# Fixing a Broken Financial System


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I'm so pleased with this wonderful turnout—surely an indication that many leaders in our Greater Philadelphia business and legal community are deeply concerned by the financial crisis that continues to unfold as we meet. And I thank Stradley Ronan for giving me the opportunity to present my views to you, as well as their presenting each of you with my newest book—number seven—published just a few months ago.

As it happens, in many respects, *ENOUGH*, anticipated—some say, *predicted*—the crisis in our markets and our economy. But the book also sends a message about the decline in our society's character and values that we have witnessed over the past few decades. No one would have been more appalled by what has gone wrong than Stradley's former senior partner, the late Andrew B. Young, Esq. I benefited greatly from Andy's mentorship as Wellington Management Company's counsel during the 25 years we worked together, as well as from the insight and wisdom of this great man for the remaining 25 years of his long life. So I take the liberty of dedicating these remarks to his memory. (Stradley, Ronan, Stevens & Young people here: never forget your fine heritage.

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

## The Story of *ENOUGH.*

Let me begin with a few comments about *ENOUGH*. I wrote my new book largely because I care deeply about the traditional values that are eroding not only in our financial system, but also in our businesses, in our communities, and even in our own lives. The story of *ENOUGH.* begins with a sort-of-poem by Kurt Vonnegut. It was entitled "Joe Heller," and I chanced upon it in *The New Yorker* in April 2005. The poem was a tribute to the late author of *Catch 22*—one of the seminal books of the post-World-War-II era, and one of its most successful. I can summarize the short poem in just a few words:

> At a party given by a billionaire on Shelter Island, Kurt Vonnegut tells Heller that their host, a hedge fund manager, had made more money in a single day than Heller had earned from his wildly popular novel *Catch 22* over its whole history. Heller responds, "Yes, but I have something he will never have . . . enough."

*Enough*. I was stunned by both the profound eloquence and the simple elegance of that word. And it couldn't have been more accurate or more timely. For a critical element of our society, including many of the wealthiest and most powerful among us, there seems to be no limit on what *enough* entails.

Think about it. We live in wonderful and sad times—wonderful in that the blessings of democratic capitalism have never been more broadly distributed around the globe, sad in that the excesses of that same democratic capitalism have rarely been more on display. We see the excesses most starkly in the continuing crisis in our overleveraged, overly-speculative banking and investment banking industries, creating a financial crisis that has been, in turn, the principal cause of the economic crisis we are facing, the worst since the Great Depression.

Despite the economic and market meltdown, however, we witness the obscene (there is no other word for it) compensation paid to the chief executive officers of our nation's publicly held corporations—including failed CEOs, often even as they are being pushed out the door—compensation that, given the capital these institutions urgently require merely to survive, is being paid by the federal government—or, more accurately, the taxpayers, or, even more poignantly, *us*.

Main Street bailing out Wall Street for its disgraceful conduct . . . it doesn't seem fair, does it? Well, it isn't!

But the rampant greed that has overwhelmed our financial system and corporate world runs deeper than money. Not knowing what *enough* is subverts our society's traditional values, as self-interest and greed replace community interest, professions behave as businesses, money vs. service to the community, and service to self takes priority over service to others. This confusion about what is *enough* leads us astray in our larger lives, as we too often bow down at the altar of the transitory and finally meaningless; and we fail to cherish what is beyond calculation, indeed eternal. Unchecked, our failures ultimately result in the diminution of our national character and values. So in a broader sense, we *all* bear some of the responsibility for what has gone wrong in America. That message about our society's worship of wealth and the growing corruption of our ethics, I think, is what Joseph Heller captured when he spoke that powerful single word . . . *enough*.

## A Speech at Georgetown

I was so inspired by Vonnegut's poem that, in my commencement address at Georgetown University's business school two years later, I used it to send a message. It was May of 2007, only a few short months before the great bubble that had enveloped our stock market, our financial system, our real estate holdings, and our economy would begin to burst. There I used "Enough" as my theme, and began it with Vonnegut's poem.

