

The Modern Corporation and the Public Interest

A Speech by

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If my title, “The Modern Corporation and the Public Interest” echoes “The Modern Corporation and Private Property,” the title of an influential 1932 monograph by Columbia professors Adolph A. Berle and Gardiner C. Means, please be clear that the similarity is intentional.¹ The principal conclusions of their landmark review of the public corporations of the day:

- The position of ownership has changed from an active to a passive agent. The typical owner has rights and expectations with respect to an enterprise, but is practically powerless to effect change.
- The spiritual values that formerly went with ownership have been separated from it.
- The value of an individual’s wealth is determined largely by the actions of the individuals in command of the enterprise—over whom the typical owner has no control. That value is also subject to the vagaries and manipulations characteristic of the marketplace.
- Individual wealth has become extremely liquid, convertible into other forms of wealth at a moment’s notice.

Note: Mr. Bogle’s comments do not necessarily represent the views of Vanguard’s present management.

¹ As an Economics major at Princeton University in 1947-51, I studied their work.

- Finally, in the corporate system, the “owner” of industrial wealth is left with a mere symbol of ownership. *The power, the responsibility, and the substance that had been an integral part of ownership in the past has been transferred to a separate group in whose hands lies control.* (Italics added.)

Berle and Means cogently identified a problem that continues to plague modern capitalism. For a time, the system worked with reasonable effectiveness, since corporate shareholders with larger investments still had both the legal rights and voting rights to protect their own interests. As ownership was gradually diffused into far smaller shareholdings, however, effective shareholder power declined, even as the latent power of those voting rights remained intact.

The Rise of the Institutional Investor

While this opus was published 85 years ago, the description of our U.S. corporate system that I have just cited still rings true—passive ownership, seemingly powerless; a decline in spiritual values; the vagaries of the marketplace; the supremacy of management. But one of the two major parties that Berle and Means identified has lost most of its standing. Ownership of stocks by individuals has plunged from 92% of all stocks in 1945 to an estimated 27% today.

Diffused ownership of stocks gradually has given way to concentrated ownership. In the early 1950s, holdings of stocks by U.S. institutional investors—first mutual funds, then pension funds, then thrift plans—began to grow, and grow rapidly. In 1945, these institutions owned only 8% of all publicly-held stocks. By 1962, 18%. By 1982, 50%. Today, institutional holdings of stocks stand at an estimated 73%. It’s hard to imagine a change more sweeping than this change in the ownership of corporate America . . . well, maybe the index fund!

The Double-Agency Society

The Berle-Means model no longer explains how our modern corporations are governed. What has emerged instead is a “double-agency” society in which corporate agents (as a practical matter, CEOs) who are duty-bound to represent their shareholders face money-manager agents who are themselves duty-bound to represent their mutual fund shareholders and their other clients, often pension funds.

Duty-bound to serve their shareholder/principals or not, corporate managers have relegated the interests of their owners to second place behind their own. They have rewarded themselves with shockingly outlandish salaries, bonuses, and stock options; they engage in vigorous financial engineering of the earnings they report to their shareholders; and they have orchestrated huge stock buy-back programs that are often undertaken to offset the dilution of earnings entailed by the exercise of the stock options that they have awarded to themselves. Corporate managers do all of this because they care deeply about their own financial interests and prestige over their peers. And the money manager/agents, ostensibly overseeing them, have let it all happen without significant protest.

These money manager agents don't seem to care about corporate governance, in part because they have their own conflicts of interest. Most are lavishly compensated, so they don't dare to cast the first stone at their wealthy fellow agents in corporate America. Further, the portfolio managers of these agents are too often short-term traders in a company's stock ("renters") rather than long-term holders of stock ("owners"). Stock renters don't care—and perhaps *shouldn't* care—about corporate governance.

When one side cares and fights for itself with a passion, and the other side doesn't care and prefers low-profile passivity, it is hardly surprising which side wins.

