

Reflections on Markets, Ethics, and Careers

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Over the years, I've done more than my fair share of speaking, but I still get my greatest joy in meeting in an academic environment, and especially with the college students who are our nation's hope for the future. While I welcome you all here this afternoon, I confess to the teachers and business leaders who have been kind enough to join us that it is the students who will be the prime focus of the latter part of my message. But I think you'll *all* find food for thought in the ideas that I'll present.

In my limited time, I want to reflect on our financial markets and our business ethics, and their relationship to the careers of our leaders, future as well as present. In my recent book *The Battle for the Soul of Capitalism*, I get right to the point in its dedication, to my twelve grandchildren—half of whom are now college students—and the other fine young citizens of their generation:

“My generation has left America with much to be set right; you have the opportunity of a lifetime to fix what has been broken. Hold high your idealism and your values. Remember always that even one person can make a difference. And do your part ‘to begin the world anew.’”

I then quickly turn to the main issue: “The business and ethical standards of corporate America, of investment America, and of mutual fund America have been gravely compromised. It is time

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

to set out on a new course that, paradoxically enough, will lead us directly back to where we began, with the traditional values of capitalism—trusting, and being trusted.”

Let’s start with why you should—indeed *must*—care about our system of free-market capitalism. I argue that it is the job of every concerned citizen to “uphold the values that once made our corporate and financial enterprises so successful, fairly providing the rewards of investing to those who put up the capital and assume the risks involved. To win the battle to restore the soul of capitalism, it is these values that must prevail.” Why? Because, as I explain, “we require a powerful and equitable system of capital formation if our nation is to overcome the infinite, often seemingly intractable, challenges of our risk-fraught modern world. Our economic might, political freedom, military strength, social welfare, and even free religious values depend upon it.”

“The Birth of Plenty”

Why capitalism? Just think of what modern capitalism has done in its 200-odd years of existence. Quoting from William Bernstein’s fabulous book, *The Birth of Plenty*, up until the beginning of the nineteenth century “the improvement in human well-being was of a sort so slow and unreliable that it was not noticeable during the average person’s *twenty-five-year* life span . . .” There was a timely convergence of human and physical capital, supported by a network of modern systems: legal, financial, commercial, educational, governmental, and the like. Result:. Then, two centuries ago, and the modern world was born the world’s standard of living began inexorably to improve. Over the next 200 years, global living standards would rise by about 2 percent per year, increasing our worldly wealth from a mere \$700 per capita to \$6,000 in real terms, nearly nine times over. (Never underestimate the power of compound interest!)

While capitalism has bestowed those economic blessings unevenly, it has bestowed them liberally, as living standards have risen all over the industrialized world. Those blessings are now spreading through the emerging economies of South America and Southeast Asia, including India and China, whose economy will surpass even America’s powerful economic engine within the next two decades.

This is not to say that the history of capitalism is without blemishes, and profoundly serious ones at that. Among its moral failings are the early abuse of child labor, and the continuing misuse of natural resources, the lack of adequate concern about our society and the environment, and its growing role on political campaign contributions in shaping vital national issues.

But in the recent era, one of the main failings of capitalism is as a *system of corporate ownership*. It has departed, not just in degree but in kind, from its proud traditional roots, a system that served us, despite its imperfections, with remarkable effectiveness for the better part of the past two centuries—a free enterprise system based on open markets and private ownership, and on trusting and being trusted. *The system worked*. Or at least it *did* work. And then, as I write in *Battle*, “Something went profoundly wrong, fundamentally and pervasively, in corporate America.

At the root of the problem, in the broadest sense, was the societal change aptly described by these words from the teacher Joseph Campbell: ‘In medieval times, as you approached the city, your eye was taken by the Cathedral. Today, it’s the towers of commerce. It’s business, business, business.’ We had become what Campbell called a ‘bottom-line society.’ But at least in my view, our society came to measure the *wrong* bottom line: *form over substance, prestige over virtue, money over achievement, charisma over character, the ephemeral over the enduring, even mammon over God.*”

It’s all too easy for you in our younger generation to look at capitalism as a money-grubbing system in which greedy businessmen, investment bankers, and money managers of hedge funds and mutual funds alike garner unfathomable wealth at the expense of the average citizen who does the nation’s work and does it with neither complaint nor the hope of outsized rewards. And while there is some truth to that—indeed, in the book I express great concern about a two-tier society divided (and hardly evenly) between “haves” and “have nots”—let us not forget that it was the flourishing of true capitalism two centuries ago that has been importantly responsible for the plenty we enjoy in the modern era.

