

The New Global Economy
Remarks by
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I'm delighted to have this opportunity to discuss the turbulent financial markets we face today. As the title of my talk suggests, I'll focus on "the new global economy," even though the global economy is hardly "new." The famous silk routes of Asia date back to 200 A.D., and—with exception of periodic wars, the Black Plague, and the Great Depression (in part a result of protectionist tariffs)—globalization has been growing ever since.¹

Perhaps no better example of the globalization of yore was British trading with China two centuries ago. It began with the staggering growth of tea imports, which created a balance of payments crisis for the British Empire, resolved by substituting opium exports from Southeast Asia to China for the rapidly-decreasing supply of sterling in the Exchequer, not a happy part of the history of globalization. But even in the more orderly modern era, global trade has grown from about 5 percent of world GDP immediately after World War II to an estimated 20 percent currently.

But if the growth of global trade is impressive, the growth of global finance is truly breathtaking. We seem to live in a world without financial borders, with traders flashing enormous investments (and speculations) across the world electronically at a nanosecond pace.

¹ For a wonderful adventure in the history of global trade, don't miss William Bernstein's terrific new book, *A Splendid Exchange—How Trade Shaped the World*, Atlantic Monthly Press, 2008.

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

This globalization is not necessarily a positive development, for speculative financial products can spread around the world, irrespective of national borders, with the speed and persistence of a flu virus. It was only extremely good work by the global centers for disease control that has so far prevented the highly contagious and often-fatal avian flu virus of a few years ago from being a modern disaster.

No such controls exist in our financial markets, where a sort of Gresham's law—"bad products," in this case, "drive out good"—prevails. The explosion in collateralized debt obligations—bonds backed by home mortgages, millions of which were backed by dubious credits—was worldwide. And the subsequent—and inevitable—reckoning was worldwide as well. UBS, Switzerland's largest bank, has written down \$37 billion (!) of sub-prime mortgage holdings, more than either Merrill Lynch (\$25 billion) or Citigroup (now \$24 billion). IKB Deutsche's Bank's \$9 billion write-off was even larger than Bank of America's (\$8 billion). And Royal Bank of Scotland, Societe Generale, Credit Agricole, and Credit Suisse have together written-down another \$20 billion. (Societe Generale suffered additional losses of some \$8 billion, incurred by a single rogue trader in the financial futures market.)

The world's stock markets, too, have become more global than ever. A decade ago, about 15 percent of the earnings of U.S. corporations arose from their international operations; by last year, non-U.S. earnings had more than doubled to 31 percent. That can't surprise you. Nearly all large U.S. firms can be characterized as "global" in their reach. Think Coca-Cola, IBM, Microsoft, GE, General Motors, and Citigroup, and you'll get the idea.

And, in this "one world" of interconnection and competition, global stock markets continue to produce similar long-term returns. For example (this may surprise you), since 1980 the annual return on the S&P 500 has averaged 13.0 percent compared with the return of 11.6 percent for the non-U.S. EAFE Index (the Morgan Stanley Capital International Europe, Australia, and Far East Index). A percentage point of that return, in fairness, has resulted from the moderate weakness of the dollar over that long span; the EAFE annual return, measured in local currencies, was 10.6 percent.

That is not to deny that there can be extended waves of superiority in one segment or the other. During the 1980s, international (i.e., non-U.S.) stocks substantially outpaced U.S. stocks (22 percent per year vs. 17 percent) and then fell far behind in the 1990s (U.S. 18 percent per

year, international 7 percent). So far in this decade, returns of both have been barely positive, with both U.S. and non-U.S. markets—in local currency terms—delivering only about 2 percent per year.

In recent years, however, with the weakness in the dollar, foreign market returns, measured not in local currency returns but in dollar returns, have been unusually strong. While the S&P 500 is up about 75 percent since the market lows reached in January 2003, the EAFE Index is up almost twice that amount—142 percent. Some regional markets have virtually exploded—Latin America funds up 600 percent; emerging markets funds up 300 percent; and China funds up 280 percent. As a result, perhaps unsurprisingly, interest in global investing by U.S. investors has reached a crescendo.

