The Fiduciary Principle: *No Man Can Serve Two Masters*

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I write at a time of financial and economic crisis in our nation and around the globe. I venture to assert that when the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that 'a man cannot serve two masters.' No thinking man can believe that an economy built upon a business foundation can permanently endure without some loyalty to that principle. The separation of ownership from management, the development of the corporate structure so as to vest in small groups control over the resources of great numbers of small and uninformed investors, make imperative a fresh and active devotion to that principle if the modern world of business is to perform its proper function.

Yet those who serve nominally as trustees, but relieved, by clever legal devices, from the obligation to protect those whose interests they purport to represent, corporate officers and directors who award to themselves huge bonuses from corporate funds without the assent or even the knowledge of their stockholders … financial institutions which, in the infinite variety of their operations, consider only last, if at all, the interests of those who funds they command, suggest how far we have ignored the necessary implications of that principle. The loss and suffering inflicted on individuals, the harm done to a social order founded upon business and dependent upon its integrity, are incalculable.

Alas, the words in those two preceding paragraphs are not mine. Rather they are the words of Harlan Fiske Stone, excerpted from his 1934—yes, 1934—address at the University of Michigan Law School, reprinted in *The Harvard Law Review* later that year.[1] But his words are equally relevant—perhaps even more relevant—at this moment in history. They could hardly present a more appropriate analysis of the causes of the present-day collapse of our financial markets and the economic crisis now facing our nation and our world.

One could easily react to Justice Stone's words by falling back on the ancient aphorism, "the more things change, the more they remain the same," and move on to a new subject. But I hope financial professionals will react differently, and share my reaction: In the aftermath of that Great Depression and the stock market crash that accompanied it, we failed to take advantage of the opportunity to demand that those who lead our giant business and financial organizations—the stewards of so much of our nation's wealth—measure up to the stern and unyielding principles of fiduciary duty

described by Justice Stone. So, 75 years later, for heaven's sake, let's not make the same mistake again.

Justice Stone's stern words force us to fasten on ethical dilemmas faced by today's business leaders. Included among these leaders are the chiefs who manage our nation's publicly held corporations—today valued in the stock market at some $12 trillion—and the professional managers of "other people's money" who oversee equity investments valued at some $9 trillion of that total, owning 75% of all shares and therefore holding absolute voting control over those corporations. Like their counterparts in business, those powerful managers have not only an *ethical responsibility*, but a *fiduciary duty*, to those whose capital has been entrusted to their care.

FIDUCIARY DUTY

The concept of fiduciary duty has a long history, going back more or less eight centuries under English common law. Fiduciary duty is essentially a legal relationship of confidence or trust between two or more parties, most commonly a *fiduciary* or *trustee* and a *principal* or *beneficiary*, who justifiably reposes confidence, good faith, and reliance on his trustee. The fiduciary is expected to act at all times for the sole benefit and interests of the principal, with loyalty to those interests. A fiduciary must not put personal interests before that duty, and, importantly, must not be placed in a situation where his fiduciary duty to clients conflicts with a fiduciary duty to any other entity.

Way back in 1928, New York's Chief Justice Benjamin N. Cardozo put it well:

> Many forms of conduct permissible in a workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace … As to this there has developed a tradition that is unbending and inveterate … Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior … Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.[2]

It has been said, I think, accurately, that fiduciary duty is the highest duty known to the law.

It is less ironic than it is tragic that the concept of fiduciary duty seems far *less* imbedded in our society today than it was when Stone and Cardozo expressed their profound convictions. As ought to be obvious to all educated citizens, over the past few decades the balance between ethics and law, on the one hand, and the markets on the other have heavily shifted in favor of the markets. As I have often put it: We have moved from a society in which *there are some things that one simply does not do*, to one in which *if everyone else is doing it, I can do it too.* I've described this change as a shift from moral absolutism to moral relativism. Business ethics, it seems to me, has been a major casualty of that shift in our traditional societal values. You will hardly be surprised to learn that I do not regard that change as progress.

At least a few others share this view. In her book *Trust and Honesty*, published in 2006, Boston University Law School professor Tamar Frankel provides worthy insights on the diminishing role of fiduciary duty in our society. She is concerned—a concern that I suspect many investment professionals would share—that American culture has been moving toward dishonesty, deception, and abuse of trust, all of which have come to the fore in the present crisis. What we need, she argues, is "an effective way to increase trust (by) establishing trustworthy institutions and reliable systems," even as she despairs that the pressures brought out by the stock market and real estate bubbles have led to "deteriorating public morals … and burst into abuse of trust" (p. 99).

