

Business and Its Publics

Reflections by John C. Bogle, Vanguard Founder

At the NYU Stern School of Business

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I'm delighted to have the opportunity to speak with you here at NYU/Stern, for a whole variety of reasons:

- First, because I'm fascinated by the subject of how business relates to its many publics, and in particular to the media. After all, the opinions held by the general public—the well-informed, if you will, “man on the street”—are largely shaped by what our magazines and newspapers, and our television sets and radios present to us.
- Second, because I'm honored to join my friend Tunku Varadarajan on the platform. You've seen one of his uncompromising articles (on the Murdoch family), and I've had the pleasure of writing twelve op-ed pieces for *The Wall Street Journal*, most under his aegis as opinion page editor. About half of them pressed my case to reform the industry (you've seen “The Spitzer Effect”); many others include pieces that he pushed me to write, often, truth told, when I wasn't sure I had the ability to deliver. (“Don't Look for Me at Davos” is a good example.) Hint: under the best of circumstances, some sort of mutual respect between businessmen and journalists result in a synergy that produces a powerful force for public knowledge and education.
- Third, because even before I joined the mutual fund industry—an opportunity greatly facilitated by the fact that I wrote my Princeton University senior thesis on it in 1949-51—I was in fact a member of the media, a “stringer” for the long-gone *Philadelphia Evening Bulletin*, covering local news—auto accidents, police and fire activity, even an occasional murder—during the summer of 1949.

I digress now to tell you of the most memorable moment of that apprenticeship, an event that made an impression on me that, arguably, shaped my whole career. On the theory that it is easier for us human beings to learn from the mistakes of others rather than from our own potentially costly mistakes, let me take a moment to tell you the story. Since *The Evening Bulletin* published a Sunday morning edition, we reporters worked every Saturday night. Late one Saturday I was told to cover a house fire some miles from the police station where I got my

instructions. (There were no cell phones in those days.) I figured it would take more than a half-hour on two different trolleys to get there. (I had no car.) It was late; I was tired, and, truth told, I was a bit bored. A house fire, for heavens sake! So I skipped the trip and got a report from the firemen when they returned. I called in the story, but the wise rewrite man quickly figured out that I had not actually gone to the scene. “What color was the house?” he boomed. To which I responded, “I’m sorry. I was wrong. I’ll get over there right away.” And I did. The house turned out to be grey, with green trim. The moral of the story, which I urge upon you: “*Whatever you do in your careers, do every job with commitment, with professionalism, and with excellence, and never, never take short-cuts.*”

If you get nothing more out of my remarks this evening on business, please remember that lesson, which has stuck with me ever since, and has represented the standard which I’ve tried my best to honor throughout my long career in the financial field. Complete information and punctilious accuracy are the responsibility of business in *all* of its communications to *all* of its constituents, including the media and the public.

Let me begin by describing the philosophy that undergirded my actions in dealing with our various publics during my quarter-century as chief executive and then as senior chairman of Vanguard. We have essentially three constituencies: (1) our crewmembers (I detest the “you” vs. “me” idea suggested by the word “employees”), (2) our clients (I don’t much care for the word “customers,” either), and (3) the public, reached largely through the media. Since virtually everything I did was designed to be an open book (most corporate secrecy is just plain silly), the standards were the same for all.

It may surprise you, but this philosophy begins with *caring*: The simple recognition that the millions of investors *whom* we serve, and the thousands of our crewmembers *with* whom we serve and are real, honest-to-God, down-to-earth human beings, with their own hopes, fears, and financial goals. To the best of my ability, I tried to think of them, not as large aggregates, but as individuals.

Secondly, this philosophy depended on integrity—personal integrity to be sure, but also corporate integrity, right down to our basic mission, which I conceived of as service to others—our clients and crewmembers—before service to self. Any institution is a fragile construct, and so “it must be the object of intense human care and cultivation. When it errs and stumbles, it

must be cared for, and the burden must be shared by all who work for it, all who own it, all who are served by it, and all who govern it.”¹ Without integrity, simply put, none of those publics will care. Nor should they.

