

“Leaving the Things that You Touch Better than You Found Them”

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Being honored by the Union League of Philadelphia—the city in whose environs, providentially, I’ve spent the past 62 years of my life—almost demands that the honoree begins with the club’s timeless motto, *Love of Country Leads*. And in fact it is love of country—the blessings of citizenship in the United States of America—that has led me through much of my own life and career. I was raised to be, above all, a good citizen, constantly reminded in my pre-Philadelphia years of, well, family values. These values are exemplified by my memory of the kind of adages like “God Bless Our Home” that were cross-stitched on the sampler pillows of years long gone.

Even today, these principles remain part of my life. “Do what’s right, no matter how painful”; “a penny saved is a penny earned”; “idle hands are the tools of the devil” (the way my Scottish forebears pronounced “devil”); “even one person can make a difference”; and “press on, regardless,” the name of my uncle’s old lobster boat. (That one came always with the reminder you must press on, not only in tough times, but in easy times as well.)

My unifying theme today is yet another of these family principles: “*leave the things that you touch better than you found them.*” This afternoon, I’d like to tell you how I tried to apply this tenet to some of the major interests of my long life: the National Constitution Center, Blair Academy, Vanguard, and our financial markets.

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

The National Constitution Center

While I've been a director of the National Constitution Center since its inception in 1988, in the early years I was a pretty poor example of that old family tenet, making little if any difference. But after a management upheaval in 1996—and with the return of my energy following a heart transplant earlier in the year—I became increasingly involved. Then-mayor Rendell and NCC president Joseph M. Torsella had brought this near-moribund project back to life, doing yeoman service in obtaining our splendid location on Independence Mall, supervising the architectural design, and raising the money for the building. Amid those efforts, late in 1999, they asked me if I'd be willing to succeed the mayor as chairman. I agreed to do so for six months, only until they could find what I described as a “real” chairman.

But last October, I began my eighth year as Chairman, enjoying one of the great experiences of my long career. Chief executive Joseph M. Torsella, a young graduate of the University of Pennsylvania (and a Rhodes scholar) proved to be a renaissance man—entrepreneur, manager, planner, historian, and extraordinary human being. Under his leadership, the new museum came into being both on budget (\$185 million, including a \$40-million endowment) and on time, opening on schedule on July 4, 2003. Small wonder that early in 2004, project completed, Joe moved on to seek public office. I could think of no finer tribute to him than to reiterate the dedication to master architect Christopher Wren, in London's St. Paul's Cathedral, circa 1711: “If you would see his monument, look around.”

Now, an outside chairman deserves only so much credit—and surely not *too* much—for the accomplishments of an institution. But hiring Richard M. (“Rick”) Stengel, a Princeton graduate (and a Rhodes Scholar, too) as Joe's successor proved to be a providential decision. Again, I did my best to support Rick, who also proved to have remarkable entrepreneurial and leadership talents. In 2006, when Rick was lured back to lead TIME magazine as its managing editor, I was devastated but understanding. But in a moment of inspiration, I quickly called Joe. Within 48 hours he'd agreed to return to the Constitution Center. I revel in his continued leadership there, second time around.

Later in 2006, when I decided to relinquish my chairmanship, I turned the job over to former President George H. W. Bush. Surely it's no mean honor to succeed a mayor who became a governor, and a similar honor to be succeeded by a president! While I received many accolades as my near-eight year stint at the Center came to an end, my biggest contribution was the simple recognition of the extraordinary talents of the two chief executives with whom I served. I supported them unstintingly, and advised them whenever they asked. Any credit directed toward me merely reflects their signal achievements and the work of our

outstanding staff. But I did my best, and left the National Constitution Center a better place—indeed a real, living, growing institution that is bringing our Constitution back into its deserved position in the mainstream of American life—than I found it in that original vision that I signed on for in 1988—then a wonderful vision, but only a vision, now become a reality.

Blair Academy

The education of our young citizens is another area of considerable interest to me. While I'm deeply troubled by the profound shortcomings of our nation's schools—and fully understand that these seemingly intractable problems arise in important measure from disturbing societal issues, including poverty, racial discrimination, drugs, and the gradual erosion of the traditional, well, “nuclear family” in which children are raised by both parents—I long ago decided to focus my own limited talent on a narrow subset of the educational universe.

Let me tell you a bit about that decision. From kindergarten through tenth grade I attended public schools of moderate ambitions—making small demands on students, and with limited curricula, albeit with some superb teachers. But my parents, ambitious for their three boys, realized that we were all capable of meeting more demanding standards. While our financial resources were meager to a fault, with generous scholarships and jobs (at school and during our vacations) we were admitted to Blair Academy, a wonderful independent boarding school in New Jersey, not far from the Delaware Water Gap.