In Professor Frankel's view, "we reduced the power of morality in law … emasculated the regulation of trusted persons (that is, fiduciaries) … abused the laws that govern fiduciaries' honesty … and opened the door to enormous losses to the public and the economic system" (p. 119). We also came to ignore the critical distinction between fiduciary law itself and a fiduciary relationship subject to contract law. What's more, she writes, "the movement from professions to businesses was accompanied by changes in the way the law was interpreted" (p. 146). We forgot the fundamental principle expressed by the apostles Matthew and Luke,[3] and repeated by Justice Stone: "No man can serve two masters."

My principal objection to moral relativism is that it obfuscates and mitigates the obligations that we owe to society, and shifts the focus to the benefits accruing to the individual. Self-interest, unchecked, is a powerful force, but a force that, if it is to protect the interests of the community of all of our citizens, must ultimately be checked by society. The recent crisis—which I have described as "a crisis of *ethic* proportions"—makes it clear how serious that damage can become.

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CAUSES OF THE RECENT CRISIS

The causes of the recent crisis are manifold. Metaphorically speaking, the collapse in our financial system has 1,000 fathers: the cavalier attitude toward risk of our bankers and investment bankers in holding a toxic mix of low-quality securities on enormously leveraged balance sheets; the *lassiez faire* attitude of our federal regulators, reflected in their faith that "free competitive markets" would protect our society against excesses; the Congress, which rolled back legislative reforms dating back to the Depression years; "securitization" in which the traditional link between borrower and lender—under which lenders demanded evidence of the borrowers' ability to meet their financial obligations—was severed; and reckless financial innovation in which literally tens of trillions of dollars of derivative financial instruments (such as credit default swaps) were created, usually carrying stupefying levels of risk and unfathomable levels of complexity.

The radical increase in the power and position of the leaders of corporate America and the leaders of investment America has been a major contributor to these failures. Today's dominant institutional ownership position of 75% of the shares of our (largely giant) public corporations compares with only about 8% a half-century ago. This remarkable increase in ownership has placed these managers—largely of mutual funds (holding 25% of all shares), private pension funds (12%); government retirement funds (9%); insurance companies (8%); and hedge funds and endowment funds—in a position to exercise great power and influence over corporate America.

But they have failed to exercise their power. In fact, the agents of investment in America have failed to honor the responsibilities that they owe to their principals—the last-line individuals who have much of their capital wealth committed to stock ownership, including mutual fund shareowners and pension beneficiaries. The record is clear that, despite their controlling position, most institutions have failed to play an active role in board structure and governance, director elections, executive compensation, stock options, proxy proposals, dividend policy, and so on.

Given their forbearance as corporate citizens, these managers arguably played a major role in allowing the managers of our public corporations to exploit the advantages of their own agency, not only in executive compensation, perquisites, and mergers and acquisitions, but even in accepting the "financial engineering" that has come to permeate corporate financial statements, endorsed—at least tacitly—by their public accountants.

But the failures of our institutional investors go beyond governance issues to the very practice of their trade. These agents have also failed to provide the due diligence that our citizen/investors have every reason to expect of the investment professionals to whom they have entrusted their money. How could so many highly skilled, highly paid securities analysts and researchers have failed to question the toxic-filled leveraged balance sheets of Citicorp and other leading banks and investment banks and, lest we forget, AIG, as well as the ethics-skirting sales tactics of CountryWide Financial?[4] Even earlier, what were these professionals thinking when they ignored the shenanigans of "special purpose entities" at Enron and "cooking the books" at WorldCom?

THE ROLE OF INSTITUTIONAL MANAGERS

But the failure of our newly empowered agents to exercise their responsibilities to ownership is but a part of the problem we face. The field of institutional investment management—the field in which I've now plied my trade for more than 58 years—also played a major, if often overlooked, role. As a group, we veered off-course almost 180 degrees from stewardship to salesmanship, in which our focus turned away from prudent management and toward product marketing. We moved from a focus on long-term investment to a focus on short-term speculation. The driving dream of our advisor/agents was to gather ever-increasing assets under management, the better to build their advisory fees and profits, even as these policies came at the direct expense of the investor/principals whom, under traditional standards of trusteeship and fiduciary duty, they were duty-bound to serve.

Conflicts of interest are pervasive throughout the field of money management, albeit different in each sector. Private pension plans face one set of conflicts (i.e., minimizing plan contributions helps maximize a corporation's earnings), public pension plans another (i.e., political pressure to invest in pet projects of legislators). And labor union plans face yet another (i.e., pressure to employ money managers who are willing to "pay to play"). But it is in the mutual fund industry where the conflict between fiduciary duty to fund shareholder/clients often directly conflicts with the business interests of the fund manager.

