"The Battle for the Soul of Capitalism"

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I'm deeply honored by the invitation to address the Miller Forum, right here in Thomas Jefferson's "academical village." Of course I'm humbled by the reputations and accomplishments of the members of your Governing Council and of the scores of our Nation's leaders who have addressed the Forum in recent years. But I'm not so intimidated that I could decline this treasured opportunity to discuss the range of issues of national importance that are the subject of my newest book, *The Battle for the Soul of Capitalism,* published late last year by Yale University Press.

Like so many of you here today, I have been blessed by the intellectual training and values of a liberal education at a great university. In my case, it was Princeton, a school linked to Virginia by more than a few great Americans. James Madison, son of Virginia, patriot, and president of the United States, is also a son of Princeton, Class of 1771, who later became the first president of our Alumni Association. And in 1904, Virginia Law graduate Woodrow Wilson, Princeton 1876, who by then was president of Princeton, was offered the opportunity to serve as the University of Virginia's first president. Happily for my university, he resisted the temptation and remained in his job, only to be elected President of the United States in 1912.

While my new book is, obviously, about capitalism, I've done my best to paint with a broader brush, beginning with an introduction entitled, "Capitalism and American Society." At the outset, I warn about the striking similarities between the United States today and the Roman Empire at its peak in the second century A. D. Drawing on Gibbon's epic, *The Decline and Fall*

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

of the Roman Empire, I warn, "that no nation can take its greatness for granted . . . For America to sustain her economic strength, her national power, and her global leadership, our nation's vast business financial complex" must function with optimum effectiveness. My clear conclusion is that we are not doing so, in large measure because capitalism has changed, and for the worse.

It is a curious fact that my new book echoes in so many ways the very principles set forth in my Princeton senior thesis, which focused on the need to put fund shareowners at the top of the investment food chain. That thesis—and all that followed—depended on an incredible stroke of luck. In Firestone Library almost 56 years ago (though it seems like only yesterday), I happened upon the December 1949 issue of *Fortune* magazine and learned for the first time that something called "the mutual fund industry" existed. When I saw the industry described in the article as "tiny but contentious," I knew immediately that I had found my thesis topic. Completed in the spring of 1951, it was entitled "The Economic Role of the Investment Company."

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

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

All of this gratuitous advice from a callow college senior was, alas, largely ignored by the fund industry. But the creation of Vanguard in 1974 as a truly *mutual* mutual fund group—operated on an "at cost" basis for the benefit of its owners rather than its managers—was my attempt to walk the walk that I had talked the talk about a quarter-century earlier. Today, I assure you that my youthful idealism remains intact. Indeed, it is shamelessly reflected not only in Vanguard, but in my new book, an expression of my concern about our American society today, my conviction that our system of capital formation is essential to our economic growth and world leadership, and my acknowledgement that much has gone wrong in that system.

There is much that needs to be fixed, for "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 of these three arenas, I discuss not only *what* went wrong, but *why* it went wrong, and *how* to go about fixing it. Right at the outset I warn the reader that mine is a tough message, bluntly delivered, opening with this epigram from St. Paul: "If the sound of the trumpet shall be uncertain, who shall prepare himself to the battle?" In this case, the battle is for the soul of our capitalistic system.

Today's Capitalism

So my trumpet, as you'll now hear is a certain one. Today's capitalism 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 the words of journalist William Pfaff. The classic system—*owners'* capitalism—had been based on a dedication to serving the interests of the corporation's owners in maximizing the return on their capital investment. But a new system developed—*managers'* capitalism—in which, Pfaff wrote, "the corporation came to be run to profit its managers, in complicity if not conspiracy with accountants and the managers of other corporations." Why did it happen? "Because the markets had so diffused corporate ownership *that no responsible owner exists*. This is morally unacceptable, but also a corruption of capitalism itself." And so it is.

Once an "ownership society" in which direct owners of stock held voting control over corporate America, we have become an "agency society," and we are not going back. But the 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. These intermediaries consume far too large a portion of whatever returns our corporations and our financial markets are 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.

