America's Financial System—Powerful but Flawed

A Lecture By

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In all of the talk about the causes of the deep-seated challenges facing our nation—globalization, enormous indebtedness, huge unemployment, the severe recession from which we are now only tentatively emerging, and the stock market crash of 2008-2009—too little attention has been paid to the critical role played by our financial system. Classical economics has tended to make a distinction between the *real* economy—the production and consumption of goods and services—and the *paper* economy—the vast network of financial assets and liabilities that is, finally, supported by the productive economy. The fact is that our productive economy and our financial economy are closely, indeed inextricably, interlinked.

The principal role of our nation's financial institutions is to allocate scarce investment capital among our corporations and economic sectors in a way that maximizes the growth potential of our economy. But changes in our financial sector have undermined this goal. Most notable among those changes are: first, the growing dominance of *agents* (giant banks and investment banks, and institutional money managers) as stock owners over *principals* (individual investors); and second, the ascendance of short-term speculation over long-term investment, focused on the illusion represented by the momentary precision of stock prices rather than the reality represented by intrinsic value—simply put, the discounted value of future cash flows. Both of these major changes in how we invest have played a critical role in creating a dysfunctional and expensive financial system, and in turn have ill-served our real economy.

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

With these profound, indeed, earth-shaking changes, our financial markets have become far more volatile and unpredictable than the underlying businesses that they ultimately represent, which collectively account for their aggregate market capitalization. Put another way, *investors* are more volatile than *investments.* Economic reality governs the returns earned by our *businesses,* but emotions and perceptions—the swings of hope, greed, and fear among the participants in our financial system—govern the returns earned in our *markets.* Emotional factors sometimes magnify, sometimes minimize, this central core of economic reality, and financial crises can arise at any time, but in the long-term it is reality that triumphs over illusion. Warren Buffett states the issue with his usual clarity. His firm, Berkshire Hathaway, is publicly held, and he regularly hammers home to his shareholders the message that he prefers its shares to trade at or around its intrinsic value—neither materially higher nor lower. He explains:

> "Intrinsic value is the discounted value of the cash that can be taken out of the business during its remaining life . . . When the stock temporarily over-performs or under-performs the business, a limited number of shareholders—either sellers or buyers—receive out-sized benefits at the expense of those they trade with. [But] over time, the aggregate gains made by Berkshire shareholders must of necessity match the business gains of the company.

The Wisdom of John Maynard Keynes

Whatever one may think about "Keynesianism" in the field of economics—essentially calling for government expenditures to stimulate demand in economies performing below their capacity—the great British economist John Maynard Keynes was little short of brilliant in the field of investment. Keynes recognized this critical distinction between economics and emotions way back in 1925. Observing the predilection of investors to implicitly assume that the future will resemble the past, Keynes warned: *"It is dangerous to apply to the future inductive arguments based on past experience unless we can distinguish the broad reasons for what it (the past) was."*

A decade later, in 1935, in his amazing *The General Theory of Employment, Interest, and Money,* Keynes focused on the two broad reasons that explain the returns on stocks. The first was what he called *enterprise*—"forecasting the prospective yield of an asset over its entire life." The second was *speculation*—"forecasting the psychology of the market." Together, these two factors

explain "The State of Long-Term Expectation" for an investment, the title of Chapter 12 of *The General Theory*.

From his vantage point in London, Keynes observed that, "in one of the greatest investment markets in the world, namely, New York, the influence of speculation is enormous . . . It is rare for an American to 'invest for income,' and he will not readily purchase an investment except in the hope of capital appreciation. This is only another way of saying that he is attaching his hopes to a favorable change in the conventional basis of valuation, i.e., that he is a speculator." Today, 75 years after Keynes wrote those words, the same situation prevails, only far more strongly.

Lord Keynes's conviction that speculation would dominate enterprise in the financial markets was based on his belief that individuals, who were then the dominant force in the markets, were largely ignorant of business operations and lacking financial savvy, prone to betting on how other investors might value their stocks in the short term. (A "beauty contest," Keynes posited; not a contest to pick the most beautiful woman, but to pick the woman whom other voters choose as the most beautiful.) This second-derivative gambling mentality leads to excessive, even absurd, short-term market fluctuations based on investors' responses to events of an ephemeral and insignificant character. Short-term fluctuations in the earnings of the stocks of business firms, he argued (correctly), would lead to unreasoning waves of optimistic and pessimistic sentiment.