“A Pathological Mutation”

But something *has* gone wrong in the capitalist system itself. It is well-described by journalist William Pfaff as a “pathological mutation” from the classic system, *owners’* capitalism—based on a dedication to serving the interests of the corporation’s owners in maximizing the return on their capital investment—to a new system, *managers’* capitalism—in which, Pfaff wrote, “the corporation came to be run to profit its managers, in complicity if not conspiracy with accountants and the managers of other corporations.” Why did it happen? “Because the markets had so diffused corporate ownership *that no responsible owner exists*. This is morally unacceptable, but also a corruption of capitalism itself.” And so it is.

Once an “ownership society” in which direct owners of stock held voting control over corporate America, we have become an “agency society,” and we are not going back. For direct ownership has largely given way to ownership by financial institutions, mainly mutual funds and pension funds. While these institutions held only 8 percent of all U.S. stock a half-century ago, today they own some 70 percent—absolute control of corporate America.

But the managers of these giant investment pools—*agents*, whose duty is to represent the interest of the pension beneficiaries and owners of mutual fund shares who are their *principals*—have too often put their own interests first, consuming far too large a portion of whatever returns our corporations and our financial markets have been generous enough to provide, with far too small a portion of these returns delivered to the last-line investors who put up all of the capital and assumed all of the risks.

An Ancient Thesis

It is a curious fact that my new book echoes in so many ways the principles that I set forth in my senior thesis at Princeton University in 1951. That thesis—and all that followed—depended on an incredible stroke of luck. In December 1949, in Princeton’s Firestone Library, I happened upon the year-end issue of *Fortune* magazine and learned for the first time that something called “the mutual fund industry” existed. When I saw the industry described in the article as “tiny but contentious,” I knew immediately that I had found my thesis topic. Completed in the early spring of 1951, it was entitled “The Economic Role of the Investment Company.”

Read today, my thesis would probably impress you as no more than workmanlike, perhaps a bit callow, but above all, shamelessly idealistic. On page after page, my youthful idealism speaks out, calling again and again for the primacy of the interests of the owner of mutual fund shares. “*The prime responsibility (of fund managers) must always be to their shareholders.*” And the deal must be fair: “there is some indication that costs are too high,” and that “*future industry growth can be maximized by concentration on a reduction of sales charges and management fees.*”

After analyzing fund performance, I concluded that “*funds can make no claim to superiority over the market averages,*” perhaps an early harbinger of my decision to create, nearly a quarter-century later, the world’s first index mutual fund. And in my conclusion, I powerfully reaffirmed the ideals that I hold to this day: The role of the mutual fund is to *serve*—“to serve the needs of both individual and institutional investors . . . to serve them in the most *efficient, honest,* and *economical* way possible . . . *The principal function of investment companies is the management of their investment portfolios. Everything else is incidental.*”

While all of this gratuitous advice from a callow college senior was, alas, largely ignored by the fund industry, the creation of Vanguard as a truly *mutual* mutual fund group—operated on an “at-cost” basis for the benefit of its owners rather than its managers—was my attempt to walk the walk that I talked the talk about all those years ago. Today, I assure you that my youthful idealism remains intact. Indeed, it is shamelessly reflected not only in Vanguard, and not only my *Battle* book, but in my new book, *The Little Book of Common Sense Investing*, both of which express—in different ways—my concern about our business and finance system, where so much has gone wrong.

