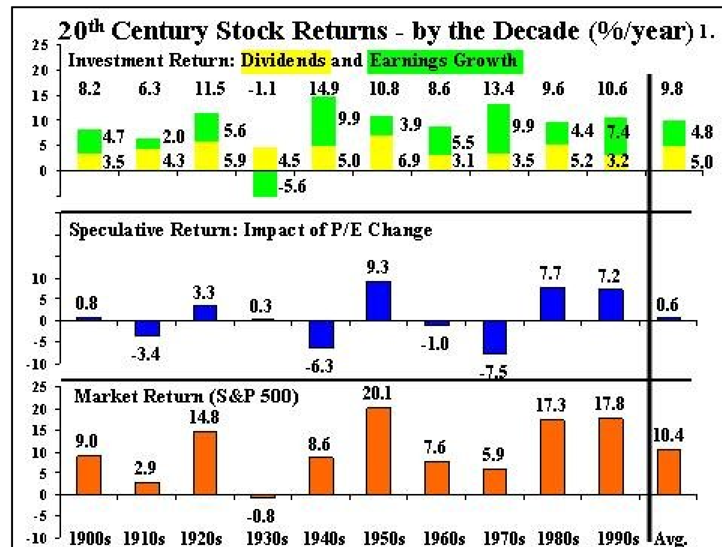
Only if we can distinguish the *reasons* why the past was what it was, then, can we establish reasonable expectations about the future. Keynes helped us make this distinction by pointing out that the state of long-term expectation for stocks is a combination of enterprise ("forecasting the prospective yield of assets over their whole life") and speculation ("forecasting the psychology of the market")[3]. I'm well familiar with those words, for 52 years ago I incorporated them in my senior thesis at Princeton, written, providentially for my lifetime career that followed, on "The Economic Role of the Investment Company," the title I chose for the thesis.

Investment Return and Speculative Returns

This dual nature of returns is clearly reflected in stock market history. Using Keynes' idea, I divide stock market returns into: 1) *Investment Return* (enterprise), consisting of the initial dividend yield on stocks plus their subsequent earnings growth, the essence of what we call "intrinsic value"; and 2) *Speculative Return*, the impact of charging price/earnings multiple on stock prices. **(Chart 1)** Let's start with the record of stocks during the twentieth century: Note first the steady contribution of dividend yields (the yellow bars) to total return during each decade; always positive, only once outside the range of 3 percent to 5 percent, and averaging 5.0 percent. Then note that the contribution of earnings growth (the green bars) to investment return was positive in every decade, with the exception of the depression-ridden 1930s, usually running between 4 percent and 7 percent, and averaging 4.8 percent per year. Result: Total *investment* returns (the top line combining dividend yield and earnings growth) were negative in

[3] Chapter 12 of *The General Theory of Employment, Interest, and Money*, John Maynard Keynes, 1936.

only a single decade (again, the 1930s), generally running in the range of 8% to 13% per year, and averaging 9.8 percent.