During the late 1990s through 2002, for example, investors added some \$620 billion to their holdings in funds with a U.S. focus, and only about \$45 billion to international funds. But following the explosion in foreign stocks in 2003, investors have added \$150 billion to their U.S. funds, but more than twice as much, \$420 billion, to their international fund holdings. Last year, in fact, 92 percent of all equity-fund purchases flowed into international funds.

My experience tells me to urge a little caution—maybe even a lot of caution—before jumping on the global bandwagon. For what seems to be happening—again!—in the fund arena is “performance chasing,” looking backward instead of forward in deciding where to invest. Investors who didn’t care for non-U.S. stocks when they seemed cheap seemed to develop a perhaps fatal attraction for them when they got, if not expensive as such, surely far *more* expensive.

In my view, trying to pick winning market sectors,—whether sectors in the U.S. market such as real estate, gold, energy, technology, or sectors in the international market such as emerging markets, China, or Latin America—is a loser’s game. I remain a believer in the broadest possible diversification and intelligent asset allocation between stocks and bonds (depending largely upon one’s age, wealth, income needs, and risk tolerance) and then doing *nothing*. It’s not the typical case of “Don’t just stand there. Do something!,” but rather, “Don’t do something. Just stand there!”

For in the long run, successful investing is not about picking stocks, or picking sectors, or picking fund portfolio managers, but about capturing the returns earned by our nation's—and the world's—businesses. The best way to do so is to own a portfolio that holds all of the corporations that comprehend the U.S. stock market, albeit with a global flavor—at, of course, the lowest possible cost. This happens to be the *only* strategy that guarantees that you will capture your fair share of whatever returns the stock market is generous enough to deliver. (Ditto, but even more so, for the bond market.) Yes, I'm speaking of index funds, a strategy endorsed not only by me, but by the likes of Warren Buffett, Paul Samuelson, Yale's David Swensen, and virtually the entire academic community.

The reasoning, of course, is straightforward. Investors in the aggregate must earn the market's return. But only before the costs of investing are deducted. After that deduction, investors must lose to the market return by that amount. So the lowest-cost provider of equity and bond portfolios inevitably provides returns that exceed the returns earned by other providers in the aggregate. Compounded over time, that difference is enormous, because fund management fees, operating expenses, trading costs, sales loads, and excess taxes can, over a lifetime, easily consume 80 percent of investment value. Investors put up 100 percent of the capital and consume 100 percent of the risk; aren't we entitled to more than 20 percent of the return?

Investment vs. Speculation

With that background, let me turn to some of the issues of the day in our financial markets, including the triumph of short-term speculation over long term investment, the roots of the crisis in the debt markets, and the role of financial innovation. It is buying and holding businesses that meets my definition of investment, an idea—believe it or not—that I pursued in my Princeton University thesis on the mutual fund industry way back in 1951. There, inspired by the wisdom of John Maynard Keynes, I drew a clear distinction between *investment* and *speculation*. Keynes defined “enterprise” as “the activity of forecasting the prospective yield of assets over their entire life.” He defined “speculation” as “the activity of forecasting the psychology of the market.

Keynes used no numbers to make that distinction. But in the late 1980s, I did exactly that. I defined enterprise as *investment* return, the sum of the current dividend yield on stocks plus their subsequent rate of earnings growth. I defined *speculative* return as the impact of the change

in the number of dollars that investors are willing to pay for each dollar of corporate earnings; that is, the annualized percentage change in the P/E multiple. Simply add the two categories of return together and, *viola!* we have the total returns generated in the stock market. (It works!)

Over the very long run, it is the *economics* of investing—enterprise—that has determined the total return on stocks. The momentary *emotions* that surround investing—speculation—so important over the short run, have ultimately proven to be virtually meaningless. For example, the 10.0 percent average annual return on U.S. stocks during the past century was almost identical to the 9.9 percentage points of investment return, an average dividend yield of 4.6 percent, plus average annual earnings growth of 5.3 percent. Speculative return added only one-tenth of one percent to that total. Despite the transient booms and busts of stock market history, for the investors who have stayed the course, buying and holding a portfolio invested across *all* of American business, has been an extraordinarily successful strategy.