It is truly astonishing how pervasive have been the failures in our capitalistic system. While it’s often alleged that these problems have been limited to just “a few bad apples,” the evidence suggests that the barrel that holds all those apples, good and bad alike, has developed some serious problems. For example:

- Yes, there have been “only” a few Enrons, WorldComs, Adelphias, and Tycos. But during the past five years, there have been 5,989 restatements of earnings by publicly-held corporations, with stock market capitalizations aggregating more than \$4 trillion, often reflecting overly aggressive accounting procedures. (Witness the recent multiple restatements by General Motors)

- Yes, the investment banking scandals involved “only” twelve firms, but among them were eight of the nine largest firms in the field. As a result of the investigations by New York attorney general Eliot Spitzer, they ultimately agreed to pay some \$1.3 billion in penalties
- Yes, similarly, there were “only” a handful of insurance companies involved in the bid-rigging scandals, also uncovered by Mr. Spitzer. But, again, they included the largest companies in the field: American International Group, Marsh & McLennan, ACE, Aon, and Zurich, all of which agreed to settle the litigation and paid billions of dollars in penalties.
- And yes, while a few of the largest mutual fund managers were not implicated in the fraudulent behavior reflected in the market timing scandals unearthed by Mr. Spitzer and his staff in 2003, many of the 23 firms that *were* involved were giants, holding more than \$1.5 trillion of investor assets, fully one-quarter of the fund industry’s long-term asset base. This disgraceful spectacle alas, was one of many examples of how fund managers placed their own interests ahead of the interests of the fund shareholders they were duty-bound to serve—the triumph of salesmanship and asset-gathering over the stewardship and integrity that were, poignantly the hallmarks of the industry when I joined it all those years ago.

Fixing our business and financial system must begin with a return to the original values of capitalism, to that virtuous circle of integrity—“trusting and being trusted”—as I mentioned at the outset. When ethical values go out the window and service to those whom we are duty-bound to serve is superseded by service to self, the whole idea of the capitalism that has been a moving force in the creation of our society’s abundance is soured.

In the era that lies ahead, the trusted businessman, the prudent fiduciary, and the honest steward must again be the paradigms of our great American enterprises. It won’t be easy, but if we all work long enough and hard enough at the task, we can build, out of a long-gone ownership society and a failed agency society a “fiduciary society,” one in which the citizen-investors of America will at last receive the fair shake they have always deserved from our corporations, our investment system, and our mutual fund industry.

Capitalism and Values

The idea that ethical values and service to the community of investors should be intimately embedded in the practices of business, of course, was also an important underlying theme of my idealistic thesis of 56 years ago. That old idealism remains with me intact—heck, it is even stronger!—today. So I'll now turn to some thoughts on what business careers should be all about, and on the meaning of success. I hope that my reflections will be especially helpful to you students as you begin to consider your role in this opportunity-rife, risk-ridden modern world, and what contribution you can make to mankind. I turn these ideas as a good preacher should, with an anecdote.

The Reverend Fred Craddock, a remarkable preacher from Georgia, may have been imagining things—the way preachers are wont to do—but he says this story really happened. Dr. Craddock was visiting in the home of his niece. There was this old greyhound dog there, just like the ones who race around a track chasing those mechanical rabbits. His niece had taken the dog in to prevent it from being destroyed because its racing days were over.

Here's how Dr. Craddock recounts the conversation. "I said to the dog, are you still racing?" "No," he replied. "Well, what's the matter? Did you get too old to race?" "No, I still had some race in me." "Well, what then? Did you not win?" "I won over a million dollars for my owner." "Well, what was it? Bad treatment?" "Oh, no," the dog said, "they treated us royally when we were racing." "Did you get crippled?" "No." "Then why?", Craddock pressed, "Why?" The dog answered, "I quit." "You quit?" "Yes," he said, "I *quit*." "Why did you quit?" At last, the reason: "I just quit. Because after all that running and running and running, I found out that the rabbit I was chasing wasn't even real." While I've received more accolades than I could ever deserve during these later years of my own long career, I must confess that even I challenge myself as to whether the rabbit *I've* been chasing is real.