Corporate Managers—Serving Themselves

In all those years since Berle/Means, the self-indulgence of our corporate manager/agents has increased sharply, particularly since 1980. The most obvious manifestation of this trend is executive compensation. In 1980, the ratio of the average compensation of CEOs was 42 times that of the average worker. By 2016, the compensation ratio had soared to 335 times. I can find no business rationale for that shocking increase, other than that corporate managers have almost unfettered power, and can use it with abandon to their own advantage.

Measured in *real* (inflation-adjusted) 1980 dollars, CEO compensation has risen at a rate of 6.5% annually, increasing by more than 560% in real terms during the period. In comparison, the compensation of the average worker increased by less than 1% per year, an insignificant cumulative increase of just 14% over 36 years. Have the CEOs forgotten that their workers are

the real builders of corporate intrinsic value? Isn't this disparity both economically indefensible and morally irresponsible?

The Ratchet Effect

Our CEO compensation system suffers from a fatal flaw. Compensation is based importantly on comparison with peers, and often gives too much weight to stock price and too little to intrinsic corporate value. When a board finds that its own CEO's pay reposes in the fourth quartile among his or her peers—"our CEO is better than that!"—it is all too likely to raise the compensation up to the first or second quartile. This leap, of course, drops another CEO into the fourth quartile. Duh!

And so the cycle repeats, ratcheting onward and upward as the years pass, almost always on the recommendation of an ostensibly independent executive compensation consultant. The so-called "free market" that sets CEO compensation doesn't exist. Rather, it is a closed market, one that is essentially created by compensation consultants, who have long since recognized that without generous recommendations on CEO pay, their own business will not long endure. Such a methodology is fundamentally flawed. Warren Buffett pointedly describes the typical consulting firm by naming it, tongue-in-cheek, "Ratchet, Ratchet, and Bingo."

Until we pay CEOs on the basis of *corporate performance* rather than on the basis of *corporate peers*, CEO pay will, almost inevitably, continue on its upward path. As a start toward reform, corporate shareholders should demand that CEO compensation be primarily related to a firm's return on total capital (ROTC) compared to the average ROTC of all U.S. corporations (and to the average ROTC of its peer corporations). The historic average ROTC for U.S. corporations is 12%. Executives would receive long-term compensation awards only to the extent that their firm's ROTC exceeded 12%. That's often a tough hurdle, but the managers are well-paid to surmount it.

Earnings Guidance and Stock Prices

The staggering amount of stock options issued to executives by our generous corporations has turned most of management's focus from increasing intrinsic corporate value to increasing the stock price. Wall Street security analysts expect CEOs to set earnings guidance,

and when earnings flag, the CEO often acts to reduce costs in order to maintain projected profits by limiting employees' compensation, laying-off experienced and loyal workers, and slashing capital expenditures. But it seems all too likely that these near-term "efficiencies" and these failures to invest adequately for future growth will eventually erode the company's prospects for the long-term.² The central issue posed is the harm done when a culture of short-term speculation focused on the price of the stock overwhelms a culture of long-term investment focused on the intrinsic value of the corporation.

The GE Story

In addition, aggressive accounting is often required to meet aggressive earnings goals. There are few better examples of this "numbers game" environment than General Electric Co. Way back in 1998, when GE had reported earnings that were within 2% of its "guidance" for 20 consecutive quarters, *Grant's Interest Rate Observer* calculated the odds of that happening in the real world as 1 in 50 billion. In 2009, GE settled a complaint from the SEC charging the firm, in *Grant's* words, with "book cooking and earnings manipulation," and paid a \$50 million fine. Editor James Grant added: "the crimes to which GE allegedly stooped reveal a management besotted with its own share price."

Chairman Jack Welch ran GE from 1981 to 2001, and left a legacy of accounting mumbo-jumbo to his successor Jeffrey Immelt, who divested large parts of the GE Capital subsidiary (a primary source of GE's earnings management) and added several new lines of business. These moves have not yet proved successful.