Curiously enough, what has happened to our system of capitalism is precisely what this university's great founder warned us about two centuries ago. Hear Thomas Jefferson: "I hope we shall crush in its birth the aristocracy of our moneyed corporations which dare already to challenge our government in a trail of strength, and bid defiance to our laws." We didn't do that, and here are nine quick examples—three each from corporate America, investment America, and mutual fund America—that reflect the negative consequences of this change.

In Corporate America:

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

- **Two, the rise of financial engineering**. In a remarkable manipulation of financial statements, corporate earnings are managed to meet the "guidance" that these executives give to Wall Street, quarter by quarter. Two of the prize tools for earnings shenanigans: (1) mergers that are made, not with a sound business rationale, but because of the consequent opportunity to manage "pro forma" earnings by creating a veritable "cookie jar" of reserves, to be drawn on at will in order to present a rosy, but false, picture of corporate growth; and (2) arbitrarily raising the assumptions for future returns on corporate pension plans, even as prospective returns eroded. Just think of it: In 1981, the 13.9 percent yield on the long-term U.S. Treasury bond was *twice* the 7 percent return projected for corporate pension funds. Currently, despite the fact that the bond yield has tumbled to 4.7 percent—65 percent *lower*—the projected pension return is now 8.5 percent, actually 20 percent *higher*. That return is simply not going to happen, and the inadequacy of pension plan assets to meet their payout liabilities to retirees is well on the way to becoming our next financial scandal.

- **Three, the failure of our traditional gatekeepers.** In the recent era, auditors, through their provision of highly profitable consulting activities, became partners, if not co-conspirators, with managements, and relaxed traditional professional standards. Regulators and legislators (who in 1993 forced the SEC to back down on requiring that option costs to be treated as—of all things!—corporate expenses) also ignored the public interest. And corporate directors failed to provide, as I put it in my book, the necessary "adult supervision of these geniuses" who managed the firms. Put more harshly, in an unattributed quotation that I came across a few years ago, "When we have strong managers, weak directors, and passive owners, don't be surprised when the looting begins." And that's, of course, what we've seen at Enron, WorldCom, and too many others.

In Investment America:

- **One, the vanishing ownership society.** Almost unobserved, direct holdings of stocks by individual investors have plummeted from 92 percent of all stocks in 1950 to only 32 percent today, as corporate control fell into the hands of giant financial institutions—largely pension funds and mutual funds—whose share soared commensurately, from 8 percent to 68 percent, a virtual revolution in ownership. But these agents, beset by conflicts of interest, have failed to place front and center the interests of their principals, passively ignoring the need for good governance and allowing corporate managers to look primarily to their own interests. As the economists would say, investment America has an "agency problem."

- **Two, the rise of short-termism**. Institutional money management, once an *own-a-stock* industry (holding an average stock for six years during my first 15 years in this field) has become a *rent-a-stock* industry, now holding a typical stock for but a single year, or even less. That sea change caused us to forget about the importance of good corporate governance. When owners are *investors*, they *must* care, and care deeply, about the rights and responsibilities of corporate governance, and must exercise those rights and honor those responsibilities. But when owners are *speculators*, renters who merely trade stocks, they could hardly care less. Simply put, as I ask in the book, "If the owners of corporate America don't give a damn about the triumph of managers' capitalism, who on earth should?" Yet our new agent/owners remain passive to a fault on governance issues.

- **Three, the triumph of illusion over reality.** As our professional security analysts came to focus ever more heavily on *illusion*—the momentary precision of the price of the stock—they increasingly ignored the *reality*—that what really matters is the inevitably vague, but eternally transcendent, intrinsic value of the corporation. (As investment icon Benjamin Graham, mentor to Warren Buffett, perceptively put it: "In the short run, the stock market is a *voting* machine; in the long run it is a *weighing* machine.") Measuring up, unfortunately, to Oscar Wilde's piercing description of the cynic, our money managers came "to know the price of *everything*, but the value of *nothing*." But when there is a gap between perception—illusion—and reality—the business fundamentals of cash flow and dividends—it is, to state the obvious, only a matter of time until the gap is reconciled . . . inevitably, in favor of reality.