Keynes' "Battle of Wits"

Keynes conceded that competition between expert professionals, possessing judgment and knowledge beyond that of the average private investor, should correct the vagaries caused by ignorant individuals. Yet he predicted that the energies and skills of the professional investor would come to be largely concerned, not with making superior long-term forecasts of the probable yield of an investment over its whole life, but with foreseeing changes in the conventional basis of valuation a short time ahead of the general public. He therefore described the market as ". . . a battle of wits to anticipate the basis of conventional valuation a few months hence rather than the prospective yield of an investment over a long term of years."

In my 1951 Princeton senior thesis on the mutual fund industry, I cited Keynes' conclusions. And I had the temerity to disagree with the great man. Rather than professional investors succumbing to the speculative psychology of ignorant market participants, I argued, these experienced pros would focus on enterprise. In what I predicted—accurately—would become a far larger mutual fund industry, our portfolio managers would "supply the market with a demand for securities that is *steady, sophisticated, enlightened, and analytic* [italics added], a demand that is based essentially on the [intrinsic] performance of the corporation rather than the public appraisal reflected in the price of its shares." Alas, the sophisticated and analytic focus on enterprise that I had predicted from the industry's expert professional investors has utterly failed to materialize. In fact, the emphasis on speculation by mutual funds has actually increased many fold. Call the score, Keynes 1, Bogle 0.

Interestingly, Keynes was well aware of the fallibility of forecasting stock returns, noting that "it would be foolish in forming our expectations to attach great weight to matters which are very uncertain." He added that "by very uncertain I do not mean the same thing as 'improbable.'" While Keynes made no attempt to quantify the relationship between enterprise and speculation in shaping stock market returns, however, it occurred to me, decades later, to do exactly that.

Putting Numbers on Keynes's Distinction

By the late 1980s, based my own first-hand experience and my research on the financial markets, I concluded that the two essential sources of equity returns were: (1) *economics*, and (2) *emotions*. What Keynes had described as enterprise I called "economics." What Keynes termed "speculation," I found well-defined by "emotions." The former I defined as *investment return*—the initial dividend yield on stocks plus the subsequent annual rate of earnings growth. The latter I defined as *speculative return*—the change in the price investors are willing to pay for each dollar of earnings. (Essentially, the return that is generated by changes in the valuation or discount rate that investors place on future corporate earnings.)

Simply adding speculative return to investment return produces the *total* return generated by the stock market. For example, if stocks begin a decade with a dividend yield of 4 ½ percent and experience subsequent earnings growth of 4 ½ percent, the *investment* return would be 9 percent. If investors are willing to pay $15 for each dollar of earnings (the price-earnings ratio) at the beginning of the decade and $20 at its conclusion, that 33 percent increase, spread over a

decade, would translate into an additional *speculative* return of about 3 percent annually. Simply adding the two returns together, the total return on stocks would come to 12 percent. It's not very complicated!

This remarkably simple numeric approach of separating enterprise and speculation—i.e., investment return and speculative return—has been borne out in practice. Indeed, I have the temerity (again!) to suggest that Lord Keynes would respect this mathematical extension of his concept. Decade after decade over the past century, we can account, with remarkable precision, for the total returns actually earned by U.S. stocks.

Investment Return and Speculative Return

The *investment* return on stocks has proven to be remarkably susceptible to reasonable expectations. The initial dividend yield—a crucial (but today underrated) factor in shaping stock returns—is a known factor at the moment one invests. The steady contribution of dividend yields to investment return during each decade over the past century has always been a positive, only once outside the range of 3 percent to 5 percent. (The yield was only 1 percent when the year 2000 began, a red flag that investors should have heeded.)

