The Lengthened Shadow, Economics, and Idealism

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and

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before the

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Good evening, ladies and gentlemen. Thank you, Ambassador Lukens and distinguished members of the dinner committee for honoring me with the invitation to address you. In the spirit of this grand occasion, I'd like to begin with some comments about what I find especially remarkable about President Wilson; in particular, how his lengthened shadow lies over America today, and how his economic policies were shaped by his idealism. I'll then turn to Vanguard, the now-giant mutual fund enterprise that I founded just 25 years ago. Only time will tell whether the lengthened shadow of my economic vision of fund management and my own idealism will lie over my firm a century hence. But I hope so.

As I understand it, it is Vanguard's distinctive approach to the stewardship of investors' assets that led to Princeton University's decision earlier this year to honor me with the Woodrow Wilson Medal—presented annually to an undergraduate alumnus for "distinguished achievement in the Nation's service." My humble delight in receiving this award almost (but not quite!) equals my utter astonishment at having been chosen, the first businessman in a long and distinguished line of public servants, artists, scientists, and authors who preceded me.

Wilson and Economics

In the course of preparing my Wilson Lecture, given in conjunction with the presentation of the medal, I studied again the stunning legacy of Woodrow Wilson as President, first of the University, and then of the United States of America. As a member of the financial community at the 20th century's end, I was profoundly impressed by one of his little-recognized but most far-sighted contributions: Setting a new direction for American economic and financial policy.

You would not have to walk very many blocks from here to read these words in the lobby of a handsome Greek Revival building: "We shall restore, not destroy. We shall deal with our economic system as it is and as it may be modified, not as it might be if we had a clear sheet of paper to write upon; and step by step we shall make it what it should be . . ." This quotation, from Wilson's brief (for him) First Inaugural Address on March 4, 1913, appears, as some of you doubtless know, at the main entrance of the Federal Reserve Bank in Washington, D.C.

Wilson proposed the Federal Reserve Act in order to bring monetary and banking reform to the nation. He worked gradually with the Congress, making numerous concessions to the existing financial system. And before the year had ended, the United States had a central bank, absent since Andrew Jackson abolished the Second Bank of the United States in 1836. Wilson's goals were to prevent the recurrence of banking panics, and to break the private monopoly of credit, so that banks would serve, in his words, as "the instruments, not the masters, of business and of individual enterprise and initiative." The Federal Reserve Bank evolved gradually over the years, finally to become the most powerful financial institution in the world. While no one—Wilson included—could have foreseen that development, surely his shadow lies over the Fed today.

Wilson's desire to fundamentally change the American economic order hardly stopped there. In that same Inaugural, Wilson proposed to cut tariffs and open America to global commerce (the Underwood Tariff Act of 1913), and to improve the administration of the Sherman Anti-Trust Act and enhance its fairness, (the Clayton and Federal Trade Commission Acts of 1914). His overriding goal, articulated time and again, was to create an environment in which free enterprise and unfettered competition could prevail. His passion for this goal was hardly hidden: to restore "that ancient time when America lay in every hamlet, when America was seen in every fair valley, when America displayed her great forces on the wide prairies, ran her fine fires of enterprise up over the mountainside and down into the bowels of the earth, and eager men everywhere captains of industry, not employees . . . America stands for opportunity. America stands for a free field and no favor. America stands for a government responsive to the interests of all." Could it be better said today?

Liberal or Conservative?

In his first Inaugural, Wilson also addressed safeguarding the health of the nation, protecting the environment for future generations, equality of opportunity, pure food, and labor conditions. Quite an agenda! But if these goals would today be characterized as liberal, surely his bedrock philosophy was conservative: "The fundamental safeguarding of property and individual right; to lift everything that concerns our life as a Nation to the light that shines from the hearthfire of every man's vision of the right." No radical he, Wilson expressed the consummate gradualist perspective: " . . . Step by step we shall make (our economic system) what it should be . . . Justice, and only justice shall be our motto."

As I read his first Inaugural, I wondered what might have been the source of his economic insights. In Princeton's Seeley G. Mudd Manuscript Library, I uncovered his essay on Adam Smith, written at Bryn Mawr College in 1887 for use in his course on Political Economy. But, alas, it focused on Adam Smith's mastery of the art of academic lecturing. Wilson's essay ("An Old Master") emphasized that the miscellany of economic thought contained in the *Wealth of Nations* was but a supplement to Smith's *Theory of Moral Sentiments*.