In Mutual Fund America:

- **One, the industry changed**. Mutual funds, once a profession with elements of a business, gradually became a business with elements—and too few elements at that—of a profession. Our traditional guiding star of *stewardship* was transmogrified into a new star—*salesmanship*. Largely focused on management when I wrote my Princeton thesis about the industry, our predominant focus today is on marketing—increasing fee revenues by building up assets under management, often by creating, promoting, and advertising speculative funds that follow the fads and fashions of the day. As you will soon learn, our fund investors have paid a terrible price.

- **Two, the conglomerates take over**. When I entered this field all those years ago, virtually 100 percent of mutual fund management companies were *privately*-held firms, relatively small, and managed by investment professionals. Since then, they have experienced their own pathological mutation. Today, 41 of the 50 largest fund management companies are *publicly*-held, including 35 that are owned by giant U.S. and global financial conglomerates, largely managed by businessmen bereft of professional investment training. It shouldn't surprise you to learn that these conglomerates are in the fund business to earn a return on *their* capital, not a return on *your* (the fund investor's) capital. They cannot do justice to both, for the record is clear that the more the managers *take*, the less the investors *make*. Alas, in the fund industry in the aggregate, you not only *don't* get what you pay for, *you get precisely what you don't pay for.*

- **Three, mutual fund returns fall drastically short of market returns**. And they fall short by almost exactly the amount of the costs they incurred—all those management fees, operating expenses, sales charges, and hidden portfolio transaction costs. How could it be otherwise? Over the past two decades, for example, the annual return of the average equity *fund* (10 percent) has lagged the return of the S&P 500 Index (13 percent) by three percentage points per year, largely because of those pesky fund costs. To make matters worse, largely because of poor timing and poor fund selection, the return actually earned by the average fund *investor* has lagged the return of the average fund by *another* 3 percentage points, reducing it to just 7 percent per year—roughly 50% of the market's annual return. Warren Buffett accurately describes the problem: "the principal enemies of the equity investor are *expenses* and *emotions."* The fund industry has failed investors on both counts.

  An *annual* return of 7% in a 13% market is a shocking gap, but the *long-term* reality is far worse. When compounded over this grand 20-year era for investing, and adjusted for inflation, the average investor has captured but 16 percent of the market's compounded real profit. (I'm not kidding! $1,000 invested in a simple index fund mimicking the Standard & Poor's 500 Stock Index in 1984 and held today produced a profit of $5,490 after inflation; for the average fund investor, the real profit came to just $910.) No wonder that David Swensen, the integrity-laden and remarkably successful manager of the Yale endowment fund, characterizes such a shortfall as "the colossal failure of the mutual fund industry."

Where is the Public Discourse?

It ought to be obvious that there is an urgent need to face up to these and other failures in the changing world of capitalism. These failures have arisen, in essence, from the triumph of the powerful economic interests of the oligarchs of American business and finance over the interests of our nation's 100 million citizen-investors, the very concern that Jefferson expressed about "the aristocracy of our moneyed corporations" in the quotation that I cited a few moments ago. Yet remarkably, little public discourse has been in evidence. In the investment community, I have seen no defense of the inadequate returns delivered by mutual funds to investors, nor of the industry's truly bizarre, counterproductive ownership structure. No demand by institutions to gain the rights of ownership that one would think are implicit in holding shares of stock. No serious criticism of the virtually unrecognized turn away from once-conventional and pervasive investment strategies that relied on the wisdom of long-term investing, toward strategies that increasingly rely on the folly of short-term speculation. And, until recent months, almost no discussion of the profound problems we are facing in our various systems of retirement plan funding. If my book helps to open the door to the introspection on these issues by our corporate and financial leaders that is so long overdue, followed by corrective action, perhaps the needed changes will be hastened.

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

Capitalism and Values

The idea that values should be intimately embedded in the practice of business, of course, was an important message of my idealistic Princeton thesis of 54 years ago. But I'm hardly alone. Even before he extolled, in *The Wealth of Nations*, the virtues of the invisible hand of competition and the essential nature of personal advantage and self-interest in making the world's economic system work, Adam Smith wrote *The Theory of Moral Sentiments*, calling for "reason, principle, conscience, the inhabitant of the breast, the great judge and arbitrator of our conduct, who shows us the real littleness of ourselves, the propriety of generosity, of reining in the greatest interests of others, the love of what is honorable and noble, the grandeur and dignity of our own characters."

