PART I

The John C. Bogle Legacy Forum—A Vision for Restoring Trust

On a cold Tuesday in January 2012, some of the most highly respected legal and financial minds in the country gathered in the heart of Wall Street at the Museum of American Finance to wrestle with a fundamental question: "Restoring Investor Trust in Financial Markets: Does Jack Bogle Offer a Prescription?"

The John C. Bogle Legacy Forum was cochaired by former chairman of the Federal Reserve Board Paul A. Volcker and former Securities and Exchange Commission (SEC) chairman Arthur Levitt Jr. Chairman Volcker set the tone for the forum with panel topics that are "relevant, provocative, unsettled." Chairman Levitt noted of the program speakers, "This event brings together the best-known financial figures to honor a visionary in global finance. Jack Bogle has given investors throughout the world more wisdom and good financial judgment than any person in the history of markets."

Volcker and Levitt led a host committee that included Sheila C. Bair, John Biggs, Alan Blinder, William Donaldson, Peter Fitzgerald, Andrew Golden, Roger G. Ibbotson, Burton G. Malkiel, and David F. Swensen.

The Forum was spearheaded by the Institute for the Fiduciary Standard, co-organized by the CFA Institute and the Museum of American Finance, and sponsored by Bloomberg Link. The Tuesday session began with the reading of a welcome letter from William Jefferson Clinton, 42nd president of the United States, who succeeded Bogle as chairman of the board of the National Constitution Center and wrote the foreword to Bogle's 2008 book *Enough. True Measures of Money, Business, and Life*.

On the evening before the Forum, a small dinner was held for the speakers. Dinner hostess Maria Eleanor Lagomasino welcomed and thanked the speakers. Tamar Frankel raised her glass to salute the honoree for his "down-to-earth wisdom." William Isaac spoke of the eternal values that Bogle articulated and lived by. The evening ended with remarks by Jack Bogle's son, John, which began with this greeting: "Good evening. My name is John C. Bogle Jr., and I run a hedge fund." John then proceeded to entertain the group with contemplations of what an appropriate "Bogle Rule" might entail, and shared his recollections of living under "Bogle Rules" growing up.

A Welcome from President William Jefferson Clinton

William Jefferson Clinton

January 30, 2012

Dear Jack:

I'm delighted to join all those gathered at the Museum of American Finance in celebrating your long-standing commitment to economic responsibility.

Throughout your celebrated career, you've made it clear that the origins of financial stability lie not within partisanship, but within the people. I continue to be inspired by your common sense solutions for renewing America's trust with a long-term economic vision.

As we focus on putting Americans "back to work" and putting our nation back in the future business, I send my best wishes to you and all your guests for a successful and productive event.

Sincerely,

Remarks from the Speakers' Dinner

Tamar Frankel, Professor of Law at Boston University and author of nine books, including *The Ponzi Scheme Puzzle* (2012), made the following remarks:

I raise my glass to John Bogle. Throughout the years he has demonstrated a unique combination of perseverance, inspirational insights, and down-to-earth wisdom. He has taught without preaching, criticized without offending, and dealt with complex ideas simply, without being simplistic. He thus engages the readers in personal conversation at the fireplace, while introducing them to his colleagues. I am proud to be one of them.

Among his teachings, John Bogle has made two important points. One is that notwithstanding the complexity of the environment, the source of all good and evil is people. The second point is that, within the range of freedom, a few principles should not be watered down. Chipping at the block of honesty by interpreting, justifying, rationalizing it away, you end up at the other extreme—dishonesty.

These views represent the balance in a human body. Each cell in our body has an innate drive to propagate. Yet in order to survive, each cell must be limited to its functions and rogue cells must be controlled. The system, I am told, is in charge of controlling rogue cells. But if they succeed in propagating and overcoming the police, these cells grow—we call them cancer—and the body as a whole will die.

The human society is similar to the human body. And John Bogle's ideas reflect the healthy balance. Internal management of mutual funds, indexing, self-limitation of money managers, and controlling costs, among others, are the immune system containing rogue cells. He shows us how the body could maintain health by each cell doing what it ought to do within the range of its capabilities, thus contributing to the whole. John Bogle has been showing this complex balance in a way that draws audiences and followers. His is a truly unique achievement.

So here is to you, John.

And this from William Isaac, Global Head of Financial Institutions for FTI Consulting and chairman of Fifth Third Bancorp, former chairman of the Federal Deposit Insurance Corporation (FDIC), and the author of the 2010 book *Senseless Panic: How Washington Failed America*, with foreword by Paul Volcker:[1]

> I have long known and respected Jack Bogle, but always from afar, as I do not believe we have ever met. It would take more time than we have for me to simply list his accomplishments, so I won't even try. Let me just say that Jack Bogle has led a life of innovation, integrity, and public service, exemplified by his creation of The Vanguard Group, the largest mutual fund company in the world with assets under management exceeding $2 trillion.
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> Both Jack Bogle and the Institute for the Fiduciary Standard demand that "trustees of other people's money act solely in the best interests of their beneficiaries." They espouse six core duties:
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> - Serve the client's best interest.
> - Act in utmost good faith.
> - Act prudently—with the care, skill, and judgment of a professional.
> - Avoid conflicts of interest.
> - Disclose all material facts.
> - Control investment expenses.
>
> The past decade has been a period of great turmoil in our nation, and never has there been a more important time to return to these core principles, which I believe can be summed up in the word *trust*. Trust—which I define as "confidence in the honesty, reliability, and fairness of people and things"—is essential to democracy, a free market economy, and the financial system. That trust has been breached in recent years by our government and major private institutions, which has been enormously damaging on many levels.

1. The views expressed by Mr. Isaac are his own.

Mopping up the economic damage—a glut of foreclosed properties, millions of lost jobs, trillions of dollars of lost savings—will take time. Restoring trust between the government and the governed and between the captains of industry and the people who invest in their companies and buy their goods and services will be more challenging.

Despite our many challenges, there is nothing wrong with America that we cannot fix if we muster the political courage and will to do it. As bad as things might be today, we have been through worse.

Most Americans place a high value on working hard to create a better life for their families, contributing to their communities and those in need, and behaving with integrity.

We must demand that the leaders of our public and private institutions adhere to those values. These are not Republican or Democratic or Tea Party values; these are American values. These should be the values of both Main Street and Wall Street.

We must hold our public and private leaders to a much higher standard than in recent decades. When leaders in the private and public sectors bring us to the edge of financial ruin, they must be held accountable and, at the very least, be swiftly removed from office.

I believe these are the values Jack Bogle and the Institute stand for. Thank you for all that you have done and are doing.

And from John C. Bogle Jr., founder and president of Bogle Investment Management:

Good evening. My name is John C. Bogle Jr., and I run a hedge fund.

Knut Rostad and the Institute for the Fiduciary Standard, and GenSpring were kind enough to invite me to say a few words about the importance of my dad's legacy to the fund industry and investors, to corporate governance, and to society today.

And I'm really glad because someone had to be here to defend the One-Percenters. I have a feeling we're going to be taking quite a beating over the next 18 hours.

Everyone in this room is aware of the enormity of my dad's impact on the investment industry, particularly on the little guy, the one saving for a child's education, for a comfortable retirement after years of hard work, for a home: the 99-Percenter.

Though let's not kid ourselves; indexing and low costs aren't for just the little guy. There are probably more One-Percenter active fund managers who index than who don't. But not for long—I assume they'll be going after those cost savings next. I can see it now—Paul Krugman's next op-ed—"Do you realize that by investing in index funds, the One-Percenters avoided paying over $5 billion in management fees?"

But my dad's impact goes far beyond the investment world. Through his speeches, interviews, and books, he challenges us, as David Swensen writes about my father's 2008 book, *Enough.*, "to aspire to become better members of our families, our professions, and our communities."

As Arthur Levitt writes, "he gives new meaning to the words 'commitment,' 'accountability,' and 'stewardship.' "

Another: "Unfortunately, there are not enough Jack Bogles around in today's world of instant gratification." High praise, though we'll ignore the fact that this one was submitted by David Sokol. He must not have read the entire book. After his recent dismissal from Berkshire Hathaway, he actually tried to get the publishers to correct the first version to "Unfortunately, there are *too many* Jack Bogles around in my self-absorbed world of instant gratification."

This forum got me thinking—how do you honor someone who has done more for investors than anyone in the history of the business? He has more honorary degrees than he can count, plaques, and certificates. What else is there?

Then it hit me—what he needs, what he deserves, is a Rule!

Your own rule—the new must-have for the titan who has everything!

Now, some rules are already taken:

The Volcker Rule—"Don't screw around with other people's money."

The Buffett Rule—"Raise taxes on every millionaire and billionaire (except me because I'm giving it all away anyhow)."

The Golden Rule—"Give all your money to Goldman Sachs."

Apparently you're nothing these days if you don't have your own rule.

"The Bogle Rule." I like the sound of it. The only problem is defining exactly what the rule should say. I started with "Take all your money away from Goldman Sachs"—probably a good rule, but the Bogle Rule has to encompass more.

The more I thought about it, the more difficult it became, as I realized how many of my dad's beliefs and lessons, how much of his wisdom and character, could provide direction and advice by which to live one's life.

Now, as kids, as my brother, Andrew, who's also here tonight, can attest, we had countless numbers of what we thought of as "Bogle Rules":

Rule 3c. In wintertime, "Never turn the thermostat above 58 degrees.

"Unless there's ice forming on the inside of the windows.

"In which case it's much too warm and should be turned down to 52."

Rule 16b. "Always wear a wool tie in preference to silk, lest you be thought of as being flamboyant.

"Or be mistaken for an active fund manager.

"Or worse: a hedge fund manager."

Rule 400k. "Never turn down an opportunity to be interviewed on TV." Even if it's on HBO with Ali G. "Yo! Check it out! We gots here my main man Mr. John Bogle. Mr. Bogle, how you spend all dat money you save dem investors? You buy many women?" (Might be too much 99-Percenter pop culture for this crowd.)

But truly, as kids, my parents taught us, by word or by example:

To treat everyone you come across, from every walk of life, with respect,

To "press on regardless," not to give up no matter how tough the challenge,

To generously give back through philanthropy to needy causes,

To live your life with integrity,
To always find the time to spend with your children.

The list goes on, but for us it can be pretty well summed up by:

"Be the best Dad you possibly can be."

I hope that we've done well in living up to these and the other principles with which we were raised. We also hope that as parents we have raised our own children to live up to these same principles. I have a 17-year-old son and a 14-year-old daughter. So we're batting 1.000. But I take solace in the fact that, even at .500, if I were an active mutual fund I'd be doing pretty well.

But as for my dad's legacy and its impact on the rest of society, I know that we'll be hearing some great ideas tomorrow. There's an incredible list of speakers and panelists, many of whom are here tonight. And there will be lots of input into where we need to go, what we need to do, to get more individuals to think like and live their lives more like my dad does.

And perhaps, just maybe, we'll get to see the embryonic formation of "The Bogle Rule."

Welcoming Remarks

A few words from David Cowen, president of the Museum of American Finance:

Welcome all to the Museum of American Finance. I am David Cowen, president of the Museum. Our core mission is to preserve, exhibit, and teach about the nation's finances and financial history; we are a Smithsonian Affiliate. We are proud to be a part of this day, which will honor the legacy of one of the giants of the industry, Jack Bogle.