Perhaps we shouldn't be surprised that our money managers act first in their own behalf. Indeed, as Vice

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Chancellor Leo E. Strine, Jr., of the Delaware Court of Chancery has observed, "It would be passing strange if ... professional money managers would, as a class, be less likely to exploit their agency than the managers of the corporations that make products and deliver services" [2007, p. 7]. In the fund industry—the largest of all financial intermediaries—that failure to serve the interests of fund shareholders has wide ramifications. Ironically, the failure has occurred despite the clear language of the Investment Company Act of 1940, which demands that "mutual funds should be organized, managed and operated in the best interests of their shareholders, rather than in the interests of (their) advisers."[5]

THE TRIUMPH OF SPECULATION OVER INVESTMENT

As control over corporate America moved from owners to agents, our institutional money managers seemed to forget their duty to act solely in the interest of their own principals, those whose savings were entrusted to mutual funds and whose retirement security was entrusted to pension plans. These new investor/agents not only forgot the interests of their *principals*, but also seemed to forget their own investment *principles*. The predominant focus of institutional investment strategy turned from the wisdom of long-term investing, based on the enduring creation of intrinsic corporate values, to the folly of short-term speculation, focused on the ephemeral prices of corporate stocks. The own-a-stock strategy of yore became the rent-a-stock strategy of today.

In what I've called "the happy conspiracy" between corporate managers, directors, accountants, investment bankers, and institutional owners and renters of stocks, all kinds of bizarre financial engineering took place. Management became the master of its own numbers, and our public accountants too often went along. Loose accounting standards made it possible to create, often out of thin air, what passes for earnings, even under GAAP standards. One good example—which is already sowing the seeds of yet another financial crisis that is now emerging—is hyping the assumed future returns earned by pension plans, even as rational expectations for future returns deteriorated.

Here, again, we can't say that we hadn't been warned well in advance. Speaking before the 1958 Convention of the National Federation of Financial Analysts Societies, Benjamin Graham, legendary investor and author of the classic *The Intelligent Investor*, described "some contrasting relationships between the present and the past in our underlying attitudes toward investment and speculation in common stocks" (p. 563). He further commented:

> In the past, the speculative elements of a common stock resided almost exclusively in the company itself; they were due to uncertainties, or fluctuating elements, or downright weaknesses in the industry, or the corporation's individual setup ... But in recent years a new and major element of speculation has been introduced into the common-stock arena from outside the companies. It comes from the attitude and viewpoint of the stock-buying public and their advisers—chiefly us security analysts. This attitude may be described in a phrase: primary emphasis upon future expectations ... The concept of future prospects, and particularly of continued growth in the future, invites the application of formulas out of higher mathematics to establish the present value of the favored issues. But the combination of precise formulas with highly imprecise assumptions can be used to establish, or rather to justify, practically any value one wished, however high ... Given the three ingredients of a) optimistic assumptions as to the rate of earnings growth, b) a sufficiently long projection of this growth into the future, and c) the miraculous workings of compound interest—lo! the security analyst is supplied with a new kind of philosopher's stone which can produce or justify any desired valuation for a really 'good stock.' Mathematics is ordinarily considered as producing precise and dependable results; but in the stock market the more elaborate and abstruse the mathematics the more uncertain and speculative are the conclusions we draw therefrom ... Whenever calculus is brought in, or higher algebra, you could take it as a warning signal that the operator was trying to substitute theory for experience, and usually also to give to speculation the deceptive guise of investment ... Have not investors and security analysts eaten of the tree of knowledge of good and evil prospects? By so doing have they not permanently expelled themselves from that Eden where promising common stocks at reasonable prices could be plucked off the bushes (pp. 563–572)?

This obvious reference to Original Sin reflected Graham's deep concern about quantifying the unquantifiable (and doing so with false precision). The implications of that bite into the apple of quantitative investing were barely visible when Graham spoke in 1958. But by

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the late 1990s, this new form of investment behavior had become a dominant force that continues to be a major driver of the speculation that has overwhelmed our financial markets.

Consider with me now how the erosion in the conduct, values, and ethics of business that I have described has been fostered by the profound—and largely unnoticed—change that has taken place in the nature of our financial markets. That change reflects two radically different views of what investing is all about, two distinct markets, if you will. One is the *real* market of intrinsic business value. The other is the *expectations* market of momentary stock prices. The British economist John Maynard Keynes [1964 (1936)] described this dichotomy as the distinction between *enterprise*—"forecasting the prospective yield of the asset over its whole life"—and *speculation*—"forecasting the psychology of the markets" (p. 155). Just as Keynes forecast, speculation came to overwhelm enterprise, the old ownership society became today's agency society, and the values of capitalism were seriously eroded.

It is little short of amazing how long ago these prescient warnings were issued. Justice Stone warned us in 1934. John Maynard Keynes warned us in 1936. Benjamin Graham warned us in 1958. Isn't it high time for us to heed the warnings of those three far-sighted intellectual giants? Isn't it high time we stand on their shoulders and shape national policy away from the moral relativism of peer conduct and greed and short-term speculation—gambling on expectations about stock prices? Isn't it high time to return to the moral absolutism of fiduciary duty, to return to our traditional ethic of long-term investment focused on building the intrinsic value of our corporations—prudence, due diligence, and active participation in corporate governance?