The outcome of the GE story of earnings engineering and management decisions is not a happy one. Consider the change in the value of the firm in the stock market: after growing from \$170 billion in 1997 to a high of \$580 billion in 2000, its market cap tumbled to \$230 billion by 2003. After a few years of stability, GE stock took another tumble in the 2007-2009 bear market, and another tumble of \$160 billion in the autumn of 2017. The market cap of what was once the

² I was a CEO for more than 30 years, and I can assure you first-hand that a committed, well-compensated, and well-trained work force has been a priceless asset throughout my entire career.

largest corporation in the world fell to \$160 billion. Net loss in market capitalization since 2000: \$420 billion, likely the largest decline in a company's market valuation in history.

Constructive Regulation

The issue of earnings engineering has not gone unnoticed by regulators. The SEC recently acted to confront the widespread aggressiveness by corporations in reporting their financial results. Among other things, the Commission emphasized that the presentation of GAAP measures in earnings reports should have “equal or greater prominence” to non-GAAP measurements. The SEC also warned against “cherry-picking” adjustments such as *including* non-recurring gains and *excluding* non-recurring charges, in an effort “to achieve the most positive measure.” This reform is long overdue.

In addition, the Commission also recently approved the recommendation by the Public Company Accounting Oversight Board of new rules that “would make auditors describe any significant issues they reviewed” with board audit committees, and to “explain any challenging, subjective, or complex judgements.”³ It is high time that the principle of full disclosure reaches this deeply into the complex details of convoluted corporate accounting. There is much more work to be done.

Where Are the Stockholders?

Even as the manager/agents of our corporations were acting in their own self-interest, our corporate shareholder agents were barely to be seen. Dare I describe it as “the Silence of the Funds”?⁴

One might have expected that as stock ownership moved from a diffuse group of often unsophisticated individual investors to a concentrated group of powerful investment professionals, these new owner/agents would make their will known. Yet until recently, nearly all money managers have been conspicuous by their absence from the corporate governance

³ Quoted from journalist Jason Zweig's column in *The Wall Street Journal*, August 21, 2017.

⁴ The title of my speech in New York before The New York Society of Analysts, October 20, 1999.

scene, generally endorsing slates of corporate directors and approving management's proxy recommendations.

The dominant money managers of our time run both mutual funds and pension plans. Based on a recent study by *Institutional Investor* magazine, we can estimate that this group of professional investors oversees some \$16 trillion of U.S. equities, a 73% share of the total.⁵ The mutual funds that they oversee alone hold 37% of total equities, and their other institutional clients hold 36%. This is by far the most dominant stock ownership position in history.

If at long last our stock owner/agents are to provide countervailing power to the power of our corporate manager/agents, mutual funds will carry a major portion of the response. This is not a new idea for me. Way back in 1951, in my Princeton University senior thesis, "The Economic Role of the Investment Company," I noted that the Securities and Exchange Commission, in its 1940 report to Congress, called on mutual funds to serve . . .

. . . the useful role of representatives of the great numbers of inarticulate and ineffective individual investors in . . . corporations in which (mutual funds) are also interested.

My conclusion, all those years ago: Mutual funds "seem destined to fulfill this segment of their economic role." (But I didn't expect to wait 65 years to see it begin!)

The fact is that mutual fund managers are charged by law with a fiduciary duty to their fund shareholders. The charge is not express, but it is crystal clear. The Investment Company Act of 1940 declares that "the national public interest and the interest of investors" require that mutual funds are "organized, operated, [and] managed" in the interest of their shareholders, and *not* "in the interest of directors, officers, investment advisers . . . underwriters, brokers, or dealers." Such a fiduciary duty must include responsible proxy voting.

Governance Activism by Mutual Funds

⁵ The field of institutional money management is highly concentrated. The ten largest asset managers account for almost half of all institutionally managed assets.

But mutual funds are hardly a unity. Funds differ substantially in their interest in governance. Considering these four industry segments provides a good starting point:

(1) Two classes of passively managed equity index funds.