Here's what I then said to those newly-minted MBAs:

> "If you enter the financial field, do so with your eyes wide open, recognizing that any endeavor that extracts value from its clients may, in times more troubled than these, find that it has been hoist by its own petard. It is said on Wall Street, correctly, that 'money has no conscience,' but don't allow that truism to let you ignore your own conscience, nor to alter your own conduct and character."

As it turned out, the warning I set forth in that speech—the need to recognize "that any endeavor that extracts value from its clients (and indeed subtracts value from our society) may, in times more troubled than these, find that it has been hoist by its own petard"—proved not only eerily prophetic, but surprisingly timely. For the financial sector was indeed about to be blown up by its own dynamite.

## An Act of Faith

The failure of our financial system is reflected in its betrayal of the fundamental principles under which we invest, a betrayal of our faith. Paradoxically, just a decade ago, I wrote in the very first sentence of my 1999 book, *Common Sense on Mutual Funds: New Imperatives for the Intelligent Investor*, that, "investing is an act of faith."

I then amplified that short, simple declarative sentence in three areas: 1) faith that our corporate managers "will generate high rates of return on our investments"; 2) faith that the "success of the U.S. economy and the nation's financial markets will continue"; and 3) faith that our professional money managers "will be vigilant stewards of the assets we entrust to them."

As we now know, our faith, far too often, has been betrayed. Too many of our corporate managers—most recently those in the banking and investment banking industries, but earlier at Enron, WorldCom and the like—have forfeited our trust by operating in their own financial interests and not in the interests of their shareholders/owners. Our economy is in the midst of the deepest recession since the Great Depression. Our stock markets have plunged to levels not seen since 1996, forfeiting nearly a dozen years of gains. (Leave aside that some of those gains reflected, well, irrational exuberance, and represented, well, "phantom returns" destined to vanish.) And our professional money managers, rather than acting as long term investors—serving as vigilant stewards of our assets and acting as prudent trustees for the mutual fund investors and the pension fund beneficiaries they were duty bound to serve—have instead largely become short-term *speculators,* behaving as stock traders and placing their own interests ahead of the interests of their clients.

## Fathers of the Crisis

There is plenty of responsibility to spread around for what went wrong. So while it is often said that "victory has a thousand fathers, but defeat is an orphan," the defeat suffered by investors in our devastating financial crisis seems to have, figuratively speaking, a thousand fathers. The Federal Reserve, keeping interest rates too low for too long after the 2000-2002 stock market crash, and failing to impose discipline on mortgage bankers. Our banks and investment banks, which designed and sold trillions of dollars worth of incredibly complex and risky mortgage-backed bonds and tens of trillions of dollars of derivatives (largely credit default swamps). They were also left holding the bag with many of these toxic derivatives, held in highly leveraged balance sheets—sometimes by as much as 33 to one or more. Just do the math; a mere three percent decline in asset value wipes out 100 percent of shareholder equity.

These institutions also brought us "securitization," selling off loans to untested financial instruments and severing the traditional link between lender and borrower. With that change, the incentive to demand credit-worthiness on the part of those who borrow almost vanished as banks lent the money and then sold the loans to these new bond funds. In banking we've come a long, long way from community lending built on the financial probity and the character of the borrower, the kind of thing we saw in "It's a Wonderful Life." (Remember Jimmy Stewart as George Bailey and Lionel Barrymore's crusty Mr. Potter?)

Our market regulators, too, have a lot to answer for: The Securities & Exchange Commission was almost apathetic in its failure to recognize what was happening in the capital markets. The Commodity Futures Trading Commission allowed the trading and valuation of derivatives to proceed opaquely, without transparency, without demanding the sunlight of full disclosure, and without concern for the ability of the counterparties to meet their financial obligations if their bets went sour.

And let's not forget Congress, which passed responsibility for regulation of the derivatives market to the CFTC almost as an afterthought. Congress allowed—indeed encouraged—risk-taking by our government-sponsored (now essentially government-owned) enterprises—Fannie Mae and Freddie Mac—allowing them to expand far beyond the capacity of their capital, and pushing them to lower their lending standards. Congress also gutted the Glass-Steagall Act of 1933, which had separated traditional banking and investment banking, a separation that for more than 60 years well-served our national interest.