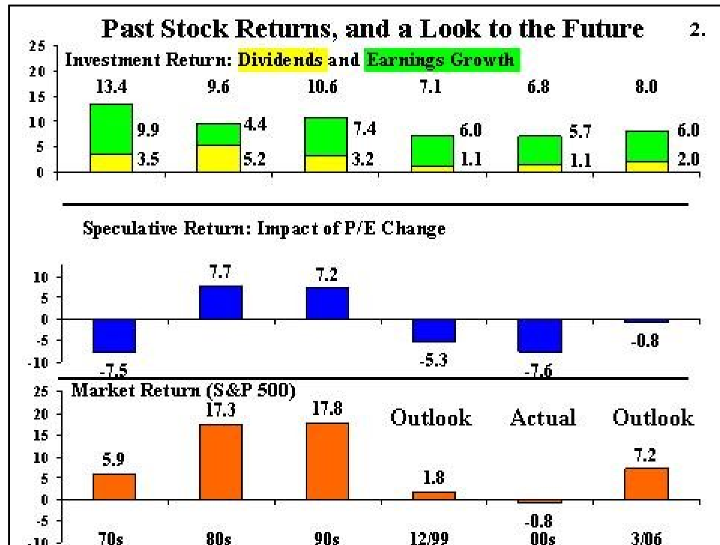


Enter *Speculative* Return: Compared with the relative consistency of dividends and earnings growth over the decades, truly wild variations in speculative return (blue bars) punctuate the chart as price-earnings ratios (P/Es) wax and wane. (A 100% rise in the P/E, from 10 to 20 times over a decade, for example, would equate to a 7.2% annual speculative return.) Curiously, without exception, every decade of significantly negative speculative return was immediately followed by a decade in which it turned positive by a correlative amount—the quiet 1910s and then the roaring 1920s, the dispiriting 1940s and then the booming 1950s, the discouraging 1970s and then the soaring 1980s—reversion to the mean (RTM) writ large. And then, amazingly, we see an unprecedented second consecutive exuberant increase in speculative return in the 1990s—a pattern never seen before. For the full century, however, the P/E multiple soared from 12.5 times to 30 times, adding 0.6 percent in annual return.

So as we look at the full 20th century, the average annual total return on stocks was 10.4 percent (orange bar)—an investment return of roughly 10 percent (5 percent from dividend yield and about 5 percent from earnings growth), and a speculative return of 0.6 percent. The message is clear: In the long run, stock returns depend almost entirely on the *reality* of the investment returns earned by *business*. The *perception* of *investors*, reflected by the speculative returns, counts for little. It is *economics* that controls long-term equity returns then; *emotions,* so dominant in the short-term, dissolve.

Returns in Retrospect, and in Prospect

In 1999, as the 20th century ended, if we simply had the Keynesian wisdom to consider the sources of past stock returns, we would have likely recognized a bubble that was about to burst. **(Chart 2)** First, the dividend yield—a known quantity—had fallen to an all-time low of 1.1%, virtually eliminating its power to drive future investment returns, and leaving the heavy lifting to earnings growth. (Right hand column) I picked 6% as a reasonable expectation for earnings growth in the coming decade, just a bit above the trendline. If so, investment return in the decade ahead would have come to 7.1%.



What about speculative return? Over the previous two decades, the market's P/E ratio had soared from seven times to 30.5 times, producing a 7.5 percentage point annual contribution to investment return. By 1999, the level of the P/E was more than double the century-long norm of 14.5 times. Even if one naively believed that "this time is different," and that such a stratospheric ratio would remain at that level, the future speculative return would be zero. But my guess was that the P/E ratio might drop to the neighborhood of 18 times—still above the norm—providing a negative speculative return of about 5 percent per year. Result: An expected average return on stocks in the 1999–2009 decade of less than 2 percent per year. Please be clear that I was *not* forecasting ten individual years each with returns of 2 percent; the stock market just doesn't behave that way. More likely, I said, was a 40 percent or 50 percent drop over a few years, followed by a return to more normal returns, say in the range of 9 percent annually.

Of course, while we may know *what* will happen in the market, we never know *when*. But in an April 6, 2000 speech, I threw caution to the winds: "So let me be clear. You can put me firmly for the camp of those who are deeply concerned that the stock market is all to likely to be riding for a painful fall—indeed a fall that may have begun as I began to write this speech ten days ago." And that's exactly what happened. The stock market promptly tumbled by precisely 50 percent to its low in October 2002, when it began its 80 percent subsequent recovery. A warning: a 50 percent drop followed by an 80 percent recovery does *not* net out to a 30 percent *gain*. In fact, the market today remains 10 percent *below* its peak. (Do the math!)

So far, my early guesses about the future look pretty good. Six years into the 1999-2009 decade, my projected investment return of 7.1 percent is running as 6.8 percent, barely "rounding error" for what's transpired; my speculative return of -5.3 percent was close to the actual of -7.6 percent; and my total return forecast (+1.8 vs. the actual return of -0.8 percent) still looks realistic.

Now let's set some reasonable expectations for what stocks might do in the next ten years. The dividend yield has nearly doubled, to 2 percent. Using the same 6 percent earnings growth assumption—hardly guaranteed!—the future *investment* return on stocks could be in the 8 percent range. Will *speculative* return add or detract from that figure? With P/Es now around 18 times (based on "normalized" operating earnings, which is a bit of a stretch), I'm dubious that we will get very much help from that source. I actually expect a little harm in the form of a slightly *lower* P/E a decade hence, a negative speculative return that might shave a point off the investment return. So reasonable expectations—seasoned, as always, with optimism—suggest a future return on stocks averaging perhaps seven percent per year. But please don't agree with me uncritically. Make your own forecast: Just add your own earnings growth estimate to today's 2 percent dividend yield, and take a guess at speculative

return. Then combine them. But never forget that it's unwise in the extreme to forecast stock returns without evaluating the broad forces that will shape them.

