Vanguard, as many of you know, is the highly regarded mutual fund company recognized for its
low-fee operation and for its integrity. It got that way largely because of John Bogle, its legendary founder
and longtime chief executive. Still sharp and feisty at age 77, Bogle sees the investing public being ripped off
by our corporations and by the financial community, especially the mutual fund industry. He has written a
book, The Battle for the Soul of Capitalism, which aims to galvanize the public into demanding remedial
action. He certainly galvanized me to appear before you today.

After completing an undergraduate thesis on the mutual fund industry at Princeton in 1951 Bogle
started with and then headed the very successful Wellington Mutual Fund. In 1974 he founded The Vanguard
Group and was its CEO into 1996. Time Magazine placed Bogle among the “100 most influential people in
the world”. Fortune called him an investment giant of the 20th century. Today he writes, lectures, appears
frequently before Congress and regulators and serves on committees that study the industry’s problems.

My goal today is to extract the essence of Bogle’s case. Everything that follows is in his book except
for a few clearly identified comments of mine. As to my credentials, in the 1950s I was a senior editor on
Engineering News-Record, a weekly construction industry magazine published by McGraw-Hill and
extracting the essence was what I did every day. Since 1959 I have owned a small corporation that provides
computer services to civil engineers and land surveyors. Since 1962 I have directed investment of my firm’s
employees pension trust.

I. CORPORATE AMERICA

Let’s start with corporate America. Bogle says the owners’ capitalism of earlier times, wherein the
lion’s share of rewards went to those who put up the money, has morphed into today’s managers’ capitalism,
which provides disproportionate rewards to those who run our corporations. The trend began 50 years ago
but gathered steam in the 1980s during the Reagan presidency. Bogle calls it “a pathological mutation”.

The root cause is the diffusion of ownership of our corporations. With rare exceptions, individual
stockholders have no influence because each owns so few shares. The overseers who are supposed to protect
the owners – corporate directors, auditors, the financial community, government regulators and our
legislators – all fail to act. Everyone goes along and the result is profoundly disturbing.

Driven by stock options, the pay of the average chief executive officer went from 42 times the
average worker’s in 1980 to 280 times in 2004. And the CEO pay does not include costly perks such as use
of company aircraft for personal travel, low interest loans, high interest paid on deferred compensation,
stepped-up retirement benefits, luxury boxes at sporting events, apartments, and country club dues.

The corporate focus shifted from a company’s long-term health to short-term results, especially as
measured by quarterly earnings reports. The short-term focus led to a path chosen by all too many
corporations. When legitimate earnings fall short, accounting principles are pushed to the very edge to create
managed earnings. When this isn’t enough, many firms cheat.

In a large survey, 60% of corporate employees said they observed violations of law or company
policy and that few of these were corrected. In a survey of 300 whistle blowers two-thirds said they lost their
jobs after reporting violations.

The most important protector of stockholder interests is supposed to be a corporation’s Board of
Directors. Directors today are reluctant, unwilling and perhaps even unable to function. CEOs of most
corporations are virtual dictators. They often select directors who are friends or managers of businesses
dependent on the corporation they are supposed to watch over. With rare exception, the stockholder has little information to go on when voting for a director, and almost all vote as recommended by management.

The legendary Warren Buffet had this to say about today’s CEOs and directors. “Too many of these people behave badly, fudging numbers and drawing obscene pay for mediocre achievement. Compensation committees too often have been tail-wagging puppy dogs meekly following recommendations by consultants who are prompted by management. The costly charade should cease. CEOs amass riches while shareholders experience financial disaster. Directors should stop such piracy.” Buffet certainly doesn’t mince words.

Far too many directors lack a full understanding of their fiduciary duty which is to ensure that the corporation’s assets are employed on behalf of the stockholders. Bogle believes so many current boards turn away from their traditional stewardship because the remarkable prosperity and booming stock markets beginning in the early 1980s induced directors to relax their vigilance. America became a “bottom-line” society, corporate profits surged, and CEO compensation exploded. The notion of stewardship declined and directors gave unfettered power to corporate managers.