Third (perhaps obviously), this philosophy requires full disclosure, straightforward disclosure, and candid disclosure with all parties concerned, including investors, crewmembers, regulators, and legislators, and above all, the press. By disclosure, I not only mean the kind of formal disclosure one associates with publicly-owned businesses, such as regular reporting of accurate financial information. I also mean full disclosure of all significant events affecting our organization and its many publics, and prompt disclosure of these events, not only when the news is good, but—especially—when it’s bad. A useful rule-of-thumb: “*When in doubt, disclose.*”

Notice, please, that my business philosophy says nothing about growth. Indeed I have a rather ambivalent attitude toward growth, and have often observed that “nothing *fails* like success.” After all, history is littered with poignant examples of empires (think Rome), business enterprises (think of our nation’s auto and steel companies), and individuals (in this heated election season, I won’t go there) who at the moment of their greatest triumph were planting the seeds of their own destruction.

It was certain that if we acted always with caring, with integrity, and with candor, Vanguard would grow, and indexing would lead the way. While I concede that “growth is the only evidence of life,” my attitude was to let our growth just happen, not by forcing it, for example through expensive sales promotions, aggressive marketing schemes, nor the offering of faddish new funds that would attract the evanescent and therefore useless assets of short-term speculators. Rather we sought to attract the durable and therefore priceless assets of long-term investors by earning their trust. I was confident that an enterprise whose mantra is not salesmanship but stewardship would grow organically, a natural result of our philosophy. And so it did. We began in September 1974 with \$1.4 Billion of investor assets, today our asset base exceeds \$1.2 Trillion.

Business or Profession?

¹ Dean Howard M. Johnson, chairman of the Massachusetts Institute of Technology.

If my ideas make you wonder whether I'm really a businessman, well, you're very perceptive. For when one's trade is providing investment management services to those millions of human beings whom I mentioned earlier, don't think business, think trusteeship, think stewardship. Remove salesmanship and marketing from your agenda. Focus your career as engaging in a profession, far more than merely engaging in a business. It's worked well for us.

Of course I understand that *every* business has elements of a profession, and *every* profession has elements of a business. As I have often observed, unless its revenues exceed its expenses, "no organization—even the most noble of faith-based institutions—will long exist." I also understand that the proper balance between business and profession varies widely, depending on the character of each company and industry. And I know full well—better than most—that maintaining that balance is a delicate challenge.

In any event, I'm deeply troubled that the balance between business and profession is shifting, and for the worse. Our society is gradually moving away from the stern traditional values of yore to the flexible values of our modern age. Today's "bottom line" society reflects the gradual mutation of our professional associations into business enterprises, in important measure because of the growing importance of making money.

Traditionally, professions were expected to embody such characteristics as a commitment to the interest of clients and to the welfare of society; a special body of knowledge; a specialized set of skills and practices; a community responsible for the oversight and monitoring of quality; and, most importantly, the capacity to render judgments with integrity under conditions of ethical uncertainty. Yet today, unchecked market forces not only constitute a strong challenge to our professions; in some cases, these forces have totally overwhelmed traditional standards of professional conduct, developed over centuries.

The dangers I describe have already come home to roost in some established professions, with incalculable harm to our society. Examples of the harsh consequences of this change are easy to come by. In public accounting, our once "Big Eight" (now "Final Four") firms gradually came to provide hugely profitable consulting services to their audit clients, making them business partners of management rather than independent and professional evaluators of generally accepted (if loose) accounting principles. The failure of Arthur Andersen, and the bankruptcy of

its client Enron in 2002, was but one example of the consequences of this conflict-riddled relationship.

Think too about the increasing dominance of “state” (publishing) over “church” (editorial) in journalism, and the scandals that reached the most respected echelons of the press—*The New York Times*, *The Los Angeles Times*, *The Washington Post*. A similar transition has taken place in the medical profession, where the human needs of the patient human concerns of the caregiver have been overwhelmed by the financial interests of commerce, our giant medical care complex of hospitals, insurance companies, drug manufacturers and marketers, and health maintenance organizations (HMOs). Put another way, we’ve moved from a concept that *there were certain things that one simply didn’t do* (the moral absolutism of a profession, I suppose) to the idea that *since everyone else is doing it, I can do it, too* (surely a form of the moral relativism of a business).