Let me reiterate the clear message: the *stock market's long-term returns are created by the fundamental investment returns achieved by American business.* If you don't believe me, listen to these words from Ben Graham's most eminent protégé, Warren Buffett. His firm, Berkshire Hathaway, is publicly held, and he regularly hammers home to his shareholders the message that he prefers its shares to trade at or around its intrinsic value—neither materially higher nor lower. He explains: "intrinsic value is the discounted value of the cash that can be taken out of the business during its remaining life . . . When the stock temporarily over-performs or under-performs the business, a limited number of shareholders—either sellers or buyers—receive out-sized benefits at the expense of those they trade with. *[But] over time, the aggregate gains made by Berkshire shareholders must of necessity match the business gains of the company."* Never forget this compelling refrain from one who knows what's important in investing. It's all about the intrinsic economics of business.

Who Earns the Stock Market's Returns?

But whatever returns the stock market is generous enough to deliver in the years ahead, please don't make the mistake of thinking that investors actually earn those returns. To explain why this is the case, we need only to understand the simple mathematics of investing: All investors as a group must necessarily earn precisely the market return, *but only before the costs of investing are deducted.* After subtracting all the costs of financial intermediation are deducted—all of those management fees, all of those transaction costs, all of those distribution costs, all of those marketing costs, all of those operating costs—the returns of investors must and will and do fall short of the market return by an amount precisely equal to the aggregate amount of those costs. In a market that returns 10 percent, we investors as a group earn 10 percent (Duh!), pay our financial intermediaries, and then pocket whatever remains.

Two conclusions: 1) *Beating the market before costs is a zero-sum game*; 2) *Beating the market after costs is a loser's game.* The returns earned by investors in the aggregate inevitably fall well short of the returns that are realized in our financial markets. How much do those costs come to? In equity mutual funds, management fees and operating expenses—the "expense ratio"—average about 1.5 percent per year of fund assets. **(Chart 3)** Add another 1 percent in portfolio turnover costs, and, say, another 0.5 percent in sales charges marketing expenses, and other small add-ons. Result: the total cost of equity fund ownership roughly doubles, to about 3% per year. So yes, *costs matter*. The great irony of investing, then, is not only that you don't get what you pay for. The reality is quite the opposite: You get precisely what you *don't* pay for. *So if you pay for nothing, you get everything.*

3.

Equity Fund Expenses

Expense Ratio	**1.5%**
Turnover Costs	**1.0**
Sales Charges	**0.5**
Total Expenses	**3.0%**

Let me illustrate this simple lesson with a wonderful quotation I came across a few years ago when I was re-reading *Other People's Money,* by Louis D. Brandeis, first published in 1914. Brandeis, later to become one of the most influential jurists in the history of the U.S. Supreme Court, railed against the oligarchs who a century ago controlled investment America and corporate America as well. He described their self-serving financial management and interlocking interests as, "trampling with impunity on laws human and divine, obsessed with the delusion that two plus two make five." He predicted (accurately, as it turned out) that the widespread speculation of that era would collapse, "*a victim of the relentless rules of humble arithmetic*." He then added this unattributed warning—I'm guessing it's from Sophocles—*"Remember, O Stranger, arithmetic is the first of the sciences, and the mother of safety."*

These quotations hit me like the proverbial ton of bricks. Why? Because the relentless rules of the arithmetic of investing are so obvious, and recognizing the obvious has, I think, been a major contributor to my career. Indeed, it's been said (by my detractors) that all I have going for me is "the uncanny ability to recognize the obvious." The curious irony, however, is that most people either seem to have difficulty recognizing what lies in plain sight, right before their eyes, or, perhaps even more pervasively, refuse to recognize the reality because it flies in the face of their deep-seated beliefs, their biases, and their own self-interest. Paraphrasing Upton Sinclair: "it's amazing how difficult it is for a man to understand something if he's paid a small fortune *not* to understand it." But only by facing the obvious realities of investing will the intelligent investor succeed.

How Much Do Costs Matter?