So, yes, now *is* time for reform. Today's agency society has ill-served the public interest. The failure of our money manager agents represents not only a failure of modern-day capitalism, but a failure of modern-day capitalists. As Lord Keynes warned us, "when enterprise becomes a mere bubble on a whirlpool of speculation, the job of capitalism will be ill-done" (p. 159). That is where we are today, and the consequences have not been pretty.

In all, our now-dominant money management sector has turned its focus away from the enduring nature of the intrinsic value of the goods and services created, produced, and distributed by our corporate businesses, and toward the ephemeral price of the corporation's stock—the triumph of perception over reality. We live in a world in which it is far easier to hype the price of a company's stock than it is to build the intrinsic value of the corporation itself. And we seem to have forgotten Benjamin Graham's [2003] implicit caution about the transience of short-term perception, compared to the durability of long-term reality: "In the short run, the stock market is a voting machine; in the long run it is a weighing machine" (p. 531).

THE MUTUAL FUND INDUSTRY

My strong statements regarding the failure of modern-day capitalism are manifested in grossly excessive executive compensation; financial engineering; earnings "guidance," with massive declines in valuations if it fails to be delivered; enormous, casino-like trading among institutional investors; staggering political influence, borne of huge campaign contributions; and, in the financial arena, bestowal of wealth to traders and managers that is totally disproportionate to the value they add to investors' wealth. Indeed, the financial sector actually subtracts value from our society.

Finance is what is known to economists as a rent-seeking enterprise, one in which our intermediaries—money managers, brokers, investment bankers—act as agents for parties on both sides of each transaction. Our intermediaries pit one party against another, so what would otherwise be a zero-sum game becomes a loser's game, simply because of the intermediation costs extracted by the various croupiers. (Other examples of rent-seekers include casinos, the legal system, and government. Think about it!)

I know something about how the financial system works, for I've been part of it for my entire 58-year career. The mutual fund industry—in which I've spent my entire career—is the paradigm of what's gone wrong with capitalism. Here are just a few examples of how far so many fund managers have departed from the basic fiduciary principle that "no man can serve two masters," despite the fact that the 1940 Act demands that the principal master must be the mutual fund shareholder:

1. The domination of fund boards by chairmen and chief executives who also serve as senior executives of the management companies that control the funds, an obvious conflict of interest and an abrogation of the fiduciary standard.
2. Focusing on short-term speculation over long-term investment, the ultimate triumph of expectations

investing over enterprise investing, resulting in great financial benefits to fund managers and brokers, and commensurately great costs to fund investors.

3. Failure to exercise adequate due diligence in the research and analysis of the securities selected for fund portfolios, enabling corporate managers to engage in various forms of earnings management and speculative behavior, largely unchecked by the professional investment community.
4. Failure to exercise the rights and assume the responsibilities of corporate ownership, generally ignoring issues of corporate governance and allowing corporate managers to place their own financial interests ahead of the interests of their shareowners.
5. Soaring fund expenses. As fund assets soared during the 1980s and 1990s, fund fees grew even faster, reflecting higher fee rates, as well as the failure of managers to adequately share the enormous economies of scale in managing money with fund shareholders. For example, the average expense ratio of the 10 largest funds of 1960 rose from 0.51% to 0.96% in 2008, an increase of 88%. (Wellington Fund was the only fund whose expense ratio declined; excluding Wellington, the increase was 104%.)
6. Charging fees to the mutual funds that managers control that are far higher than the fees charged in the competitive field of pension fund management. Three of the largest advisers, for example, charge an average fee rate of 0.08% of assets to their pension clients and 0.61% to their funds, resulting in annual fees of just $600,000 for the pension fund and $56 *million* for the comparable mutual fund, and presumably holding the same stocks in both portfolios (Bogle [2005, p. 199]).[6]
7. Diluting the value of fund shares held by long-term investors, by allowing hedge fund managers to engage in "time zone" trading. This vast near-industry-wide scandal came to light in 2003. It involved some 23 fund managers, including many of the largest firms in the field—in effect, a conspiracy between mutual fund managers and hedge fund managers to defraud regular fund shareholders.
8. Pay-to-play distribution agreements with brokers, in which fund advisers use *fund* brokerage commissions ("soft" dollars) to finance share distribution, which primarily benefits the *adviser*.
9. Spending enormous amounts on advertising—almost a half-billion dollars in the last two years alone—to bring in new fund investors, using money obtained from existing fund shareholders. Much of this spending was to promote exotic and untested "products" that have proved to have far more ephemeral marketing appeal than enduring investment integrity.
10. Lending securities that are the property of the *fund* portfolios, but siphoning off a portion of the profits from lending to the *adviser*.