We want to thank our cohosts of Bloomberg, the CFA Institute, and the Institute for the Fiduciary Standard for making this event possible. Jack has an incredible legacy and you will be hearing about that today, but one thing is clear: He has always done the hard right over the easy wrong, to always be a good friend to the small investor, looking out for the little guy.

His legacy also includes being a good friend of this Museum, and among his many accomplishments is that he is a member of our Advisory Board. I'd like to also point out that several other members of our Museum's Advisory Board are here today, including Bill Donaldson and Paul Volcker.

One story we like to share, and it's well known and Jack writes about it is his books, is that he was the fortunate recipient of a heart transplant. So we can be assured that there is at least one Wall Streeter with a heart!

Once again, congratulations to Jack from the Museum.

Opening Remarks by John C. Bogle

John C. Bogle opened the Forum with the following words:

I know of no precedent for Wall Street (as it were) honoring one of its own, marking a legacy of 60 years in the investment profession. (Not so many souls hang around that long!) So I'm greatly honored, truly humbled, and profoundly appreciative that so many industry leaders, financial and academic professionals, friends and colleagues are joining in this wonderful day of celebration.

I've done the best I could to build a better world for investors. Yes, in Philadelphia the press has described me as an entrepreneur, creator, inventor, and citizen, and even compared me—not unfavorably—with Benjamin Franklin. . . . But Walter Isaacson, having completed his biography of Franklin some years back, next turned to Albert Einstein, and then, only a few months ago, to Steve Jobs. I'm not hanging by my thumbs awaiting Mr. Isaacson's phone call (nor his note on my iPad).

Yes, I did start the world's first index mutual fund (though lots of people claim to have thought of it long before I did so). It is now the world's largest equity fund. . . . But the index fund concept represents the essence of simplicity, the triumph of Occam's razor. It required no genius, so I've never won a MacArthur "Genius" grant (and don't deserve one).

Yes, it took determination (and luck, and timing, and the support of a few key directors of the Wellington Fund) to create the first U.S. *mutual* mutual fund organization to be managed, not in the interests of its managers, but in the interests of its fund shareholders. . . . But, despite the name I chose, Vanguard remains a leader with no followers. Even 38 years later, our firm's structure has yet to be copied or even emulated, so low in excitement and acclaim that neither Brad Pitt nor Robert Redford has shown any interest in making a Bogle movie. (*Bogleball*? *Bogle—the Sundance Kid*?)

Yes, I've tried to create a business with character and class, holding human values high. That's a task I've yet to complete. . . . But it's not the only task before me, for I've yet to climb all Seven Summits, host the Oscars, or (despite my Scots heritage) solve the mystery of Loch Ness; nor have I been a candidate to manage the Phillies (or even the Red Sox); and it's too late for me to run for President. (Sorry 'bout that!)

Yes, I'm now writing my tenth book, many of which have been best sellers . . . but only for a little while. After a single week on the *New York Times* best-seller list, *Enough*. was replaced by—I guess it's okay to say it aloud—*Real Sex for Real Women*. "Is this a great country or what?"

Yes, I've been among the strongest advocates in my field for activism in corporate governance. . . . But words aren't the same as deeds, and I've yet to see any tangible results whatsoever. The silence of the funds remains deafening, but I'm not about to give up the mission.

Yes, I've had a few portraits painted. . . . But one sits in my office (it's a long story), not in the Louvre or even the Philadelphia Museum of Art. I confess too that there is a larger-than-life sculpture of me on the Vanguard campus. . . . But its only function seems to be to allow fund industry leaders to describe me (cynically, of course) as "a saint with a statue."

Yes, I think I've played a major role in bringing into the public discourse the importance of long-term investing, of rational expectations for returns in the financial markets, and of the crying need for a fiduciary standard. . . . But there's so much I haven't done: Walk on water, leap tall buildings with a single bound, publish poetry in Russian, make the cover of *Time*, or *Fortune*, or *Forbes*, or *Bloomberg Businessweek*.

Despite my infinite failings, however, I'm simply unable to conceal my pride on this great day of celebration. I'm reminded again of Benjamin Franklin, whose character was central to his dedication to the public interest, so easily observable in his entrepreneurship, in the joy he took from his creations, and in his ingenuity, his energy, and his persistence. That trait of character also found its expression in Franklin's ongoing struggle, not unlike my own, to balance pride with humility—a balance that, in this age of bright lights, celebrity, and money, our society seems to have largely ignored. As Franklin wrote in his autobiography:

In reality, there is, perhaps, no one of our natural passions so hard to subdue as pride. Disguise it, struggle with it, beat it down, stifle it, mortify it as much as one pleases, it is still alive, and will every now and then peep out and show itself; you will see it perhaps often in this history; for even if I could conceive that I had completely overcome it, I should probably be proud of my humility.

In candor, these words serve to remind me that my own pride must be all too evident in the brief history of my career that I've recited here, a career focused on the stewardship of the wealth of our nation's citizens. Too often, I'm sure, my pride has indeed peeped out and shown itself, reminding me that my own humility could doubtless use a little more development.

I must work on that tomorrow. . . .

Thank you again.[2]

Chapter 1: Four Distinguished Panels

The Legacy Forum featured four panel discussions, plus remarks by Gary Gensler, chair of the Commodity Futures Trading Commission (CFTC), and a lively conversation between Paul Volcker and Bogle.

The first panel discussion, on index funds, featured industry luminaries Burton Malkiel, David Swensen, and Gus Sauter. All agreed on the case for indexing, but also mixed it up and expressed differing views on the role of active management in an investor's portfolio, high-frequency trading, and exchange-traded funds (ETFs).

The second panel, on corporate governance, offered candid discussions on board members' responsibilities, conflicts of interest, and executive compensation. Former White House executive pay czar Kenneth Feinberg shared his experiences dealing with fairness in compensation. Former SEC chief accountant Lynn Turner offered insights into the common shortcomings of boards and board membership.

In the third panel, three former chairmen of the Securities and Exchange Commission and the CEO of a Wall Street lobby discuss the issue of fiduciary

2. My focus on what I *haven't* done was inspired by Jason Gay's *Wall Street Journal* column of December 1, 2011, on what former Denver Broncos quarterback Tim Tebow, the then-momentary toast of the National Football League, hasn't done.

duty for brokers. Notable was a general deference to different business models when applying fiduciary standards. Former SEC chairman Harvey Pitt suggests that brokers use candid language to convey their conflicts of interest, such as, "My firm puts out its own investments and I may make more money if I recommend those." Chairman Levitt disagreed: "That's where we part ways, Harvey. Having been a broker, I know the reluctance of brokers to be that forthcoming."

Paul Volcker and Jack Bogle then rivet the audience with their friendly banter and candid commentary in a joint interview with Bloomberg's Kathleen Hays. Starting with a question about their "secret" for being "at the top of your game" in their 80s, Bogle answers quickly, "Go to Princeton." In the ensuing wide-ranging discussion, the two giants of finance opine on topics ranging from investor confidence and the Volcker Rule to the bond market and political reform.

The Legacy Forum concluded with a fourth and final panel, moderated by Summit Business Media editor James Green. It featured comments by former Vanguard senior executive Jeremy Duffield and Wall Street strategist Martin Fridson, who provided a lively discussion of Bogle's (then) nine books.

First Panel: Simplicity and Low Cost in Investing: Is the Indexing Model the Way Forward?

American investors poured almost $100 billion into equity mutual funds between 2008 and 2012. But that statistic conceals more than it reveals. In fact, investors pulled some $460 billion out of actively managed equity funds, and invested $560 billion in index funds—a $1 trillion swing in investor preference. This triumph of indexing could not have occurred without the efforts of the pioneers who brought indexing to the investing public. The idea started in academia and spread to pension funds in the late 1960s and early 1970s. But it was John C. Bogle who created the first index mutual fund, finally making indexing available to all investors.

The index fund, founded in 1975, is one of the cornerstones of Bogle's legacy.[3] In celebration of his legacy, four luminaries of investing came together at the Museum of American Finance on Wall Street to discuss the development of indexing:

- Princeton University professor Burton G. Malkiel, who, in the first edition of his classic book *A Random Walk Down Wall Street* (1973), called for "a new investment instrument: a no-load, minimum-management-fee mutual fund that simply buys the hundreds of stocks making up the market averages and does no trading."
- Former Vanguard chief investment officer (CIO) Gus Sauter, who took over the administration of the Vanguard 500 Index Fund in 1987 and has been instrumental in leading the growth of indexing at Vanguard ever since.
- Yale University CIO David F. Swensen, who has managed Yale's endowment since 1985 and is the author of *Unconventional Success: A Fundamental Approach to Personal Investment* (2005), which argues that index funds should play a primary role in the portfolios of most investors.
- Roger G. Ibbotson (moderator), a Yale University professor and chairman and CIO of Zebra Capital Management, whose annual book *Stocks, Bonds, Bills, and Inflation* serves as a standard reference used by capital market participants.

3. The other principal cornerstone is his 1974 creation of *a truly mutual* mutual fund structure, in which the fund shareholders actually own the fund management company, which operates on an at-cost basis. Arguably, it was this structure that fostered the new firm's focus on indexing.

Burton Malkiel: The CMH Trumps the EMH

The intellectual foundation of the index fund is the efficient market hypothesis (EMH). The EMH posits that prices set in the capital markets reflect all the information available for a given security; therefore, securities are always fairly priced and asset managers cannot consistently generate excess returns. Yet the debate around the EMH is hardly settled, as Malkiel pointed out.

"We all know that the EMH is very controversial," he said. "Professor Robert Shiller at Yale has called it the most egregious error in the history of economic thought. GMO Co. founder Jeremy Grantham has said, 'The EMH was more or less responsible for the recent financial crisis.' "

But Bogle didn't rely on the EMH to justify index funds. He is a strong proponent of Occam's razor, the fourteenth-century maxim (after the English philosopher Sir William of Occam) that states, "When there are multiple solutions to a problem, pick the simplest one." So Bogle provides a justification for indexing that is both practical and compelling. In Malkiel's words, "The argument that Jack makes justifies indexing whether or not you think markets are efficient. Jack calls his hypothesis the CMH, the 'cost matters' hypothesis. And the argument is really quite simple. We don't live in Lake Wobegon. We can't all be above average. Therefore, portfolio management is going to be a zero-sum game."

Not a Zero-Sum Game

Malkiel explained, "If there are some portfolio managers who are holding the stocks that go up more than average, then it has to be the case that some other portfolio managers are holding the stocks that went up less than average. But in the presence of costs, it's not a zero-sum game; it's a negative-sum game. And the average manager, then, has to underperform the market by the amount of the fees charged."

He continued, "With a very nice empirical study—which I have told Jack was certainly good enough to earn him tenure at a major university if he would like to change careers—he actually showed that performance is strongly related to the fees charged. As Jack puts it, the investor who wants to be in a top-quartile fund should buy one with bottom-quartile explicit expenses and bottom-quartile turnover. As a matter of fact, in the more colorful way that Jack puts it, in this industry the investor doesn't get what he pays for; he gets precisely what he *doesn't* pay for. That is, if he pays *nothing*, he gets *everything*—whatever returns the stock market delivers. And that, of course, leads us inexorably back to index funds, which are the quintessential low-expense, low-turnover funds."