Our professional security analysts also have much to answer for, especially in their almost universal failure to recognize the huge credit risks assumed by the new breed of bankers and investment bankers who were far more interested in earnings growth for their institutions than in the sanctity of their balance sheets. So do our credit rating agencies, for bestowing AAA ratings on securitized loans in return for enormous fees—handsomely paid in return by the very issuers who demanded those ratings, which allowed what proved to be largely junk bonds to be sold in the marketplace. (Yes, it's called "conflict of interest.")

Yes, there's plenty of blame to go around, finally rooted in the American citizenry at large with our insatiable demand for "more" and our growing appetite for self-indulgence rather than the well-being of our system.

## How Can We Fix Our Broken System?

So we have a real mess on our hands. How does it ever get resolved? The first thing to recognize is that it's *our* mess. In the economy, it will take considerable time to unwind the huge debt overload we have taken on in our mortgages, and our consumer debt, and considerable time for our banking system to re-liquefy its tattered balance sheets. The task will hardly be made easier when our hard-pressed families save more and spend less. We are living through "the paradox of thrift," economist John Maynard Keynes's formulation that described savings as good and necessary for the individual, even as those same savings are counterproductive for our consumer-driven economy, crying for the long awaited upsurge in business activity.

How much time will it take? I'd guess—although I have neither great insight nor economic expertise—that it might take a year and a half to two years before the recession slows and business activity turns upward. It took a long time to create this economic crisis, and it will take a long time to fight our way out of it. But ultimately, given reforms in our system, the resilience of our American society and our American economy will reassert itself.

I should point out that while the tools we use to stimulate the economy are now being chosen by our president and our congress, these remedies are uncertain and untested. They can help us through the crisis, but what we need most of all are the clarity and consistency necessary to restore confidence. The $789 billion stimulus package that is now on the track to the President's desk is a long way from perfect, but it is largely doing the right things—increased unemployment benefits, tax cuts for those earning less than $200,000 per year, infrastructure improvements, help to mortgage holders. Imperfect as the bill surely will be, it's impossible to argue that the federal government should ignore this ghastly economic crisis.

In addition to the stimulus package, of course, we're dealing with a separate financial package designed to rescue our banking system—another $1 trillion (public and private) and counting, and $1 billion of Federal loan backing. (We seem immune to shock over the nearly $3 trillion of Federal commitment out there!) Treasury secretary Geithner's recent proposals seemed to fall on deaf ears, and the stock market—in its inevitably speculative unwisdom—immediately gave him a failing grade. But there is no miracle cure. Nonetheless, the essence of the Treasury plan is correct: we need to engage private capital as well as public capital in order to enable our banks—one by one—to clean up their balance sheets and resume normal lending practices. The secretary also promised "stress tests" designed to assess their financial health, again, bank by bank. (One might have thought this had been a long-standing practice of bank managers and bank regulators alike. But that was not the case.) And surely banks that don't pass the test—and there may be quite a few—will have to be liquidated, with their deposits largely guaranteed under existing federal law.

If the federal government pays the bank piper, of course, it has the right to call the tune. That's the right of ownership, and it brings up the issue of nationalization our—let's face it—already partially-nationalized system. My own view is that the government has not driven nearly a hard enough bargain with the institutions for which it has provided capital. Indeed, I suspect that, say, Dubai, would have demanded a lot more equity for a $55 billion capital infusion into Citigroup than a low-yielding preferred stock and warrants that might entitle it to own less than 1 percent of the company. (For the record, the current market value of Citigroup is about $19 billion, down from $274 billion as recently as 2006. Citi also has some $500 billion of short- and long-term debt, which simple mathematics tells us must also be, to one degree or another, on the endangered species list.)

## The Heart of the Matter

But little attention has been given to the broader systemic issues that have contributed to this crisis. Two overarching changes in capitalism have clearly played a major role. The heart of the matter goes to the very issue of the ownership of our giant publicly-held corporations.

Only if its *managers* are focused on creating long-term value for its *owners* can corporate America be the prime engine of the nation's growth and prosperity and a major source of innovation and experimentation. To the extent that mangers sit unchecked in the driver's seat, feathering their own nests at the expense of their owners, capitalism cannot flourish.