Given such failures as these, doesn't Justice Stone's warning that I cited at the outset seem even *more* prescient? Let me repeat the key phrases: "The separation of ownership from management, … corporate structures that … vest in small groups control over the resources of great numbers of small and uninformed investors, … corporate officers and directors who award to themselves huge bonuses[,] … financial institutions which consider only last, if at all, the interests of those whose funds they command." Just as we ignored the fiduciary principle all those years ago, we have clearly continued to ignore it in the recent era. The result in both cases, using Justice Stone's words is "the loss and suffering inflicted on individuals, the harm done to a social order founded upon business and dependent upon its integrity, are incalculable." Today, as you know, much of that harm can be calculated all too easily, amounting to several trillions of dollars. So, this time 'round, let's pay attention, and demand a return to fiduciary principles.

A PIECE OF HISTORY

While the overwhelming majority of financial institutions operate primarily in the interests of their agents and at the expense of their principals, not quite all do. So I now draw on my personal experiences in the mutual fund industry to give you one example of my own encounter with this issue. As far back as 38 years ago, I expressed profound concern about the nature and structure of the fund industry. Only three years later, my convictions led to action, and 35 years ago this September, I founded a firm designed, to the best of my ability, to honor the principles of fiduciary duty.

I expressed these principles when doing so was distinctly counter to my own self-interest. Speaking to my partners at Wellington in September 1971—1971!—I cited the very same words of Justice Stone with which I opened my remarks this evening. I then added:

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> I endorse that view, and at the same time reveal an ancient prejudice of mine: All things considered, absent a demonstration that the enterprise has substantial capital requirements that cannot be otherwise fulfilled, it is undesirable for professional enterprises to have public stockholders. This constraint is as applicable to money managers as it is to doctors, or lawyers, or accountants, or architects. In their cases, as in ours, it is hard to see what unique contribution public investors bring to the enterprise. They do not, as a rule, add capital; they do not add expertise; they do not contribute to the well-being of our clients. Indeed, it is possible to envision circumstances in which the pressure for earnings and earnings growth engendered by public ownership is antithetical to the responsible operation of a professional organization. Even though the field of money management has elements of both, there are, after all, differences between a business and a profession … [So we must ask ourselves this question]: if it is a burden to our fund and counsel clients to be served by a public enterprise, should this burden exist in perpetuity?

My candor may well have played a supporting role in my dismissal as chief executive of Wellington Management Company in January 1974. While it's a saga too complex to detail in this article, my being fired gave me the chance of a lifetime—the opportunity to create a new fiduciary-focused structure for our funds. I proposed just such a structure to the directors of the Wellington funds.[7] Wellington Management Company, of course, vigorously opposed my efforts.

Nonetheless, after months of study, the directors of the funds accepted my recommendation that we separate the activities of the funds themselves from their adviser and distributor, so that the funds could operate solely in the interests of our fund shareholders. Our new structure involved the creation of a new firm, The Vanguard Group of Investment Companies, owned by the funds, employing their own officers and staff, and operated on an at-cost basis, a truly *mutual* mutual fund firm.

While Vanguard began with a limited mandate—to provide only administrative services to the funds—I realized that, if we were to control our own destiny, we would also have to provide both investment advisory and marketing services to our funds. So, almost immediately after Vanguard's operations commenced in May 1975, we began our move to gain substantial control over these two essential functions. By year's end, we had created the world's first index mutual fund, run by Vanguard.

Then, early in 1977, we abandoned the supply-driven broker–dealer distribution system that had been operated by Wellington since 1928 in favor of a buyer-driven "no load" approach under our own direction. Later that year, we created the first-ever series of defined-maturity bond funds, segmented into short-, intermediate-, and long-term maturities, all focused on high investment quality. In 1981, Vanguard assumed responsibility for providing the investment advisory services to our new fixed-income funds as well as our established money market funds. (As you can imagine, none of these moves was without controversy!)

Since our formation in 1974, the assets of the Vanguard funds have grown from more than $1 billion to some $1 *trillion* currently, now the nation's largest manager of stock and bond mutual funds. Some 82% of that $1 trillion—$820 billion—is represented by passively managed index funds and "virtual" index funds tightly linked to various sectors of the fixed-income market. Some 25 external investment advisers serve our remaining (largely actively managed equity) funds, with Wellington Management advising by far the largest portion of those assets. Most of these funds have multiple advisers, the better to spread the risk of underperformance relative to their peers.