As Malkiel pointed out, the data supporting the CMH are compelling, and additional evidence continues to mount. "The data continued to come in overwhelmingly in support of indexing as an optimal strategy for individual investors. For example, 2011 was a particularly good year for indexing: 83 percent of large cap managers were outperformed by the S&P 500; 82 percent of bond managers were outperformed by Barclays U.S. Aggregate Bond Index. Similar kinds of numbers were recorded for managers of European funds, emerging market equities, small cap equities, whatever asset class you want.

"Now, 2011 was an unusual year. No one—no supporter of indexing, and there isn't a bigger supporter than me—is going to tell you that 80 percent of active managers are going to be beaten each year. The longer-run figures suggest that in the typical year, two-thirds of active managers are generally beaten by the benchmark indexes, and the one-third that win in one year aren't the same as the one-third who win in the next year."

Awarding Tenure

Malkiel continued, "Moreover, the degree to which the typical active manager underperforms the benchmark is well approximated by the difference in costs between the average actively managed fund and the index fund. So, the Bogle CMH continues to be overwhelmingly supported by the data. And when you think of ideas in finance that are supported by the data, I don't know of one that's better supported by the data than Bogle's CMH, which is why I want to award him tenure right off the bat."

While the index fund has been, in Bogle's phrase, "both an artistic and a commercial success," he has improved the prospects for investors in many other ways as well. Malkiel said, "Jack's contributions to the welfare of individual investors go far beyond simply indexing. The active funds managed by Vanguard have rock-bottom expenses and low portfolio turnover. Jack built his values into the Vanguard organization, such as his insistence that the sole criterion for the success of the organization was that it be run for the exclusive benefit of the investor. These values will, I believe, endure indefinitely.

"I think perhaps the best way to describe Jack is to quote from one of the many, many published articles singing his praises. 'John Bogle is the greatest investor advocate ever to grace the fund industry. The profound changes he brought to the realm of personal finance will be felt for years to come.'

"And my favorite quote about Jack comes from the dedication of an investment book that was published by the Bogleheads, which is a group of acolytes dedicated to disseminating Jack's ideas. The dedication reads, and I'll quote, 'While some mutual fund founders chose to make billions, he chose to make a difference.' "

Gus Sauter: The Index Fund Builder Who Followed the Architect's Designs

Bogle's investment philosophy of simplicity, low costs, and proper asset allocation is enduring. In Bogle's words, it is appropriate "no matter how high a greedy stock market flies, nor how low a frightened market plunges." So it should come as no surprise that his commitment to indexing did not waver in the aftermath of the Black Monday market crash in 1987, which occurred just weeks after Bogle hired Gus Sauter. If Bogle is the architect of indexing, he chose a great builder to execute his design.

Very few people have been as central to the growth of indexing as Sauter has been. Early on in his tenure, he developed trading strategies to help Vanguard's index funds track their benchmarks as closely as possible, and he wrote the computer code to implement those strategies. He has long been a respected leader in market structure policy, has helped index providers optimize the structure of their benchmarks, and is trusted by policy makers in Washington for his commitment to the best interests of clients and efficiency in the market.

Gus opened his remarks with an anecdote: "I'm thinking back to the first time that I met Jack. It was August of 1987. I was interviewing for a job at Vanguard and, if you recall, back at that point in time the stock market was up 45 percent in the first eight months of that year. I was interviewing for this job to manage the equity index fund—*one fund*—and I was a little nervous that the market had just spiked up and it might turn down. So I asked Jack, 'I'm the last guy in the door here. If the market tanks, am I the first guy out the door?' And he assured me, 'No, no. We're very committed to indexing. We're going to make a go of this.' And sure enough, I started on October 5 of 1987; two weeks later the market crashed. Our index fund went from $1.2 billion to $800 million overnight. I apologized to the board of directors a month later, but I still contend it wasn't my fault."

"Someday Indexing Is Going to Be Really Big"

Sauter recalled, "When I first started, the assets of our single S&P 500 index fund (another index fund was on the drawing board) totaled $1 billion—just 3 percent of our assets. The other 97 percent were actively managed assets at Vanguard—Vanguard started as an active firm. And I remember Jack coming into my office, probably about 1990, and saying, 'Gus, you just wait. Someday indexing is going to be really big. We'll have $10 billion someday.' And I thought, 'Wow.' As I look back now, we've got about $1 trillion at Vanguard in indexed assets, and I'm thinking Jack's not typically prone to understatement.

"Indexing really has grown quite a bit," said Sauter. "It just absolutely took off in the middle part of the 1990s and throughout the past 10 years as well. It's a low-cost way to gain exposure to the market. And if you can get that low-cost way of gaining exposure to the broadly diversified market, you're going to outperform a majority of investors. There are no guarantees in this industry, but one thing that you can have a great deal of certainty about in advance is that with index funds, you will be among the better performers or usually above average, and you just don't know that with active management.

"Indexing now represents about 30 percent of the equity fund industry. It has absolutely exploded in size. Of that, about 11 percent of mutual fund assets are in conventional index funds and the other 14 percent or so would be in ETFs [exchange-traded funds], which are, by and large, index mutual funds. We offer ETFs right alongside our conventional index funds, and we look at them as just another way to distribute the index fund."

A Difference of Opinion?

The rise of ETFs is one development on which Bogle and Sauter don't exactly see eye to eye. However, their differences are more in emphasis and tone than substance. While Bogle appreciates the low cost, low turnover, and tax efficiency of ETFs (attributes they share with traditional index funds [TIFs]), he worries that the very structure of ETFs, which can be traded "all day long, in real time" (as an early ETF advertisement claimed), implicitly encourages investors to churn their portfolios rather than maintaining a disciplined, long-term strategy. Sauter prefers to focus on the positive aspects of ETFs that are shared with TIFs. As he put it, "I think there's been some confusion in the industry about ETFs, and that's somewhat unfortunate. They were originally promoted as a new product, better than indexed mutual funds. And I kept thinking, 'Well, wait a minute. They *are* indexed mutual funds.' And so we got off to kind of an unusual start there."

But Bogle and Sauter share concerns about the many fringe investment products that have polluted the ETF space. Sauter pointed out, "There are some unusual products that are confusing to investors, and that fly in the face of what the benefits of indexing really are. There are some of these levered products that really require a keen understanding of what's going on. There are many investors who didn't understand what they were getting into. There are some commodity ETFs, and I think that commodities are a very appropriate investment, but a lot of investors don't necessarily understand what they're getting into with a commodity ETF. They don't necessarily get the return of the underlying asset. There was an article in *BusinessWeek* a couple of years ago about an ETF in energy. Crude oil had doubled in price, yet the ETF only went up about 45 percent. It was because the markets were in what is called contango.[4] So it requires a sophisticated understanding of what's going on to really figure this out. And that does fly in the face of what indexing really is all about."

"Some Investors . . . Don't Know What They're Getting Into"

"One problem about ETFs would be the democratization of all of these arcane types of strategies," Sauter said. "The good news is that in the ETF world, most of the assets are in the big, broadly diversified index portfolios, and we think that's where the assets should go. At the same time, individual investors can get exposure to more trouble than you can imagine if they don't know what they're getting into in the ETF space. I think a lot of these ETF strategies can be used effectively by professionals with high skill. But all of a sudden, these types of portfolios are being made available to some investors who really don't know what they're getting into. I think the levered products were an example of that."

With respect to the basics of simple, low-cost, long-term investing, any differences between the philosophies of Bogle and Sauter disappear. "We think of

4. Contango is essentially a situation where the price on futures for a commodity exceeds the actual expected price. So as futures contracts are rolled over, contango puts downward pressure on the value of futures contracts as the price inevitably declines to meet the actual market price of the commodity.

indexing as a very simple way, a very effective way, a cost-effective way, to gain exposure to the market," said Sauter. "And we think that most investors should pursue a balanced portfolio, should be broadly diversified, and, by and large, keep things kind of simple. Jack's always talked about stocks, bonds, and cash. Get your asset allocation right. There's so much work that indicates if you get your asset allocation right you'll be in pretty good shape. But too many people spend too much time trying to figure out what the next hot stock will be, and too little time trying to figure out what their asset allocation should be."

David Swensen: A Great Money Manager Endorses Indexing

For decades, Bogle has worked to ensure that fund managers act in accordance with their role as fiduciaries. He has railed against the rise of "managers' capitalism" (see *The Battle for the Soul of Capitalism*, 2005) and described the "double-agency society" and the "happy conspiracy" between corporate manager/agents and money manager/agents (see *The Clash of the Cultures*, 2012) in which corporate and financial intermediaries divert wealth away from the owners of corporate America to themselves.

In his quest to build a new fiduciary society, he has found a kindred spirit in David Swensen, the CIO of Yale University. Since he took the reins in 1985, Swensen has delivered extraordinary returns for Yale's endowment. His investment strategy has come to be known as the Yale model of investing, with an emphasis on alternative and illiquid assets. Swensen has also been an outspoken critic of the financial industry who shares many of Bogle's concerns with high costs and low standards of many investment managers.

"I think Jack Bogle is absolutely correct, as he usually is, when he says that fiduciary responsibility is the fundamental issue for the fund management industry," said Swensen. "Unfortunately for mutual fund investors, the profit motive of fund managers conflicts with their fiduciary responsibility to fund shareholders.

Profit seekers charge high fees, gather unreasonable amounts of assets, and pursue volatile investment strategies. In contrast, fiduciaries charge low fees, limit assets under management to reasonable levels, and pursue stable investment returns."

Supported Overwhelmingly by the Evidence

Echoing Malkiel's point about how the case for indexing is supported overwhelmingly by the evidence, Swensen cited a study conducted by Rob Arnott, student of investment theory and prolific writer on the financial markets. "He looked at 20 years' worth of mutual fund returns and compared them not to a peer group median, which I think is a huge cheat, but rather to the results of the Vanguard 500 Index Fund. And over 20 years, 80 percent of the funds failed to match the pretax return and fell short by an average of 2.1 percent per year. On an after-tax basis, 85 percent of the funds failed to match the returns and failed by 2.8 percent per annum. And the striking thing about these results is that they don't account for survivorship bias and they don't account for loads or other broker-related charges. So if you factor in the broker-related charges and take into account the survivor bias—a huge portion of funds disappear over time—there's almost no chance that you're going to pick an active fund that's going to beat the index over a 20-year period."

The damage inflicted on investors by the mutual fund industry isn't limited to high fees. Swensen argued that a combination of volatile investment strategies and misleading marketing by fund managers leads to poor investor outcomes. "Many people are familiar with the behavioral studies that show that investors tend to chase performance. They buy funds that have performed well and sell funds that have performed poorly. So these terrible results that you get from for-profit active managers are exacerbated by the individual's tendencies to buy high and sell low—to buy after something has done well and sell after it's done poorly. And the greater the volatility in the fund results, the greater the problem."