The long-term rate of earnings growth, on the other hand, while hardly as given to precision as the current dividend yield, is relatively stable. The fact is that (after-tax) corporate earnings have historically grown at about 5 percent (in nominal terms), roughly the same rate as the growth of our economy. Earnings have rarely represented less than 4 percent of our annual Gross Domestic Product, nor more than 8 percent. With the exception of the depression-ridden 1930s, the contribution of earnings growth was positive in every decade, usually composing between 4 percent and 7 percent per year of total stock returns. If we can but recognize that corporate earnings have, with remarkable consistency, grown at about the rate of the GDP, we can understand that the fundamentals of our economy drive long-term stock returns.

But in the short-term, it is speculative return that calls the tune. *Speculative* return is, well, speculative, and has alternated from positive to negative over the decades, as price-earnings multiples are highly volatile. Over history, P/Es have generally ranged from 10 times to about 25 times (although as high as 40 times a decade ago!). When P/E ratios are historically low (say, below 10 times) they have been highly likely to rise over the subsequent decade. And if they have

been historically high (say, above 20 times) they have been highly likely to decline. But in neither case is it given to us to know *when* the change is coming. So, certainty about the future never exists, nor are probabilities always borne out. But applying reasonable expectations to investment return and speculative return and then combining them has proved to be a sensible and effective approach to projecting the total return on stocks over the decades.

The point is this: Over the very long run, it is the *economics* of investing—enterprise—that has determined total return. The evanescent *emotions* of investing—speculation—so important over the short run, have ultimately proven to be virtually meaningless. In the past century, for example, *investment* return accounted for fully 9 percent of the 9.5 percent annual return on U.S. stocks (an average dividend yield of 4.5 percent plus average annual earnings growth of 4.5 percent). *Speculative* return—the result of an inevitably period-dependent increase in the price-earnings ratio from 13 times to 21 times—accounted for only 0.5 percent of the total. Long-term ownership of American business, then, has been a winner's game.

Hyman Minsky Adds the Crucial Ingredient

These simple insights based on the sources of stock market returns provides a solid framework for understanding how markets work. But it has only been in later years that I have come to understand the extent to which speculation in the financial economy is interlinked with productivity in the business economy, and can profoundly influence changes in it. When I learned of the work of the great American economist, Hyman Minsky (1919-1996), who dedicated his late career largely to what he described as the "financial instability hypothesis"—essentially, that stability leads to instability—I knew I had found not only many important insights into how the world works, but a distant early warning of the financial storm we are now weathering.

In 1974, Minsky observed the fundamental linkage between finance and economics: "The financial system swings between robustness and fragility, and these swings are an integral part of the process that generates business cycles." According to Minsky, the prevailing financial structure is a central determinant of the behavior of the capitalist economy. Likewise, the dynamism of profit-driven motives influences economic activity within the context of a given institutional structure, a structure that is itself ever changing. Resonating to the ideas of economist Joseph A. Schumpeter, Minsky emphasized that:

> Financial markets will not only respond to profit-driven demands of business leaders and individual investors, but also as a result of the profit-seeking entrepreneurialism of financial firms. Nowhere are evolution, change, and Schumpeterian entrepreneurship more evident than in banking and finance, and nowhere is the drive for profits more clearly the factor making for change.

In Minsky's theory, "the financial system takes on special significance not only because finance exerts a powerful influence on business activity, but also because this system is particularly prone to innovation, "as would become abundantly evident during our recent era . . . Since finance and industrial development are in a symbiotic relationship, financial evolution plays a crucial role in the dynamic patterns of the economy." Minsky placed a heavy focus on a firm's financial structure, under which, in return for debt capital, the firm contracts for a schedule of repayments to its lenders. He defined three ways in which a given firm (or government) can use its assets to fund its liabilities:

(1) Hedge financing, in which the prospective cash flows are sufficient to cover *both* interest payments *and* amortization of debt.

(2) Speculative financing, in which cash flows are sufficient to pay the interest, but insufficient to pay the principal amounts as they fall due.

(3) Ponzi financing, in which cash flows from operations are insufficient to meet interest payments. The obvious options for such a firm or government are either to increase its indebtedness, or to default.

These definitions, which Minsky set forth in 1994, represent an almost prescient warning about the failures of our flawed financial system that would be so harmful during the recent era. They also stand as a warning of the fragile financial underpinning of our federal government (and many state and local governments, too) today.