Certified public accountants are supposed to follow generally accepted accounting principles in their audits of corporations. Bogle says they are frequently under great pressure to produce opinions that conform to their client’s view. And when the accountant is also providing consulting services to the company it is auditing, the pressure to stretch accounting principles intensifies because consulting fees average twice the auditing fees. When they don’t “go along” CPAs risk both losing the account and failing to get new business as the word gets out. The sad truth is that supposedly independent auditors have abdicated their fiduciary responsibility and become partners of management.

Loose accounting standards allow the creation of earnings out of thin air. A charge taken earlier is reversed. Large items are called “immaterial,” assumed returns on pension plans are jacked up, customers are loaned money to make purchases which are counted as valid sales, there are special deals at quarter’s end to help the quarter’s numbers. This creative accounting is only a small step removed from dishonest accounting, a boundary Bogle says that today is crossed far too often.

The fiction of managed earnings reaches its zenith in the assumption of future earnings of corporate pension funds. Financial experts agree that the current expected return of a pension portfolio 60% in stocks and 40% in bonds is 5.8%. But corporations on average assume a future annual return of 8.6%. Allowing for a reserve, Bogle believes that today corporations should be using a 5.0% future return.

Here’s a typical example of earnings shenanigans. In 2001 Verizon reported net income of $389 million and awarded executive bonuses based on that amount. Net income included $1.8 billion of pension fund income. But the pension fund actually lost $3.1 billion that year. Verizon simply raised its pension projection to 9.25% and thus produced the fictional earnings.

A common ploy of corporations is to report pro forma earnings. Such earnings do not include many real costs such as restructuring charges, asset write-downs, stock option expenses, and investment losses. For ten years beginning in 1991, pro forma earnings exceeded actual earnings by an average 11% for all companies in the S&P 500 Index. In 2001 1,500 companies reported pro-forma earnings.

One of the worst offenders was Yahoo! in its 3rd quarter report for 2001. The company reported earning 1 cent per share. A footnote stated earnings excluded depreciation, amortization, payroll taxes on exercised stock options, acquisition-related costs and restructuring costs. In that quarter Yahoo! actually lost 4 cents per share.

Business Week Magazine once asked 160 corporate chief financial officers their response to the statement “As CFO I fought off requests that I misrepresent corporate results.” 55% said yes they had resisted, 12% said that they did misrepresent and only 33% said they were never asked to cheat. Bogle agrees with an analyst who wrote everyone has gotten used to companies that massage the bottom line so there is not even a slight disappointment.
The financial community fails to call attention to managed earnings and auditor complicity. It ignores realistic analyses and ethical guidelines and joins in deluding the investor. Bogle says Wall Street is utterly worthless in watching over corporate conduct. More on this later.

Regulation by the Securities and Exchange Commission is a mixed bag. Under chairmen Levitt and recently Donaldson the SEC occasionally tried. But corporate lobbying of Congress stymied most reform efforts. For example, in 1998, Congress forced the SEC to back down on its proposal to stop accounting firms from providing both auditing and consulting services to the same client at the same time. In 1993 the Financial Accounting Standards Board wanted to require the expensing of stock options but Congress voted overwhelmingly to kill it. Recently a few corporations have begun to expense stock options and this much-needed practice has a chance of wide adoption.

Bogle offers numerous recommendations to fix Corporate America’s problems. They boil down to the imperative that stockholders, the owners, must protest loud and long to force the corporations, the overseers and the legislators, especially the legislators, to adopt remedial measures. Thus far proponents of the status quo, abetted by the current Bush administration, are beating back most proposed changes.

Several months ago I watched a TV interview program on which Ira Millstein, a widely respected Washington insider and attorney, stated that the Sarbanes-Oxley reform law of 2002 has caused corporate boards to improve their oversight except for one very critical exception. There is essentially no effort to address the biggest problem, excessive compensation of CEOs and top management. Incidentally, Millstein offered high praise of The Battle for the Soul of Capitalism.

Bogle’s book is a polemic but here and there he offers investing advice. Here are the top ten red flags warning that a corporation may be troubled, drawn from a list of 24 in the book, which Bogle drew from another book listing 175.

