

Chapter 1

Don't Count on It! The Perils of Numeracy*

Mysterious, seemingly random, events shape our lives, and it is no exaggeration to say that without Princeton University, Vanguard never would have come into existence. And had it not, it seems altogether possible that no one else would have invented it. I'm not saying that our existence matters, for in the grand scheme of human events Vanguard would not even be a footnote. But our contributions to the world of finance—not only our unique mutual structure, but the index mutual fund, the three-tier bond fund, our simple investment philosophy, and our overweening focus on low costs—have in fact made a difference to investors. And it all began when I took my first nervous steps on the Princeton campus back in September 1947.

My introduction to economics came in my sophomore year when I opened the first edition of Paul Samuelson's *Economics: An Introductory Analysis*. A year later, as an Economics major, I was considering a topic for my senior thesis, and stumbled upon an article in *Fortune* magazine on the “tiny but contentious” mutual fund industry. Intrigued, I immediately decided it would be the topic of my thesis. The thesis in turn

*Based on my keynote speech at the “Landmines in Finance” Forum of The Center for Economic Policy Studies at Princeton University on October 18, 2002.

proved the key to my graduation with high honors, which in turn led to a job offer from Walter L. Morgan, Class of 1920, an industry pioneer and founder of Wellington Fund in 1928. Now one of 100-plus mutual funds under the Vanguard aegis, that classic balanced fund has continued to flourish to this day, the largest balanced fund in the world.

In that ancient era, Economics was heavily conceptual and traditional. Our study included both the elements of economic theory and the worldly philosophers from the 18th century on—Adam Smith, John Stuart Mill, John Maynard Keynes, and the like. Quantitative analysis was, by today's standards, conspicuous by its absence. (My recollection is that Calculus was not even a department prerequisite.) I don't know whether to credit—or blame—the electronic calculator for inaugurating the sea change in the study of how economies and markets work, but with the coming of the personal computer and the onset of the Information Age, today numeracy is in the saddle and rides economics. If you can't count it, it seems, it doesn't matter.

I disagree, and align myself with Albert Einstein's view: "Not everything that counts can be counted, and not everything that can be counted counts." Indeed, as you'll hear again in another quotation I'll cite at the conclusion, "to presume that what cannot be measured is not very important is blindness." But before I get to the pitfalls of measurement, to say nothing of trying to measure the immeasurable—things like human character, ethical values, and the heart and soul that play a profound role in all economic activity—I will address the fallacies of some of the measurements we use, and, in keeping with the theme of this forum, the pitfalls they create for economists, financiers, and investors.

My thesis is that today, in our society, in economics, and in finance, we place too much trust in numbers. *Numbers are not reality*. At best, they're a pale reflection of reality. At worst, they're a gross distortion of the truths we seek to measure. So first, I'll show that we rely too heavily on historic economic and market data. Second, I'll discuss how our optimistic bias leads us to misinterpret the data and give them credence that they rarely merit. Third, to make matters worse, we worship hard numbers and accept (or *did* accept!) the momentary precision of stock prices rather than the eternal vagueness of intrinsic corporate value as the talisman of investment reality. Fourth, by failing to avoid these

pitfalls of the *numeric* economy, we have in fact undermined the *real* economy. Finally, I conclude that our best defenses against numerical illusions of certainty are the immeasurable, but nonetheless invaluable, qualities of perspective, experience, common sense, and judgment.

Peril #1: Attributing Certitude to History

The notion that common stocks were acceptable as investments—rather than merely speculative instruments—can be said to have begun in 1924 with Edgar Lawrence Smith's *Common Stocks as Long-Term Investments*. Its most recent incarnation came in 1994, in Jeremy Siegel's *Stocks for the Long Run*. Both books unabashedly state the case for equities and, arguably, both helped fuel the great bull markets that ensued. Both, of course, were then followed by great bear markets. Both books, too, were replete with data, but the seemingly infinite data presented in the Siegel tome, a product of this age of computer-driven numeracy, puts its predecessor to shame.