The Triumph of Speculation

Keynes had predicted that otherwise sensible professional investors would gradually abandon their focus on enterprise and follow the ignorant crowd of uninformed individuals in betting on the psychology of the market, attaching their hopes to a favorable change in the conventional basis of valuation, i.e., that they are speculators. In my thesis, I disagreed with the master. In a much larger mutual fund industry, I argued, professional investors would come to focus on the wisdom of long-term investment rather than the folly of short-term speculation. (I was surely right about the industry's bright prospects! That \$2 billion industry of 1951 is today a \$12 trillion behemoth.)

After reaching peak turnover of 140 percent in 1929, I predicted that fund managers would behave as “steady, sophisticated, enlightened, and analytic” investors, focused on enterprise—on corporate performance and intrinsic value—rather than momentary and evanescent share prices. Alas, fund managers turned out to behave in the reverse; “*volatile, unsophisticated, unenlightened, and superficial.*” Call it Keynes 1, Bogle nothing. Indeed, I have often said, after Oscar Wilde's definition of the cynic, that our industry's security analysts too often “know the price of everything, but the value of nothing.”

Fund turnover has risen from about 15 percent during my first 15 years in this business to 100 percent in recent years, reflecting a trend toward speculation that has been growing since the mid-1960s. Total turnover on the New York Stock Exchange was also less than 20 percent through the mid-1960s. Even by the mid-1990s, it rarely exceeded 50 percent. But in 2007, stock turnover exceeded 200 percent per year. If we include the trading in exchange traded funds (ETFs), that number has now soared to 280 percent, double the 1929 level. Clearly, the nature and character of our equity markets have changed. We are in a new era, one with the highest speculation component in history.

How Did We Get Here?

This soaring volatility in our financial markets—what I’ve described as “an orgy of speculation”—is a product of many forces. Surprisingly enough, one is the institutionalization of the stock market. The change is dramatic: Over the past half-century, individual ownership of stocks by individual investors has dropped from 92 percent of the total to 26 percent. Institutional ownership—largely by mutual funds and corporate and government pension funds—has soared from 8 percent to 74 percent—quite literally, a revolution in stock ownership that has changed the nature and structure of our financial markets.

Part of the problem is that these giant institutions, striving to build their own profitability, turned their focus away from management and toward marketing, toward whatever will sell, explaining ever-more-narrowly-focused, riskier portfolios. Let’s call that the triumph of salesmanship over stewardship. These agents—now largely controlled by giant U.S. and international financial conglomerates—have too often put their own interests ahead of the interests of those whom they are duty-bound to serve, those 100-million-plus fund shareholders and pension beneficiaries who inevitably feed at the bottom of the food chain of investing.

What’s more, I would argue that our now-dominant institutional agents have not only failed to honor the interest of their shareholders/beneficiary *principals*, but they have also abandoned the time-honored investment *principles* that focused on the wisdom of prudent long-term investment, and turned instead to an excessive focus on short-term speculation, so clearly demonstrated by the soaring portfolio turnover that I described earlier, a change that is detrimental to their own interests as well as to our financial system.

Turbulence and Financial Innovation

To be sure, financial institutions have held the majority of all U.S. equities for several decades now and their focus on short-term expectations with the attendant high turnover has been in place even longer. So what is it that accounts for the recent surge of market turbulence? To begin with, in this new environment, the *raison d'être* for money managers, and basis by which they are held accountable, became the maximization of the value of the investments made by their clients, measured over periods as short as years or even quarters. Even as institutional managers turned increasingly to speculation (just as Keynes had predicted), corporate executives became increasingly attuned to short-term profits and the stock-market valuations of their firms. I call this the “happy conspiracy” among institutional owners of stocks and corporate managers and directors to focus more on stock prices—speculation—than on long-term intrinsic values—investment.