It is said, accurately, that professionals must accomplish their good works with a commitment to use their mastery to fulfill a “mission that inspires passion, a mission that gives beyond the self . . . (even though) pursuing a noble mission is often painful.” I see no reason that such a mission couldn’t also characterize the best businesses—those that serve their clients and customers as well as our society. As a whole, I believe that such firms will generate sustainable growth and will—even in this rapidly changing world—survive for the longest time. Thinking of “business as a calling,” if you will, may, paradoxically, insure commercial success.

Business Enterprises

Now let’s turn to the current state of our business enterprises—in particular, our giant publicly-held corporations—and our giant investment institutions—now themselves largely owned by giant publicly-held financial conglomerates. Of course both represent a peculiar mix of business and profession, but they have moved a long way from the traditional values of capitalism, which includes entrepreneurship and risk-taking, raising capital, free markets and vigorous competition, and earning profits for those who put up the capital. But those values also included the fundamental principle of trusting and being trusted.

In the latter part of the 20th century, however, the very structure of capitalism began to erode. Not only had “trusting and being trusted” come to play a diminishing role, but the owners

of our businesses—those whose capital was at stake—were relegated to a secondary role in the functioning of the system. One of the major forces behind this baneful change was the disappearance of the old “ownership society” in which the shares of our corporations were held almost entirely by direct stockholders. Since 1950, direct ownership of U.S. stocks by individual investors has plummeted from 92 percent to 26 percent, while indirect ownership by institutional investors has soared from 8 percent to 74 percent. Our old ownership society is now gone, and it is not going to return. In its place we have a new “agency society” in which our financial intermediaries now hold effective control of American business.

But these new *agents* haven’t behaved as agents should. Our corporations, our pension managers, and our mutual fund managers have too often forgotten their professional roots and focused on their businesses. Most money managers have come to focus on the folly of short-term speculation, rather than the wisdom of long-term investment. They have put their own financial interests ahead of the interests of the *principals* whom they are duty-bound to represent, those 100 million families who are the owners of our mutual funds and the beneficiaries of our pension plans. As Adam Smith wisely put it 200-plus years ago, “managers of other people’s money (rarely) watch over it with the same anxious vigilance with which . . . they watch over their own . . . they very easily give themselves a dispensation. Negligence and profusion must always prevail.” And so negligence and profusion among our corporate directors and money managers have indeed prevailed in present-day America.

Business and the Media

It seems to me that the media has given this sea change short shrift, perhaps because the press has a difficult time differentiating between business results and stock prices. Most businesses, truth told, change at a glacial pace. Not much happens from one day—to say nothing of one minute—to the next. So the daily grinding out of business performance as such is not very newsworthy, and provides only periodic bursts of potential interest—mergers and acquisitions, for example, and failures and bankruptcies. But the momentary movements of the stock market seem to transfix the media—fortunes made and lost, instant gratification (or catastrophe). Every change in the market—say the S&P 500—or in a stock’s price is treated like a newsworthy *event*—even though it is an event that simply enriches some participants, inevitably at the expense of others. (The stock market is essentially a “closed system.”)

For long-term investors as a group, owning businesses is a *winner's game*. After all, businesses earn a return on their capital, and they pay dividends, and they grow with our economy. Trading stocks with other investors, on the other hand, is inevitably, a *zero-sum game*—Peter's gain is Paul's loss. But only before costs. After the huge costs paid to the croupiers of Wall Street day after day—hundreds of billions of dollars each year—on all that frenetic activity that we read about as billions of shares of stock change hands day after day, that zero-sum game of beating the market is converted—magically, but mathematically—into a *loser's game*. The minute by minute fluctuations of the market, using Shakespeare's metaphor, are truth told “a tale told by an idiot, full of sound and fury, signifying nothing.” (You'll know that's Macbeth, Act V.)

Even as the media covers this sound and fury if it were of surpassing importance, financial journalists ignore the fact that essentially 100 percent of the *long-term* return on stocks is based on the profitability of our corporate businesses. Short-term speculation does little to enhance or diminish that return. (The stock market's long-term nominal annual return of about 9 ½ percent, for example, was produced almost entirely by dividend yields averaging 4 ½ percent and annual earnings growth averaging 5 percent.)