But it's not the panoply of information imparted in *Stocks for the Long Run* that troubles me. Who can be against knowledge? After all, "knowledge is power." My concern is too many of us make the implicit assumption that stock market history repeats itself when we know, deep down, that the only certainty about the equity returns that lie ahead is their very uncertainty. We simply do not know what the future holds, and we must accept the self-evident fact that historic stock market returns have absolutely nothing in common with actuarial tables.

John Maynard Keynes identified this pitfall in a way that makes it obvious.* "It is dangerous to apply to the future inductive arguments based on past experience [that's the bad news] unless one can distinguish the broad reasons for what it was" (that's the good news). For there are just two broad reasons that explain equity returns, and it takes only elementary addition and subtraction to see how they shape investment experience. The too-often ignored reality is that stock returns are shaped by (1) economics and (2) emotions.

*John Maynard Keynes commenting on Edgar Lawrence Smith's book (1926).

Economics and Emotions

By *economics*, I mean *investment* return (what Keynes called *enterprise**), the initial dividend yield on stocks plus the subsequent earnings growth. By *emotions*, I mean *speculative* return (Keynes's *speculation*), the return generated by changes in the valuation or discount rate that investors place on that investment return. This valuation is simply measured by the earnings yield on stocks (or its reciprocal, the price-earnings ratio).[†] For example, if stocks begin a decade with a dividend yield of 4 percent and experience earnings growth of 5 percent, the *investment* return would be 9 percent. If the price-earnings ratio rises from 15 times to 20 times, that 33 percent increase would translate into an additional *speculative* return of about 3 percent per year. Simply add the two returns together: Total return on stocks = 12 percent.[‡]

So when we analyze the experience of the Great Bull Market of the 1980s and 1990s, we discern that in each of these remarkably similar decades for stock returns, dividend yields contributed about 4 percent to the return, the earnings growth about 6 percent (for a 10 percent *investment* return), and the average *annual* increase in the price-earnings ratio was a remarkable and unprecedented 7 percent. Result: Annual stock returns of 17 percent were at the highest levels, for the longest period, in the entire 200-year history of the U.S. stock market.

*John Maynard Keynes, *The General Theory of Employment, Interest, and Money* (New York: Macmillan, 1936; Harcourt, Brace, 1964), Chapter 12. This chapter makes as good reading today as when I first read it as a Princeton student in 1950. Interestingly, in the light of the thesis that I present in this essay, Keynes introduced these concepts with no quantification whatsoever. So I have taken the liberty of inserting the appropriate data.

[†]The earnings yield is also influenced by the risk-free bond yield. But because that relationship is so erratic, I have ignored it. For the record, however, the correlation between the earnings yield on stocks and the U.S. Treasury intermediate-term bond since 1926 has been 0.42. However, for the past 25 years it was 0.69, and for the past 10 years 0.53.

[‡]I recognize that one should actually multiply the two (i.e., $1.09 \times 1.03 = 1.123$), obviously a small difference. But such precision is hardly necessary in the uncertain world of investing, and when addressing the lay investor, simplicity is a virtue.

The Pension “Experts”

Who, you may wonder, would be so foolish as to project future returns at past historical rates? Surely many individuals, even those expert in investing, do exactly that. Even sophisticated corporate financial officers and their pension consultants follow the same course. Indeed, a typical corporate annual report expressly states, “Our asset return assumption is derived from a detailed study conducted by our actuaries and our asset management group, and *is based on long-term historical returns.*” Astonishingly, but naturally, this policy leads corporations to raise their future expectations with each increase in past returns. At the outset of the bull market in the early 1980s, for example, major corporations assumed a future return on pension assets of 7 percent. By the end of 2000, just before the great bear market took hold, most firms had sharply raised their assumptions, some to 10 percent or even more. Since pension portfolios are balanced between equities and bonds, they had implicitly raised the expected annual return on the *stocks* in the portfolio to as much as 15 percent. *Don't count on it!*

As the new decade began on January 1, 2000, two things should have been obvious: First, with dividend yields having tumbled to 1 percent, even if that earlier 6 percent earnings growth were to continue (no mean challenge!), the investment return in the subsequent 10 years would be not 10 percent, but 7 percent. Second, speculative returns cannot rise forever. (Now he tells us!) And if price-earnings ratios, then at 31 times, had simply followed their seemingly universal pattern of reversion to the mean of 15 times, the total investment return over the coming decade would be reduced by seven percentage points per year. As the year 2000 began, then, reasonable expectations suggested that annual stock returns might just be zero over the coming decade.*

