Building a Fiduciary Society

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Not so long ago, Rahm Emanuel, President Obama's chief of staff, expressed one of the eternal verities of our society: "Never allow a crisis to go to waste. (Crises) are opportunities to do big things."

That principle applies in a particularly profound way to the financial sector of our economic society. The crisis in our stock market and in our economy has presented us with the opportunity to do a really big thing—to reform our financial system. Over the past half-century, that system has changed radically, and for the worse. Our old *ownership* society, in which stocks were owned largely by individuals is long gone and will not return. Its successor, the *agency* society, now prevails, institutional money managers holding and trading the lion's share of U.S. stocks and operating in their own financial interests. The present crisis is, in important measure, a reflection of that change, and it gives us the opportunity to build, out of the ashes of our failed agency society, a new *fiduciary* society in which the interests of the investors who put their capital to work come first.

The Financial Crisis

There's no doubt that we have a financial crisis on our hands. In my long career in finance, going way back to 1951, I've witnessed ten bear markets (defined as stock market

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declines of 20 percent or more). The current bear market is the worst of the bunch—off by almost 55 percent, even worse than 1973-74 and 2000-2001, when the drops reached 50 percent. What's more, this decline is the first that I can recall in which the distress in the *financial* economy has so profoundly impacted the *real* economy of goods and services, harming a large mass of our citizenry, even those who had no meaningful participation in the boom that led to the bust, but who are now paying the penalty for the market's excesses.

It is not Wall Street, but the ordinary citizens of the United States who will foot the bill for the gross financial excesses of the recent era. "The government," as always, has no money of its own. So it is paying the financial sector with our money. We may pay for part of this bailout with higher taxes; but given our flawed political system, the cost is more likely to be extracted from future generations with dollars that buy less. Inflation is just another form of taxation, albeit one that is sharply regressive.

What we are witnessing is the verification of "the financial instability hypothesis" put forth by the economist Hyman P. Minsky (1919-1996). In 1992, Minsky warned that, "capitalist economies exhibit . . . debt deflations that . . . spin out of control (as) the economic system's reactions to the movement of the economy amplify the movement." Sad to say, Minsky adds, ". . . government interventions aimed at containing the deterioration (are often) inept in historical crises." It remains to be seen whether he was right or wrong on that point.

Minsky concluded that over long periods of prosperity, the economy transits from financial structures that make for a stable system to structures that makes for an unstable system; i.e., that "stability leads to instability," largely through what he described as hedging, speculation and Ponzi finance. With these words, all those years ago, Minsky proved a prophet of today's crisis. Another of his insights was also prophetic: "Institutional complexity (for example, today's collaterized debt obligations and credit default swaps) may result in several layers of intermediation between the ultimate owners of the communities' wealth, and the (business and individual) units that operate and control the communities' wealth."

This separation between ownership and control has now come to pass. In our old *ownership* society 92 percent of all stocks were owned by individuals and 8 percent by institutions. But in today's *agency* society, only 24 percent of stocks are owned by individuals, with the remaining 76 percent held by institutions. This sea-change in ownership has moved the locus of control of corporate America from owners to managers, a change I've described as "a pathological mutation in capitalism."

The Consequence of Agency Capitalism

How has this separation contributed to the recent crisis? First, because our newly-empowered financial agents—largely the giant institutional money managers that advise mutual funds and retirement plans—have far too often placed their own financial interests ahead of the interests of fund owners and retirement plan beneficiaries; that is, ahead the interests of their own *principals*. And second, because these agents have departed from traditional investment *principles*—focused on the wisdom of long-term investing—and have embraced a new focus that engages in the folly of short-term speculation.

How great a departure does this change in investment principles represent? An enormous change, however rarely noted. Today, turnover of stocks in the United States, which ran in a range of 20 to 30 percent during my first twenty years in the financial sector, came to an estimated 300 percent in 2008—more than ten times as large. In the mutual fund industry the change has also been extreme, albeit at lower levels. Turnover among actively-managed equity funds has risen from 16 percent in those early years to an average of 95 percent in 2008. Such turnover—whether 300 percent or 95 percent—is *not* investment, focused on long-term cash flows and intrinsic values. It is speculation, focused on short-term bets on stock prices.