The company has an aggressive CEO and a compliant chief financial officer
It has a multitude of anti-takeover devices
Reported profits are rising but cash flow is declining
The company is defendant in many class-action lawsuits
Senior management includes a former auditor
CEO pay is not linked to performance
Top executives own very little of company stock
The company always meets or beats earnings expectations
One-time earnings are used to reach the earnings target
The company’s financial results are restated

II. INVESTMENT AMERICA

Let’s turn now to the investment community which includes the managers of pension funds and mutual funds, stockbrokers, investment bankers, commercial banks, insurance companies, the stock exchanges and the newest arrival, hedge funds. Bogle’s history begins in the 1930s. First though a few words of what went on before, from a book about Jay Gould.

Wild and woolly was the essence of financial America between the late 1800s through the 1920s. There were the sharpies like Jay Gould and the suckers who bought and traded stock offerings. Regulation was almost nil, fraud was endemic, economic monarchs like Vanderbilt and Morgan dominated. The first President Roosevelt using anti-trust laws and the bully pulpit curbed but did not end the uncontrolled antic activity. The second President Roosevelt put some teeth into Securities and Exchange Commission regulation by appointing one of the sharpies, Joe Kennedy, as chairman.
In the 1930s and 40s individuals owned almost all shares of America’s stocks. Only a handful of stockholders had any real control so senior corporate managers could take advantage if they chose. But they didn’t according to financial historians. With rare exception, corporations were run to benefit the owners not the managers.

The corporate shift from owners’ capitalism to managers’ capitalism accelerated in the 1960s and paralleled the investment community’s shift from long-term to short-term, from investing to speculating, from emphasis on value stocks to embracing the more risky growth stocks. Corporate and government pensions plans, insurance companies and the mutual fund industry began acquiring or managing large amounts of stock. Today, individuals hold just 36% of all stocks. The one hundred largest institutions, the so-called Institutional 100, control 52% of corporate America and the remaining 12% is held by thousands of smaller institutions.

Theoretically the Institutional 100 has absolute control over the nation’s corporations. But thus far, with rare exceptions, the giant institutions remain silent. Bogle says they behave not like King Kong but rather like Mighty Joe Young, the powerful gorilla whom sweet music lulls into compliance and serenity. The investment banking scandals in 2002 drew scant public comment from money managers when they ought to have led the charge for remedial action.

Bogle is astonished at the lack of oversight by money managers. In the last 50 years …

- No money manager ever sponsored a proxy resolution that was opposed by corporate management.
- Not a single money manager testified before Congress on critical proposals such as expensing stock options and the Sarbanes-Oxley reform bill.
- The SEC proposal to permit financial institutions to nominate corporate directors was not supported and even discouraged by a few managers.
- After combing the records, Bogle could find no manager who spoke out in favor of stronger shareholder rights.

One reason financial managers ignore their oversight responsibility is their conflict of interest when managing the retirement plan assets of corporations whose shares they own. There is a system of circularity in which the owners are the owned. For example, Citigroup’s money management arm manages accounts that own Citigroup stock. This is like asking the fox to mind the henhouse.

During the last two decades a large number of investment management firms have been bought by financial conglomerates. In 2005 conglomerates controlled $2.3 trillion of mutual fund assets and $1 trillion of common stocks, which represents about 22% of the $15 trillion total market. These conglomerates manage mutual funds, operate brokerages, underwrite new securities, and lend money to companies whose shares are held in the mutual funds and pension accounts they manage. The Glass-Steagall Act of 1933 which banned the alliance of commercial bankers and securities underwriters has been eroded by legislative changes and lax regulation.

There is some good news. In the aftermath of the numerous scandals and fines in recent years, pension funds run by state and local governments and by labor unions are ratcheting up their activism, as is TIAA the giant agency which provides investment services to persons involved in education. Indeed, a few of the largest conglomerates are in process of spinning off or restructuring their asset management divisions.

Investment America largely ignores corporate governance because of what Bogle calls short-termism. If the money managers focus almost exclusively on current stock price rather than the intrinsic value of the corporation, we should not be surprised when stock price drives the corporate manager. And when the corporate manager plays earnings games to enhance stock price, the money manager happily accepts the illusion.