If at the start of 2000 we were persuaded by history that the then-long-term annual return on stocks of 11.3 percent would continue, all would be well in the stock market. But if we listened to Keynes and simply thought about the broad reasons behind those prior returns on stock—investment versus speculation—we pretty much knew *what*

* Update: As it turned out, the annual return on stocks for the 1999–2009 decade came to -0.2 percent.

was going to happen: The bubble created by all of those emotions—optimism, exuberance, greed, all wrapped in the excitement of the turn of the millennium, the fantastic promise of the Information Age, and the “New Economy”—had to burst. While rational expectations can tell us *what* will happen, however, they can never tell us *when*. The day of reckoning came within three months, and in late March 2000 the bear market began. Clearly, investors would have been wise to set their expectations for future returns on the basis of current conditions, rather than fall into the trap of looking to the history of total stock market returns to set their course. Is it wise, or even reasonable, to rely on the stock market to deliver in the future the returns it has delivered in the past? *Don't count on it!*

Peril #2: The Bias toward Optimism

The peril of relying on stock market history rather than current circumstances to make investment policy decisions is apt to be costly. But that is hardly the only problem. Equally harmful is our bias toward optimism. *The fact is that the stock market returns I've just presented are themselves an illusion.* Whether investors are appraising the past or looking to the future, they are wearing rose-colored glasses. For by focusing on theoretical *market* returns rather than actual *investor* returns, we grossly overstate the returns that equity investing can provide.

First, of course, we usually do our counting in *nominal* dollars rather than *real* dollars—a difference that, compounded over time, creates a staggering dichotomy. Over the past 50 years, the return on stocks has averaged 11.3 percent per year, so \$1,000 invested in stocks at the outset would today have a value of \$212,000. But the 4.2 percent inflation rate for that era reduced the return to 7.1 percent and the value to just \$31,000 in real terms—truly a staggering reduction. Then we compound the problem by in effect assuming that somewhere, somehow, investors as a group actually *earn* the returns the stock market provides. Nothing could be further from the truth. They *don't* because they *can't*. The reality inevitably always falls short of the illusion. Yes, if the stock market annual return is 10 percent, investors as a group obviously enjoy a *gross* return of 10 percent. But their *net* return is reduced by the *costs* of our system of financial intermediation—brokerage

commissions, management fees, administrative expenses—and by the *taxes* on income and capital gains.

A reasonable assumption is that intermediation costs come to at least 2 percent per year, and for taxable investment accounts, taxes could *easily* take another 2 percent. Result: In a 10 percent market, the *net* return of investors would be no more than 8 percent before taxes, and 6 percent after taxes. Reality: Such costs would consume 40 percent of the market's nominal return. But there's more. Costs and taxes are taken out each year in *nominal* dollars, but final values reflect *real*, spendable dollars. In an environment of 3 percent annual inflation, a nominal stock return of 10 percent would be reduced to a real return of just 7 percent. When intermediation costs and taxes of 4 percent are deducted, the investor's real return tumbles to 3 percent per year. Costs and taxes have consumed, not 40 percent, but 57 percent of the market's real return.

Taken over the long-term, this bias toward optimism—presenting theoretical returns that are far higher than those available in the real world—creates staggering differences. Remember that \$31,000 real 50-year return on a \$1,000 investment? Well, when we take out assumed investment expenses of 2 percent, the final value drops to \$11,600. And if we assume as little as 2 percent for taxes for taxable accounts, that initial \$1,000 investment is worth, not that illusory nominal \$212,000 we saw a few moments ago—the amazing productive power of compounding *returns*—but just \$4,300 in real, after-cost terms—the amazing destructive power of compounding *costs*. *Some 98 percent of what we thought we would have has vanished into thin air.* Will you earn the market's return? *Don't count on it!*