As the woes of our financial system resonate through our economy, it seems crystal clear that our current recession represents a "Minsky Meltdown" of significant proportions. While I believe that our economy is not facing the kind of depression that our nation endured in the early 1930s, we simply don't know whether our plummeting stock market: (a) has yet to adequately anticipate the depth of the economic downturn; (b) has already anticipated most of it; or (c) has anticipated something much worse than what is likely to transpire.

"Phantom Wealth"

I'm inclined to believe that the answer is somewhere between (b) and (c). Why? Because the market value of U.S. stocks has tumbled from $17.2 trillion at the October 2007 high to $7.9 trillion at the recent low. Yes, a significant portion—perhaps as much as $3 to $4 trillion—of that record financial wealth was in fact “phantom wealth”—borne not of the cumulative earnings and dividends generated by American business, but of extraordinarily high—indeed, speculative—valuations that were accorded by the marketplace to those fundamental investment returns.[1] Whatever the case, sooner or later, valuations will reflect reasonable expectations for dividend yields and earnings growth, and the wealth created by business will determine the future level of stock prices. Put another way, let’s not forget Benjamin Graham’s observation that while in the short run the market is a *voting* machine, in the long run it is a *weighing* machine. Put yet another way, “the fundamental things apply as time goes by.”

Now a caveat: Corporations generate earnings for the owners of their stocks, pay dividends, and reinvest what’s left in the business. In the aggregate, over the past century, the nominal returns generated by our businesses have grown at an annual rate of about 9 ½ percent per year, including about 4 ½ percent from dividend yields and 5 percent from earnings growth. But these are the *gross* returns generated by the corporations that dominate our system of competitive capitalism. Investors who hold stocks, either directly or through the collective investment programs provided by mutual funds and defined benefit pension plans, receive their returns only *after* the cost of acquiring them and then trading them back and forth among one another.

While some of this activity is necessary to provide the liquidity that has been the hallmark of U.S. financial markets, it has grown into an orgy of speculation that pits one manager against another, and one investor (or speculator) against another—a “paper economy” that, as Minsky warned, can devastate the real economy where our citizens save and invest. It must be obvious that our present economic crisis was, by and large, foisted on Main Street by Wall Street—the mostly innocent public taken to the cleaners, as it were, by the mostly greedy financiers.

The economist Henry Kaufman warned about this very problem in his book, *On Money and Markets,* published in 2000:

[1] Using the valuation model developed by Dr. Robert Shiller of Yale, the valuations were even more extreme. In October 2007, stocks sold at prices equal to 27 times earnings during the prior ten years, compared to the long-term multiple of 16 times. Result (if you agree with his premise): at the market peak, phantom wealth totaled nearly $7 trillion.

"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 . . . 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 . . . 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."

Dr. Kaufman's early warning, of course, went unheeded. For our financial system is a greedy system, depending on high transaction volumes, high leverage, and rank speculation to maximize its own rewards. As a result, it consumes far too large a share of the returns created by our business and economic system.

Writing in the *Journal of Portfolio Management* a year ago, I described the enormous costs of the financial sector: ". . . mutual fund expenses, plus all those fees paid to hedge fund and pension fund managers, to trust companies and to insurance companies, plus their trading costs and investment banking fees . . . totaled about $528 billion in 2007. These enormous costs seriously undermine the odds in favor of success for investors. For *the investor feeds at the bottom of the costly food chain of investing*, paid only *after* all the agency costs of investing are deducted from the market's returns."

We Are All Indexers

So what's to be done? First, we need our citizens to understand the difference between investment and speculation, and to recognize that—simply because of the costs of the financial system—long-term investors *must* win and short-term speculators *must* lose. I dare say that the optimal solution lies right before our eyes: Owning the entire stock market as our equity position, and holding it forever. Yes, I'm speaking of the stock market index fund. But please don't think about that as a self-interested statement on my part. Think, instead of this reality: *As a group, we are all indexers.*

But because providers of financial services are largely smart, ambitious, aggressive, innovative, entrepreneurial, and, at least to some extent, greedy, it is in their own financial interest to have investors ignore that reality. Think about it: Our financial system earns most of its money by persuading investors to trade stocks or by paying money managers to do their trading for them. Thus, this system pits one investor against another, buyer vs. seller. Each time a share of stock changes hands (and today's daily volume averages some 10 billion shares), one investor is (relatively) enriched; the investor on the other side of the trade is (relatively) impoverished.