In that earlier book, Adam Smith had reckoned with such unselfish motives as "love, benevolence, sympathy, and charity in filling life with kindly influences." So, Wilson's essay excused the exclusive concentration of self-interest and expediency in the *Wealth of Nations*. But it is in *Moral Sentiments* (though Wilson did not cite this passage in his essay) that we find an overriding ethical principle that might surprise today's conservatives who trumpet Adam Smith's philosophy of free competition:

> "It is reason, principle, consensus, the inhabitant of the breast, the reason within, the great judge and arbitrator of our conduct . . . who shows us the propriety of generosity, of reigning in the greatest interests of our own for yet the greater interests of others, the love of what is honorable and noble, the dignity of our own characters."

It is my view that the idealistic spirit of those lines—and I don't think I am mistaken in hearing in them the cadences of Woodrow Wilson's later addresses—had more to do with his shaping of the program of economic and monetary reform enunciated in his first Inaugural address than a detailed understanding of the workings of the economic system of the early 1900s. I believe, in short, that Wilson's idealism was the inspiration for his economics.

Whether the issue was control of our nation's monetary policy or the reduction of tariffs, Wilson fashioned economic policy to restore the democratic ideals of the nation's founders. In his first inaugural, Wilson lamented that " . . . we reared giant machinery which made it impossible that any but those who stood at the levers of control should have a chance to look out for themselves." Wilson's administration would seek to redress the imbalance between the broad citizenry and the powerful financiers and industrialists of the Gilded Age. Wilson would undertake a moral crusade to "square every process of our national life again with the standards we so proudly set up at the beginning and have always carried at our hearts."

Even 90 years later, in this age of global economics, Wilson's shadow lies on the institutions and policies through which the American business and financial community conducts its affairs around the world. His shadow also, of course, lies on Princeton University. On becoming President of the University in 1902, he implemented the preceptorial system and revolutionized teaching, added greatly to the University's physical plant, established a new curriculum, added an honors program, and inspired today's system of residential colleges. (His "favorite dream of a collegiate Quad Plan" was rejected in 1908, a setback that contributed to his decision to leave Princeton and run for Governor of New Jersey. But by 1966 "Woodrow Wilson College" became the first of Princeton's five residential colleges.[1])

So too his lengthened shadow lies on the United Nations, the realization of his failed dream of a League of Nations, a crushing defeat for this idealist that doubtless contributed to the stroke he suffered in 1918, ending his political life. Nonetheless, we cannot miss the echo of Emerson's epigram (and we know that Wilson was an avid reader of Emerson's essays): "An institution is the lengthened shadow of one man." Whatever the case, surely the shadow of Wilson lies unmistakable, unwavering and dominant today, over Princeton, our economy, and the United Nations.

Turning now from Wilson's formidable shadow, I now turn inward to discuss, with some trepidation, the career of the Woodrow Wilson Medalist for 1999. As I reflect on the matter, it occurs to me that Wilson would have delighted in the precedent-breaking award of the Medal to a businessman. In evidence, I offer his Princeton Inaugural Address: The University must "serve a free nation whose progress, whose power, whose prosperity, whose happiness, whose integrity depend on individual initiative and sound sense." He expected "the merchant and the financier (to) have traveled minds . . . for every considerable undertaking has come to be based on knowledge, on thoughtfulness, on the masterful

[1] Writing about Wilson in 1945, Professor George McLean Harper, who knew Wilson at Princeton, opined, "some day perhaps a residential college such as he envisioned will be incorporated into the University and named for him." A fine prediction!

handling of men and facts." It is, he said, "the free capital of the mind the world most stands in need of, spiritual as well as material, which advance the race and help all men[2] to a better life . . . No task rightly done is truly private. It is part of the world's work."

The Economics and Idealism Behind Vanguard's Founding

I've tried to dedicate my career to, using Wilson's words, "a task rightly done." It was almost 25 years ago to the day when our firm was incorporated. I chose the name "Vanguard" for the new enterprise, hoping to capture the tradition of HMS Vanguard, Lord Nelson's flagship, which led his victory over Napoleon's fleet at the Nile 200 years ago. (Nelson's triumph was recently crowned by *The New York Times* as the greatest naval battle of the millennium.) If Vanguard has distinguished itself, it is through our mission of stewardship, our single-minded devotion to giving the mutual fund investor a fair shake.