Fund *Investor* Returns Lag Fund *Reported* Returns

Swensen continued, "In 2005, Morningstar did a study in which they looked at all 17 categories of their equity mutual funds and compared dollar-weighted returns (the returns actually received by investors) to time-weighted returns (reported by the funds). In every single instance in the 10-year performance histories of these categories of funds, the dollar-weighted returns were lower than the time-weighted returns, meaning that individuals went in after they had performed well and sold after they performed poorly. And the greater the volatility, the greater the difference. In the technology fund, the difference between dollar-weighted and time-weighted returns was 13.4 percent per annum. It's stunning. People got into the hot tech stocks after they did well, sold after they did poorly, and damaged their returns enormously.

"A fiduciary would offer low-volatility funds and encourage investors to stay the course, which is exactly what Jack Bogle's Vanguard does with its broad-based index funds and with its valiant attempts to educate investors. But the for-profit mutual fund industry benefits by offering high-volatility funds. It plays the cynical game of selling four- and five-star funds, which are funds that *have* performed well, not funds that *will* perform well, and encourage people to sell their one- and two-star funds, which are funds that have not performed well but will not necessarily perform poorly in the future. And this allows brokers to churn investor portfolios. It allows investors to pretend that they're adding value to their clients by switching them out of the low-rated funds and into the high-rated funds."

The solution to these problems, Swensen observed, is already here. "Of course, Jack Bogle provided a solution to this problem of the conflict between profit motive and fiduciary responsibility. The Vanguard funds operate not on a basis of generating profits for the owners of the funds; rather, they allow the investors in the funds to, in essence, own the management companies and provide these not-for-profit vehicles that offer low-cost index funds. Jack Bogle has given us the tools that we need as investors to succeed. Thank you, Jack."

Roundtable Discussion

The panel transitioned to a roundtable discussion, which began with moderator Ibbotson asking how active and index funds fit together in an investment portfolio. Professor Malkiel started by addressing whether he is disappointed that equity index funds have only a 25 percent market share after being on the market for over 35 years. "If you think of an idea that started in the academy and that was so difficult to get started and has had that much traction," said Malkiel, "I don't see the glass as half empty or two-thirds empty. It see it as one-third full. So I'm actually delighted that indexing has done as well as it has, and I think you ain't seen nothing yet. I think you're going to see indexing continue to grow over time."

While no one disputes the evidence in support of indexing, Sauter pointed out that there still may be a supporting role for active management in an investor's portfolio. Despite "how difficult it is in active management to outperform because of the cost matters hypothesis, it doesn't rule out the fact that an actively managed portfolio can outperform, even over the long term," said Sauter. "I would note I did a study about six or seven years ago, trying to actually quantify this: What percentage should investors have indexed versus what percentage invested actively? I won't go into it in great detail, but I created an efficient frontier and some utility curves and all that sort of stuff.

"Basically what I found was if you have no skill in selecting managers—and, quite honestly, most people don't have skill in selecting managers—then you actually should be 100 percent in index funds. If you have an extreme amount of skill, beyond what anybody's capabilities actually are, I would argue, you should still have 22 percent of your assets indexed. So index funds should be, in many cases, the one investment you have. In some cases, it's a great foundation to build the rest of your portfolio on if you actually have skill in picking some active managers."

"If You're in the Middle, You're Dead"

For Swensen, the difference in pursuing either active or passive strategies is even more black and white. "I think that there are two sensible approaches to take in investing—either 100 percent active or 100 percent passive. I think, unfortunately, most people end up in the middle. For most things in life, the right solution is usually in the middle. But when it comes to investing, if you're in the middle, you're dead. So you should either be all in, 100 percent active, or all in, 100 percent passive. Who should manage their assets actively? I think the only sensible way to structure an active management program is to have a group of incredibly highly qualified professionals who devote their entire careers to trying to find managers or investment strategies that can beat the market."

Another development that Bogle laments is the rise of short-termism in the financial world. Over the six-plus decades that his career spans, he has seen trading volumes and turnover rates soar while investors focus on ever shorter time horizons. The fact that short-termism is detrimental to investors is built into Vanguard's foundation, as Sauter pointed out. "One of Jack's many sayings is, 'Stay the course,' and so Vanguard has always promoted long-term investing. The reason is we think that maximizes an investor's chance of achieving his or her investment goals. If we felt investors could time markets, we'd suggest that they go out and time markets. But we don't think we can do it. We think that most investors get caught up in behavioral problems; they're chasing last year's returns. So it's too often a buy high and sell low strategy. We think investors are best served by figuring out the proper asset allocation and then really just sticking with it over time, realizing that, yes, you're going to go through some volatile periods, but in the long run just getting the market rate of return is going to be a pretty good thing."

Malkiel expanded on the behavioral problems that plague many investors, including professional investors. “More money went into equity mutual funds in the first quarter of 2000 than ever before. And it didn’t go into broad mutual funds; it went into the high tech funds because that was what was hot. At the height of the financial crisis in 2008, money poured out of the market. And you might say, ‘Well, that’s just dumb individuals.’ But when you look at the cash positions of professional investors, which I have done, you find exactly the same thing. Professionals tend to have more cash at the bottom of the market and the least amount of cash at the top of the market.”

High-Frequency Trading —“A Tax on the Rest of Us”

The panel had some disagreement about the role of high-frequency trading in the markets. High-frequency trading has grown substantially in recent years, with studies suggesting that these high-speed algorithms account for anywhere from 50 percent to 70 percent or more of daily trading volume. The utility of these lightning-fast traders is still up for debate. “There’s obviously a lot of volume in the marketplace that is not long-term, but I don’t think it’s necessarily market timing,” said Sauter. “I think a large part of high-frequency trading—which tends to be a lightning rod out there—really is playing micro-inefficiencies in the marketplace and closing those inefficiencies.”

Swensen was surprised by Sauter’s view. “I always viewed high-frequency trading as a tax on the rest of us,” he said, “a bunch of smart people taking advantage of order execution rules as opposed to doing something good for the marketplace.”

But for Sauter, the proof is in the pudding. “We’ve measured our transaction costs over time, and 15 years ago, our transaction costs would have been in the 1 percent range or more, and that actually was good back then. What we’ve seen over the past 15 years is our transaction costs have declined precipitously. There have been lots of reasons for that. There were changes in the order handling rules, and the proliferation of ECNs [electronic communication networks]; there was decimalization, but also high-frequency traders, which, I think, are kind of the glue that makes all of that happen. We have so many different venues to trade on now; you need somebody to bring those venues back together again, and I view that as the role that the high-frequency traders are playing."

Malkiel pointed out another useful role played by high-frequency traders. "If I'd buy an S&P 500 ETF, it's the high-frequency traders that ensure that the ETF is going to be appropriately priced, because if it was at a premium over the price of the 500 stocks in the market, a high-frequency trader/arbitrager is going to short the thing that's overpriced and buy the stocks and create the unit to cover the short. So I'm not saying that everything that is done by high-frequency trading is correct, but there is certainly an appropriate role for it that doesn't hurt the individual investor. You could even argue that it helps the individual investor."

Individual Investors Need the Tools to Make Intelligent Financial Decisions

One member of the audience asked that if it is time for a concerted effort to better educate investors, given all the evidence that individuals often make poor investment decisions. "I think one of the big problems that we're creating for ourselves and society," observed Swensen, "is we're putting more and more responsibility for retirement savings on the individual without giving the individual the tools that are necessary to make intelligent financial decisions. We've talked about the for-profit mutual fund industry, how they're actually doing things that are adverse to the interests of their investors. And then you've got this firm, Vanguard, operating on a not-for-profit basis, that doesn't have this conflict, that works to educate investors; but it's only one firm."

Sauter pointed out some of the things Vanguard does to ensure investors are well educated. "Jack set up Vanguard to be an advocate for investors. We don't view our role as solely being a 'product' manager providing index funds. We also think that education is a very important part of what we do. So we have an education series or 'plain talk' discussions on the website. At the same time, we have created products that are designed to simplify investing for individual investors. We have our target retirement funds. If you can figure out when you're going to turn 65, you can figure out which fund is going to be right for you. We've created other products that are designed as being kind of advice inside of a product, so we have a spectrum requiring different levels of investment knowledge."

Second Panel: Executive Compensation and Good Corporate Governance

Institutional money managers own some 70 percent of the stocks in the U.S. equity market. Mutual funds alone own more than 30 percent of all equity shares. This voting power gives institutional investors, and mutual funds in particular, virtually complete control over corporate America. With this enormous power, one might expect institutional investors to actively watch over corporate America, working with management to maximize the value of their investments. In reality, nothing could be further from the truth. As John Bogle bluntly states in *The Clash of the Cultures*, "most mutual funds have failed to exercise the rights and responsibilities of corporate citizenship."

Our financial system is plagued by a fundamental conflict of interest: Institutional money managers have the responsibility and means to serve as a watchdog over corporate America, yet they are also seeking the business of those same corporations for retirement plan administration and asset management. As an anonymous money manager once said, "There are only two kinds of clients we can't afford to offend: actual and potential." Perhaps because of this obvious conflict of interest, institutional investors have largely failed in their duty to require that the leaders of corporate America place the interests of their shareholder/owners ahead of their own interests. Yet, in Bogle's grim assessment, "while the managers of most large fund groups carefully review and consider corporate proxies, with few major exceptions, they overwhelmingly endorse the proposals of corporate managements. When they vote, they usually do just as they are asked; they support management's recommendations. This practice is a far cry, not only from activism and advocacy, but from the very process of corporate governance."

The John C. Bogle Legacy Forum brought together an expert panel on corporate governance and executive compensation issues:

- Kenneth Feinberg, founder and managing partner of Feinberg Rozen, LLP, served as Special Master for TARP Executive Compensation, the U.S. Treasury Department's so-called pay czar, responsible for setting compensation for top executives at several firms that received Troubled Asset Relief Program (TARP) money, and as Special Master of the September 11th Victim Compensation Fund. Feinberg has a unique perspective on the process of determining appropriate compensation.
- Lynn E. Turner, chief accountant of the U.S. Securities and Exchange Commission from 1998 to 2001, and a managing director at LitiNomics. His government service and long experience as a CPA give him a firsthand view of the issues facing the accounting profession today. An all-around expert on corporate governance issues, Turner was heavily involved in the shaping of the Sarbanes-Oxley Act.
- Alan S. Blinder (moderator), the Gordon S. Rentschler Memorial Professor of Economics and Public Affairs at Princeton University, served as a member

on President Clinton's Council of Economic Advisers and as vice chairman of the Board of Governors of the Federal Reserve System; he is the author of numerous books, academic articles, and newspaper and magazine essays, and a regular columnist for the *Wall Street Journal*.

Kenneth Feinberg

The Need "to Do Something Symbolic"

In the wake of the financial crisis and the bailout of numerous firms through TARP, political pressure mounted on Congress to do something about executive compensation at the firms receiving taxpayer money. (Taxpayers find something distasteful about massive bonuses for executives at firms relying on government bailouts for their very existence!) So the Treasury Department brought in Kenneth Feinberg as Special Master for TARP Executive Compensation. "Congress passed a law in the wake of the TARP bailout, and Congress decided populism means street revenge," said Feinberg. "Congress wanted to do something symbolic—*symbolic*—so it passed a law that said that the government—the Treasury—will fix the pay of the top 25 corporate officials in only those seven companies that took the most TARP assistance: Citigroup, AIG [American International Group], Bank of America, General Motors, GMAC, Chrysler, and Chrysler Financial. Only for those seven will government set the pay—not the prescriptions, the actual calculation. It had never been done before as far as I know—actually adding up what somebody ought to make in the private sector. But if that's the law of the land, then that's the law of the land, so I agreed to do it.