Bogle says much of the investment management industry has a bad case of hyper-short-term trading as evidenced by portfolio turnover rate, a measure of how long stocks are held. Through the mid 1960s, the
average annual turnover of equity mutual funds was 15%. Put another way, the average stock was held for 6.5 years. The average turnover rate hit 100% in the late 1990s and reached 150% in 2004. This means stocks are being held for much less than a year. The traditional own-a-stock philosophy has become rent-a-stock. It seems obvious that today’s manager won’t spend money to evaluate a company’s governance when its stock will be soon be sold.

Even though trade commission rates have tumbled, Wall Street has prospered because trading volume has soared. Combined New York Stock Exchange and NASDAQ daily volume exploded from 15 million shares in 1970 to 3.3 billion in 2004. Broker revenues reached $270 billion in 2004.

The record is clear that holding for the long term provides higher returns than short term trading. In the past 10 years, equity mutual funds in the lowest turnover rate quartile averaged an annual return of 11.6%, while the highest turnover quartile had 8.8%. Compounded over the decade, the low-turnover funds increased 200% compared to 132% for the high turnover funds. Note that Warren Buffet says his favorite holding period is forever.

Bogle is especially caustic about the financial community’s uncritical and enthusiastic reception of corporate earnings projections that defy both reason and history. A study of half a million earnings forecasts in saner times showed there was a 1 in 200,000 chance that earnings for ten consecutive quarters could be forecast within 5% of reported earnings. Yet for 20 quarters ending in 1998 the consensus for General Electric was never more than 2.4% off. Obviously a lot of earnings management was going on.

The bull markets of the early 1980s and the late 1990s combined to generate a spectacular 17% annual return on stocks over the 20 years. Earnings and dividends accounted for 10% and the remaining 7% was what Bogle calls speculative return, buyers bidding up stock price for no solid reason. The annual 7% speculative return over two decades was unprecedented. The total 17% annual return was the highest and longest in the entire 200-year history of the stock market.

Bogle expected that few stock analysts would be so foolish as to project future returns based on this recent record-setting growth so heavily influenced by speculation. He is astounded that almost everyone does. Even after the market bust beginning in 2000, stock analysts use the 1980 to 2000 history and project annual growth rates that have little chance of being met.

Bogle urges investors to be skeptical when a company proposes a merger or acquisition. A *Business Week* study showed that 61% of all mergers have reduced corporate value. Bernstein Research, a respected market analyst, found that in the first three years after an acquisition, the returns of the acquirers averaged 22% less than the stock market. And the largest losses were by companies that financed them with stock rather than cash.

Another factor in the rise of speculation is the reduction in dividends paid to stockholders. In the 1950s annual dividends averaged 5% of stock value. By 2000 they had dropped to 1%. Dividends have increased lately but still in early 2005 they averaged only 1.8%. Bogle is pleased with the rising dividends, especially because owners of dividend-paying stocks hold twice as long as owners of non-dividend stocks.

**Hedge funds** are much in the news lately. Bogle offers a sobering report and predicts their high flying days are numbered. Open only to the wealthy, hedge funds are driven by aggressive managers who invest in anything the manager thinks will produce extraordinary returns. The risk level varies from extremely low to truly awesome. The Long-Term Capital Management Fund that failed spectacularly in 1998 had $7 billion of cash and leveraged assets of $140 billion.

A few hedge funds achieve incredible returns, most do not. Indeed, the average annual return between 1996 and 2003 was 9.3%, compared to the conservative Wellington mutual fund which produced 10.1% over the same period.
Hedge fund managers charge unbelievably high fees: 2% of assets per year plus between 20 and 50% of total profits. A few superstar managers routinely earn $500 million a year.

Today's 400 largest hedge funds have total assets of $1 trillion, including about $600 billion in stocks. Although they own just 4% of the stock market hedge funds, because of 300 and 400% annual turnover rates, now account for 40% of NYSE and NASDAQ daily volume. Over 1800 hedge funds have failed between 1995 and 2003, many being folded into successful funds to hide their demise.