How much do costs matter? A ton! Indeed, fund costs have played the determinative role in explaining why, for example, during the quarter-century from 1980–2005, when the return on the stock market itself averaged 12.5 percent per year, the pre-tax return on the average mutual fund averaged just 10.0 percent. That 2.5 percent differential is about what one might have expected, given our 3% rough estimate of fund costs. (Never forget: Market return, minus cost, equals investor return.) Simply put, fund managers have arrogated to themselves an excessive share of the financial markets' returns, and have left fund investors with too small a share.

On first impression, that annual gap may not look large, but when compounded over 25 years it reaches really staggering proportions. In fact, $1000 invested in a simple S&P 500 Index Fund returned 12.3 percent per year during that period (the market return of 12.5 percent less costs of just 0.2 percent), growing by $17,080. By way of contrast, the average equity mutual fund's return of 10.0 percent grew that original $1000 by just $9,820, or little more than half as much (57 percent of the total).

But it gets worse for the equity funds. With all of their frantic portfolio turnover—trading stocks, essentially with one another, at a rate of 100 percent per year—the average actively-managed fund surrendered 1.8 percent of that annual return to taxes, bringing the after-tax return to 8.2 percent and reducing the compound cumulative profit to $6,170. If that sounds like a pretty good profit, just compare it with the after-tax profit with our 500 Index Fund, which has virtually no turnover. Its owners were subjected to income taxes of only 0.6 percent per year (on the divided income generated by the fund), with a net after-tax return of 11.7 percent. Result: a net profit of $14,820, or nearly two-and-one-half *times* the profit on the average managed fund.

And now a cold shower of financial reality. Let's make one final adjustment to our returns. So far, we've done all our measurements in *nominal* dollars, ignoring the fact that it is only *real* dollars—dollars that are adjusted to take inflation into account—that are available for us to spend. During the past 25 years, inflation averaged 3.3 percent, reducing the real after-tax return of the index fund to 8.4 percent, and the average fund to but 4.9 percent. Cumulative *real* profit after compounding on the original $1,000 investment: just $2,270 for the average actively-managed equity fund; $6,450 for the passively-managed index fund. **(Chart 4)** The average fund produced only about one-third of the profit earned by the market itself through the simple index fund, which was there for the taking. Dare I remind you yet again, fund

expenses and taxes matter! Indeed, they make the difference between investment success and investment failure.

Average Fund versus 500 Index Fund, 1980 - 2005 4.

	500 Index Fund		Avg. Fund		Fund % of Index Profit
	Rate	Profit on $1,000	Rate	Profit on $1,000	
Gross Return	12.5%	$17,920	12.5%	$17,920	100%
Fund Lag	-0.2		-2.5		
Pre-tax Return	12.3%	$17,080	10.0%*	$9,820	57%
Taxes	-0.6		-1.8		
After-tax Return	11.7%	$14,820	8.2%	$6,170	42%
Inflation	-3.3		-3.3		
Real Return	8.4%	$6,450	4.9%	$2,270	35%

*Lipper reported return reduced by 0.6% for estimated survivor bias and 0.3% for sales charges.

In short, the humble arithmetic of investing—the logical, inevitable, and unyielding penalty assessed by investment costs, excessive taxes, and rising living costs—devastates the returns that investors in mutual funds earn over time. Using Justice Brandeis's formulation, the mutual fund industry is obsessed with the delusion—and is foisting that delusion on investors—that a *nominal gross* return of 12 ½ percent per year in the stock market, minus fund expenses of 2.5 percent, minus taxes of 1.8 percent, and minus inflation of 3.3 percent, still equals a *real net* return of 12 ½ percent. *Well, to state the obvious, it doesn't!* And unless the fund industry changes, it will falter and finally fail, a victim, yes, of the relentless rules of humble arithmetic. Were he here at your Academy this evening, Justice Brandeis surely would have warned, *"Remember, O cadets, that arithmetic is the first of the sciences and the mother of safety."*

Your Retirement Account

These examples may seem like abstract numbers that have little meaning in your personal lives. But in fact they have great meaning. So let's heed Justice Brandeis's warning and do the arithmetic of what they might mean to each of you. A practical way to begin is to reflect for a moment on that $30,000 loan that each of you will be eligible for in your junior year. (The interest rate, as I understand it, is so low that you can't afford *not* to borrow the money.) Once you have it in the bank, what should you do with it? Well, you might consider investing a portion of it for your retirement. But there are many ways to do so, and you'll be absolutely amazed at the difference in how much money you can accumulate if only you invest that money wisely.