During the past half-century, the very nature of capitalism has undergone a pathological mutation. We have moved from an *ownership society* in which 92 percent of stocks were held by individual investors looking after their own interests and only 8 percent by financial institutions, to an *agency society* in which our institutions now hold 75 percent of stocks and individuals hold but 25 percent.

These institutional agents have not only betrayed the interests of the *principals* to whom they owe a duty of trusteeship, but have also abandoned their traditional investment *principles*. For it is these agents who have been the driving force in changing the central characteristic of market participation from *long-term investment*—owning businesses that earn a return on their capital, creating value by reinvesting their earnings and distributing dividends to their owners—to *short-term speculation*, essentially trading stocks and betting on their future prices. It is not only hedge funds that are playing this game, but most mutual funds and many giant pension plans.

Today, we are witnessing an orgy of speculation the likes of which have never been seen before. Turnover in the U.S. stock market is at the previous high in 1929 was 140 percent; it fell to about 25 percent during my first few decades in this business. Last year, turnover was about 350 percent, speculators trading with other speculators, each with the idea of taking advantage of those on the other side of the trade, creating—to state the obvious—*zero* in economic value. It is the rise of speculation that explains why in a typical year the market *never* moved by daily increments of 3 percent or more (up or down) but have experienced 50 such days since 1/1/08.

## Speculation is in the Driver's Seat

But Wall Street marketers and entrepreneurs loved this new system of speculation in complex products, quantification, innovation, and unconstrained risk, for it made them billions in profits.  So it was easy for Wall Street insiders to wallow in the wealth it generated for themselves, and ignore its destruction of their clients' wealth. Revenues of our stock brokerage firms, money managers, and the other insiders soared from an estimated $60 billion in 1990 to some $600 billion in 2007.

So while trading back and forth with one another—foolish as it is—is by definition a zero-sum game, once the costs of our Wall Street croupiers are deducted it is a loser's game. (Think Las Vegas, think the Atlantic City Race Track. Heck, think Governor Rendell's lottery.) So for investors as a group—who inevitably feed at the bottom of the food chain of investing receiving whatever market returns remain after the croupiers costs—trading is a loser's game, by the amount of these costs. That $600 billion in 2007 plus many hundreds of billions in earlier years, obviously represent a truly staggering hit to the gains investors earned in the bull market, and a financial slap in their face in the bear market that followed. Any confidence in Wall Street that our investors once may have had has largely vanished, just as it should have. The speculators among us, and those of us who have forgotten the distinction between investment and speculation—two groups that inevitably display a large amount of greed—must share a portion of the responsibility for the financial bubble and the ensuing crash.

When an own-a-stock industry becomes a rent-a-stock industry, concern about corporate governance is the first casualty—a harbinger that our capitalistic system is not working properly. Yet the ideal owner is a long-term stockholder, perhaps even a permanent owner, whose goals are closely aligned with those of the corporation, *The Economist* of London expressed it well: "Everything now depends on financial institutions pressing even harder for reforms to make boards of directors behave more like overseers, and less like the chief executive's collection of puppets . . . Financial institutions must also fight to restore their rights as shareholders and use their clout to elect directors, who would be obliged to represent only their collective interest as owners. Chief executives will still run their firms; but, like any other employee, they would also have a boss."

The giant institutions of investment America must take the lead in accomplishing these goals. Our money managers not only hold 75 percent of all shares, but they have the staff to pore over corporate financial statements and proxies; the professional expertise to evaluate CEO performance, pay, and perquisites; and, once full disclosure of all proxy votes (by pension funds as well as mutual funds) becomes mandatory, the incentive to vote in the manner that their beneficiaries have every right to expect. Their dereliction of duty in these areas also bears an important responsibility for what went wrong in our financial sector. (Who, for example, was analyzing those toxic balance sheets of our banks?)