Another culprit is financial innovation. While innovation is broadly regarded as an unmixed blessing, in the financial sector it is hardly uniformly so. There is a sharp dichotomy it seems to me, between the value of innovation to the *financial institution* itself—the investment bank, the money manager—and the value of innovation to its *clients*. Heavily motivated by self-interest, the providers of financial services are to organize the instrumentalities of business and government—let’s call them stocks and bonds—into packages and, well, “products” that earn profits for themselves, even as they are also designed to serve the perceived needs of investors. Some of these innovative products are simple and cost-efficient; others, at the extreme, are mind-bogglingly complex and expensive.

What’s more, our institutions have a large incentive to favor the complex and the costly over the simple and the, well, cheap; quite the opposite, I would argue, of what most investors want and need. Given recent events in the financial markets in which some of our nation’s—and the world’s—mightiest financial institutions have collectively already taken some \$170 billion (estimated to total an astonishing \$300 billion when all’s said and done) of write-downs from their forays into relatively new, untested and complex financial instruments that I described earlier—let alone the hundreds of billions of losses experienced by their clients. Innovation, often in the name of making our U.S. markets more competitive while foreign markets, has once again gone too far.

CDOs are but one example of the exploding market for financial derivatives. As recently as 1960, for example, derivatives on the S&P 500 Index—futures and options in essence, speculation on the future price of the Index, either to take on huge risk exposure or to hedge against market declines—did not even exist. Today, an estimated \$23 trillion of these futures and options are outstanding, compared to the \$13 trillion actual market value of the 500 Index itself. The “speculation market,” then, is almost double the value of the “investment market.” However striking that relationship, these derivatives are a mere drop in the bucket of the global total of some \$500 *trillion* in financial derivatives of all types; as a point of reference, the gross domestic product (GDP) of the entire world is about \$50 trillion, a mere one-tenth of the derivative total.

A few years ago, Warren Buffett described derivatives as “financial weapons of mass destruction,” while Alan Greenspan applauded their benefit, noting that “the prudent use of derivatives help banks to reduce risk.” Today it seems clear that it was Buffett who got it right. While innovations such as derivatives have enriched the financial sector (and the rating agencies) with enormous fees, these over-rated, as it were, CDOs have wreaked havoc on the balance sheets of those who purchased them, and held them, including the banks and brokers themselves.

What is more (if we need more!), related “specialized investment vehicles (SIVs) have also created havoc. To sell these instruments, our giant banks increasingly issued “liquidity puts” to buyers, guaranteeing to repurchase them on demand at face value. Citigroup, it turns out, was not only holding \$55 billion of CDOs on its books, but also some \$25 billion of SIVs that have been “put” back to the bank, a fact not publicly disclosed by Citi until last November. Astonishingly, former Treasury Secretary Robert Rubin, chairman of Citi’s Executive Committee (and a man, one might say, of not inconsiderable financial acumen) has stated that until last summer *he had never even heard of liquidity puts*. (Not quite as embarrassing as former chairman Charles Prince’s earlier comment: “As long as the music is playing you have to keep dancing. We’re still dancing.”)

The peculiar characteristics of financial innovation are not limited to fixed-income investments underwritten by our investment banks. The mutual fund sector too has much to answer for. For example, in the late 1990s, innovation in the mutual fund sector was designed to capitalize on the so-called “New Economy.” We created literally hundreds of technology funds, telecommunication funds, internet funds, and “aggressive growth” funds whose holdings were dominated by stocks in those sectors, luring nearly a half-trillion dollars from fund investors

during the three-year-bubble surrounding the market's peak in March 2000. In the great bear market that followed, the NASDAQ ("New Economy") Index dropped nearly 80 percent, and the NYSE ("Old Economy") Index fell by 33 percent. Was this innovation good for fund marketers? Clearly yes. Good for fund investors? Categorically no. It remains to be seen whether today's hottest mutual fund idea, ETFs—index funds that "can be traded all day long, in real time"—will prove to be a blessing to fund investors, or a bane.

The Age of Turbulence

This "age of turbulence" in which we now live is the product of too many years of cheap credit, and of sharply deteriorating credit standards, as well "new" products like derivatives and product packaging—like securitizing mortgages—in which its lenders off-load their loans to investors. Our highly-leveraged commercial banks and investment banks failed to consider the extraordinary risks of the securities they were creating and marketing, and earned billions in fees and commissions, even as they were left with tens of billions of dollars—even hundreds of billions—on their own balance sheets.