Blair changed my life. At the end of my two years there, despite my slow start in adjusting to its far tougher academic program, I graduated second in the Class of 1947. The masters were all teachers and they were characters; they exuded character; they unfailingly demanded high character of their charges; and they pushed me to the very limits of my abilities. Without Blair, I never could have gained admission to Princeton. Given what Blair did for me, I incurred a huge debt to the Academy, as well as a huge obligation.

My *debt* can be precisely measured in the financial benefits Blair offered me, and I've long since repaid that debt in dollars and cents, many times over. But my *obligation* is infinite. For virtually everything I've achieved in life began with my few years there, when a boy became a young man, well-prepared for college, and launched on his long voyage on the turbulent seas of life.

When I was invited to join Blair's Board of Trustees in 1970, I reveled in the opportunity to repay my obligation. While in the early years I was slow in getting involved in board affairs, I was elected as its

chairman in 1984, and served in that post through 1999. (I continue as a dedicated trustee to this day.) Even as my heart began to fail and during my long siege in the hospital awaiting the transplant, I threw myself into helping to rebuild my old school, to develop a long-range plan, and to restore its reputation. During that era, we've added a new classroom building, a new arts center, a new library, and a new girl's dormitory, and are now building a new student center and gymnasium. At the same time, our endowment fund has risen from a pathetic \$900,000 to a reasonable (but hardly excessive!) \$54,000,000.

Would that these were all my personal accomplishments! Alas, they're not. Most of the credit goes to the remarkable headmaster who joined us in 1989 and leads the school to this day. Even as with Joe and Rick at the Constitution Center, hiring Headmaster T. Chandler ("Chan") Hardwick and his wife Monie remains my signal achievement at Blair. With the support of a splendid faculty and staff and a fine alumni body, these two wonderful human beings have invested their lives in making the school that I love among the best in the nation. Now educating remarkable young citizens who will serve as America's leaders in the new century, Blair Academy is a far better institution today than when I found it (or did it find me?) in 1945, all those years ago.

Vanguard

I suppose that its fairly easy to leave something better than you found it when it didn't even exist in the first place. I'm speaking, of course, of Vanguard, the little company that I founded all those years ago, a company started by accident and begun as an experiment. The legends about Vanguard's creation happen to be true. Yes, in January 1974, I was fired from my job as chief executive of Wellington Management Company. Yes, I then presented a plan to the directors of the Wellington-managed mutual funds under which I would remain as *their* chief executive, and the funds would retain their own operating staff. Yes, after months of tussling, the directors approved that initial plan, and Vanguard was incorporated on September 24, 1974. (And yes, I picked that name out of an old book of Great Britain's naval history, where I learned for the first time of Lord Nelson's flagship at the Battle of the Nile in 1798; it was *HMS Vanguard*.)

The creation of that unique new structure led to: (1) the establishment of a new form of governance in the mutual fund industry, a *mutual* structure in which the interests of fund investors would take precedence over the interests of fund managers and distributors, in constitutional terms, a governance "of the investor, for the investor, and by the investor." (2) The formation of the world's first index mutual fund, a passive portfolio designed simply to mimic the returns provided by the stock market, a standard that

precious few portfolio managers have measured up to over time. (3) The development of a new paradigm for bond fund management, using innovative three-tier structure of short-term, long-term, and intermediate-term portfolios that quickly became the industry standard. And (4) the abandonment, literally overnight, of a proven broker-dealer, commission-oriented “supply-push” distribution system in favor of a new and untried no-sales-charge, “demand-pull” system for self-motivated investors.

None of these changes came easily. To accomplish them required a devil-may-care attitude; a blasé disregard for risk; a profound conviction, without hard evidence, that they would work; and the sheer energy required to get it all done. Yet despite what we regarded as our noble intentions, the completion of our structure was initially opposed by the Securities and Exchange Commission, which rejected our structure and dawdled over our appeal for years. When the Commission finally gave us its unanimous approval, it came with an endorsement that proved to be prophetic: “The Vanguard plan actually furthers the (1940 Investment Company) Act’s objectives, and promotes a healthy and viable complex in which each fund can better prosper.”

And prosper we did. By the time the SEC finally gave us the green light in 1981, seven long years after we began, the stock market recovery had begun, and our assets had doubled, from \$1.4 billion to \$3 billion. Every three years thereafter, assets would double again and again with remarkable regularity. In 1983, to \$6 billion; 1985, \$12 billion; 1986, \$24 billion; 1989, \$50 billion; 1992, \$100 billion; 1995, \$200 billion; and again to \$400 billion in 1998. Remarkable! While it took longer—seven more years—for our assets to double yet again, we crossed the \$800-billion mark in 2004. Today we oversee \$1.1 *trillion* of other people’s money.