I have little doubt, however, that our Vanguard crew and our clients believe that the rabbit I've been chasing in my career—essentially the mission to give investors a fair shake in their quest to accumulate assets for a secure future—is real. And of course it *is*. So what's bothering me? Perhaps it comes down to how a friend, many years ago, defined "success"—a word that I don't particularly care for—as consisting of wealth, power and fame. But those three

attributes don't represent success. They represent the *fruits* of success, and I've seen enough of life to be absolutely sure that each one is a false, mechanical rabbit.

In business, I fear, too many think of defining *wealth* in terms of dollars and cents, rather than of family, friendships and contributions to society; of defining *fame* by newspaper headlines and television appearances, rather than in reputation among colleagues and contemporaries; and of defining power as power over the corporate purse and over corporate persons, rather than intellectual and moral power. But I hope each of you will define your own success in these latter terms. For you students, there's plenty of time for that later on in your lives. The point is to ask yourself whether you want to chase the illusory rabbit of *success*—defined by our conventional assessment of wealth, fame, and power—rather than the real rabbit of *meaning*—defined by integrity, virtue, and inner strength, doing our best with whatever talents that the Lord has been kind enough to endow in us.

Think with me for a moment about those whom we can all agree *are* chasing real rabbits—teachers and scientists, sculptors and painters, historians and musicians, authors and poets, physicians and surgeons, jurists and true public servants, ministers and priests and rabbis. Perhaps they earn our respect because they do their good work as members of professions, putting the interests of their constituencies—and even the interests of society—ahead of their own self-interest, and knowing that accumulating great financial wealth in their endeavors is almost out of the question, that national or worldwide fame is rare, and that power—at least *temporal* power—is conspicuous by its absence.

But don't stop there. Let's think too about the humble folk of this life who do the world's work—farmers and carpenters, soldiers and firemen, plumbers and mechanics, computer programmers and train conductors, pilots and navigators, landscapers and stone masons, all of those who help us to live our lives in comfort. You know them. People who get up with the sun and do an honest day's work, usually with neither complaint nor hope of accolade; souls who are rarely rewarded with those elusive fruits of so-called success. Yet surely few of them need worry about whether the rabbit they chase is real. *Of course it is.*

The Unexamined Life?

But I'll bet they do worry! In the quiet of the evening and the sometime loneliness of the soul, many of those who shouldn't *need* to reflect on the value of hard work and a life well-lived doubtless do exactly that. But whether *they* do or not, surely *we* who have been blessed in the past with what passes for success, and you who are gaining the education and social graces that are often deemed requirements for future success—we who by the blessings of our birth, our genes, our talents, our luck, and the help others have given us—deserve no such exemption. Everyone here this afternoon ought to heed Socrates' warning, "The unexamined life is not worth living."

So examine your life and remember that we're all in the human race together—those of us who earn a reputation through our careers, those who undertake the nobler missions of life, and those humble souls who do the world's hard work, to say nothing of you here today who, by virtue of your education, your ambition, and your higher promise, will be required to carry the torch for a new and better generation, and are preparing yourself for the task. *Don't miss the opportunity you have been given.* For every single one of us, the job begins with getting up in the morning, going through the day trying to make the world a better place—even better by a tiny amount—and as a result, entitled to enjoy a well-earned night's rest. Then, rather than chasing after that rabbit, finding that it's fake, and quitting in dismay, like the greyhound we met, let's just make sure that we chase the *real* rabbit of life, and then keep running, and running, and running, as hard as we possibly can.

Just what *is* that real rabbit? How could anyone possibly *know*? But I think it has something to do with using whatever talents God is generous enough to bestow on us, as best we flawed human beings can, to serve our fellow man. We could do worse than honor William Penn's timeless words:

I expect to pass through this world but once. Any good therefore, that I can do, or any kindness I can show to any fellow creature, let me do it now. Let me not defer or neglect it, for I shall not pass this way again.

Modern-day capitalism, alas, has strayed far from that noble creed. I trust that you in the coming generation will take on the challenge that I urged in my opening words, "To rebuild the

world anew.” So, you young citizens, please never, never lose your idealism. And, to those of you who are older, (even if you’re my age), don’t you dare lose yours either. And if perchance you have lost it, get inspired by our new generation and find it once again. Now.