Bogle believes that sophisticated investors will begin turning away from hedge funds because returns will decline, because the difficulty of selecting winning funds will increase, because of the obscene manager fees, and because of the low tax efficiency of hedge fund profits.

III THE MUTUAL FUND INDUSTRY

We turn now to the mutual fund industry Bogle knows so well. At a national industry meeting in 2003 a keynote speaker offered these words: “Our strong tradition of integrity continues … Our shareholders trust their mutual funds are being managed with their interests in mind … Critics including former SEC chairmen, members of Congress, academics, the Bard of Omaha, journalists, and a saint with his own statue have all weighed in about our failings … I wonder what life would be like if we’d actually done something wrong.” Bogle, of course, is the saint referred to.

Less than four months later the mutual fund scandals exploded. Then New York State attorney general Eliot Spitzer charged four mutual funds with allowing preferred investors to trade after hours when they had the advantage of late-breaking news. The market timing scandals grew from the original four to 23, implicating some of the oldest and largest mutual funds. Other scandals involving shady selling practices soon surfaced with 11 firms eventually being charged.

A relative pittance in fines and restitution was paid and the 23 firms guilty of illegal market timing had a tiny outflow over the next year. The industry told the public the misdeeds were akin to parking at a meter and not paying and the public continued investing. After hours trading and shady selling practices garnered the headlines but Bogle says they are small potatoes compared to the many legal ways the mutual fund industry rips off the investing public.

The vast majority of today’s mutual funds, like corporations, give managers a disproportionate share of the returns. But whereas corporations have stockholders who potentially have control, almost all the largest mutual funds today are owned by separate companies that deny mutual fund shareholders any opportunity for governance. Mutual fund managers have free rein and they take advantage.

Annual management expenses of mutual funds are measured as a percent of assets. Equity fund assets grew from $10 billion in 1960 to over $4 trillion in 2004. Given the economies of scale, one would expect the expense percent to decline. Instead it doubled. The nine largest equity funds in 1960 averaged half a percent. By 2003 eight of the nine largest were over 1%. Only Vanguard’s Wellington fund decreased, to 0.32%.

Management expenses do not include portfolio transaction costs, sales charges, and a plethora of special fees. Equity funds today are hyperactive traders whose transaction costs average 0.9% of assets. Add another 0.4% for sales charges, redemption fees, early redemption penalties, and outside investment advice. All told today the total annual cost to the average shareowner is about 2.5% of assets, while the total expenses of most Vanguard funds remains under one percent. The difference, some $60 billion annually, could be returned to shareowners if the industry went back to the way it operated in the 1950s and 60s (i.e., low turnover, fair but not extravagant compensation of managers, low sales loads, moderate marketing expenses).

The adverse effect of high-expense funds is illustrated by equity fund performance over ten years ending in 2004. The gross return of all funds was similar, around 12.5%. After expenses were deducted, the
lowest expense quartile returned 11.9% while the highest quartile returned 8.1%. The power of compounding over time better illustrates the effect. One dollar invested ten years ago became $2.07 for the lowest expense quartile and just $1.18 for the highest.

For 20 years beginning in 1985 the S&P 500 Index averaged 13.2% annual return, while the average equity fund gained 10.4%. The difference is almost exactly equal to the equity fund expense. $10,000 invested in the S&P Index in 1985 would be $120,000 in 2004 while the same investment in the average mutual fund would be only $73,000.

Most large fund families allow shareholders to freely move money between different funds, as for example, between a stock fund and a money market fund. Long-term investors are penalized by the excessive activity of short-term owners because the equity fund either has to keep a redemption reserve or buy and sell as cash comes in and out. The cost of this legal market timing is huge. Some funds routinely reach 300% turnover. If 150% turnover requires transaction costs of 0.9%, project what they are for more than double the average turnover rate.

In today’s go-go market, fund managers try to capitalize on most every latest fad by forming new funds and marketing them heavily. And the public often responds, because it likes the hot new idea. The new funds focus on Internet, technology and telecommunications stocks in the overpriced and risky NASDAQ market. And they often fail. Bogle puts the loss at hundreds of billions of dollars. Of course shareholders are responsible for their foolishness, but fund managers bear much of the blame because they start the risky funds and promote them to the hilt.