It is hardly an exaggeration to say that, without Princeton, there would be no Vanguard. For my interest in this industry sprang to life in the University's spanking-new Firestone Library, quite by accident, in 1949. There, I stumbled across an article in FORTUNE magazine that described the mutual fund industry as "tiny but contentious." I decided on the spot that it should be the topic for my senior thesis, which I entitled, "The Economic Role of the Investment Company." So, thank you President Wilson, for making the departmental thesis a requirement for the bachelor's degree!

It seems problematical that my thesis, as some have generously alleged, laid out the design for what Vanguard would become. But, true or not, many of the practices I specified then would, nearly 50 years later, prove to lie at the very core of the success reflected in the growth of our fund assets from $1 billion in 1974 to $500 billion in 1999. "The principal function of mutual funds is the management of their investment portfolios. Everything else is incidental . . . Future industry growth can be maximized by a reduction of sales loads and management fees . . . Mutual funds can make no claim to superiority over the market averages." And, with a final rhetorical flourish, funds should operate "in the most efficient, honest, and economical way possible." Were these words an early design for a sound enterprise? Or merely callow, even sophomoric, idealism? I'll leave it to you to decide. But whatever the case, it works!

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[2] In Wilson's day, of course, "men" was synonymous with "humankind." We must not forget, however, that it was in his administration that the 19th amendment (women's suffrage) was added to the Constitution.

The fact is that Vanguard's economics, like Wilson's, were in important measure shaped by idealism. For what distinguishes Vanguard from the typical business enterprise is our mission: To place the interest of our investors before our own commercial interests. Our truly *mutual* mutual fund structure is unique in the fund industry: The funds' management is controlled by the fund shareholders, not by an outside management company, and is operated on an "at-cost" basis, not for a hefty management fee. With the substantial profits normally earned by the management company eliminated, this mutual structure has been the major contributor in generating aggregate savings to our investors—and hence added returns—that now approach $20 *billion.* The other contributor has been our deep, assiduous, slavish, passionate dedication to providing our stewardship to the shareholders who have entrusted their resources to our care at *rock-bottom* operating costs; that is, "in the most economical way possible."

Down with Costs, and Carthage Too

All of this is important only if costs matter. They do. *Costs matter*. I repeat this phrase so often that one journalist compared me with Cato, the Roman orator whose speeches in the Forum always ended with a call for the defeat of Carthage: "*Carthage delanda est.*" In my shameless repetition of this theme in speech after speech, I'm reminded of Wilson, who, when asked how often he used the same idea in his addresses, replied: "You will have to wait a long time for me to be able to answer that question." (That is, he expected to continue to use the same ideas over and over again.)

How *much* do costs matter? Hugely! Taking into account sales charges, management fees, operating expenses, and portfolio turnover, the average mutual fund deducts about 2½% per year from investor returns. Assuming—an arbitrary assumption indeed—that the manager is able to match an annual stock market return of, say, 10% *before* costs, 25% of the investor's return is consumed by costs in a year, 33% in a decade, and—I'm glad you're sitting down!—fully 48% of his return is consumed in a quarter century. Nearly one-half of the cumulative return generated by the stock market has been confiscated by the costs incurred by the typical mutual fund.

It was largely in the context of minimizing costs that I entitled my Woodrow Wilson lecture "The Hedgehog and the Fox." The title comes from Archilochus' ancient dictum, "The fox knows many things. But the hedgehog knows one *great* thing." In my remarks, I contrasted the many financial foxes in the money management field—often brilliant, clever, and wily, vulpine to a fault—who trade stocks constantly in a futile effort to beat the stock market, only to be destined finally to failure, dragged down by the heavy costs of their active investment approach. The one great idea of the hedgehog, on the other hand, is simply to buy a diversified list of stocks and hold them, well, forever. This is, of course, a fair depiction of the strategy of Warren Buffett. But it is also the driving force in Vanguard's success: The passively managed market index fund. In its most pristine form, the index fund—operated at a cost best described as trivial—owns a share in every business in America, and never sells it.

Who wins, the fox or hedgehog? Well, let's look at the record. If you had invested $10,000 with the typical mutual fund fox at the outset of this 17-year bull market—the greatest in all history—it would today be valued at $136,000. The same investment with the all-market fund hedgehog would be valued at $182,000. Just owning American business—at low cost—and doing *nothing* else, resulted in an extra $46,000 in return. The difference lies *solely* in relative cost. No wonder investors are starting to appreciate indexing. And no wonder the financial foxes hate it. For, as the record shows, foxy active management, with its heavy fees and costs, simply results in a diversion of the market's returns *from* the shareholders *to* the managers.