Let's assume you want to invest $8,000 of the total for your future needs. Let's further assume you expect to hold that capital until late in your working years, say, when you'll be about 60 years of age. Since the miracle of compounding means that, yes, time is money, let's see what happens during that period with four different alternatives, assuming that the stock market is generous enough to favor us with an average return of 8 percent per year.

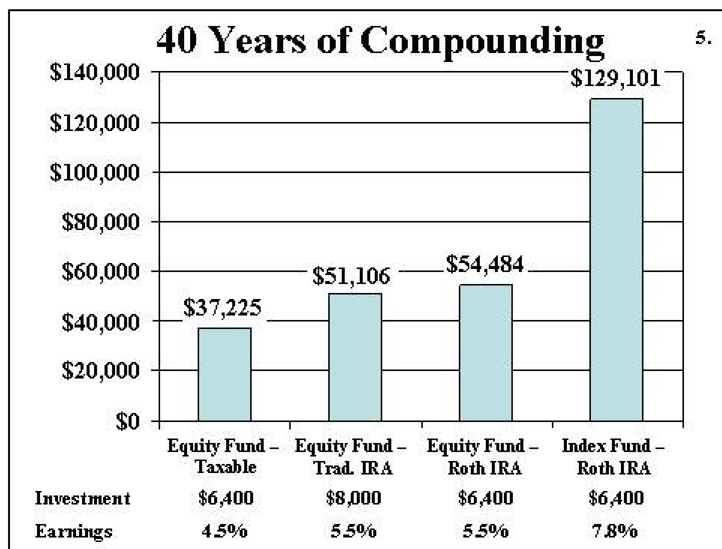
In the first example, just put aside $8,000. After federal and state income taxes of, say, $1,600, you'll have $6,400 to invest, and you choose a standard, garden-variety, actively-managed equity mutual fund, paying taxes on its dividend income and realized capital gains at an average tax rate of a little less than 20 percent of that total each year. Of course you'll pay that 2½ percent all-in fund cost and, say, 1

percent in taxes on the 5 ½ percent return that remains each year, a net return of 4 ½ percent. Result: At the end of 40 years, you will have accumulated $37,225, and pay taxes on the future returns it generates.

Now let's be smart. Why not put that $8,000 in a tax-deductible traditional Individual Retirement Account (IRA)—the $4,000 maximum in year one, and again in year two. In the IRA, your income and gains are tax-sheltered until retirement, so forty years hence your accumulation would total $68,106, subject (if withdrawn at once) to a 25 percent tax of about $17,000, reducing the total to $51,106, again with future income taxable to you.

Now let's be a little smarter. Choose a Roth IRA, where your *initial* contributions are not tax deductible, but all of your *future* income and gains, and all of the payments you later draw down are free of tax. You pay a $1,600 tax on the $8,000 and invest the $6,400 remaining in an actively-managed equity fund. Value forty years later: $54,484, with no future taxes to pay on your accumulated wealth: *tax-free* income for the rest of your life.

But now, recognizing the relentless rules of humble arithmetic, let's get *really* smart. You invest the $6,400 in the Roth IRA, but instead of using an expensive actively-managed mutual fund, you select a, well, cheap all-stock-market index fund that produces the 8 percent market return minus a cost of only 0.2 percent, leaving you with an effective after-tax return of 7.8 percent. Forty years later, a pleasant surprise awaits you. Your account is valued at $129,100—more than double any other alternative, and again, almost miraculously, no taxes on the future income it generates. **(Chart 5)**



To take advantage of the *miracle* of compounding *returns*, then, don't let the *tyranny* of compounding *costs* destroy your investment accumulation. Failing to invest any of your loan and spending it all with a sort of "here today, gone tomorrow" philosophy really is not a very wise strategy. (Heck, maybe even add $8,000 to the combination one-two punch of Roth IRA and Index fund for two *more* years, producing as much as a quarter of a million dollars!) But it's hard to see that any intelligent investor who understands the economic principles that are the foundation of the creation of stock market returns—earnings and dividends—and who also understands the relentless rules of humble arithmetic that are the foundation of a winning investment strategy would fail to choose the only investment program that is virtually guaranteed to provide you with your fair share of whatever returns the stock market is generous enough to bestow on us in the years ahead. It is indeed a "one-two" punch.