Adam Smith, here, the apostle of virtue, is advising us to put the greater interest of others before the interest of ourselves, and our failure to do so is reflected in modern-day managers' capitalism in which the interests of those who run our corporations and financial institutions are ascendant. My *Battle* book is replete with scores of specific recommendations to help us return to our roots, the most sweeping of which is the call for the formation of a federal commission to (a) recommend policies that respond to the failure of our agency society in which direct stockowners have become an endangered species, and (b) to take the steps necessary to ultimately eliminate the frightening shortfalls—recently estimated at $1.2 trillion for pension plans alone—in the expected future wealth that investors will accumulate through the vastly underfunded retirement plan system that is the foundation of our national savings. These two problems are directly related, and best solved by the creation of a fiduciary society in which intermediaries truly represent—first, last, and only—the interests of those they serve.

So, I recommend this federal approach for the development of an investor-oriented—not manager-oriented—fiduciary society. But even if that recommendation is not implemented for a decade or more, Adam Smith's legendary "invisible hand"—each investor acting in his or her own enlightened self-interest—will gradually bring about the changes I seek. If we investors simply have the wisdom to understand how the financial system works, and to move our own money where our own common sense dictates, then the system of financial intermediation that has failed so many investors in the modern era will change. One way or another, then, whether by government fiat or by the invisible hand of our citizens, the soul of capitalism—the traditional owners' capitalism that served us so well, for so long—will be reclaimed.

What "The Invisible Hand" Means

Adam Smith was, of course, right. We owe it to ourselves to look after our own economic interests. Even in a financial system whose vast strength is punctuated with serious—and in some cases disabling—weaknesses, there is no law that requires us to be victimized, and, however rare they may be today, attractive options for investors remain. Since the first three rules of investing are said to be "Diversify, Diversify, Diversify," those of us who rely on the productive wisdom of long-term investing—and have not been lured into the counterproductive folly of short-term speculation—are obliged to own (surprise!) stock and bond market index funds.

As evidenced from the substantial shortfall in returns experienced by mutual fund investors in the example that I cited earlier, the investment merits of indexing—the broadest possible diversification, at the lowest reasonable cost, without sales loads or marketing fees, and with maximum tax efficiency—have proven themselves over and over again. Yes, I concede that owning such funds is as interesting as watching the grass grow, or perhaps as interesting as watching paint dry. But since less than 10 percent of investors or investment managers are apt to beat the market over the long-term, buying and holding a low-cost index fund and capturing nearly 100 percent of whatever annual returns the financial markets are generous enough to deliver to us seems a far better option than plunging headlong into a game rigged with such overpowering odds against success.

Of course, since I started the first index mutual fund a little over three decades ago—Vanguard Index 500 is now the largest fund in the world—you would be wise to discount my passionate advocacy of indexing. So ignore me! But listen to Warren Buffett. Listen to Yale's David Swensen. They both say exactly the same thing. Listen to Jack Meyer, the former—but equally sensational—manager of Harvard's endowment fund. Listen to any Nobel Laureate in Economics, beginning with Paul Samuelson. Heck, ask the finance professors here at the University of Virginia (who are probably indexers themselves). Let's face it: *the jury is in*. The verdict is: Index! (I leave the proportion in stock and bond index funds to your own good judgment; surely some of each.)

We'd best take the problems I've outlined today seriously, for we must solve them if our nation's citizen-investors are to be blessed by the promises of our Declaration of Independence—"the right to life, liberty, and the pursuit of happiness"—and of our Constitution—"to promote the general welfare . . ." Fixing today's CEO-centric corporate world, eliminating the excesses of the financial system, and repairing the faltering mutual fund industry—returning control from managers to owners in a new fiduciary society—is on the way. I hope my book will give it a good push. But whether it comes about through laws and regulations, or by the wisdom finally acquired by crowds of investors making intelligent investment decisions as they simply seek to further their own economic interests, *so it will be*. That conclusion reflects my lifelong idealism, and it remains my ideal today.