More than parenthetically, that long string of business decisions was made in a situation in which Vanguard's very existence was in doubt, because the Securities and Exchange Commission had initially refused to approve Vanguard's assumption of marketing and distribution responsibilities. But after a struggle lasting six (interminable!) years, the SEC reversed itself in February 1981. By unanimous vote, the Commission declared that

> [t]he Vanguard plan is consistent with the provisions, policies, and purposes of the [Investment Company Act of 1940]. It actually furthers the Act's objectives … enhances the funds' independence … benefits each fund within a reasonable range of fairness … [provides] substantial savings from advisory fee reductions [and] economies of scale … and promotes a healthy and viable mutual fund complex in which each fund can better prosper (p. 128).

A PRESCIENT SEC?

The SEC's words now seem prescient. With few exceptions, the Vanguard funds—and their shareholders—

have prospered. Measured by Morningstar's peer-based rating system (comparing each fund with other funds having distinctly comparable policies and objectives), Vanguard ranked first in performance among the 50 largest fund complexes (Bogle [2008, p. 14]).

Vanguard has also provided shareholders with substantial savings from advisory fee reductions and economies of scale, in fact, the lowest costs in the field. Last year, over all, our funds' aggregate operating expense ratio came to 0.20% of average assets, compared to 1.30% for the average mutual fund. That 1.1 percentage point saving, applied to $1 trillion of assets, now produces savings for our shareholders of some $11 billion annually. And, as the world of investing is at last beginning to understand, low costs are the single most reliable predictor of superior fund performance. As we read in Homer's *The Odyssey*, "fair dealing yields more profit in the end" (p. 421).

If you are willing to accept—based on these data—that Vanguard has achieved both *commercial* success (asset growth and market share) and *artistic* success (superior performance and low costs), you must wonder why, after 35 years of existence, *no* other firm has elected to emulate our shareholder-oriented structure. (A particularly ironic outcome, as I chose the name Vanguard in part because of its conventional definition as "*leader* in a new trend.") The answer, I think, can be expressed succinctly: under our at-cost structure, all of the profits go to the fund shareholders, not to the managers, resolving the transcendent conflict of interest of the mutual fund industry. In any event, the leader, as it were, has yet to find its first follower.

Vanguard represented my best effort to align the interests of fund investors and fund managers under established principles of fiduciary duty. I leave it to wiser—and surely more objective—heads than mine to evaluate whether or not I overstate or hyperbolize what we have accomplished. But I freely acknowledge that we owe our accomplishments to the three simple principles: the firm is 1) *structurally* correct (because we are owned by our fund investors); 2) *mathematically* correct (because it is a tautology that the lower the costs incurred in investing, the higher the returns); and 3) *ethically* correct (because we exist only by earning far greater trust and loyalty from our shareholders than any of our peers). Measured by repeated evaluations of loyalty by independent research firms, there has been no close rival for our #1 position. Please be appropriately skeptical of that self-serving claim, but look at the data. In a 2007 survey, one such group concluded, "Vanguard Group generates far more loyalty than any other company" (Coleman [2007, p. C13]).[8]

TO BUILD THE FINANCIAL WORLD ANEW

Creating and restructuring Vanguard was no easy task. Without determination, expertise, luck, timing, and the key roles played by just a handful of individuals, it never could have happened. So when I suggest that we must now go beyond restructuring the nature and values of a single firm to restructuring the nature and values of the entire money management business—to build the financial world anew—I am well aware of how difficult it will be to accomplish that sweeping task.

And yet we dare not stand still.

> For we meet at a time when, as never before in the history of the country, our most cherished ideals and traditions are being subjected to searching criticism. The towering edifice of business and industry, which had become the dominating feature of the American social structure, has been shaken to its foundations by forces, the full significance of which we still can see but dimly. What had seemed the impregnable fortress of a boasted civilization has developed unsuspected weaknesses, and in consequence we are now engaged in the altogether wholesome task of critical re-examination of what our hands have reared (Stone [1934, pp. 1–2]).

As you may have suspected, I've once again cited a section of Justice Stone's 1934 speech, and it's high time we take it seriously. For the fact is that there has been a radical change in our investment system from the ownership society of a half-century ago—which is gone, never to return—to our agency society of today—in which our agents have failed to serve their principals—mutual fund shareholders, pension beneficiaries, and long-term investors. Rather the new system has served the agents themselves—our institutional managers.

Further, by their forbearance on governance issues, our money managers have also served the managers of corporate America. To make matters even worse, by turning to short-term speculation at the expense of long-term investment, the industry has also damaged the interests of the greater society, just as Lord Keynes warned.

Yet despite the extraordinary (and largely unrecognized) shift in the very nature of corporate ownership, we have failed to change the rules of the game. Indeed, in the financial sector we have rolled back most of the historic rules regulating our securities issuers, our exchanges, and our investment advisers. While we should have been improving regulatory oversight and adminis-

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tering existing regulations with increasing toughness, both have been relaxed, ignoring the new environment, and therefore bear much of the responsibility for today's crisis.