Not Bogle Alone

You'll just have to forgive my continuing enthusiasm for indexing and my unshakable conviction that low-cost index funds are the way. I don't get paid for my advocacy, but you could easily believe I'm biased by my good fortune in starting the first index mutual fund way back in 1974. So ignore my own importuning. But at least listen to Nobel Laureate Paul Samuelson of MIT, who called the creation of that first index fund as "the equivalent to the creation of the alphabet and the wheel." Or listen to Jack Meyer, the former manager of Harvard's incredibly successful endowment fund: "The investment business is a giant scam. Most people think they can find fund managers who can outperform, but most people are wrong. You should simply hold index funds. *No doubt about it*."

If that's not enough, listen to another brilliant endowment fund manager, David Swensen of Yale University, who describes "the colossal failure of the mutual fund industry; resulting from (its) systematic exploitation of individual investors . . . as funds extract enormous sums from investors in exchange for providing a shocking disservice . . . (as) excessive management fees take their toll, and (manager) profits dominate fiduciary responsibility. Or listen to one of the most successful mutual fund managers of all time, Fidelity Magellan Fund's Peter Lynch: "Most investors would be better off in an index fund."

If that's not enough, listen to Warren Buffett: "When the dumb investor realizes how dumb he is and buys a low-cost index fund, he becomes smarter than the smartest investors." And if all of *that* is not enough, listen to your teachers of economics, finance, and business here at the Academy. Ask them how *they* invest. And if you're *still* not persuaded, use your own common sense and calculate the benefits provided by the humble arithmetic of sensible investing. As you make your own decision, you owe that much to yourself.

Comparative Advantage or Community Advantage?

Now let me turn to the human values of the investment field, beginning with the stark difference between what I describe as "*comparative* advantage" and "*community* advantage." If the fund industry is to create greater wealth accumulation for investors—to create meaningful value for the future wealth of the human beings whom we are *honor* bound to serve, and to measure up to our *duty* to the citizens of our *country* (returning to the "duty, honor, country" theme that you all know so well)—we owe it to our shareholders to focus on the realities of stock market returns and the arithmetic of mutual fund investing. Yet our industry leaders continue to focus nearly all of their attention on the search for the Holy Grail of achieving superior performance for the shareholders of their own individual funds, seemingly ignoring the fact that all market participants as a group must earn average returns. Put another way, in terms of the returns we earn for our clients, we in the investment community are, and must be, average.

Here, I want to make a point about the difference between "comparative advantage" and "community advantage." As you observe from the coverage of the financial markets in the newspapers, the money magazines, and CNBC, you'll think it's all about comparative advantage—picking winning stocks, or capitalizing on a market inefficiency that improves performance relative to the stock market, or developing strategies that will enable a given manager to gain an edge over his or her rivals. Yet we ply our trade in what is essentially a closed market system, and we can't change whatever returns the markets are generous enough to bestow on us. So each dollar of advantage one investor gains in the market comes only at the direct one-dollar disadvantage of the other market participants. As a group, we are *inevitably* average.

Nonetheless, rare indeed are the individual fund managers who believe that they are only average. Nearly all believe that they can gain a sustained edge over the market. *But they can't all be right.* If the bell curve is a fact—and it is—so is the reality that most investment managers are going to be average. But in the world of money management, the picture is even darker. For we are average only before our

investment costs are deducted. After costs, as a group, managers are and must be losers to the market. Put another way, costs shift the entire bell curve of manager performance to the left.

But it is a rule of life that none of us want to be average, let alone doomed by arithmetic to providing below average returns. We all believe we're above-average drivers, above-average decision makers, above-average in intelligence, perhaps even above-average lovers. But, alas, we are not in the idyllic Eden known as Lake Wobegon, where everyone is above average. Competition to be the best is, up to a point at least, healthy, and our efforts to be the best, however fruitless in the aggregate, provide the transaction volumes that are required for liquidity and market efficiency. Yet, paradoxically, the closer we move to market efficiency, the closer we come to a world in which the returns earned by the smart (or lucky) managers move toward the average, and the returns earned by the dumb (or unlucky) managers move up toward the average. (It's called "reversion to the mean"—RTM—and it is everywhere!)

Realizing that the upshot of all our feverish investment activity is to advantage Peter only at the expense of Paul is doubtless vaguely painful to investment professionals, and we rarely acknowledge that fact to investors. Yet some of our best and brightest citizens continue to compete—arguably, ever more vigorously—in this game of comparative advantage that is inevitably a zero-sum game before costs and a loser's game after costs.

