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Restoring Faith in Financial Markets

It is time institutional investors exerted control over publicly held companies.

By **JOHN C. BOGLE**

"Investing is an act of faith." So I wrote in 1999, the very first sentence of my book, "Common Sense on Mutual Funds." But as 2009 ended, writing in the updated 10th anniversary edition after the passage of this turbulent decade, I concluded that "the faith of investors has been betrayed."

How so? Because the returns generated by our corporate stewards have often been illusory, created by so-called financial engineering and produced only by the assumption of massive risks. What's more, too many of our professional money managers have failed to act as vigilant stewards of the money that we investors entrusted to them.

In short, far too many of our corporate and financial agents have failed to honor the interests of their principals—the mutual fund investors and pension beneficiaries to whom they owed a fiduciary duty. The ramifications were widespread—for the failure of money managers to observe the principles of fiduciary duty played a major role in allowing our corporate managers to place their own interests ahead of the interests of their shareholders.

Over the relatively brief span of a half century, our institutional agents have come to be the dominant force in corporate America. Institutional investors held less than 10% of all U.S. stocks in the mid-1950s, 35% in 1975, and 53% a decade ago, and now institutional investors own and control almost 70% of the shares of U.S. corporations. Mutual funds own the predominant amount, 26%; private pension plans another 11% and government pension plans another 9%.

The rise of agency ownership has been steady, and seemingly inexorable. But this revolution in equity ownership—it is no less than that—has been accompanied by many shortcomings, in part because it linked the agents of corporate America with the agents of investment America. As Leo E. Strine, vice chancellor of the Delaware Court, observed in a speech in 2007, "No longer are the equity holders of public corporations diffuse and weak . . . (they) represent a new and powerful form of agency, which presents its own risks to both individual investors and . . . the best interests of our nation." Yet, he noted, professional money managers are no less likely "to exploit their agency than the managers of corporations that make products and deliver services."

First, the folly of short-term speculation has replaced the wisdom of long-term investing as the star of capitalism. A rent-a-stock system has replaced the earlier own-a-stock system. In 2009, the average stock turnover appears to have exceeded 250% (changed hands two and a half times), compared to 78% a decade ago, and 21% barely 30 years ago.

Result: The momentary illusion of the price of a stock took center stage, replacing the enduring reality of the company's intrinsic value—the discounted value of its future cash flow. Our newly empowered agents ignored the famous warning of Benjamin Graham in "The Intelligent Investor" that "in the short run, the market is a voting machine; in the long run, it is a weighing machine."

Two, the financial sector became the driving force in the U.S. economy. During the past decade, revenues of stock exchange firms (excluding trading gains or losses) rose to an estimated \$375 billion from \$200 billion, and mutual fund fees and expenses rose to nearly \$100 billion from \$47 billion. The higher these intermediation costs, of course, the lower the returns to investors as a group. Alas, in this Alice-in-Wonderland world of the financial markets, the investor feeds at the bottom of the food chain.

Three, innovation became the buzzword of the era. But innovation was dominated by complex new products, such as credit default swaps and collateralized debt obligations, designed to make money for Wall Street firms rather than for their clients. Former Federal Reserve Chairman Paul Volcker recently opined that the only financial innovation of the era that created value was the ATM. (He has also agreed that the index fund created substantial value for investors.)

Four, all of this speculative market activity and costly marketing activity seemed to lead institutional money managers to ignore the realities that drove the balance sheets and income statements of the companies held in their portfolios, a striking failure of professional security analysis. "Financial engineering" was left to run rampant and "anything goes" seemed to be the rule in the quest to meet earnings guidance. The late Robert Bartley, long-time editor of this newspaper, got it right when he wrote in *The American Spectator* (Dec. 2003-Jan. 2004), "true profits are represented by cash—a fact—rather than reported profit—an opinion."

Five, absent the check of their institutional owners, corporations pushed executive compensation to unprecedented heights. From 42 times the average worker's salary in 1980, the compensation of the typical chief executive of a U.S. corporation now approaches a staggering 400 times the average worker's salary. Despite the collapse in corporate earnings during the recent financial crisis, there are few signs that executive compensation has been significantly affected.

While many social forces contributed to these aberrations in capitalism, the dominance of our new agency system played the major role. Regulation alone will not be sufficient to correct these gross abuses, for the self-interest of our agents, abetted by powerful and well-financed lobbyists—paid for, finally, by the very corporate and mutual fund shareholders whom new regulations are designed to serve. There are few regulations that smart, motivated, targets cannot evade.

The process of restoring the faith of investors must begin with a demand that the agent/owners of investment America stand up for the rights of their principals/beneficiaries. What we need is congressional action to establish a federal principle of fiduciary duty—encapsulated by the phrase "no man can serve two masters."

This principle will require institutional managers (1) to act solely in the interests of their shareholders and beneficiaries; (2) to observe due diligence and professional standards in their investment practices; (3) to honor their responsibilities as owners by active participation in corporate governance; and (4) to eliminate conflicts of interests in their activities.

Together, these standards would require the giant financial institutions of investment America to behave as owners of corporate America, actively voting proxies in the interests of their principals; playing a role in dividend payouts and executive compensation as well as in mergers and acquisitions; limiting (or even eliminating) excessive stock options; and demanding the independence of directors from management (including the separation of the roles of chief executive and board chairman).

In addition, policy makers ought to be considering structural changes that would enhance the role of investors and diminish the role of speculators. For example, granting longer-term (say, two- to five-year holders of stock) extra voting rights and/or a higher dividend; a federal transfer tax on securities transactions; or a tax on short-term realized capital gains (say, shares held for less than six months), applicable to taxable as well as tax-exempt investors such as IRAs.

As the new year and the new decade begin, it is time to restore the faith of investors in our interlinked corporate and financial systems. This is not a task for the fainthearted, or for the impatient.

Early in 2002, I called for the creation of a Federation of Long-Term Investors, in which institutional investors—including the giant index fund managers who alone hold some 15% of U.S. stocks—would join together to force these long-overdue changes and exert their ownership power over our publicly-held companies.

Then, I found few allies. Today, perhaps, this is an idea whose time has come.

Mr. Bogle is founder and former chief executive of the Vanguard Group. The 10th anniversary edition of his "Common Sense On Mutual Funds" was published by Wiley last month.

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