Escaping Costs and Taxes

It goes without saying that few Wall Street stockbrokers, financial advisers, or mutual funds present this kind of real-world comparison. (In fairness, *Stocks for the Long Run* does show historic returns on both a real and nominal basis, although it ignores costs and taxes.) We not only pander to, but reinforce, the optimistic bias of investors. Yet while there's no escaping inflation, it is easily possible to reduce both investment costs and taxes almost to the vanishing point. With only the will to do so, equity investors can count on (virtually) matching

the market's gross return: *owning the stock market through a low-cost, low-turnover index fund*—the ultimate strategy for earning nearly 100 percent rather than 60 percent of the market's nominal annual return. *You can count on it!*

The bias toward optimism also permeates the world of commerce. Corporate managers consistently place the most optimistic possible face on their firms' prospects for growth—and are usually proven wrong. With the earnings guidance from the corporations they cover, Wall Street security analysts have, over that past two decades, regularly estimated average future five-year earnings growth. On average, the projections were for growth at an annual rate of 11.5 percent. But as a group, these firms met their earnings targets in only 3 of the 20 five-year periods that followed. And the actual earnings growth of these corporations has averaged only about one-half of the original projection—just 6 percent.

But how could we be surprised by this gap between guidance and delivery? The fact is that the aggregate profits of our corporations are closely linked, indeed almost in lockstep, with the growth of our economy. It's been a rare year when after-tax corporate profits accounted for less than 4 percent of U.S. gross domestic product, and they rarely account for much more than 8 percent. Indeed, since 1929, after-tax profits have grown at 5.6 percent annually, actually lagging the 6.6 percent growth rate of the GDP. In a dog-eat-dog capitalistic economy where the competition is vigorous and largely unfettered and where the consumer is king—more than ever in this Information Age—how could the profits of corporate America *possibly* grow faster than our GDP? *Don't count on it!*

Earnings: Reported, Operating, Pro Forma, or Restated

Our optimistic bias has also led to another serious weakness. In a trend that has attracted too little notice, we've changed the very definition of earnings. While *reported* earnings had been the, well, standard since Standard & Poor's first began to collect the data all those years ago, in recent years the standard has changed to *operating* earnings. Operating earnings, essentially, are reported earnings bereft of all those messy charges like capital write-offs, often the result of unwise investments and

mergers of earlier years. They're considered "non-recurring," though for corporations as a group they recur with remarkable consistency.

During the past 20 years, *operating* earnings of the companies in the S&P index totaled \$567. After paying \$229 in dividends, there should have been \$338 remaining to reinvest in the business. But largely a result of the huge "non-recurring" write-offs of the era, cumulative reported earnings came to just \$507. So in fact there was just \$278 to invest—20 percent less—mostly because of those bad business decisions. But it is *reported* earnings, rather than *operating* earnings, that reflect the ultimate reality of corporate achievement.

Pro forma earnings—that ghastly formulation that makes new use (or abuse) of a once-respectable term—that report corporate results net of unpleasant developments, is simply a further step in the wrong direction. What is more, even auditor-certified earnings have come under doubt, as the number of corporate earnings restatements has soared. During the past four years, 632 corporations have restated their earnings, nearly *five times* the 139 restatements in the comparable period a decade earlier. Do you believe that corporate financial reporting is punctilious? *Don't count on it!*

“Creative” Accounting

Loose accounting standards have made it possible to create, out of thin air, what passes for earnings. One popular method is making an acquisition and then taking giant charges described as “non-recurring,” only to be reversed in later years when needed to bolster sagging operating results. But the breakdown in our accounting standards goes far beyond that: cavalierly classifying large items as “immaterial”; hyping the assumed future returns of pension plans; counting as sales those made to customers who borrowed the money from the seller to make the purchases; making special deals to force out extra sales at quarter's end; and so on. If you can't merge your way into meeting the numbers, in effect, just change the numbers. But what we loosely describe as *creative* accounting is only a small step removed from *dishonest* accounting. Can a company make it work forever? *Don't count on it!*

That said, I suppose it does little harm to calculate the stock market's price-earnings ratio on the basis of anticipated *operating* earnings.