Surely that growth can be described as a *commercial* success for our firm. More importantly, Vanguard has also proved to be an *artistic* success for our fund shareholders. The returns earned by our funds are consistently ranked near the top of our industry, most recently as #1 by *Global Investor*. How could it be otherwise? For this is an industry where cost is *everything*. After all, for investors as a group beating the stock market is a *zero-sum* game before the huge costs of financial intermediation, that a *loser’s game* after deducting those costs. These *relentless rules of humble arithmetic*, using Justice Brandeis’s formulation, backed by our mutual structure and our legendary thriftiness, guaranteed that we would be—as we are, by a huge margin—the world’s lowest-cost provider of financial services.

Today’s Vanguard has become a sort of prototypical 21st century firm—a virtual organization; enormous in size; heavily reliant on process, real-time communications, and computer technology; and

managed largely by the contemporary numeric standards of modern management. But at our core, at least through my idealistic eyes, our founding values remain largely intact, thriving on our commonsense mutual structure, on our simple investment strategies, and on eternal verities such as service to others before service to self, doing our best to hold high the belief that ethical principles and moral values must be, finally, the basis for any enterprise worth its salt. So yes, I'm reasonably comfortable—if hardly objective!—in my conviction that, Vanguard will remain the fully-realized manifestation of our original vision that it is today. What is more, we have made a positive impact on our industry—in direction, if hardly in magnitude—that will ultimately make the mutual fund industry a better industry than it is today.

The Financial Markets

But it was years before I founded Vanguard that I first engaged with our financial markets. (Until then, given our family's circumstances, I was very familiar with large debts and threatening repayment notices, but knew nothing—*zero*—about investments.) But when I happened to open *FORTUNE* magazine in December 1949, I learned of the mutual fund industry for the first time. I was intrigued and inspired by the prospects of this then “tiny but contentious” industry, and wrote my Princeton thesis about it. The thesis, in turn, led directly to my first full-time job in the summer of 1951—with Philadelphian Walter L. Morgan's Wellington Fund—and my career in the financial markets began.

It would be, well, fatuous to think that I've left our nation's markets in better shape than when I first found them way back in 1949. It would also be wrong. For institutional investing has moved from an earlier era focused on the professional standards of trusteeship to a new era of asset gathering and salesmanship, from management to marketing, from the wisdom of long-term investing to the folly of short-term speculation, and from being *owners* of stocks to *renters*. (Turnover of shares in the stock market was about 25 percent in the 1950s and 1960s; today it is 150 percent—six *times* as high.) These changes have ill-served investors.

So in my speeches across the land, and especially in my most recent two books (*The Battle for the Soul of Capitalism*, and *The Little Book of Common Sense Investing*), I'm shamelessly campaigning to return capitalism and the financial markets to the values that made them such priceless national assets in an earlier age. Only if we return our economic system to its proud roots, and focus on long-term investing rather than short-term speculation will the job of capitalism be well done. Emboldened by the fine reviews of *The Little Book* in Sunday's *New York Times*, in Monday's *USA Today*, and in today's *Wall Street Journal*, I'm encouraged that the message is finally beginning to gain traction.

It's only a small step from the workings of the financial markets to the consideration of what returns we might expect from stocks in the years ahead. (Our host has asked me to discuss this question.) While only a fool tries to predict what the stock market will do in the short term—there are, alas, lots of fools who do exactly that—predicting long-term returns is largely a product of another set of those simple “relentless rules of humble arithmetic,” similar in concept to the causal linkage between maintaining low investment costs and capturing your fair share of stock market returns.

Why so? While in the short-run stock returns are largely shaped by *emotions*—such as optimism, pessimism, hope, greed, and fear—in the long run they are shaped almost entirely by *economics*. For example, over the past century, of the 9.6 percent average annual nominal (before inflation) *Total Return* generated by common stocks, fully 9.5 percent was accounted for by the average dividend yield of 4.5 percent and average earnings growth of 5.0 percent—the *Investment Return* on capital earned by America's businesses. The remaining 0.1 percent came from *Speculative Return*, the willingness of investors to pay a slightly higher price for each dollar of corporate earnings at the end of the period than at the beginning.

Since a majority of you here today are not investment professionals, let me put this concept in the homey terms I used in this very hall just a few years ago. Then, I explained stock market returns with a, well, crusty speech entitled “The Bagel and the Doughnut.” The date was January 5, 2000, almost precisely at the stock market's peak; the occasion, a meeting of Philadelphia's Sunday Breakfast Club. In my remarks, I relied on an analogy inspired by William Safire in his essay, “Bagels vs. Doughnuts.” These baked goods, Safire tells us, are similar in shape but different in character: Bagels are “serious, ethnic, and hard to digest. Doughnuts are fun, crumbly, sweet, and fattening.”