But the news media, competing to attract public attention and readership, needs news that is interesting, exciting, dramatic, and—of course—frequent. And financial markets provide just that, with their constant price changes in real-time. While these changes ultimately must reflect the reality of those glacial changes in corporate cash flow, the stock market is primarily an *expectations market*, a market that reflects human emotions, surges of optimism and pessimism based on hope, greed and fear. Business on the other hand, is about the *real market*, a market that reflects on the delivery of real goods and services, produced, Manufactured, and delivered by real people, using real strategies, that result in real earnings and real dividends.

In short, those that invest (as a group) win: those that speculate (as a group) lose. This is the central message of “The Evolution of an Investor” from Conde Nast's *Portfolio*, included in your materials. It is the story of a successful stockbroker who comes to understand the system and the damage it does to investors, turns his back on speculation, and adopts instead a new approach that focuses on long-term investment. Alas, this wise article—which describes Wall Street as “an elaborate fraud”— is a rare exception to the conventional business media, which

continues to provide news stories at lightening speed under deadlines that demand news every moment, appealing, of course, to the short-term concerns of their readership.

Executive Compensation

Let me close with a few comments about how the business world and the media handle executive compensation. I hold, deeply, the conviction that the vast majority of our corporate CEOs are substantially overpaid, many *grossly* overpaid. As is well-known, while the *real* (inflation adjusted) compensation of the average employee has remained pretty much flat during the past 25 years (now at \$35,000), the real compensation of the average CEO (now about \$10,000,000) has risen eight-fold.

Yet, there's no evidence that CEOs as a group have created much extra value. Indeed, during that quarter-century, they've projected that the earnings of their companies would grow at 11 percent (in nominal dollars), but delivered growth of 6 percent, only half as much even as our economy has grown at a 6.2 percent rate. But CEO pay is not based on corporate *performance*. It is based on the pay of corporate *peers*. And since each corporate board seems to believe that its own CEO is well above average, whenever the CEOs pay ranks in the bottom quartile among his peers, he gets moved up a few quartiles. Of course, some other CEO is thus inevitably cast into the bottom quartile, and so on. This "ratchet effect," the product of the compensation consultants who, I can assure you, don't make a living by recommending salary cuts, is a real problem, to which the only solution is a demand by stockholders to require corporate performance—not peer compensation—as a condition of compensation above a certain (modest) norm. But, as I've noted, since our all-powerful institutions have serious conflicts of interest and behave more like speculators than investors, don't hang by your thumbs awaiting this reform.

The other major culprit enabling excessive executive compensation is the heavy reliance on stock options. They seem to be "free," but they're not. So as seemingly reasonable as they may seem, such options can significantly dilute the interest of the "real" shareholders of the company. To avoid such dilution, companies typically buy back stock in the market, whether or not these prices are reasonably related to company achievement. Further, stock prices (as I've already noted) often have little to do with the amount of real intrinsic value the company, and its executives and staff, are creating (or dissipating). The idea that stock options link the interest of executives with the interests of shareholders turns out to be, simply, a canard.

The media are pretty good at publishing substantial information about CEO compensation and options. (Witness “The Perfect Payday” in *The Wall Street Journal*.) But it doesn’t seem to help. If we want to get serious about the scandal of executive compensation, the media need to tackle it as NBC tackled the profligate waste in federal spending a few years back. At the close of its “Nightly News” it presented a “Golden Fleece Award,” embarrassing the government bureaus involved. My dream is for a new Golden Fleece Award, a weekly naming of CEOs whose compensation is fleecing the company’s shareholders, right there in front of 10 million viewers on NBC. But it’s not going to happen, in part because the media are *owned* by corporations, those same corporations that are in turn controlled by CEOs, an obvious structural conflict that ought to raise some interesting discussions about where journalism the profession ends, and journalism the business begins.

A Final Word

In studying “Business and Its Publics,” you’ve chosen a fascinating subject that raises provocative issues about the relationships between business and the stock market and between business conduct and professional conduct, issues which for my nickel don’t get nearly enough attention in the press. So I’m happy that you’re being exposed to them here at NYU/Stern.

While I’ve been around long enough to be roughly the age of your grandfathers, I hope I’ve stimulated your interest in these issues, and especially in the profound conflicts of interest so sharply delineated in the financial corner of the giant world of business and commerce. I hope, finally, that you’ll think about the message sent through me by Kurt Vonnegut in “Enough” and take up, as part of your career and your mission, to go out there and build a better world. And that’s what I tell my 12 grandchildren too.