But, as noted earlier, this is no *zero-sum game*. The financial system—the traders, the brokers, the investment bankers, the money managers, the middlemen, "Wall Street," as it were—takes a cut of all this frenzied activity, leaving investors as a group inevitably playing a *loser's game*. As bets are exchanged back and forth, our attempts to beat the market, and the attempts of our institutional money managers to do so, then, enrich only the croupiers, a clear analogy to our racetracks, our gambling casinos, and our state lotteries.

So, if we want to maximize the returns earned by our citizen/investors, we must drive the money changers—or at least most of them—out of the temples of finance. *Why? Because we investors collectively own the market. When we individually compete to beat our fellow market participants, we lose. But when we abandon our inevitably futile attempts to obtain an edge over other market participants and all simply hold our share of the market portfolio, we win*.

Corporate Citizenship

In addition to its excessive costs, the speculation that permeates today's financial system has another unfortunate consequence. *Investors* must care about corporate governance. *Speculators* do not care, and arguably—much as I hate to say it—should not care. So when our money management agents fail to exercise the rights and responsibilities of corporate ownership, in particular, by assuring that the governance of the corporations in our portfolios is focused on serving the interests of the shareholders of those corporations rather than the interests of their management. The massive substitution of agency ownership of stocks for personal ownership, then, is one of the major challenges of twenty-first-century capitalism, and it is high time for our agents to represent their principals.

But the failure of our professional institutional money managers to act as responsible corporate citizens is only part of their contribution to the present crisis. Another factor is at least as critical: their apparent failure to do their job as professional investors, thoroughly evaluating, analyzing, and appraising the financial positions—the balance sheets and the income statements—the managements, and the strategies of the corporations they cover. How on earth did our smart, well-educated, seasoned analysts miss what was going on at Bear Sterns, at Lehman, at Citicorp, at AIG, and (in an earlier cycle) at WorldCom and at Enron? If our investment professionals, responsible for the prudent investing of other peoples' money, didn't undertake adequate research of those corporations, shame on them. And if the information they needed and demanded was not provided, and they still held the stocks, shame on them for that.

Let me summarize the major issues I've presented. (1) Our old *ownership* society has pretty much vanished and will never return. (2) The *agency* society that has largely replaced it has failed to honor first and above all the interests of its principals—largely mutual fund shareholders and pension beneficiaries. (3) Our financial sector has abandoned its traditional investment principles; moving from long-term investment to short-term speculation. (4) In our parochial interest in winning the investment game by betting against other market participants, we have defied the mathematical certainty that the higher the costs of investing, the lower the returns that, as a group, investors earn. (5) Together, these trends have led to an abandonment of investor concerns about corporate governance, and the inadequacy of investment research and security analysis.

While these issues may be different from those of the past, the principles are age-old. Consider this warning from Adam Smith way back in the 18^{th} century:

> *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.

Building a Fiduciary Society

So what we must do is develop a new *fiduciary* society which guarantees that our last-line owners—those mutual fund shareholders and pension fund beneficiaries whose savings are at stake—their rights as investment principals. These rights must include:

(1) The right to have their money-manager agents act solely in their behalf. The client, in short, must be king.

(2) The right to rely on due diligence by managers, in the services, the mutual funds, and the financial products that they offer.

(3) The guarantee that our agents will be responsible corporate citizens, restoring to their principals the neglected rights of ownership of stocks.

(4) The elimination of all conflicts of interest that could preclude the achievement of these goals.

Of course it will take federal government action to foster the creation of this new fiduciary society that I envision. Above all else, it must be unmistakable that government intends, and is capable of enforcing, standards of trusteeship and fiduciary duty under which money managers operate with the *sole* purpose and in the *exclusive* benefit of the interests of their beneficiaries—largely the owners of mutual fund shares and the beneficiaries of our pension plans.