"Over 16 months, we set pay for the top 25 people. Now, nobody suggested that that authority be expanded. Nobody in Congress or the administration ever suggested, 'Why not do it for everybody in the private sector?' So we invited the seven companies in. They were under my jurisdiction only as long as they owed the taxpayers those loans. Once they repaid, they were out from under my jurisdiction. Four of the companies borrowed money to get out from under my jurisdiction, and they're gone. Citigroup, Bank of America, Chrysler, Chrysler Financial—they're no longer part of this. GM, Ally, and AIG—AIG will be under the jurisdiction of the Treasury forever.

"The Graveyard Is Filled with Irreplaceable People"

"We asked, 'What do you think we ought to pay you?' Everybody in the seven companies made the same argument: 'This person is irreplaceable. If we lose this person and we don't pay her enough, she will go to a competitor. She's going to go work in China. Everybody's going to work in China if they look for a job, and the company will founder. This person is irreplaceable.' I said, 'The graveyard is filled with irreplaceable people, right?' People aren't irreplaceable. These people stayed at these jobs, and we fixed the pay, and the American people were riveted by this."

"The Gap Between Wall Street and Main Street"—Executive Pay Captures the Public's Attention

Feinberg believes that people aren't interested in a public debate about economic incentives; rather, they just want to know the bottom line. "They're really interested in two aspects of this. Much more important is how much people are going to make. Forget all this highfalutin discussion about incentives. What rivets the American people is the gap between Wall Street and Main Street pay. That's what people outside, walking down the street, find interesting."

Despite the fact that he describes the exercise as primarily symbolic, Feinberg thinks there is the possibility of some lasting effect. "The incentives that we promulgated included much less up-front guaranteed cash, and much more compensation tied to company stock performance over the long term, which cannot be redeemed for two, three, four years. I think the prescriptions that we promulgated while I was at Treasury will (hopefully) have some impact."

However, Feinberg points out that there are several other forces at work in setting executive compensation. "I think there are three much more important influences on pay. One is Adam Smith—the marketplace. I think the marketplace is self-correcting in a lot of respects. I think if you look at the marketplace, that's had more impact on pay than anything we've done. Two, the Volcker Rule and liquidity rules have had an impact indirectly on pay because big companies can't invest in excessively risky ventures the way they did. It's more difficult to do so in light of liquidity requirements and the Volcker Rule. And three, more interest among federal agencies: the SEC with its transparency rules on pay, FDIC and Sheila Bair's work with the banks, the Federal Reserve, and the G-20 with Secretary [Timothy] Geithner. I think those three reasons—Adam Smith, Dodd-Frank, and more agency interest—are, relatively speaking, more important than anything we're doing or I did with these few people and these few companies."

Lynn Turner

Lynn Turner is a respected voice on corporate governance issues. His career in accounting, auditing, and beyond has been dedicated to improving transparency in order to maximize value for shareholders. He shares many of Jack Bogle's concerns with the erosion of fiduciary standards evident in corporate America today, and he places much of the blame at the feet of the boards of directors. "In medieval England, the common use of the word *stewardship* meant the responsible use of a congregation's resources in the faithful service of God. In the corporate sense, the word has come to mean the use of an enterprise's resources in faithful service to its owners, but somehow the system has let us down. Boards of directors far too often turned over to the companies' managers the virtually unfettered power to place their own interests first. Both the word and the concept of stewardship became conspicuous by their absence from corporate America's values."

Standards for a Successful Board

Turner described what he sees as the requirements for a successful board. "In my opinion, if we're going to have a good board, we've got to have a number of standards that those boards meet. First of all, they've got to be a very knowledgeable board. We want people who understand the business, know what it's about, and can get in and dig in and figure out if it's on the right track or not. I look for a board that has the diversity and knowledge that we also look for in the CEO—those same critical success factors that the CEO has to have as far as knowledge of operations, marketing, and running the R&D projects are concerned. You've got to have those same qualities on the board if you're going to have a successful board.

"We want a diverse board so that if the CEO needs advice, he can call them anytime and get their input," Turner continued. "I've found that when you have a troubled CEO you also have a troubled board—they go hand in hand. We've seen some examples in the past few years, like HP [Hewlett-Packard] and others that I think spell that out in spades."

"There's Nothing Wrong With Having a 'No' Vote"

It has become common in recent years for boards to seek consensus and speak with a single voice. But Turner does not necessarily think that is progress. "It's got to be an independent board, one that is willing to speak up and have good communication. Often I've sat on boards where some people say, 'Oh, we've got to have a unanimous vote all the time. We can never have a "no" vote.' That's not a truly independent board. There's nothing wrong with having a 'no' vote in the boardroom. In fact, that is probably an indication that you've got a good board and people are really kicking the issues around as they should. Once you've had the 'no' vote, though, you need to move on. You need to have a group that works together as a solid group, and once the 'no' vote is taken, regardless of whether you win or lose, you've got to move on."

A critical factor for a successful board is engagement, and the board cannot be properly engaged if its members do not have adequate time to devote to the company. "You've got to have time to spend on the board," Turner asserted. "These boards take a lot of time, and too often I see board members show up and they're just popping open the board book as they arrive. That just doesn't get it done.

You have to spend enough time on the floor—what I would call 'on the concrete,' where things actually happen—compared to time 'on the carpet,' where you just don't see what's going on in the nuts and bolts of the company."

"The Banana Report"

"I remember being on one board where I went out and visited manufacturing plants," Turner recalled. "During one of the meetings, I was sitting with all the managers at the plant and they told me about this banana report. I said, 'Well, what do you mean by a banana report?' I had never heard about it in the boardroom. As it turned out, that was the single most important report that the management team used to run what was a huge Fortune 500 size company. That report had never made it into the boardroom, yet it was accurate almost to the dime as to how that company was going to perform. You've got to be able to go out there and get that type of information."

Turner relayed another anecdote about a director who overextended himself. "When I was running the Glass Lewis proxy voting service, I received a call from a director whom we had voted against in the past because we thought he served on too many boards. He served on seven boards of public companies at the time. He called me and said, 'Lynn, I wonder if you would mind if I serve on one more.' I said, 'Well, tell me what you do. You've got six or seven boards you're already serving on. Do you do anything outside of the boards?' He said, 'Well, I serve on a couple of not-for-profit boards as well.' I said, 'Okay, so you're on six or seven public boards and a couple not for profit. Is there anything else you do?'

"He said, 'Well, I do serve as the executive director of a not-for-profit foundation in New York City.' And I said, 'Well, how much time do you spend on that?' 'Oh, about half my year.' And I said, 'You've got no time. You're on that for half the year. These boards [should] take 200, 300 hours. You're on six or seven already and you're asking me if you've got enough time to serve on another board?'

I mean, just common sense would tell you what the answer was and that phone call shouldn't have been made. So you've got to have time."

Losing Elections but Winning Board Seats

Turner then moved on to some of the most significant corporate governance issues that he sees, starting with the issue of majority voting. Until recently, the default in many cases was the plurality voting standard, in which the director with the most "for" votes is elected to the board. The controversial implication of plurality voting is that, in the common case of uncontested elections, merely a single "for" vote ensures that a director is successfully elected.

Turner described his concerns: "One thing that indicates to me that the board is not working is when the board refuses to have majority voting. Capitalism and democracy go hand in hand. You can't have one without having the other. To have a boardroom where you don't have democracy, where a director can get reseated with just one vote from a shareholder, as it is today, is flat-out wrong. When the majority of large companies have already gone with majority voting, the rest need to get on that ship. In fact, we've had 200 to 300 corporate directors who have not received a majority of the vote; they have been voted off of the board and yet almost every single one of them has chosen to remain on the board, and the board has let them. It doesn't look as though those boards are working for the shareholders."

Turner then turned his attention to forum shopping and the corporate-friendly laws in Delaware. "The next thing that gets under my skin is forum shopping. This is where companies, with the approval of their board, look to move all their litigation to the state of Delaware, which doesn't speak highly for the Delaware courts. I dislike it when shareholders try to move litigation to a particular county in Mississippi or Indiana or wherever. Likewise, I really dislike it when companies try to do the same to me and go forum shopping. I also dislike it when they try to take my right away—that I think is in the Constitution—that says I have the right to the U.S. judicial system. We're seeing people propose that I, as a shareholder, do not have the right to the U.S. court system. I get forced into an arbitration system that, quite frankly, has turned out to be very costly and is clearly tilted against me."

Turner pulled no punches when describing his animus toward the Supreme Court's decision in the *Citizens United* case. "I hate the political contribution issue, the *Citizens United* case. I think we've got to find a way to get transparency around that. Research has shown that companies that get highly involved with political contributions often damage the value of my investment. Making political contributions is their right—the court has said that—but we certainly need transparency around it."

Roundtable Discussion —"CEOs Became Kings and Queens"

Moderator Alan Blinder posed a question to the panel dealing with the change in the role of corporate executives over the years. "When I was a youngster, a long, long time ago, CEOs of major corporations were the top employee of that corporation. That was their attitude. That was the attitude people had toward them. Sometime between now and then, and some years ago, CEOs became kings and queens and princes and princesses, and I would like your thoughts about how that happened, and whether it's been harmful or good for that matter. And if it's harmful, what, if anything, can be done about it?"

Kenneth Feinberg replied with a sort of libertarian approach to the issue of executive compensation. "I'm not sure there's much you can do about it. What I've learned in the brief time I had that job of fixing pay is that unless you're going to attack the problem with sort of a shotgun, every company is different. Everybody's compensation culture is different, and there are limitations in a free society on what you can really legislate or promulgate. Now, as you point out, Professor, I see in my work abuses. But I worry whether the solutions shouldn't be left to the marketplace or whether the solutions imposed are worse than the problem. That's a roundabout way of saying yes, I'm troubled by the growing gap between CEOs and energy traders and line employees, but that's the easy part. When you're trying to figure out what to do about it, that's where you get into some deep water I think."

Lynn Turner, in contrast, sees the possibility that improved corporate governance can play a role in reining in unchecked executive power. "I'd probably differ with Ken on this. I think that to say we can't solve the problem is to say you're going to accept the status quo. And I think that's unacceptable. I think this is starting to tear this country apart, and I think it's tearing at the very social fabric. So, I don't think you can say you can't fix it. I think you've got to go find a fix."

Government Is Not the Answer

"I don't think that the fix lies in the government," Turner continued. "I don't put a whole lot of faith there. I think that what you've got to do is you've got to put in a system that holds these people accountable, one that requires a great deal of transparency so people can see what's going on. When you give shareholders a vote on compensation and you give them the right to replace directors and you give them majority voting, you are starting to create such a system."

Turner didn't limit the role of corporate governance to having a say on pay, however. "The other piece of it that we don't have, though, is a higher fiduciary standard for the asset managers. We often call these people institutional investors, and that's a grave misnomer. They are asset managers that collect assets and charge fees for it—that's how they make their money and that's their business.