(a) **Traditional index funds (TIFs)**. Broad-market-based, miniscule-cost, *passive* index funds designed to be held for a lifetime by *passive investors*. The prototypical TIF remains the world's first index (S&P 500) fund that I founded in 1975.

(b) **Exchange-traded index funds (ETFs)**. Low-cost *passive* index funds designed to be traded “in real time” by *active investors*. ETF portfolios are usually more concentrated than TIF portfolios, and often leveraged.

(2) Two classes (often blurred) of actively managed mutual funds.

(a) **Generally, large-cap funds**. These funds have average management costs and portfolio turnover typically in the 50% annual range—by today's standards, long-term stockholders—too often chosen by investors on the basis of outstanding past returns. Of course such returns rarely recur. It's called “reversion to the mean,” or RTM.

(b) **Smaller-cap and specialized funds**. These funds carry higher costs, and annual portfolio turnover rates that often run in the range of 100% or more. The performance of these funds tend to be more volatile than the large-cap funds, and their investors tend to focus on extraordinary past returns, turning their fund holdings over more rapidly. Here, RTM strikes even more powerfully.

During the past two decades, index funds have created a revolution, one in which the interests of our citizen/investors (“Main Street”) are increasingly taking priority over the interests of money managers, brokers, marketers, and financial buccaneers (“Wall Street”). But—mark my words—it is the traditional index fund that will remain the prime mover in the revolution in the field of corporate governance that is now emerging.

Yes, it's taken a long time. But remember that the impact of the first index fund on the world of finance also took a long time. That index fund (“Bogle's Folly”) was the subject of sarcastic jokes and skepticism. Fully two decades (1975-1995) passed before index funds began to gain traction. Yet today index funds hold some 41% of the assets of all U.S. equity mutual

funds, on the way to topping 50%. Indexing is an idea whose time has finally come, a disruptive innovation that places the interests of investors ahead of the interests of fund managers.

Early Signs of Progress

We have a long way to go before corporate governance participation by active money managers and passive index funds reaches full fruition. But the tide is moving strongly in that direction. One encouraging sign is the “Commonsense Corporate Governance Principles,” an open letter from a group of major institutional managers that calls for a focus on “long-term value creation.” Its set of governance principles was developed by a group of giant index fund managers (Vanguard, BlackRock, and State Street) and active money managers with a strong tendency to invest for the long term (including American Funds and T. Rowe Price).

Another encouraging sign of greater participation in corporate governance (especially to yours truly!) is the evolution of Vanguard, now the world’s largest index fund manager (\$3 trillion) and second largest money manager (\$4.5 trillion). The turnaround in the firm’s philosophy has been dramatic. In 2003, Vanguard joined Fidelity in a major public statement *opposing even the disclosure of its proxy votes* at corporate annual meetings. But by 2012, Vanguard was actively engaging with the managers of its portfolio holdings.

Then in 2017, Vanguard came full circle, providing its first formal annual report on “Investment Stewardship.” This 36-page document disclosed Vanguard’s voting policies, and categorized in detail how the Vanguard funds voted their 2017 proxies on 38 types of propositions. Yes, most of these votes were cast as “for” votes, consistent with the recommendations of corporate managements. Nonetheless, as it is said, “a journey of 1,000 miles begins with a single step.”

A Framework for Reform

The power of entrenched managements operating in their own self-interest remains pretty much as it was described by Berle and Means in 1932. But the shareholder base is now dominated by a fairly small group of very large money managers, each with abundant

information at their fingertips and with substantial holdings in virtually every large publicly-held corporation in our nation. But investment professionals can't do it alone. They need to work to develop agreement on a broad, national set of principles such as these:⁶

1. A government requirement that, as fiduciaries, managers must act solely in the long-term interests of their beneficiaries.
2. An affirmation by government that an effective shareholder presence in all public companies is in the national interest.
3. A requirement that all institutional money managers should be accountable for the compulsory exercise of their votes, in the sole interest of their shareholders.
4. A recognition of the right of shareholders to nominate directors and make proxy proposals, subject to appropriate limits.
5. A demand that any ownership structure of managers that entails conflicts of interest be eliminated.