While the government action is essential, however, the new system should be developed in concert with the private investment sector, an Alexander Hamilton-like sharing of the responsibilities. The task of returning capitalism to its ultimate owners will take time, true enough. But the new reality—increasingly visible with each passing day—is that the concept of fiduciary duty is no longer merely an ideal to be debated. It is a vital necessity to be practiced.

What's at stake here is the very role of capitalism in our society. Should it serve corporate managers and money managers? Or should it serve the citizens who invest their capital? Is speculation to ride in the saddle, or will investment call the tune? Some 70 years ago the eminent British economist John Maynard Keynes warned us:

> *"When enterprise becomes a mere bubble on a whirlpool of speculation, the consequences may be dire . . . when the capital development of a country becomes a by-product of the activities of a casino . . . the job (of capitalism) will be ill-done."*

Once a profession in which business was subservient, the field of money management has largely become a business in which the profession is subservient. That job is indeed being ill-done today. Business enterprise has taken a back seat to financial speculation. The multiple failings of our flawed financial sector are jeopardizing, not only the financial security of our nation's savers but the economy in which our entire society participates.

Fiduciary Duty

Let me take a moment to be clear and explore what we mean by fiduciary duty, a concept that goes back some eight centuries in British common law. Fiduciary duty is essentially a legal relationship of confidence or trust between two or more parties, most commonly a *fiduciary* or *trustee* and a *principal* or *beneficiary*, who justifiably reposes confidence, good faith, and reliance in his trustee. The fiduciary acts at all times for the sole benefit and interests of another, with loyalty to those interests. A fiduciary must not put personal interests before that duty, and must not be in a situation where his fiduciary duty to clients conflicts with a fiduciary duty to any other entity.

Whether we like it or not, fiduciary duty is, in a sense, creeping up on us. ERISA requires companies that sponsor defined contribution plans to be subject to the standard of fiduciary duty—even as it exempts (oddly enough!) some plan service providers, usually mutual fund management companies, from such a standard. And early in 2008, one fund manager (Federated Investors) called for "A New Paradigm for Federal Regulation of Financial Intermediaries," suggesting that "all financial intermediaries that provide advice to individual customers should be fiduciaries."

A few weeks ago, Federated received what seemed to me surprising support from Paul Stevens, President of the Investment Company Institute, the principal lobbyist for fund management companies. The fiduciary standard, Stevens suggested, requires advisers to put their clients' interests first, and "does provide a standard of responsibility and accountability." He then asked the rhetorical question, "Isn't that something that all of our recent experience suggests is important?" My answer: "Unequivocally *yes."*

Yet both the Federated and the ICI comments seemed to gloss over the fact that there are two types of investment advisers, albeit similarly defined. In the 1940 *Investment Company* Act, the term "investment adviser" essentially means a management company that regularly furnishes advice to a mutual fund with respect to the selection and management of portfolio securities. In the *Investment Advisers* Act, the term "investment adviser" essentially means any firm that engages in the business of advising others and receives compensation for doing so, and excludes broker- dealers whose performance of such services is solely incidental to the conduct of his business as a broker-dealer.

I totally support the efforts of FI360 to extend the standards of fiduciary duty that now apply to advisers registered under Investment Adviser Act to all financial advisers. While, the earliest financial planning group to operate under this standard is NAPFA, consisting of fee-only planning and advisory firms but that standard is now advocated by the Financial Planning Association (FPA), the Investment Adviser Association, the North American Securities Administration and the CFA Institute. But the fiduciary industry standard must be extended to other financial advisors, *including* broker-dealers who elect to act as advisors.

Of course this idea generates considerable heat, but I am not sure why. Surely it should be made clear to clients whether they are relying on (1) trained investment professionals, paid solely through fully-disclosed fees to oversee their investments; or (2) sales representatives who sell the products and services of the companies that they represent, whether life insurance, annuities, mutual funds, or anything else. Simply put, the first group is representing its clients; the second group is representing its employers. And each firm's advertising and promotion should make this distinction clear.