When they return—as they must—to their traditional focus on long-term investing, these institutional owners must fight for the access to the levers of control over the corporations they own that are both appropriate for their dominant ownership position and a reflection of their willingness to accept both the rights and responsibilities of corporate citizenship. And if these institutions do not soon return to traditional standards of prudent investment, we'll have to institute a Federal stature of fiduciary duty, under which the interests of those whose capital is at stake comes first—a new ownership focus for our flawed agency-society. And this is one of the major reforms in the regulation we need in our emerging financial system.

The task of returning capitalism to its owners will take time, true enough. But the new reality—increasingly visible with each passing day—is that proper corporate governance is not merely an ideal to be debated. It is a vital necessity to be practiced. The role of the owners, I underscore, is to do no more than ensure that the interests of directors and management are aligned with those of the shareholders in a substantive way. When there is a conflict of interest, it is the shareholders who should make the decision. It is in the national public interest and in the interest of investors that the owners—represented largely by investment America—come to realize that enlightened corporate governance is not merely a right of business ownership. It is a responsibility to the nation.

In these days when we seem to like "stories" to explain complex issues, each of these men exemplify, respectively three short anecdotes centered on individuals whose names will be familiar to you—(1) Alan Greenspan, (2) Bernard Madoff, and (3) Barack Obama, an unlikely triumvirate if ever there were one—and their respective roles in: (1) how this financial crisis began, (2) how we fooled ourselves, and (3) what we must do to work out way through the incredibly intractable economic woes that now plague us. I'll do this analysis by relating.

## Alan Greenspan and the Bubble

First, former Federal Reserve Chairman Alan Greenspan. More than any other individual, he was central to the development of the financial bubble and the burst that inevitably followed. He successfully urged his fellow Fed governors to continue to make easy credit available when the time to tighten credit had long since arrived, and to ignore the perils created by a free-wheeling mortgage banking business in which the necessary link between borrowers and lenders had been severed. His intellectual analysis and his market-moving power, it turns out, were based on a false premise.

To his credit, in his testimony before Congress last October, Greenspan admitted his mistake. He acknowledged that the crisis had been prompted by "a once-in-a-century credit tsunami," which had arisen from the collapse of a "whole intellectual edifice." "Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity—myself especially—are in a state of shocked disbelief," he said. This failure of self-interest to provide self-regulation was, he said, "a flaw in the model that I perceived as the critical functioning structure that defines how the world works."

It's worth dwelling on that phrase: "*the critical functioning structure that defines how the world works*." As the *New Yorker* writer John Lanchester observed: "That's a hell of a big thing to find a flaw in." Here's another way of describing that flaw, Lanchester continues: "the people in power thought they knew more than they did. The bankers evidently knew too much math and not enough history—or maybe they didn't know enough of either." To which I would add, *enough* indeed!

## Bernard Madoff and How We Fool Ourselves

Next, let's turn to issue number two, how we fooled ourselves in the financial markets, where investors—individual and institutional alike—seemed to lose all perspective. Short-term speculation—more than at any time in the entire history of our nation—was the star of this show, and long-term investment barely played even a supporting role. Too many of us were too greedy, too willing to believe that there were managers who could roundly beat the returns generated in our markets; almost childlike in our eagerness to pay the substantial costs to capture these returns (which proved non-existent); and more or less unaware of the powerful marketing system that greases the machinery of Wall Street. All of these baneful forces converged in the enormous Ponzi scheme directed by Bernard Madoff.

Unlike Greenspan, Madoff was only a marginal contributor to the present crisis, but he surely is its exemplar. Like so many of the complex innovations created by our nation's largest and most prominent financial institutions, Madoff's Ponzi scheme was indeed blown up by its own dynamite. While investors seemed surprised by the collapse of the Madoff fund and astounded by its magnitude, however, we should not have been.

In fact, the investment returns he claimed were preposterous. In my long career, I've seen some money managers who have earned *high* returns, and others who have succeeded in earning *consistent* returns—in each case, whether by skill or luck. But any seasoned investor knows that a pairing of returns that are *both* high *and* consistent is truly oxymoronic. Yet Madoff attracted wealthy investors who thought of themselves as part of the "smart money" crowd, or sought to join that crowd. Too often these investors entrusted their fortunes to managers who knew "the secret" of making lots of money, a secret that would enrich those who had, well, *enough*, but wanted still more. Alas, however, the secret of beating the markets is that there is no secret.