"If we create the type of fiduciary standard that Jack Bogle has talked about in his book *Don't Count on It!* (2011), where those asset managers actually have to vote their shares in the best interest of their investors, then I think you'll have a workable system in the marketplace. To Ken's point, it's not government-driven; it's built around transparency. You've got to give me all the clear details about compensation. You've got to put it to a vote. And if it's a negative vote, the people are held accountable. In this past year, quite frankly, in most of the say-on-pay votes they [compensation rates] were accepted. But there were some where they weren't. I think that type of marketplace mechanism will work and work great. We're part of the way there, but we've got to go the rest of the way, and we've got to get a fiduciary standard or it will not work."

Questions and Answers

An audience member asked about the importance of separating the roles of CEO and chairman of the board. "The board has a fiduciary obligation that I think is critically important," responded Turner. "By separating the roles of CEO and chairman I think you get the board more focused on that obligation to the shareholders, and I think that's a very positive thing.

"What is interesting about it is that 20 years down the road we will be there. We will have separation in most public companies. If you look at the progress of governance in this country, we are extremely slow. We'll be there on proxy access. We'll be there on separation of CEO and board chairman. We'll be there on majority voting. We're getting very close on majority voting, but it takes us forever and it takes us a lot of stumbles to get there. It would be nice if we can just get there and get to a more efficient system that would actually result in higher returns for our businesses, which I'm convinced will occur. So I think the separation is very important. It will happen. It will turn out to be very good, but we'll go through a very painful process in getting there."

Citizens United— "A Horrible Decision"

The topic of the *Citizens United* decision was raised again by a member of the audience. "There is research out there that clearly shows that companies that tend to lobby more aggressively have had negative impacts from that on their shareholder values," said Turner. "So from a shareholder perspective, that obviously concerns me.

"I personally have never had a corporation stand up and have a discussion with me, and I've seen no one tell me when the point of conception is with a corporation, so I'm not sure I understand why they're deemed to be a person. I think that was one of the most outlandish decisions by the Supreme Court that we've ever seen. I think it takes the Supreme Court back to the days of the 1850s and the Dred-Scott-type days. I think it's just a horrendous decision.

"I think companies need to be running a business and need to be serving all their constituents—their employees, their management team, their shareholders, and the community; and I think when you get into the type of political financing that we've got from corporations you get away from those goals. It gets into people's personal ideologies and that doesn't serve me as an investor in any way, fashion, shape, or form."

Feinberg wholeheartedly agreed with Turner's sentiments on *Citizens United*. "*Horrible* decision. A horrible decision that's had a very negative impact. Forget corporate America; it's had a very negative impact, I personally believe, on the entire political discourse in this country.

"You'll need either a Constitutional amendment to change it or over time a change in the personalities on the Supreme Court. Those are the only two solutions. If the existing court finds a First Amendment right to contribute whatever you want, I don't see a short-term solution. Never mind the amount of money being spent by corporate America lobbying in Washington and creating a cottage industry in Washington; the impact of it on the overall political dialogue in this country I think is very, very, very negative. It's very unfortunate."

Reflections by John Bogle

John Bogle is so passionate about corporate governance that he simply had to join in the conversation. Continuing the discussion about *Citizens United* and corporate political contributions, Bogle added, "We don't need a Supreme Court decision. We don't need a Constitutional amendment. We need the shareholders to stand up for their rights. Financial institutions own 70 percent of every publicly held corporation in America, and they do nothing. So they have to be aroused. They must exercise the rights and honor the responsibilities of stock ownership.

"In particular I think there ought to be a shareholder vote—and I sent this proposal to the SEC—on political contributions. Disclosure is fine as a second step, but as a first step let us ask the shareholders of the company, the owners of the company, whether the corporation should make any political contributions whatsoever. And I suggested they would have to have a 75 percent majority of the vote to be able to give those corporate assets away.

"My second point is regarding the failure of our accountants. They have a terrible conflict of interest. Lynn and I were on the Independence Standards Board, created by Chairman Levitt. It's just unbelievable what goes on in the accounting world. Our large CPA firms (the final four) are the captives of management. They represent management and not shareholders."

The "Marketplace" for Executive Compensation

"Finally, we can't rely on the 'marketplace' to ensure reasonable executive compensation," Bogle concluded. "The marketplace for executive compensation is set by a word that we haven't heard up here. The management goes to the compensation consultants, and I can't imagine that there has ever been a compensation consultant that's stayed in business by saying to a chief executive, 'You deserve less money.' When we focus on the compensation of peers rather than corporate performance—the creation of intrinsic value—we have the ratchet effect, and every year compensation goes up, up, up." (In *The Clash of the Cultures*, Bogle noted that problems created by such a "consultopoly" parallel those created by a monopoly or an oligopoly.)

Feinberg agreed with Bogle's point about executive compensation consultants. "At Treasury I decided that I ought to go out and retain the services of an independent compensation consultant to help us. But we couldn't find an independent compensation consultant. We looked. We finally had to go to academia to find a couple of independent compensation consultants. Commercially, for the reasons you say, there was either a direct conflict or a perceived conflict, and it made our job tougher."

Third Panel: Fiduciary Duty: What Is the Future?

"A Double-Agency Society Engaged in a Happy Conspiracy"

"The managers of other people's money [rarely] watch over it with the same anxious vigilance with which . . . they watch over their own. Like the stewards of a rich man, they very easily give themselves a dispensation. Negligence and profusion therefore must always prevail." These words, written by the great Scottish moral and economic philosopher Adam Smith, succinctly describe the problem of agency. Manager/agents play a central role in the management of both today's giant multinational corporations and the massive pools of investor capital that fund them. As John Bogle puts it, these agents are the dominant participants in a "double-agency society" engaged in a "happy conspiracy." Together, they control nearly all of the public companies in the United States. The traditional values of trusteeship have been "eroded by the same temptations that have challenged agent/principal relationships since the beginning of time: the natural temptation for agents to enrich themselves at the expense of their principals."

Rather than giving primacy to their roles as fiduciaries, today's manager/agents, in Bogle's words, "came to an apparent, if tacit, understanding that the principal focus of corporate accomplishment is 'creating shareholder value.' That's a fine goal, of course, but their shared definition of value has focused on the short-term, evanescent, emotion-driven price of the stock, rather than the long-term, solid, reality-driven intrinsic value of the corporation." Managers trade stocks at the highest turnover levels in history, often trading them for periods measured in days or weeks or even seconds. This short-termism is one of the primary factors driving the change away from the wisdom of long-term investment toward the folly of short-term speculation. To make matters worse, our manager/agents have captured the corporate and financial systems and installed a "heads I win, tails you lose" culture that rewards those at the top no matter the outcome. Golden parachutes for failed corporate executives and excessive fees for underperforming asset managers are today's norm.

A Common-Law System of Fiduciary Duty

Hundreds of years ago, English common law developed a way to mitigate some of these agency issues: a common-law standard of fiduciary duty—the requirement that agents place the interests of their principals first. To the detriment of investors today, we have drifted too far from that lofty standard. But there is a growing chorus of voices calling for a return to the fiduciary standard, John Bogle's being one of the strongest. Bogle has long been an advocate for a federal statutory standard of fiduciary duty, one that not only ensures that money managers act with prudence, but that also demands good corporate governance, with conflicts of interest resolved in favor of shareholder/principals. Such a standard would require all fiduciaries to act solely in the long-term interest of their beneficiaries.

So how do we get there? That question was posed to several individuals who have seen this battle fought from the inside. The panel on fiduciary duty at the John C. Bogle Legacy Forum featured individuals who have seen this fight play out from the inside. The panelists included three former SEC Chairmen:

- Harvey L. Pitt, chairman of the U.S. Securities and Exchange Commission (2001–2003); CEO of Kalorama Partners.
- David R. Ruder, chairman of the U.S. Securities and Exchange Commission (1987–1989); William W. Gurley Memorial Professor of Law, Emeritus, Northwestern University School of Law.

- Arthur Levitt Jr. (moderator), chairman of the U.S. Securities and Exchange Commission (1993–2001); operating executive at the Carlyle Group.
- T. Timothy Ryan Jr., Global Head of Regulatory Strategy and Policy at JPMorgan; former president and CEO of the Securities Industry and Financial Markets Association (SIFMA).

Arthur Levitt set the tone for the panel. While all of the panelists want investors to be well served, he expects that there will be subtle differences in their approaches to applying the fiduciary standard to stock brokers, who now operate under the "suitability" standard. "I'm sure that there'll be a lot of agreement that we all favor the same thing. But if you listen carefully, I think you'll find that all of the panelists do not favor precisely the same outcome. I think we'd all agree that investor protection is critical, but this issue of how to protect that investor and how to sidestep the different interests that the adviser and the broker may have that are apart from those of the investor is the topic that we will discuss."

T. Timothy Ryan

John Bogle has long been an outspoken advocate for the fiduciary standard. But it should not be surprising that the financial industry, in general, does not share Bogle's enthusiasm. T. Timothy Ryan Jr., speaking as the then head of SIFMA, one of Wall Street's chief lobbying organizations, does not embrace the role of the fiduciary standard with open arms. Many of his constituents in the industry would prefer to continue to operate under suitability standards similar to those in existence today. In addition to fee-based independent financial advisers, the retail side of the financial industry includes broker/dealers, underwriters, and distributors who feel that the fiduciary standard does not make sense for their business models.

David Ruder

David Ruder approaches the issue from a different angle. As a longtime academic and former SEC chairman, Ruder observed that the issue is nuanced. "I think that there is a movement to try to impose upon broker/dealers the same fiduciary obligations that investment advisers have. But I've been an academic all my life, a law professor, and I don't see things in black and white. So just that statement alone is not enough. The standard that is being proposed is the standard for broker/dealers that will apply when providing personalized investment advice about securities to a retail customer.

"What is the standard?" asked Ruder. "The standard in the Dodd-Frank Act is to act in the best interests of the customer without regard to the financial interests of the broker/dealer or investment adviser providing the service. So the idea is that the standard should be the same for both broker/dealers and investment advisers. But there are questions about whether that's appropriate.

Brokers and Advisers—The Same Standard?

"For instance, should a dealer acting as dealer in selling a security to the public be required to have this fiduciary duty to say to the public, 'There's something wrong with what I'm selling you'? Or should the dealer be allowed to proceed as an independent person dealing in an arm's-length manner? I know the industry has concerns about that. It's something that they say will affect the way the industry operates.

"The second question that I really have difficulty with is that the Dodd-Frank Act says that it might be possible for investors to have the ability to acknowledge the conflict of interest and waive their right to the fiduciary standard. So I see there are details in the way the industry operates that will purvey the operation of the new law. I do think that it is important for the retail investor to see that he has one kind of duty owed either by the broker or by the investment adviser. But it's going to be a very difficult problem in getting to that result."

Harvey Pitt

"Most People Don't Understand the Differences."

Former SEC chairman Harvey Pitt thinks the key to the fiduciary standard issue is how actual investors are impacted. "I look at this whole question from a very different perspective. And that is pragmatics. What really happens out in the marketplace when people are besieged by either brokers or independent financial analysts or the like? Because in essence, I think the touch point has to be what people think they are getting. And even where a broker may not be giving personalized investment advice, the broker may be looked upon by customers as someone who is putting his client's interests first.