But I believe that a federal standard of fiduciary duty should also apply to mutual fund advisers. That is the best way—perhaps the only way—for this industry to honor the lofty goal expressed in the preamble to the Investment Company Act of 1940: "the national public interest and the interest of investors" require that mutual funds be "organized, operated, and managed . . . in the best interests of their shareholders, *rather than* in the interests of advisers, underwriters or others." While that message would seem unequivocal, however, the drafters of the act not only failed to define just what they meant by the "national public interest and the interest of investors," but they permitted, as we now know, a governance structure that would later fly directly in the face of the national public interest and the interest of investors. [2]

It is only to state the obvious that a once-small mutual fund industry, managed by firms whose owners were the investment professionals who managed the money is now a giant industry in which the vast majority of firms—26 of the largest 30 firms are either publicly-owned (7 firms) or, more likely (19 firms), owned by financial conglomerates—face a conflict of interest, with a duty owed to two parties with opposing interests, a situation that would be precluded by a fiduciary duty standard. These owners are in business to maximize the returns on *their* capital, *not* to maximize the returns of the capital of their mutual fund investors. (Although they do their best to do so, but of course without even the remotest incentive to reduce their fees. *Au contraire*!) Most of the private firms of yore have vanished, although it is significant that those that yet remain rank among the very largest firms in the industry.

Success in the fund field, then, is largely measured by gathering the largest possible base of assets under management, the surest route to maximizing advisory fees. This strategy has led to aggressive marketing, over-the-top advertising of the fund performance, creation of exotic new fund products—yes, capitalize on *products*—to meet the investment fads of the day, and quantitative approaches to investment management based on historical investment returns that are, truth told, virtually meaningless.

So it is small wonder that the huge economies of scale in mutual fund management have benefited fund managers far more than fund shareholders. Small wonder that the industry's focus has moved from management to marketing. Small wonder that in all the rush to salesmanship in the fund industry, stewardship seems to have been left in the dust. To return stewardship to the preeminent position it deserves in money management, establishing a federal fiduciary standard for *all* money managers is essential. Quoting ICI leader Stevens again, "isn't that something that all of our recent experience suggests is important?" Again, of course it is important!

[2] I recognize that in the 1960 amendments to the Investment Company Act, the fund adviser "is deemed to have a fiduciary duty with respect to the receipt of compensation." But that provision has been largely eliminated by the courts. It now seems likely to receive further review in the U.S. Supreme Courts.

Conclusion

Let me close with this warning:

> *"I venture to assert that when the history of the financial era which has just drawn to a close comes to be written, most of the mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that 'a man cannot serve two masters' . . . the development of the corporate structure so as to vest in small groups control over the resources of great numbers of small and uninformed investors, make imperative a fresh and active devotion to that principle if the modern world of business is to perform its proper function. Yet, those who serve nominally as trustees, but relieved, by clever legal devices, from the obligation to protect those who interests they purport to represent . . . [and] consider only last the interests of those whose funds they command, suggest how far we have ignored the necessary implications of that principle."*

I wish that those were my words. But they are not. They are the words of Supreme Court Justice Harlan Fiske Stone, and they were written in 1934. "The more things change, the more they remain the same." What's more, I endorsed them to my partners at Wellington Management Company way back in 1971, three years before Vanguard was founded, with a structure—the management company owned by the funds and operated on an "at cost" basis—which represented my best effort to eliminate, or at least mitigate to the maximum extent possible, the many conflicts of interest in money management that I've described to you today. So I am hardly a newcomer to the idea of reforming our financial sector. I've done my best, and the record is clear that it has worked in the interest of Vanguard fund shareholders.

But 1971 was a long time ago, and 1934 even longer. So let's take advantage of this crisis so that we won't have to hear a latter-day Justice Stone render that analysis all over again. *Let's take this opportunity to do big things*. Whether we are, like most of you in this audience, serving as investment advisers to the human beings who need your help, or, as I am, part of the giant mutual fund industry that dominates our financial sector, we owe no less to our clients. We cannot fail again to honor this trust.