The key question today is the extent to which these problems in our financial system will infect our U.S. economic system and our global systems as well. The long boom in the real estate market has now turned down, with home prices in retreat, so similar to what happened in the "new era" stock market early in 2000, and stock prices remain below the levels they reached eight long years ago. As I see it, our policy makers are running scared, with the Federal Reserve making credit available to banks (likely a necessary step) and driving short-term interest rates down (great for borrowers but terrible for lenders and savers, and probably terrible for the dollar). I'm not at all sure that this is sound policy-making, for it increases the likelihood that inflation will rear its ugly head later on.

Our political leaders, too, seem to have pressed some sort of panic button, enough to unite a Democratic congress and a Republican administration in an election year. But I'm also concerned that the \$160 billion fiscal stimulus plan—right out of Keynesianism—will not provide much in the way of stimulating the economy, even as it adds to an already staggering deficit in the Federal budget. Yes, it's easy for our politicians to give money to "the people," for of course it's these self-same people who are in fact doing the giving. When they pay for the "gift," either through higher taxes or through devalued dollars, that truism will become clear.

In short, it is by no means obvious that this combined blast from our monetary masters and our fiscal authorities will make a positive difference either to our markets or our economy. Maybe, just maybe, we should *not* intervene and just let the markets clear. Not only are our markets driven by the confidence of investors putting their dollars on the line, but our economy is driven by the confidence of consumers spending on their needs and wants, and corporations, spending to enhance the returns on their capital. That confidence has been shaken.

The inherent risk in our financial markets—enhanced in the recent present era by truncated time horizons, the dominance of speculation over investment, excessive financial innovation, easy credit, a seeming unawareness of burgeoning credit risk, and a concentration of assets in banking conglomerates—has markedly increased during the recent era. I share the concern of many economists that these problems in our financial system may well carry over to the performance of our economy, now approaching—if not already in—recession. If that is the case, we will see the leveling off of corporate earnings growth, perhaps followed by significant earnings declines. Thus, the probabilities favor continued market turbulence—and some economic turbulence as well.

So the risks are high; the uncertainties rife. Yet perhaps we'll muddle through. After all, throughout our 230-year history, America has always done exactly that. Perhaps, once again, our society and our economy will continue to reflect the resilience that they have demonstrated in the past, often against all odds. And perhaps we'll come to our collective senses and develop the courage to take arms against this sea of troubles that I've described today, and by opposing, end them. If we do, the stock market will undoubtedly respond and resume the upward course that is based on the intrinsic economic value of business growth.

Let me close on a more constructive note. Of course our markets need “financial entrepreneurs,” traders, and short-term speculators, “risk-takers restlessly searching to exploit anomalies and imperfections in the market for profitable advantage.” Equally certain, our markets need “financial conservatives,” long-term investors who “hold in high esteem the traditional values of prudence, stability, safety, and soundness.”² In my judgment, letting that balance get out of hand bears a heavy responsibility for today's turbulence and uncertainty.

² The quotations are from Dr. Kaufman's book, page 304.

In his brilliant 2001 memoir, *On Money and Markets*, the economist/investor Henry Kaufman, one of the wisest of all the wise men in Wall Street's long history, shared my concerns, expressing his own fears about the globalization of finance, the derivatives revolution, the corporatization of Wall Street, the limits on the power of policy makers, and the transformation of the character of our markets. In his final chapter, he summarizes his concerns:

Trust is the cornerstone of most relationships in life. Financial institutions and markets must rest on a foundation of trust as well. . . . 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 can we improve the ratio of benefits to costs in our economic system. . . Regulators and leaders of financial institutions must be the most diligent of all.

Together, participants in our financial markets must work together to restore that balance, and return financial conservatism to its rightful pre-eminence. For as Lord Keynes wrote all those years ago, "When enterprise becomes a mere bubble on a whirlpool of speculation, the job of capitalism will be ill-done."

That is the one thing that none of us can afford to allow.