Bogle calls incubator funds a license to steal. Managers start tiny funds owned by insiders, and operate them aggressively often by granting them initial public offerings. If and when an incubator fund hits the jackpot, it is offered to the public through heavy advertising of huge past growth percentages that cannot be maintained. The SEC is supposed to prevent such hosing of the public but the regulation is lax.

401(k) plans often cost employees a lot of money. Employers almost always offer only one family of funds, and more often than not, one which has high expenses. The implication is that deals are made between employers and fund managers that are not in the best interest of the employees. Bogle cites an editorial in Barron’s that supports the contention of funny business. Barron’s mind you is a magazine that usually denies everything when business wrongdoing is charged.

As America became a bottom-line society where money is prized over all other achievements, the fund industry changed from a profession of investment management to a business of product marketing. As the fund industry became big business, $8 trillion in 2005, all of the major funds except Vanguard incorporated which shielded them from shareowner influence. Many of these corporations were subsumed into large financial conglomerates, which further removed fund management from the shareholders.

The record shows that funds operated by conglomerates provide inferior returns compared to those of relatively smaller private firms. Of the 54 largest mutual fund groups, 13 are private and 41 are part of conglomerates. Over ten years ending in 2003, the eight best performers were all private firms.

As a stock fund grows it is more difficult to maintain earlier returns and almost all do not. A $1 billion fund has some 2,500 stocks to choose from while a $20 billion fund has perhaps 250. Fidelity’s Magellan Fund is a classic example of the penalty of bigness. Through 1993 its returns beat the S&P 500 Index by 3.5% annually. As assets grew to $110 billion returns lagged the 500 Index by 2.1%. Essentially the fund became an expensive index fund. Today Magellan is half its peak size and the remaining investors would probably do better with an S&P 500 Index fund. But while giant size hurts the investor it enriches the manager through increased fees. Very few funds limit their size by prohibiting additional investment.

Bogle criticizes fund managers’ two-tier fee structure for investment advice. They charge their own funds many times more than they charge outside clients when they have to bid competitively. For example,
CalPERS, the giant California pension fund, pays less than .10% while these same advisors charge their own mutual funds up to 12 times this rate for presumably the same type of portfolio advice.

As implied in the keynote speech that called Bogle a saint, the mutual fund industry is almost unanimous in rejecting Bogle’s charges and opposing his reforms. Bogle hopes the public will learn from his book just how much the mutual fund industry is doing wrong. He believes reform will come, if not soon then eventually, when enough of the 95 million mutual fund shareholders get angry. Many leaders are already on board. They include Warren Buffet, Arthur Levitt, Steve Galbraith, Pete Peterson, Henry Kaufman, Walter Isaacson, Eliot Spitzer and Mario Cuomo.

So what can investors do until the great reformation arrives if indeed it ever does? Bogle implies that if you can’t mimic Warren Buffet and find companies with good long-term prospects and buy and hold, you are better off with index funds. Agreeing is Jack Meyer who had spectacular success managing Harvard University’s giant endowment fund. He says “The investment business is a giant scam. Up to 90% of mutual fund managers are deleting value. Most people should have index funds to keep fees low and taxes down. No doubt about it.” Peter Lynch, the extraordinarily successful manager of the early Magellan Fund, also says most investors would be better off in an index fund.

This afternoon you have heard John Bogle’s indictment of corporations and the financial industry. He offers numerous remedial measures many of which are listed on a handout you can pick up at the front and rear doors. After the break I will be pleased to answer questions about the book which I’ve read four times. But I think the session will be more productive if you will share your response to Bogle’s call for investor action. Which of Bogle’s charges resonate most strongly? Are you now less enamored of your investment advisor? Are you concerned enough to join in trying to force Congress and the SEC to better protect investors’ interests? And I’d like to hear from those who have embraced Bogle’s assessment of the financial industry’s shenanigans and have found investment strategies that finesse the mess. I will share mine. Thank you for listening and please come back in 15 minutes.