"I started at the Commission in 1968, and we had a lot of broker/dealer cases back in those days. And all of the cases were about concerns that certain brokers hadn't really represented the interests of their clients. If you look at it from that perspective, I'm not persuaded that many people know the difference between the obligations of the suitability rule, the know-your-customer rule, or fiduciary duty. Most people don't understand the differences. Even if they are sophisticated, they're sophisticated about companies where they would like to invest, but they all start with the presumption that the professional who is working with them and to whom they entrust their capital is looking out for their best interests. So as I see it, one really has to start from that model as opposed to trying to decide, first, whether we should have a uniform standard.

"Second, does it have to be applicable across the board in all circumstances? If a broker is doing nothing more than executing trades directed by his or her customers, I don't really perceive that kind of service as requiring a fiduciary standard. If the customer is undertaking to make his or her own decisions, doing his or her own research, I don't see that as warranting the imposition of a fiduciary standard. But if the customer is relying on the professional to provide the kind of assistance and advice that most of us rely on securities professionals for, I think the law has done a poor job of keeping up with the realities of the marketplace.

I think it's not so much that we have to have a uniform standard as it is that we ought to make the reality comport with what people think they're getting. And if they're not getting that, have the professionals totally disclaim whether or not they are offering anything other than, say, a bare execution service.

"It may be far better simply to say we are obligating broker/dealers and investment advisers and financial analysts and the like to act in the best interests of their customers, and to the extent that they are not providing services, to make sure that those services are clearly excluded. Some people have a question as to whether, for example, you can carve out certain services.

Disclose the Conflicts?

"I think if people are sophisticated enough to invest in the markets, and if brokers and investment advisers don't use boilerplate but genuinely tell their customers, 'You should understand you're the one who's going to be making the selections, but if I recommend something to you, I may have a potential conflict. I'm obligated to tell you what my conflict is so you know that there are other alternatives out there.' I don't see why that's such a hard position for the professionals to achieve."

Roundtable Discussion

Chairman Levitt crystallized the argument in favor of a uniform fiduciary standard suggested by Chairman Pitt. "The advisory industry is basing their argument essentially on an unlevel playing field. Brokers are free of the obligations that are imposed upon advisers. What you're suggesting, as I understand it, is a rule that would apply across the board to both brokers and advisers to follow the same standards, the same rules, the same obligations."

"Yes," replied Chairman Pitt, "subject to the ability to make it clear that, as a broker, 'I'm not going to provide you with any investment ideas. That's not what our relationship is. Or if I am going to provide you with investment ideas, you should know that my firm puts out its own investments and I may make more money if I recommend those, and I'll tell you about that. But you have to understand going in that that's what I'm going to do.' "

Chairman Levitt did not feel that this position would work in practice. "That's where we part ways, Harvey. Having been a broker, I know the reluctance of brokers to be that forthcoming. It's very unusual when a broker takes an order and he doesn't have some question, some comment, some observation. David, would you accept the Dodd-Frank version of fiduciary responsibility and go with that as it is?"

"I think the standard is fine," replied Chairman Ruder. "But if there's going to be rule making, there are all kinds of questions that need to be asked."

"The D.C. Circuit Court Does Not Like the SEC Right Now"

Chairman Pitt acknowledged that there are practical concerns with a universal fiduciary standard, but didn't think those concerns should stand in the way of the optimal solution for investors. "Let me just say I thought Arthur raised a very good point as to what you can expect from people who are being paid on a commission basis, how forthcoming they will be. Obviously, there will always be people who look to cut corners. But I don't think that should dictate what the proper standards are. I think that means there just needs to be effective enforcement if people go off the reservation. I think the SEC right now cannot win a regulatory case in the D.C. Circuit [Court of Appeals], and thus if any lawyer filed a suit in any other circuit it would probably be prima facie malpractice because the D.C. Circuit does not like the SEC right now. But both the SEC and the CFTC are trying to regulate the derivatives and swaps markets for the first time; they have to adopt hundreds of rules and they have no real experience doing the kinds of cost-benefit analyses that the Court of Appeals seems to be requiring."

Many observers have argued that the SEC's cost-benefit analysis requirement has allowed those skeptical of financial regulation to obstruct the rule-making process. Chairman Levitt asked the panel their thoughts on the issue. "Is there any way, Harvey, of really fulfilling the request for cost-benefit analysis?" asked Levitt. "It seems to me this area is so complex that there will always be a way to challenge whatever cost-benefit analysis is set forth by the agency."

"I think there is," answered Chairman Pitt. "And the first thing that really has to be done is that the agencies have to stop using lawyers to do their cost-benefit analysis."

Better Statistical Analysis for the SEC Is Needed

Chairman Ruder also believes it is possible for the SEC to effectively enact new rules despite the cost-benefit analysis requirement. "I think that the Commission needs to present a good case that there are benefits that can't be quantified because we're looking to the future. And it seems to me that's a persuasive argument. I think the argument would get further in the Second Circuit than it would in the D.C. Circuit. And the other thing to note is that the SEC has turned toward having a better statistical analysis, a better set of economists, and needs to be quite careful."

Chairman Pitt believes that the political environment that exists today is much different than when he started at the SEC in 1968. "When Ray Garrett was chairman (and I was privileged to be his executive assistant from 1972 to 1974), a scandal erupted because the equity funding problem had been brought to the Commission's Los Angeles office, and people did not see the problem. So the fellow who raised it took it to the *Wall Street Journal*. They saw it, ran with it, and then the Commission had to spend a great deal of time explaining how equity funding could have come about with all of these regulatory protections.

"The difference was it was a genuine inquiry. People were trying to figure out how this happened instead of figuring out who they could blame for it. It happened. People do screw up. So you get over that and you say, 'Okay, how do we fix this now so that there's less likelihood something like this will happen?' instead of saying, 'Who can we pillory because they missed something like this?'

"That, to me, is what's making work at the current Commission very difficult. And the one thing I would tell those of you here who deal with entities that are regulated is that a fearful, attacked, uncertain regulator is much worse than the most aggressive and vehement regulator. I'd much rather have regulators who believe in what they're doing and are not afraid to go after what they see, and if they overstep their bounds they get pushed back. But we have a Commission now that's—and I agree with you, Arthur, I think they are doing a terrific job—but we have a Commission now where the staff sits in fear that whatever decisions they make will be turned against them for one reason or another. And nobody can regulate in that kind of environment."

"Blood Sport" in the Nation's Capital

Chairman Levitt agreed. "I testified before Congress on an average once every three and a half weeks. Every time I testified it took two days of staff preparation to get me up there. That's an outrageous waste. What happened during our years, certainly during Harvey's and mine, was the business community, instead of making the SEC the first stop, made it the second stop after they had seen congressional staff and congressional members. And the job of those congressional members, particularly of the opposing party, was to make the Commission look inept and stupid and was enormously time consuming. And still is. What is happening in Washington today is a blood sport, and that's not good for investors. It's not good for regulators."

There still remains an unsettled issue in that investment advisers and broker/dealers have, in some cases, different roles in the financial industry. While it is reasonable to expect investment advisers to behave as fiduciaries at all times, some would argue that broker/dealers, in at least some of their capacities, can reasonably operate at arm's length with clients. Chairman Ruder elaborated: "I think it's too easy to say there should be a single fiduciary standard, because businesses are different. The one piece of it that is clear to me is that the dealer is acting in an arm's-length manner and is selling securities that the dealer is buying and selling. And in that case, it may be that you don't want to have a solid fiduciary duty. But when the broker is providing investment advice to the retail client, then I think there needs to be a standard the broker can be held to, and that is that the broker must put the best interests of the client first."

Put the Interests of Clients First—"A Place Where Everybody Ought to Be Able to Agree"

Chairman Pitt agreed with Chairman Ruder. "The goal, I think, is that if I'm doing something more than just being an order taker, I am supposed to put the interests of my clients first. That, it seems to me, is a place where everybody ought to be able to agree. And although the devil will be in the details, I don't think you have to fuss with separate definitions to separate conduct. That is what they do for a living. And I have high confidence that they'll be able to do it and be able to do it well. I'm sure we'll have comments. Others will have comments. And they'll look at them and figure out the answers to those questions."

Chairman Levitt closed the discussion by reiterating his concerns about the cost-benefit analysis requirement. "I probably differ from the others at this table. I really believe the cost-benefit issue is a very, very slippery slope and used by the Congress to thwart regulation. I take from my colleagues' observations that they feel that there is a way of defining sensible cost-benefit obligations."

Reflections by John Bogle—The Fiduciary Standard Should Also Apply to Institutional Money Managers

While the distinguished panel focused on a requirement that registered investment advisers and stockbrokers (wealth managers or account executives) are held to a standard of fiduciary duty to their clients, Bogle added, "I believe that such a standard should also be demanded of institutional money managers—now managing some $13 trillion of other people's money—agents for mutual fund investors, for beneficiaries of private and public pension plans, and for college endowment funds and beneficiaries of trust accounts supervised by banks. These institutional investors now hold more than 70 percent of all U.S. stocks, up from only 8 percent in 1951 when my long career in the mutual fund industry began."

"Mutual Funds Must Be Organized, Operated, and Managed in the Interests of their Shareholders"

Surely, Bogle added, such a fiduciary standard is *implicit* in the management of assets for clients. Indeed, in the Investment Company Act of 1940, regulating mutual funds, it is blunt and *explicit*: Mutual funds must be "organized, operated, and managed" in the interests of their shareholders rather than in the interests of "investment advisers and underwriters" (fund distributors).[5] Nothing could be much clearer than that mandate. But that noble standard appears in the preamble to the 1940 Act, followed by no explicit standards, nor any means for its enforcement. According to Bogle, "the watchdog has been given no teeth."

Powerful interest groups already resist imposing the fiduciary standard on registered advisers, but the tide seems to be moving in that direction, with the Institute for the Fiduciary Standard relentlessly pushing the ideas from noble principle to business conduct. Despite its clear mandate to institutional investing, that advance will be a tougher slog. But using Chairman Pitt's closing words: "[E]verybody ought to be able to agree. . . . And I have high confidence that [the industry and the regulators will] be able to do it and be able to do it well."

Fourth Panel: Jack Bogle, the Communicator

Ten books; 575 speeches; 14 academic articles; 750 annual reports; more than a dozen op-eds in the *New York Times* and the *Wall Street Journal*; countless television and radio appearances; volumes of correspondence with Vanguard shareholders.

5. Investment Company Act of 1940.

Bogle "Informs, Educates, Entertains, Challenges . . ."

Effective communication has been one of the secrets to Jack Bogle's success. But he is not merely an effective communicator; he simultaneously informs, educates, entertains, challenges, and ultimately, improves the understanding of those with whom he communicates. Bogle communicates in a straightforward yet sophisticated manner. Whether you're a financial novice turning on CNBC and seeing him speak for the first time or you're an experienced industry professional reading about the latest developments in an academic financial journal, you are sure to be enlightened by Jack Bogle. The final panel discussion of the John C. Bogle Legacy Forum brought together two experts on Bogle's oeuvre. The panelists for this final conversation were:

- Martin Fridson, Global Credit Strategist, BNP Paribas Asset Management, Inc.; writer of reviews for several of Bogle's books.
- Jeremy Duffield, chairman, Australian Centre for Financial Studies (ACFS); director, McNamee Lawrence & Co. LLC (MLC); former chairman and Founding Managing Director, Vanguard Investments Australia.
- James Green (moderator), Group Editorial Director, Investment Advisor Group, Summit Business Media.