The net result of using the higher (albeit less realistic) number is to make price-earnings ratios appear more reasonable (i.e., to make stocks seem cheaper). By doing so, the present p/e ratio for the S&P 500 index (based on 2002 estimates) comes to a perhaps mildly reassuring 18 times based on *operating* earnings, rather than a far more concerning 25 times based on *reported* earnings. But our financial intermediation system has far too much optimism embedded in it to promulgate the higher p/e number.

Nonetheless, it is folly to rely on the higher earnings figure (and resultant lower p/e) without recognizing the reality that in the long run corporate value is determined, not only by the results of the firm's current operations, but by the entire amalgam of investment decisions and mergers and combinations it has made. *And they don't usually work.* A recent *BusinessWeek* study of the \$4 trillion of mergers that took place amid the mania of the late bubble indicated that fully 61 percent of them destroyed shareholder wealth. It's high time to recognize the fallacy that these investment decisions, largely driven to improve the numbers, actually improve the *business*. *Don't count on it!*

Peril #3: The Worship of Hard Numbers

Our financial market system is a vital part of the process of investing, and of the task of raising the capital to fund the nation's economic growth. We require active, liquid markets and ask of them neither more nor less than to provide liquidity for stocks in return for the promise of future cash flows. In this way, investors are enabled to realize the present value of a future stream of income at any time. But in return for that advantage there is the disadvantage of the moment-by-moment valuation of corporate shares. We demand hard numbers to measure investment accomplishments. *And we want them now!* Markets being what they are, of course, we get them.

But the consequences are not necessarily good. Keynes saw this relationship clearly, noting that "the organization of the capital markets required for the holders of *quoted* equities requires much more nerve, patience, and fortitude than for the holders of wealth in other forms . . . some (investors) will buy without a tremor unmarketable investments

which, if they had (continuous) quotations available, would turn their hair gray.” Translation: It’s easier on the psyche to own investments that don’t often trade.

This wisdom has been often repeated. It is what Benjamin Graham meant when he warned about the hazard faced by investors when “Mr. Market” comes by every day and offers to buy your stocks at the current price. Heeding the importuning of Mr. Market allows the emotions of the moment to take precedence over the economics of the long term, as transitory shifts in prices get the investor thinking about the wrong things. As this wise investor pointed out, “In the short-run, the stock market is a *voting* machine; in the long-run it is a *weighing* machine.”*

Momentary Precision versus Eternal Imprecision

Yet the Information Age that is part of this generation’s lot in life has led us to the belief that the momentary *precision* reflected in the price of a stock is more important than the eternal *imprecision* in measuring the intrinsic value of a corporation. Put another way, investors seem to be perfectly happy to take the risk of being precisely wrong rather than roughly right. This triumph of perception over reality was reflected—and magnified!—in the recent bubble. The painful stock market decline that we are now enduring simply represents the return to reality. Is the price of a stock truly a consistent and reliable measure of the value of the corporation? *Don’t count on it!*

Among the principal beneficiaries of the focus on stock prices were corporate chief executives. Holding huge numbers of stock options, they were eager to “make their numbers,” by fair means or foul, or something in between. As the numbers materialized, their stock prices soared, and they sold their shares at the moment their options vested, as we know now, often in “cashless” transactions with bridge loans provided by the company. But unlike all other compensation, compensation from fixed-price options was not considered a corporate expense.

*Benjamin Graham and David Dodd, *Security Analysis* (1934, 1940; New York: McGraw-Hill, 2008), 70.

Such options came to be considered as “free,” although, to avoid dilution, most corporations simply bought compensatory shares of stock (at prices far above the option prices) in the public market. It is not only that shares acquired through options were sold by executives almost as soon as they were exercised, nor that they were unencumbered by a capital charge nor indexed to the level of stock prices, that makes such options fundamentally flawed. It is that compensation based on raising the price of the stock rather than enhancing the value of the corporation flies in the face of common sense. Do stock options link the interests of management with the interests of long-term shareholders? *Don't count on it!*