Minsky recognized the obvious perils of securitization. "(Financial innovators and marketers) did not hazard any of their wealth on the longer term viability of underlying packages of mortgages. Obviously, in such packaged financing the selection and supervisory functions of lenders and underwriters are not as well done as they might be when the fortunes of the originators (remain at risk) over the longer term. All that was required for the originators to earn

their stipend was skill avoiding obvious fraud and in structuring the package." Remarkably, Minsky had this insight in 1994, long before the issuance of the complex and highly risky credit default swaps, collateralized debt obligations, and structured investment vehicles that characterized the era that has now come to its crashing conclusion.

Business Values and Investment Values Gone Awry

Let me now sum up how our business values and investment values have gone awry and the consequences of this failure. I'll first cite the grave concerns of both Keynes and Minsky, and then add my own perspective. Keynes' famous paragraph can hardly be more incisive:

> As the organization of investment markets improves, the risk of the predominance of speculation does however increase. Speculators do no harm as bubbles on a sea of enterprise. But the position is serious when enterprise becomes a bubble on a whirlpool of speculation. When the capital development of a country becomes the by-product of the activities of a casino, the job (of capitalism) is likely to be ill done.

And Minsky comes out with a similar conclusion:

> In a capitalist economy, the past, the present, and the future are linked not only by capital assets and labor force characteristics but also by financial relations. The key financial relationships link the creation and the ownership of capital assets to the structure of financial relations and changes in this structure. Institutional complexity may result in several layers of intermediation between the ultimate owners of the communities' wealth and the units that control and operate the communities' wealth.
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> Like all (profit-seeking) entrepreneurs in a capitalist economy, bankers are aware that innovation assures profits. Thus, bankers (indeed, all intermediaries in finance) are merchants of debt who strive to *innovate* in the assets they acquire and the liabilities they market. This newest stage of capitalism, money manager capitalism . . . became a reality in the 1980s as institutional investors, by then the largest repositories of savings in the country, began to exert their influence on financial markets and business enterprises . . . The *raison d'être* for money managers, and basis by which they are held accountable, is the maximization of the value of the investments made by their clients. Not surprisingly,

therefore, business executives became increasingly attuned to short-term profits and the stock-market valuation of their firm. The growing role of institutional investors fostered continued financial-system evolution by providing a ready pool of buyers of securitized loans, structured finance products, and myriad other exotic innovations . . . something (is) basically wrong with the financial structure."

My own views of our flawed financial system closely parallel these views of Minsky and Keynes. Let me turn, then, to my own concerns about the current state of our commercial institutions—in particular, our giant publicly-held corporations—and our giant investment institutions—now largely owned by giant publicly-held financial conglomerates. Both corporate America and investment America represent a peculiar mix of business and profession, but they have moved a long way from the traditional values of capitalism. The origins of modern capitalism, beginning with the Industrial Revolution in Great Britain back in the late 18th century, had to do, yes, with entrepreneurship and risk-taking, with raising capital, with vigorous competition, with free markets, and with the returns on capital going to those who put up the capital.

Central to these values of early capitalism was the fundamental principle of trusting and being trusted. But by the latter part of the 20th century, we were to witness the erosion of the very structure of capitalism. Not only had "trusting and being trusted" come to play a diminishing role, but the actual owners of our businesses were relegated to a secondary role in the functioning of the system, the result of two major developments.

First, in our old "ownership society," the shares of our corporations were held almost entirely by direct stockholders, but today it is giant financial institutions that call the tune. Since 1950, direct ownership of U.S. stocks by individual investors has plummeted from 92 percent of all shares to 30 percent, while indirect ownership by institutional investors has soared from 8 percent to 70 percent. Our old ownership society is 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. While investing "Other People's Money" should be based on trust and stewardship, our corporations, pension managers, and mutual fund managers have too often 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. Some 200-plus years ago, Adam Smith described this "agency problem" in these simple terms:

> 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 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.