As his reputation for having the "smart money secret" was burnished by individual investors, institutional managers who should have known better also joined the "high-and-consistent-returns" throng. Madoff's scheme was fostered by marketers who recommended him to their own substantial clients—hedge-fund-of-hedge-funds managers who were taken in by Madoff's scam, even as they were grossly enriched by it. In just four years, for example, a single firm received $500 million of fees, simply by investing their clients' money in Madoff's fund. Apparently ignorant of the time-honored rule "trust, but verify," these managers flunked the due-diligence test. Paid such huge revenues for so little effort, they are a vivid example of one of Upton Sinclair's timeless warnings, which I paraphrase here: "It's amazing how difficult it is for a man to understand something if he's paid a small fortune *not* to understand it."

## President Obama, Leadership, and Confidence

My third and final subject is "where do we go from here?" We are facing the worst economic crisis of my adult lifetime (I was born just before the Great Depression, so I don't remember it!), a financial mess that is enormous beyond imagination, and complex beyond the intellectual capacity of most (perhaps all!) of us. What's more, the solutions that we are considering are without precedent—and therefore uncertain of success. Resolving the crisis and reforming the system will take patience and sacrifice—two traits that at the moment seem far from being the defining elements of our national character.

Here is where Barak Obama comes in. For while resolution and reform will come neither easily nor quickly, both require strong leadership. And without strong leadership, we are lost. I speak not as a partisan but as a citizen when I express my belief that President Obama can—and will—give us the kind of leadership we urgently require. Clearly, he understands the challenge. Recall with me these words from his Inaugural Address:

> "That we are in the midst of crisis is now well understood . . . Our economy is badly weakened, a consequence of greed and irresponsibility on the part of some, but also our collective failure to make hard choices and prepare the nation for a new age . . . The question before us (is not) whether the market is a force for good or ill. Its power to generate wealth and expand freedom is unmatched, but this crisis has reminded us that without a watchful eye, the market can spin out of control—and that a nation cannot prosper long when it favors only the prosperous. The success of our economy has always depended not just on the size of our gross domestic product, but on the reach of our prosperity; on our ability to extend opportunity to every willing heart . . . the surest route to our common good."

> "Those values upon which our success depends—hard work and honesty, courage and fair play, tolerance and curiosity, loyalty and patriotism—these things are old. These things are true. What is demanded then is a return to these truths. What is required of us now is a new era of responsibility—a recognition, on the part of every American, that we have duties to ourselves, our nation, and the world, duties that we do not grudgingly accept but rather seize gladly, firm in the knowledge that there is nothing so satisfying to the spirit, so defining of our character, than giving our all to a difficult task. This is the price and the promise of citizenship."

As I listened to the president's Inaugural Address, I was impressed with his obvious gift of oratory. And when I read the text in the next day's newspaper, I was even more struck by the power, the clarity, and the realism that resounded throughout his cadences. While he didn't use the phrase "America, we have had *enough"* (as he did—of course, to my delight—in his speech accepting his party's nomination), I was struck by how his words and values paralleled what I had written months earlier for my own ENOUGH.. In the section in which I ask, "Enough for America?," see if you don't find the echoes of my own ideals in the ideals of our new president:

> "While we seem to have quite enough things in the United States, our traditional values seem to be eroding, and soon we'll not have nearly enough of them. So let's never forget that over the long term it is not things, nor power, nor money that form the heart of any nation. Rather, it is values, the very values, applied to our society that I have described here for us as individuals: the persistence, resilience, moral standards, and virtue that have made this nation great. The question, in short, is not whether the United States has enough money—enough productive wealth—to maintain and enhance its global presence and power, but whether we have enough character, values, and virtue to do so."

And that's really what *ENOUGH.* is all about . . . and that's surely *enough* words to inflict on you on this busy morning, during this long winter of our discontent. These are truly "the times that try men's souls," but please remember the eternal wisdom of these words: "This too shall pass away." And so today's crisis shall pass away, as time and the resilience of our system—and important changes in the way we manage American capitalism—heal our wounded economy. It can't pass away too soon for me!