Of course American society is in a constant state of flux. It always has been, and it always will be. I've often pointed out that our nation began as an agricultural economy, became largely a manufacturing economy, then largely a service economy, and most recently an economy in which the financial services sector had become the dominant element. Such secular changes are not new, but they are always different, so enlightened responses are never easy to come by. Justice Stone [1934], once again, recognized that new forces demand new responses:

> It was in 1809 when Jefferson wrote: 'We are a rural farming people; we have little business and few manufactures among us, and I pray God it will be a long time before we have much of either.' Profound changes have come into American life since that sentence was penned. [These] inexorable economic forces, [create] public problems [that] involve an understanding of the new and complex economic forces we have created, their relationship to the lives of individuals in widely separated communities engaged in widely differing activities, and the adaptation to those forces of old conceptions developed in a different environment to meet different needs (p. 5).

To deal with the new and complex economic forces our failed agency society has created, of course we need a new paradigm: a fiduciary society in which the interest of investors comes first, and ethical behavior by our business and financial leaders represents the highest value.

BUILDING A FIDUCIARY SOCIETY

While the challenges of today are inevitably different from those of the past, the principles are age-old. Consider this warning from Adam Smith way back in the 18th century: "Managers of other people's money (rarely) watch over it with the same anxious vigilance with which … they watch over their own … [T]hey very easily give themselves a dispensation. Negligence and profusion must always prevail" [1776, p. 800].[9] And so in the recent era, negligence and profusion have prevailed among our money manager/agents, even to the point of an almost complete disregard of their duty and responsibility to their principals. Too few managers seem to display the "anxious vigilance" over other people's money that once defined the conduct of investment professionals.

So what we must do is develop a new *fiduciary* society to guarantee that our last-line owners—those mutual fund shareholders and pension fund beneficiaries whose savings are at stake—have their rights as investment principals protected. These rights must include:

1. The right to have money manager/agents act solely in their principals' behalf. The client, in short, must be king.
2. The right to rely on due diligence and high professional standards on the part of money managers and securities analysts who appraise securities for principals' portfolios.[10]
3. The assurance that agents will act as responsible corporate citizens, restoring to their principals the neglected rights of ownership of stocks, and demanding that corporate directors and managers meet their fiduciary duty to their own shareholders.
4. The right to demand some sort of discipline and integrity in the mutual funds and financial products that they offer.
5. The establishment of advisory fee structures that meet a "reasonableness" standard based not only on *rates* but *dollar amounts*, and their relationship to the fees and structures available to other clients of the manager.
6. The elimination of all conflicts of interest that could preclude the achievement of these goals.

More than parenthetically, I should note that this final provision would seem to preclude the ownership of money management firms by financial conglomerates, now the dominant form of organization in the mutual fund industry. Among today's 40 largest fund complexes, only 6 remain privately held. The remaining 34 include 13 firms whose shares are held directly by the public, and an astonishing total of 21 fund managers are owned or controlled by U.S. and international financial conglomerates—including Goldman Sachs, Bank of America, Deutsche Bank, ING, John Hancock, and Sun Life of Canada. Painful as such a separation might be, conglomerate ownership of money managers is the single most blatant violation of the principle that "no man can serve two masters."

Of course it will take federal government action to foster the creation of this new fiduciary society that I envision. Above all else, it must be unmistakable that government intends, and is capable of enforcing, standards of trusteeship and fiduciary duty under which money managers operate with the *sole* purpose and in the *exclusive*

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benefit of the interests of their beneficiaries—largely the owners of mutual fund shares and the beneficiaries of our pension plans. As corporate reformer Robert Monks [2002] accurately points out, "capitalism without owners will fail."

While government action is essential, however, the new system should be developed in concert with the private investment sector, an Alexander Hamilton-like sharing of the responsibilities in which the Congress establishes the fiduciary principle, and private enterprise establishes the practices that are required to observe it. This task of returning capitalism to its ultimate owners will take time, true enough. But the new reality—increasingly visible with each passing day—is that the concept of fiduciary duty is no longer merely an ideal to be debated. It is a vital necessity to be practiced.

So a lot is at stake in reforming the very nature of our financial system itself, which in turn is designed to force reform in our failed system of governance of our business corporations. The ideas I've passionately advocated in this article, however, are hardly widely shared among my colleagues and peers in the financial sector. But soon, perhaps, many others will ultimately see the light; for example, in March 2009, the idea of governance reform received encouraging support from Professor Andrew W. Lo of the Massachusetts Institute of Technology, one of today's most respected financial economists:

> … [T]he single most important implication of the financial crisis is about the current state of corporate governance … a major wake-up call that we need to change [the rules]. There's something fundamentally wrong with current corporate governance structures, [and] the kinds of risks that typical corporations face today (p. R2).