Ignorant Individuals Lead Expert Professionals into Trouble

Years ago, Keynes worried about the implications for our society when “the conventional valuation of stocks is established [by] the mass psychology of a large number of ignorant individuals.” The result, he suggested, would lead to violent changes in prices, a trend intensified as even expert professionals, who, one might have supposed, would correct these vagaries, follow the mass psychology, and try to foresee changes in the public valuation. As a result, he described the stock market as “a battle of wits to anticipate the basis of conventional values a few months hence rather than the prospective yield of an investment over a long term of years.”*

A half-century ago, I cited those words in my senior thesis—and had the temerity to disagree. Portfolio managers in a far larger mutual fund industry, I suggested, would “supply the market with a demand for securities that is steady, sophisticated, enlightened, and analytic, a demand that is based essentially on the (intrinsic) performance of a corporation rather than the public appraisal of the value of a share, that is, its price.” Well, 50 years later, it is fair to say that the worldly wise Keynes has won, and that the callowly idealistic Bogle has lost.

*John Maynard Keynes, *The General Theory of Employment, Interest, and Money* (New York: Macmillan, 1936; Harcourt, Brace, 1964), 155.

And the contest wasn't even close! Has the move of institutions from the wisdom of long-term investment to the folly of short-term speculation enhanced their performance? *Don't count on it!*

Economics Trumps Emotion—Finally

In those ancient days when I wrote my thesis, investment committees (that's how the fund management game was then largely played) turned over their fund portfolios at about 15 percent per year. Today, portfolio managers (that's how the game is now played) turn over their fund portfolios at an annual rate exceeding 110 percent—for the average stock in the average fund, an average holding period of just 11 months. Using Keynes's formulation, "enterprise" (call it "investment fundamentals") has become "a mere bubble on a whirlpool of speculation." It is the triumph of emotions over economics.

But it is an irrefutable fact that in the long run it is economics that triumphs over emotion. Since 1872, the average annual real stock market return (after inflation but before intermediation costs) has been 6.5 percent. The real investment return generated by dividends and earnings growth has come to 6.6 percent. Yes, speculative return slashed investment return by more than one-half during the 1970s and then tripled(!) it during the 1980s and 1990s. But measured today, after this year's staggering drop in stock prices, speculative return, with a net negative annual return of -0.1 percent during the entire 130-year period, on balance neither contributed to nor materially detracted from investment return. Is it wise to rely on future market returns to be enhanced by a healthy dollop of speculative return? *Don't count on it!*

The fact is that when perception—interim stock prices—vastly departs from reality—intrinsic corporate values—the gap can be reconciled only in favor of reality. It is simply impossible to raise reality to perception in any short timeframe; the tough and demanding task of building corporate value in a competitive world is a long-term proposition. Nonetheless, when stock prices lost touch with corporate values in the recent bubble, too many market participants seemed to anticipate that values would soon rise to justify prices. Investors learned, too late, the lesson: *Don't count on it!*

Peril #4: The Adverse Real-World Consequences of Counting

When we attribute certitude to history, when we constantly bias our numbers to the positive side, and when we worship the pleasing precision of momentary stock prices above the messy imprecision of intrinsic corporate values, the consequences go far beyond unfortunate numeric abstractions. These perils have societal implications, and most of them are negative.

For example, when investors accept stock market returns as being derived from a type of actuarial table, they won't be prepared for the risks that arise from the inevitable uncertainty of investment returns and the even greater uncertainty of speculative returns. As a result, they are apt to make unwise asset allocation decisions under the duress—or exuberance—of the moment. Pension plans that make this mistake will have to step up their funding when reality intervenes. And when investors base their retirement planning on actually achieving whatever returns the financial markets are generous enough to give us and tacitly ignore the staggering toll taken by intermediation costs and taxes, they save a pathetically small portion of what they ought to be saving in order to assure a comfortable retirement. Nonetheless, wise investors can totally avoid both the Scylla of costs and the Charybdis of taxes by educating themselves, by heeding the counsel of experienced professionals, or by attending the wisdom of academe.

An Ill-Done System of Capital Formation

But the peril of our preference for looking to stock prices—so easy to measure by the moment—rather than to corporate values—so hard to measure with precision—as our talisman is less easily overcome. Lord Keynes was surely right when he wrote, “when enterprise becomes a mere bubble on a whirlpool of speculation, the job [of capital formation] is likely to be ill-done.” In the post-bubble environment, the job *has* been ill-done. But while some of the speculation has now been driven from the system and the day-trader may be conspicuous by his absence, the mutual fund industry still needs to get its high-wire act together and at last go back to the future by returning long-term investment policy to its earlier primacy over short-term speculation.