Building this framework will not be easy, but it is essential in order to support the independent exercise of the voting power of our money managers.

The Structure of the Corporation of Tomorrow

Pushing governance reform even further, here are some constructive ideas, courtesy of Uwe Reinhardt, professor of Political Economy at Princeton University's Woodrow Wilson School⁷:

“The cornerstone of the model would be the complete independence of the Board of Directors from the corporation's management, so that the Board can truly respect its constituency, the shareholders, *vis a vis* management.” This principle would require that large, publicly held corporations be organized as follows:

⁶ This list echoes the reforms passionately advocated by long-time corporate governance advocate Robert A.G. Monks.

⁷ Dr. Reinhardt, a prince of a human being who pulled no punches with his students nor with vested interests, departed this earth on November 14, 2017 at age 80. The world will miss his wisdom, his passion, and his unshakable integrity. So will I!

1. A Board chairman who is completely independent of management.
2. A Board on which no executives of the corporation, except for the chief executive officer, would serve. (The CEO would be a non-voting member.)
3. A small staff to serve the board, reporting to the chairman.
4. The firm's public accountants would report directly to the Board.
5. Such a Board structure would mean that the compensation and nominating committee would be composed only of independent directors.

In addition, each corporation should be required to provide limited but fair access to its annual proxy statement to stock owners who wish to offer proxy proposals or to nominate directors.

Achieving these goals will not be easy. I recognize that many of these proposals for reform are idealistic and out of today's mainstream. Most CEOs are unwilling to cede part of their imperial power to anyone else. A small staff for the board has also been a non-starter. But where there is a will to reform our flawed governance system, there will be a way.

Nor Are the Money Managers Without Sin

If only "he who is without sin may cast the first stone," our nation's money managers, too, have work to do to mitigate their own flaws so that they can enter the corporate governance arena with clean hands.

The fact is that mutual fund managers have their own conflicts. A bizarre industry structure in which even giant fund groups holding \$1 trillion of assets or more find it necessary to hire an outside firm to manage them. A corporate dichotomy in which these managers are often publicly held and thus have conflicting fiduciary duties in serving two different masters (the fund shareholder and the management company shareholder), with financial incentives that favor the management company master. And a counterproductive set of priorities in which aggressive marketing supersedes professional management.

Further, given the fact that so many institutional managers must be considered short-term *renters* of stocks rather than long-term *owners*, it's not at all clear why we should allow full corporate voting rights to the renters. Perhaps we need a sort of tapered voting rights in which holders of stock for, say, at least two years earn full voting rights and holders for less than a year have none.

This provision may sound extreme. But if the idea is that the greatest business success comes to corporations that focus on the long-term, it makes considerable sense. Finally, some combination of passively managed traditional index funds (TIFs) and actively managed large-cap funds that invest for the long term will hold the key to corporate governance reform.⁸

Finally, I confess my surprise (and disappointment) that the growth of TIFs—*typically bought and held by passive investors for the long-term*—has been eroded by the intercession of ETFs—*typically traded in the short term by active investors*—often focused on the short-term. My long experience in mutual fund investing has completely persuaded me that great *marketing* ideas for the fund industry are rarely, if ever, productive *investment* ideas for its shareholder/clients.

Past experience confirms that insight. The average TIF has provided significantly higher investment returns than the average ETF during every year of the past decade, usually by two to three percentage points annually. The cumulative investor returns: TIFs +105%, ETFs +62%. (Even the 71% investor return of actively managed equity funds exceeded the ETF return.) All that is required for the final triumph of the TIF is that ETF investors learn from their own experience.