Warren Buffett's crusty but wise partner, Charlie Munger, shares my concern that in the field of money management, as far as the interests of clients are concerned, there can be no net value added, only value subtracted. Here's what he had to say about the commitment of so many exceptional people to the field of investment management:

> Most money-making activity contains profoundly antisocial effects . . . As high-cost modalities become ever more popular . . . the activity exacerbates the current harmful trend in which ever more of the nation's ethical young brain-power is attracted into lucrative money-management and its attendant modern frictions, as distinguished from work providing much more value to others..

Yet the participants in our investment system have it within their power to do exactly that—to create a community advantage that provides value to all those whom we serve. It won't be achieved, believe me, by suddenly having *all* fund managers providing returns so far above average that they offset the terrible drag of costs and taxes. *How could that possibly be?* It will be achieved *only* by slashing the costs of financial intermediation and reducing the overcapacity present in our investment business today in the form of, for example, the grossly excessive number of mutual funds, the enormous fees paid to their operators, and the staggering transaction costs engendered by our high levels of stock-trading activity.

Yet, if capitalism is to flourish, enriching the returns of all investors as a group must be a vital goal for our investment society. As I say in *The Battle* . . . the triumph of managers' capitalism over owners' capitalism in corporate America has been paralleled by an even greater triumph of managers' capitalism over owners' capitalism in investment America—the field of money management. So long as moneymaking activity simply shifts returns from the pedestrian to the brilliant or from the unlucky to the lucky or from those who naively trust the system to those who work at its margins, then *of course*, it has "profoundly antisocial effects." Only if we vigorously work to reduce system costs, thereby increasing investor returns while holding risk constant can we make capitalism work better for our stockowners. And wouldn't that create, well, profoundly *social* effects that are the diametrical opposite of today's *anti*-social effects that so concern Mr. Munger?

Wrapping Up

As I visit the Academy once again, and speak to you this evening, my mind keeps returning this stark contrast: On the one hand, your commitment to placing your own self-interest aside in favor of service to our great nation, especially during the deeply troubled times in which we live. On the other

hand, the commitment of so many of our corporate, investment, and mutual fund leaders to placing their own self-interest ahead of the stewardship we owe to those 100 million citizens who have entrusted their hard-earned assets to our financial markets. While the nation struggles with its finances, too many members of our financial community wallow in the gross excesses of modern life, often in ostentatious mansions, yachts and private jets made possible largely by a soaring stock market that seems totally unconcerned about the risks that abound today—terrorism, war, risky investments, staggering amounts of borrowed money in our private sector and public sector alike, and many more.

In the recent stock market bubble, we witnessed the culmination of an era in which our business corporations and our financial institutions, working in tacit harmony, corrupted the traditional nature of capitalism, shattering both confidence in the markets and the accumulated wealth of countless American families. Something went profoundly wrong, fundamentally and pervasively, in corporate America. At the root of the problem, in the broadest sense, was a 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, as I added, "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."

These words may seem strong, but I expressed the idea far more strongly two years ago in this self-explanatory letter to the editor of *The Wall Street Journal*:

> "After reading your article about the ($185 million) compensation package recently paid to Richard Grasso, President of the New York Stock Exchange, his blistering op-ed response, and your editorial—and whatever all that petty bickering suggests about sums so enormous that few Americans can even imagine them— I read Michael Phillips' moving front-page story about the selfless heroism of Cpl. Jason Dunham in Iraq. I lingered on his every word, every moment, every explosion, every turn for the worse, every hope for survival. And then the devastating news: At 4:43 PM on April 22, Marine Cpl. Jason L. Dunham died.
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> "Look, I'm just a businessman. And a Republican too. But I hope and pray that all of us who have basked in the glorious financial excesses of modern-day managers' capitalism will take a brief timeout from all of our getting and our self-important lives, get down on our knees, and say a prayer for those who have given—sadly, on our behalf—what Lincoln called "the last full measure of devotion."

I pray that none of you here today will be called upon to give that last full measure of devotion to the fine nation you proudly serve. But even after today's clouds have passed—as they will—I also hope you will join the millions of other young men and women of your generation who share your values and your commitment. As I say in my new book, dedicated to my twelve grandchildren (five of whom are your contemporaries): "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.'"