It is not just our capital markets that have been corrupted by the perils of relying so heavily on the apparent certitude of numbers. It is our whole society. The economic consequences of managing corporations by the numbers are both extensive and profound. Our financial system has, in substance, challenged our corporations to produce earnings growth that has not been and cannot be sustained. When corporations fail to meet their numeric targets the hard way—over the long-term, by raising productivity, improving old products and creating new ones, providing services on a more friendly, more timely, and more efficient basis, challenging the people of the organization to work more effectively together (and those are the ways that our best corporations achieve success)—they are compelled to do it in other ways.

One of these ways, of course, is the aggressive merger-and-acquisition strategy I've earlier noted. Even leaving aside the commonplace that most mergers fail to achieve their goals, the companies that followed these strategies were well-described in a recent *New York Times* op-ed essay as “serial acquirers [whose] dazzling number of deals makes an absence of long-term management success easy to hide.”* Tyco International, for example, acquired 700(!) companies before the day of reckoning came. But the final outcome of the strategy, as the *Times* piece explained, was almost preordained: “Their empires of [numbers] hype can be undone very quickly by market discipline.” Are such strategies a formula for long-run success? *Don't count on it!*

In this context, it's amazing how much of companies' returns today are based on financial factors rather than operating factors. The pension plan assets of the 30 companies in the Dow-Jones Industrial average now total \$400 billion, not far from the corporations' collective book value of \$700 billion. Off-balance sheet financial schemes proliferate (or *did!*). Selling put-options to reduce the cost of repurchasing shares and avoid the potential dilution of stock options helped prevent earnings penalties in the boom, but has come back to deplete corporate coffers in the bust. And lending by major corporations to enable consumers to buy their wares has skyrocketed. Perhaps unsurprisingly, it isn't looking so good in today's economic environment.

*Jeffrey Sonnenfeld, *New York Times*, June 5, 2002.

When Paper Covers Rock, What Comes Next?

Too many so-called industrial companies have become financial companies—companies that *count* rather than *make*. (Witness the fact that the senior aide to the CEO is almost invariably the chief financial officer, often viewed by the investment community as the *eminence gris*.) Such companies, again quoting the *New York Times* article, “base their strategies not on understanding the businesses they go into, but assume that by scavenging about for good deals, they can better allocate their financial resources than can existing financial markets.” As we now observe the consequences of this strategy, we come to a painful realization. *Don't count on it!*

You may remember the children's game in which rock breaks scissors, scissors cut paper, and paper covers rock. In manias, as prices lose touch with values, paper indeed covers rock. “Paper” companies that *count* have acquired “rock” companies that *make*, and the results have been devastating. When I mention AOL/Time Warner, Qwest/U.S. West, and WorldCom/MCI, I don't have to tell you which is paper and which is rock. These are among the most poignant examples of a phenomenon in whose aftermath hundreds of thousands of loyal long-term employees have lost their jobs, and their retirement savings have been slashed unmercifully.

That the penalties for our financial mania are borne by our society was well-stated in a perceptive op-ed piece in the *Wall Street Journal*: “Stock prices are not simply abstract numbers. [They] affect the nature of the strategies the firm adopts and hence its prospects for success, the company's cost of capital, its borrowing ability, and its ability to make acquisitions. *A valuation unhinged by the underlying realities of the business can rob investors of savings, cost people far more innocent than senior management their jobs, and undermine the viability of suppliers and communities.*”^{*} Yes, the human consequences of excessive reliance on numbers, as we now know, can be remarkably harsh.

^{*}Joseph Fuller and Michael C. Jensen, *Wall Street Journal*, December 31, 2001.