Investment return, I argued, is the bagel of the stock market, reflecting the reality of intrinsic business values. Its underlying character is nutritious, crusty and hard-boiled. *Speculative* return is the spongy, tempting, and sweet doughnut of the market itself, reflecting investment expectations and driven by the illusion of momentary stock prices, however precise. The bagel-like *economics of investing* are almost inevitably productive in the long run; the doughnut-like *emotions of investing* are fickle and largely unpredictable—witness the Great Bull Market of the 1980s and 1990s, and its collapse in 2000-2002, almost entirely the result of a change in the doughnut of investing from the soft sweetness of unbridled optimism on the part of investors to the acid sourness of pessimism.

In that January 5, 2000 speech, I considered the outlook for the stock market during the first decade of the new millennium. I asked just two questions: (1) Will the bagel of investment fundamentals give us its usual sustenance? And (2) Will the doughnut of speculation get even sweeter than it was when I spoke, or will it finally sour again?

Here's how I answered the first question about investment return: Since the dividend yield on stocks was then at an all-time low of just over 1 percent, it was sure to contribute little to future investment returns. (Remember that the long-term norm was 4 ½ percent.) As to earnings growth, ever the optimist, I guessed that 8 percent growth might be possible. Thus, the economics of investing suggested an investment return of 9.2 percent—the 1.2 percent yield, plus 8 percent earnings growth.

My answer to question (2) about speculative return: The bullish emotions that had driven stock returns skyward during the 1990's, could not recur. After all, stocks were then selling at 30 times earnings; almost double the long-term norm of 16 times. (What was the market thinking?!) I suggested that P/E ratio would drop to perhaps 20 times, slashing 4 percentage points per year from the projected investment return of 9.2 percent, thereby reducing the total return on stocks to about 5 percent during the first decade of the 21st century, only about one-half of the long-term norm of 9.6 percent.

While my projection was then seen as absurdly pessimistic, in fact it proved to be a bit too optimistic. Earnings growth was virtually identical to my 8 percent guess-timate, but the price/earnings multiple tumbled to 17 times, somewhat below my projection of 20 times. But in terms of Total Return, the forecast looks pretty good, with the market on track to produce about a total return of 4 percent per year during the decade ending in 2009—remarkably close to the 5 percent figure that I forecast seven years ago.

So, emboldened by a combination of wisdom, common sense, luck, and yes, the relentless rules of humble arithmetic, let's look ahead to the next ten years. I expect the bagel of investment return to be nicely positive, most likely in the range of eight percent per year; i.e., adding today's dividend yield of a higher but still stingy two percent to what I'll guess is earnings growth in the six percent range. (After all, corporate earnings grow at about the same nominal rate as our economy. What else is new?) As to speculative return, I think investors are a bit too optimistic, and therefore I look to slightly lower valuations—a doughnut not quite so sweet—perhaps lowering the Total Return on stocks to 7 percent per year. Will that forecast be as accurate as my previous guess? Only time will tell, but I am hardly alone among experienced investors who believe we are facing an era of subdued returns in the stock market.

If that 7 percent projection is correct, investors would be wise to do their best to capture it. That means low-cost, long-term *investing*—yes, just what an index fund does—that will guarantee you with your fair share of whatever returns our financial markets are generous enough to provide, the consummate *winner's* game. And it means recognizing and accepting that high-cost, short-term *speculation*—with all of its trading costs, expensive management fees, and unnecessary taxes—is the consummate *loser's* game. Despite the failure of our financial system, then, there is no reason you can't avoid its myriad potholes, and by so doing be a winner.

Wrapping Up

As I look back over the institutions whose lives I've been privileged to touch, I confess to letting a little *pride* peep out—much as I've tried (in Benjamin Franklin's pungent words) to “disguise it, beat it down, stifle it, mortify it as much as one pleases, pride will nonetheless every now and then peep out.” And so it does when I concede that I've likely left the National Constitution Center, Blair Academy, and Vanguard, to some degree at least, better than I found them. Alas, I cannot say that I've done the same in my against-all-odds fight to restore the mutual fund industry to its proud heritage, to build a better financial system for our nation, and to return capitalism to a more productive role in our society. Nonetheless, I hold the absolute conviction that my crusade places me on the right side of history, and that positive change will one day result from my efforts.

And I'm not giving up. After all, how could I possibly ignore final inspirational saying in that litany of family values that I told you about at the outset: “*Press On, Regardless.*”