In sum, the change in the rules that I advocate—applying to institutional money managers a federal standard of fiduciary duty to their clients—would be designed, in turn, to force money managers to use their own ownership position to demand that the managers and directors of the business corporations in whose shares they invest also honor their own fiduciary duty to the holders of their shares. Finally, it is these two groups that share the responsibility for the prudent stewardship over both corporate assets and investment securities that have been entrusted to their care, not only reforming today's flawed and conflict-ridden model, but developing a new model that, at best, will restore traditional ethical mores.

And so I await—with no great patience!—the return of the standard so beautifully described by Justice Cardozo all those years ago, excerpts from his words cited earlier in my remarks:

> Those bound by fiduciary ties … [are] held to something stricter than the morals of the marketplace … a tradition unbending and inveterate … not honesty alone but the punctilio of an honor the most sensitive … a level of conduct … higher than that trodden by the crowd.

In his profound 1934 speech that has been the inspiration for this article, Justice Harlan Fiske Stone made one further prescient point on serving the common good:

> In seeking solutions for our social and economic maladjustments, we are too ready to place our reliance on what (the policeman's nightstick of) the state may command, rather than on what may be given to it as the free offering of good citizenship … Yet we know that unless the urge to individual advantage has other curbs, and unless the more influential elements in society conduct themselves with a disposition to promote the common good, society cannot function … especially a society which has largely measured its rewards in terms of material gains … We must [square] our own ethical conceptions with the traditional ethics and ideals of the community at large. [There is] nothing more vital to our own day than that those who act as fiduciaries in the strategic positions of our business civilization, should be held to those standards of scrupulous fidelity which [our] society has the right to demand (pp. 4, 10, and 13).

The 75th anniversary of Justice Stone's landmark speech reminds all of us engaged in the profession of investment management how far we have departed from those standards of scrupulous fidelity, and gives us yet one more opportunity to strengthen our resolve to meet that test, and build a better financial world.

ENDNOTES

Mr. Bogle is the founder and former chairman of The Vanguard Group of Investment Companies. This essay is drawn largely from his April 1, 2009, lecture on business ethics at the Columbia University School of Business. The views expressed in this essay do not necessarily reflect the views of Vanguard's present management.

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[1]Harlan Fiske Stone [1872–1946] received his law degree at Columbia in 1898, and served as dean of Columbia Law School from 1910 to 1923. In 1925, President Calvin Coolidge appointed Stone as Associate Justice of the United States Supreme Court. In 1941, President Roosevelt appointed him as Chief Justice of the United States, and he served in that position until his death in 1946. A curious coincidence is that Justice Stone appeared on the cover of *Time* magazine on May 6, 1929, just two days before my own birth on May 8. In its profile story, *Time* accurately speculated that one day Stone would become the Chief Justice, in part because (in those backward sentences that distinguished the early style of the magazine), "Well he has always tackled the public interest."

[2]*Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928).

[3]See Luke 16:13 and Matthew 6:34 of the King James Version of the New Testament.

[4]I'm speaking here of the buy-side analysts employed directly by these managers. The conflicts of interest facing Wall Street's sell-side analysts were exposed by the investigations of New York Attorney General Spitzer in 2002–2003.

[5]The Vanguard Group, Inc., 47 S.E.C. 450 (1981).

[6]These figures are based on 2002 data. The Supreme Court will consider the issue of the effectiveness of the process by which mutual fund managers set the fee rates that they charge to the funds under their control with the oral arguments in *Jones v. Harris Associates* scheduled for November 2, 2009. My *amicus curiae* brief in favor of overturning that decision was filed with the Court on June 15, 2009.

[7]The lecture at Columbia University, on which this article is based, is essentially the third part of a trilogy that chronicles the development of the fund industry and of Vanguard itself. The first two parts of the trilogy were my speech "Re-Mutualizing the Mutual Fund Industry—The Alpha and the Omega" at Boston University Law School on January 21, 2004, and my speech "A New Order of Things: Bringing Mutuality to the 'Mutual' Fund" at George Washington University on February 19, 2008. All three are available on my eblog at www.johncbogle.com.

[8]Figures are based on data from Cogent Research. The Vanguard loyalty score (percentage of strong supporters minus strong detractors) was a *positive* 44. The fund industry scored a pathetic *negative* 12.

[9]In those days, profusion was defined as a "lavish or wasteful expenditure or excess bestowal of money, substance, etc., squandering, waste" (Oxford English Dictionary, 2nd ed., Vol. XII, 1989, p. 584).

[10]Peter Fisher, widely respected BlackRock executive and former Treasury Department official, believes we should force institutional investors to do a better job of analysis, and establish demanding minimum standards of competence (Murray [2009]).

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