Counting at the Firm Level

The perils of excessive numeracy don't end there. Even otherwise sound companies dwell too heavily on what can be measured—market share, productivity, efficiency, product quality, costs—and set internal goals to achieve them. But when *measures* become *objectives*, they are often counterproductive and self-defeating. Most measurements are inherently short-term in nature, but far more durable qualities drive a corporation's success over the long-term. While they cannot be measured, character, integrity, enthusiasm, conviction, and passion are every bit as important to a firm's success as precise measurements. (Call it the six-sigma syndrome.) It is *human beings* who are the prime instrument for implementing a corporation's strategy. If they are inspired, motivated, cooperative, diligent, and creative, the stockholders will be well served.

Yet recent years have shown us that when ambitious chief executives set aggressive financial objectives, they place the achievement of those objectives above all else—even above proper accounting principles and a sound balance sheet, even above their corporate character. Far too often, all means available—again, fair or foul—are harnessed to justify the ends. As good practices are driven out by bad, and the rule of the day becomes “everyone else is doing it, so I will too,” a sort of Gresham's law comes to prevail in corporate standards.

“Management by measurement” is easily taken too far. I recently read of a chief executive who called for earnings growth from \$6.15 per share in 2001 to a nice round \$10 per share in 2005*—an earnings increase of almost 15 percent per year—but without a word about how it would be accomplished. I don't believe that the greater good of shareholders is served by such a precise yet abstract numeric goal. Indeed what *worries* me is not that it *won't* be achieved, but that it *will*. In an uncertain world, the company may get there only by manipulating the numbers or, even worse, relying on cutbacks and false economies, and shaping everything that moves (including the human beings who will have to bend to the task) to achieve the goal. *But at what cost?* The sooner companies cease their aggressive “guidance,” the better.

*2010 update: Earnings topped the \$10 per share target in 2009.

For I believe that a quarter-century from now the companies that will be leading the way in their industries will be those that make their earnings growth, not the *objective* of their strategy, but the *consequence* of their corporate performance. Will the numbers *counters* outpace the product *makers*? *Don't count on it!*

An Individual Perspective

Lest I be accused of *innumeracy*, however, please be clear that I'm not saying that numbers don't matter. Measurement standards—*counting*, if you will—is essential to the communication of financial goals and achievements. *I know that.* But for the past 28 years I've been engaged in building an enterprise—and a *financial* institution at that—based far more on the sound implementation of a few commonsense investment ideas and an enlightened sense of human values and ethical standards than on the search for quantitative goals and statistical achievements. Vanguard's market share, as I've said countless times, must be a *measure*, not an *objective*; it must be *earned*, not *bought*. Yet the fact is that our market share of fund industry assets has risen, without interruption, for the past 22 years. (We did benefit, greatly, by being a *mutual* company, with neither private nor public shareholders.)

Our strategy arose from a conviction that the best corporate growth comes from putting the horse of doing things for clients ahead of the cart of earnings targets. *Growth must be organic, rather than forced.* And I've believed it for a long time. Indeed, here is how I closed in my 1972 annual message to the employees of Wellington Management Company (which I then headed) about giving too much credence to the counting of numbers:*

The first step is to measure what can be easily measured. This is okay as far as it goes. The second step is to disregard that which cannot be measured, or give it an arbitrary quantitative value. This is artificial and misleading. The third step is to presume that what cannot be measured really is not very

* Quoting pollster Daniel Yankelovich.

important. This is blindness. The fourth step is to say that what cannot be measured does not really exist. This is suicide.

There is, then, a futility in excessive reliance on numbers, and a perversity in trying to measure the immeasurable in our uncertain world. So when *counting* becomes the name of the game, our financial markets, our corporations, and our society pay the price. *So don't count on it!*

Numbers are a necessary tool and a vital one. But they are a *means* and not an end, a condition *necessary* to measure corporate success, but not a condition *sufficient*. To believe that numbers—in the absence of the more valuable albeit immeasurable qualities of experience, judgment, and character—are all that illuminate the truth is one of the great failings of our contemporary financial and economic system. Wise financial professionals and academics alike should be out there searching for a higher, more enlightened set of values. So, having begun this essay by describing how my career in the academy began, I'll close with a two-centuries-old quotation from the Roman poet Horace about the proper role of the academy:

Good Athens gave my art another theme
To sort what is from what is merely seen
And search for truth in groves of academe.