The second reason for the debasement of the values of traditional capitalism is that our new investor/agents not only seemed to ignore the interests of their *principals*, but also seemed to forget their own investment *principles.* In the latter part of the twentieth century, the predominant focus of institutional investment strategy turned from the wisdom of long-term investing to the folly of short-term speculation. During the recent era, we entered the age of expectations investing, where projected growth in corporate earnings—especially earnings guidance and its subsequent achievement, by fair means or foul—became the watchword of investors. Never mind that the reported earnings were too often a product of financial engineering that served the short-term interest of corporate managers and Wall Street security analysts alike.

But when long-term *owners* of stocks become short-term *renters* of stocks, and when the momentary precision of the price of the stock takes precedence over the eternal vagueness of the intrinsic value of the corporation itself, concern about corporate governance is the first casualty. The single most important job of the corporate director is to assure that management is creating value for shareholders; yet when that goal became secondary, our new investors seemed not to care. While their 70 percent ownership position gives our institutional agents absolute voting control of corporate America, all we hear from these money managers is the sound of silence. Not only because they are more likely to be short-term speculators than long-term investors, but also because they are managing the pension and thrift plans of the corporations whose stocks they hold, and thus face a serious conflict of interest where controversial proxy issues are concerned.

This conflict is pervasive, for it is said that money managers have only two types of client they don't want to offend: *actual*, and *potential.*

And so in corporate America we have witnessed staggering increases in executive compensation not only unjustified by corporate performance, but also grotesquely disproportionate to the pathetically small increase in real (inflation-adjusted) compensation of the average worker; financial engineering that dishonors the idea of financial statement integrity; and the failure of the traditional gatekeepers we rely on to oversee corporate management—our regulators, our legislators, our auditors, our attorneys, our directors. It's high time for our now-empowered institutional agents to fight for the rights of their investor principals, honoring their agency responsibilities of corporate ownership and exercising their rights in overseeing governance.

Building A Fiduciary Society

So, out of the ashes of our old *ownership* society and our failed *agency* society we must develop a new *fiduciary* society, one that guarantees 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 on 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.
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. Painful as such a separation might be, conglomerate ownership of money managers is the single most blatant violation of the biblical principle that "no man can serve two masters."

Grounds for Hope

Had I not found agreement with this harsh indictment of present-day capitalism from some of the most respected names in investing and in academia, I might be a little less certain of my ground. But leaders of great repute in both communities have stood up and spoken out, and their wisdom will ultimately make a positive difference. In his remarkable 2000 book *On Money and Markets*, the eminent financier, economist, and historian Henry Kaufman put it this way:

> Unfettered financial entrepreneurship can become excessive—and damaging as well—leading to serious abuses and the trampling of the basic laws and morals of the financial system. Such abuses weaken a nation's financial structure and undermine public confidence in the financial community . . . When financial buccaneers and negligent executives step over the line, the damage is inflicted on all market participants . . . and the notion of financial trusteeship too frequently lost in the shuffle. *Only by improving the balance between entrepreneurial innovation and more traditional values—prudence, stability, safety, soundness—can we improve the ratio of benefits to costs in our economic system . . .*

And just a few weeks ago, *Daedalus*, the Journal of the American Academy of Arts and Sciences, devoted its entire Fall 2010 issue to "the financial crisis and economic policy." Its lead essay by Harvard professor and acclaimed author Benjamin M. Friedman asks the question, "Is our Financial System Serving Us Well?" Dr. Friedman expresses grave concerns about the shortcomings of our financial system in allocating scarce investment capital, and the high—and growing—costs of its operations. He concludes that the "breakdown in the financial system (has) inflicted serious damage on the real economy, damage that may last for years . . . "

Solving these problems goes far beyond the tinkering with the system that characterized much of the recent Dodd-Frank financial reform legislation. The solutions will require the

wisdom and objectivity of dedicated academics, combined with the intelligence and experience and independence of the most integrity-laden leaders of corporate America and investment America alike. Further, democracy being democracy, even the most promising solutions for restoring our powerful but flawed financial system will ultimately require the perspective and understanding of our elected representatives. We need such academics, private sector leaders, and political leaders with the courage and character to fix what has been broken. Of course there are never enough such extraordinary citizens to allow us to envision an easy road ahead. But surely understanding the issues, which I have tried to help you with this evening, will enable an informed citizenry to begin to tackle the monumental task that lies before us.