More than any other firm, Vanguard has been the fund industry's hedgehog, applying its one great thing to pioneer in many of the fund industry's most productive and investor-friendly innovations: the mutual (investor-owned) structure; the index fund; the tax-managed fund; the money market fund; the management of bond funds in defined asset classes; the direct marketing of shares to investors through no-load funds, without salesmen or commissions; and many others. While we were not always first to adopt these strategies, we have been widely credited as being the driving force in their acceptance, for our single-minded focus on low cost has made them work for investors in an extraordinarily effective way. It was said of Wilson, "he may not have *coined* all of his vital ideas, but he *mined* them as no others did." So too it might be said of Vanguard.

A Lengthened Shadow?

Is Vanguard, too, "the lengthened shadow of one man?" I'm not so sure. But I hope and pray that the shadow of the investment philosophy and the human values—the economics and the idealism—I have championed will lie forever on our firm. For they are the right philosophy and the right values, sound, enduring, even eternal. As for the man himself, I assure you that Vanguard today is far more durable than its now-aging founder, and indeed far greater than *any* one man. Our superb crew, now numbering more than 10,000, is committed and deeply dedicated to our core values. And our investors, from whom I hear with extraordinary frequency, demonstrate a remarkably sophisticated understanding of what Vanguard is all about. Even as Wilson placed his hopes in the people and believed that the real wisdom of human life is compounded out of the experiences of the common man, so I freely place *my* trust in the wisdom and common sense of our shareholder-owners, and in their continued recognition of the soundness of Vanguard's approach to investing.

Of all that I admire about Wilson—his powerful intellect; his commanding presence; his graceful, flowing use of the English language; the length of his foresight and the breadth of his vision—I admire most his stubborn, uncompromising idealism, reflected, in a colleague's view, in "his recklessly, passionately-outspoken, crusading spirit." He was not above responding to a statement that there are two sides to every question with a curt, "Yes there are. A right side and a wrong side." Nor was he beyond telling a colleague, "Do as you think best," while always leaving underneath the veiled injunction, "but do it this way." And as he freely admitted, he hardly become easier and more placable with age. "The older I get, the hotter I get," Wilson said—and he was only 52 then! I confess that my colleagues at Vanguard might see these same traits in me.

It was Wilson's stubborn idealism that stood in the way of accomplishing his final goals while at Princeton—a collegiate campus—and while at the White House—a League of Nations. I can only recall F. Scott Fitzgerald's statement: "Show me a hero, and I'll write you a tragedy." But is tragedy truly the right word? Both developments have now come to pass. And for me, whether one finally succeeds or fails, steadfast commitment to one's own principles and values is what a man's life is all about. In the words of Theodore Roosevelt, Wilson's predecessor in the White House, "The credit belongs to the man in the arena, who knows the great enthusiasms; who strives valiantly in a worthy cause; who, at best, knows in the end the triumph of high achievement; and who at worst, if he fails, at least fails by daring greatly, so that his place shall never be with those cold and timid souls who know neither victory nor defeat." The qualities that result in compromise, while valuable, even priceless in some circumstances, are rarely responsible for the building of a great institution.

Finally, my idealistic view—for which I offer no apologies—is that the mutual fund firm should be of the clients, by the clients, and for the clients, holding their interests above the financial interests of the manager-entrepreneur; providing a service of stewardship to the human beings who place with the firm their assets and their trust alike. And low cost is so central to that view that, even as in Wilson's case, the idealism that I've invested in Vanguard leads to its economics. "And there are other things," he wrote in his Princeton Inaugural, "besides material success with which we must supply our generation. It must be supplied with men who care more for principles than for money, for the right adjustments of life than for the gross accumulations of profit. The problems that call for sober thoughtfulness and mere devotion are as pressing as those which call for practical efficiency."

President Wilson closed that address with this ringing peroration, with which I close my own remarks this evening: "I have studied the history of America. I have seen her grow great in the paths of liberty and of progress by following after great ideals. Every concrete thing she has done has seemed to arise out of some abstract principle, some vision of the mind. Her greatest victories have been the victories of peace and of humanity. And in days quiet and troubled alike, Princeton has stood for the nation's service." Continuing his vision—and remember, this address was given in 1902, nearly a century ago—he added this profound prophecy: "A new age is before us, in which, we must lead the world . . . the spirit of the age will lift us to every great enterprise, but the ancient spirit of sound learning will also rule us . . . and the men who spring from our loins shall take their lineage from the founders of the republic." And so in the United States of America the spirit of the age remains, this very evening.