Please don't be intimidated by this litany of flaws that have come to pervade today's debased version of capitalism. We can fix them, and we will. The nation's citizen/investors will demand nothing less. Our nation is already moving, if haltingly, toward returning the system to its traditional roots of trusting and being trusted. Our old individual *ownership* society is gone and will not return. Our present *agency* society has failed to serve its principals, as corporate managers and fund managers alike have placed their own interests above the interests of their beneficiaries and owners. It is time to begin the world anew, and build a *fiduciary society* in which stewardship is our talisman.

The Modern Corporation and the Public Interest

Let me close by returning to my title—"The Modern Corporation and the Public Interest"—and endeavoring to answer the question: "What *is* the public interest that the modern

⁸ In early 2002, in a speech to the New York Society of Security Analysts, I first suggested creating a "Federation of Long-Term Investors." Intrigued by the idea, Warren Buffett offered to be part of it if I could persuade some of the largest fund managers to join. I failed in that effort. The idea died.

corporation should serve?” Of course, the principal goal of the money management agents must be that the corporations whose shares they hold are managed with the interests of their shareholders as their highest priority.

But there can be no doubt that producing long-term growth in the intrinsic value of the firm should remain the optimal goal of the modern corporation. Not the evanescent swings in short-term stock prices, but the durable creation of the intrinsic value of the business. After all, paraphrasing Warren Buffett:

When the price of a stock temporarily over-performs or under-performs the business, a limited number of shareholders—either sellers or buyers—receive out-sized benefits at the expense of those they trade with. [But] over time, the aggregate gains made by the firm’s shareholders must of necessity, match the business gains of the corporation.

But lest we forget, “the public interest” means the interest of our society as a whole. Princeton’s Uwe Reinhardt nicely sums it up. The goal of our society must be “genuine wealth creation for the economy as a whole. It is not only about financial wealth, but about the total wealth created by all of the nation’s human capital, its physical infrastructure, and its governmental institutions, including national security and the law.” Corporate managers and money managers alike have a vested interest in the preservation of the values shaped by these other contributors to their own wealth and to the wealth of our nation.

The enterprises that will endure are those that generate growing profits for their owners, something they do best *only* when they take into account the interests of their customers, their employees, their communities, and indeed the interests of our society. Please don’t think of these ideals merely as foolish idealism. They are the ideals that capitalism has depended upon from the very outset. Hear Adam Smith: “He is certainly not a good citizen who does not wish to promote, by every means of his power, the welfare of the whole society of his fellow citizens.”

No one says it better than Theodore Roosevelt.⁹ He begins his 1910 speech on “The New Nationalism” by quoting Abraham Lincoln:

I hold that while man exists it is his duty to improve not only his own condition, but to assist in ameliorating mankind. . . . Labor is prior to, and independent of, capital. Capital is only the fruit of labor, and could never have existed if labor had not first existed. Labor is the superior of capital, and deserves much the higher consideration.

Roosevelt continues with his own words:

The material progress and prosperity of a nation are desirable chiefly so long as they lead to the moral and material welfare of all good citizens. . . . The absence of effective . . . restraint upon unfair money-getting has tended to create a small class of enormously wealthy and economically powerful men, whose chief object is to hold and increase their power. The prime need is to change the conditions which enable these men to accumulate power which is not for the general welfare that they should hold or exercise. . . . The right to regulate the use of wealth in the public interest is universally admitted.

Wrapping Up

If the mission of today’s modern corporation is to serve the public interest, then our giant, ever more powerful institutional investors must educate themselves as to what is real in investing, and what is illusory. We must understand the nature of traditional capitalism; the wisdom of long-term investing and the folly of short-term speculation; the productive power of compound interest to build returns; and the confiscatory power of compound costs to slash those very same returns. In all, the relentless rules of humble arithmetic. We all need to stand back, take a moment for introspection, and finally recognize that these obvious precepts must drive institutional investment management in the years ahead. The arc of investing is bending toward fiduciary duty and the public interest, and its progress is inevitable.

⁹ Roosevelt’s speech was delivered at the dedication of the John Brown Memorial Park in Osawatomie, Kansas, on August 31, 1910.