James Green: Setting the Stage

Moderator James Green began the discussion:

> We're here to talk about John Bogle's books, nine so far, with a tenth due for publication later this year, but while we do that, we'll also attempt to assess Mr. Bogle's influence—not just his written word, but also his communication style and his communications approach that runs throughout all his public work. My role as editorial overseer of *Investment Advisor* magazine, of *Research* magazine, and of Advisorone.com is to ensure that these publications serve those professionals who provide investment and wealth management advice to individuals.

We've long recognized the contributions of Mr. Bogle, both to professionals and to clients. In fact, at the time of our 30th anniversary of *Investment Advisor*, we named Mr. Bogle the most influential person in the investment adviser space over those 30 years. He's also been very generous with his time with our reporters, and with the media in general over his long career.

Mr. Bogle never speaks down to the end client. But he does always speak up to professionals, appealing to their better natures, both because it's the right thing to do and because it's the right thing to do for their clients. He speaks simply and bluntly, but also has long used his bully pulpit to call professionals to a higher calling. Professionals have listened, both in this country and throughout the world, as I think we'll agree. He's also a contrarian of sorts, and I think that contrariness is part of his contribution to the public debate about investing.

Martin Fridson: Reflections on Bogle's Books

Martin Fridson then took a moment to reflect on Bogle's impact as an author:

"A Genuine Benefit to the Investor"

Jack Bogle is best known for spreading the gospel of indexing. We've heard quite a bit about that today, and I mean that in the most positive sense. It is something he believes in very strongly, and it has a genuine benefit to the investor, which comes across very strongly in his book. But this is not merely something that he advocates because of a belief in it; he supports this with very powerful, and very rigorous, and intensive research. And that research is accessible to the nonprofessional investor. It does not rely on elaborate quantitative methods that would be very esoteric.

In fact, both he and I have served on the advisory council for the *Financial Analysts Journal*. He has commented from time to time that we need to make sure that, in addition to articles with a lot of research that is very quantitative in nature, we must have articles accessible to the general investor as well. I think the power in the research is not through the massive weight of very advanced research methods, but really the power is knowing the right question to ask and then going out and finding an answer to that and communicating it effectively.

While indexing is a major theme throughout the books that I've reviewed, he goes beyond that, and covers such things as the shortcomings of security analysis, some constructive criticism of institutional money management, corporate governance, executive pay, and how economic statistics are reported. He's mentioned financial reporting by companies and some of the deceptions—that's a topic that's dear to my heart. The government is not totally blameless in that regard, either. He also questions the role of mergers and acquisitions and whether they add value to the economy.

Finally, as for his communications skill, I would say that this goes very directly to the point that he's often made about moral absolutism. I found that having acted in a role as editor on some occasions, the biggest problem is when writers don't really know what they want to say. They feel ambivalent or confused about the message. If they have a clear idea of what they want to say, the writing tends to follow pretty clearly from that.

"He Lets You Know Where He Stands"

With Jack Bogle, he lets you know where he stands—he knows where he stands, most importantly—and therefore comes across loud and clear in his writing, and that's why he's such a powerful communicator in that medium.

His story[6] is well known among investment professionals. After writing his Princeton University senior thesis on the fledgling mutual fund industry, he joined Wellington Management, where he rose to chief executive officer. Fired in the wake of the 1972–1974 bear market, Bogle rebounded by founding The Vanguard Group. There, he pioneered and tirelessly championed the index fund, one of the most important financial innovations of the past half century.

6. This section is part of Fridson's review of Bogle's book *The Clash of the Cultures*.

"An Oft-Told Tale"

It is an oft-told tale, yet even Bogle junkies will learn some fascinating new facts from *The Clash of the Cultures: Investment vs. Speculation*. For instance, Bogle recounts that in 2004, he unsuccessfully tried to persuade the chairman of Putnam Investments' funds to convert to the "mutual mutual fund" organizational structure introduced by Vanguard, in which fund shareholders own the management company. In 1994, he purchased 100 shares of T. Rowe Price in order to stay informed about the activities of a Vanguard competitor. His $4,189 investment has grown to $208,960, and the dividend alone now runs $4,325 annually, underscoring the point that investment management has proven far more lucrative than investment.

Readers may also be surprised to learn that Bogle's premise for launching the first index fund was not that markets are invariably efficient; sometimes, he writes, they are "wildly inefficient." Rather, he documented that costs of investment management—particularly those associated with excessive portfolio turnover—had directly reduced the return investors could have earned if a cost-effective means of holding the market portfolio had been available to them. In one study he conducted on this matter, Bogle found that the stocks held by actively managed mutual funds at the start of the year performed better than the funds' actual portfolios 52 percent of the time.

"From a Profession . . . to a Business"

In his tenth book, *The Clash of the Cultures*, Bogle takes up the cudgels on behalf of investors, who he believes have been poorly served by most of the investment industry. He deplores the evolution of money management from a profession—by definition, a group of practitioners who should put their clients' interests ahead of their own—to a business that frequently earns profits at the expense of its clients. Bogle quotes Delaware Court of Chancery chancellor Leo Strine's remark that although legal scholars make much of the agency problem created by the separation of ownership from control of operating companies, they have largely ignored a similar problem in the ownership of investment organizations by public stockholders or financial conglomerates, rather than by the owners of the assets under management. One troubling conflict of interest that Bogle sees in this separation is the extreme reluctance of money managers to vote against corporate management in proxy battles, lest they hurt their chances of winning mandates from the corporations' 401(k) plans. He notes that the California State Teachers' Retirement System, which faces no such conflict, votes against management 23 percent of the time.

Institutional Investors Must Exercise Their Rights as Shareholders

If Bogle had his way, institutional investors would use their voting power to push for essential corporate reforms. For one thing, he would rein in CEOs' compensation, which has grown from 42 times to 320 times the average U.S. salary since 1980 on the premise that the corporate kingpins have created massive shareholder value. In reality, he asserts, the average corporation's real profits have failed to keep pace with GDP growth over the period. Bogle criticizes the profligate use of stock options in executive pay, noting that the modest amount of resulting annual shareholder dilution can cumulate to as much as 25 percent over a decade. Also in the governance area, Bogle wants corporations to refrain from making political contributions unless 75 percent of their shareholders approve of the practice.

Citing John Maynard Keynes, one of Bogle's major themes is the need to distinguish between *investment*—forecasting an asset's yield over its full life—and *speculation*—forecasting the psychology of the market. He sees a place for speculation in a healthy capital market but argues that the balance has shifted too far away from investment. For example, he contends that the exchange-traded fund (ETF) is a sound concept but thinks the financial industry has gone overboard by offering variants that dangle the lure of a quick buck. Some of these innovations have turned out to have severe design flaws. For instance, one ETF designed to triple the return of its associated index worked well enough on a daily basis but not over longer periods. Over the most recent five years, it returned –25 percent, versus 10.5 percent for the S&P 500 Index. Early in 2012, an ETF designed to magnify volatility surged when the sponsor stopped creating new units, then plunged 50 percent over two days in a sideways market.

Diligent Research, with a Few Exceptions

Bogle has been diligent in his research, leaving only minor imperfections in the finished texts. He dutifully credits the originators of the aphorisms he sprinkles throughout *The Clash of the Cultures*, yet in one case he neglects to identify Hillel as the source. Along with countless other authors, Bogle maintains that Keynes said, "When conditions change, I change my mind. What do you do?" There is but thin evidence that the eminent economist ever uttered those words, and it is apparently owing to another eminent economist, Paul Samuelson, that so many people believe he did. Quoting a speech in which Benjamin Graham alluded to the expulsion from Eden, Bogle mentions "Graham's reference to Original Sin." Original Sin is a uniquely Christian doctrine derived from events recounted in the book of Genesis and so presumably was not the intent of the Jewish Graham's allusion.

In *The Clash of the Cultures*, he brings invaluable historical perspective to current issues ranging from high-frequency trading to the looming crisis in the U.S. retirement system to the use of mutual fund investors' money to promote the growth of assets under management. ("There is no evidence whatsoever," he writes, "that advertising benefits fund investors by bringing in an amount of new assets adequate to create economies of scale that offset the amount spent. On the other hand, there is considerable evidence that building assets above a certain size impinges on the manager's ability to create superior performance.") Every thoughtful investor can benefit from John Bogle's wisdom, served up with refreshing modesty by a giant in a field notorious for outsized egos.

Jeremy Duffield: The Right-Hand Man's Perspective

Jeremy Duffield continued the panel discussion:

My first experience with Jack Bogle's communication skills was when I worked in Paul Volcker's Federal Reserve System back in 1979. I came up to give a speech on money market funds just seven days after Chairman Volcker had let interest rates loosen in pursuit of killing off inflation. Jack happened to be in the audience. He came up to introduce himself afterward and invited me to come and see a real-world mutual fund company and find out what it was all about. I had no intention at the time of pursuing anything but an academic career, but within six months I was working for Jack as his assistant, and that was my introduction to Jack's persuasiveness and his communication skills.

Today, I want to talk about my observations of Jack as a communicator. I do this not really to praise Jack, but to help us build on his legacy, because I hope everyone in this room has some part of Jack's legacy that they want to take away and work on in their own lives. To do that, I think you have to be an effective communicator, and I've really enjoyed 32 years of observing Jack's skills as a communicator. I'd like to share a few of my observations with you, and give you some of the secrets of Jack's success as a communicator.

"Absolutely Maniacal and Disciplined"

The first point is that it helps to be compulsive about it—to be absolutely maniacal and disciplined about being a great communicator. And Jack certainly is that. So the first lesson is you've got to work very, very hard at it. Anyone who's watched Jack scrawling with those arthritic hands of his on a yellow pad knows just how hard that work actually is. But Jack's done this, not just with his books (10 books, including his newest book *The Clash of the Cultures*), but with 575 speeches, 14 papers published in the *Journal of Portfolio Management* and the *Financial Analysts Journal*, 100 television appearances, 750 annual reports he wrote to shareholders, and the countless pieces of shareholder correspondence that his longtime assistant Emily Snyder has typed over the years.

Jack takes communication very, very seriously and works very, very hard at it. But even with all that hard work, you're not going to be a great communicator unless you have three things. First, you need great content; next, an ability to impart that content with great impact and style; and finally, great credibility. And those are the secrets, I think, of Jack's success. Sticking with the content, I think Marty's absolutely right to say that Jack has clarity about what he wants.

He has his own North Star, which is definitely about putting the investor's interests first. And having your own North Star really makes a difference. He has all those things Marty talked about—a thorough research approach, real content across a breadth of topics, giving you commonsense guidelines on how to invest, how to act, and how to live. There's a lot of content in this man's life's work.

It's also fun to think about his style and impact. From a style and impact point of view, he's an absolute master. He's a master of the art, and I say this with full intent of meaning he does it without artifice. It's an art. His command of the language is just superb. Superb. He's a master storyteller, and I've never seen anyone who can build on the work that other people have done by abstracting their quotes and using them to great effect. He incorporates quotes both to reflect and respect the originator's work, and to build upon them with his own ideas. He's a real master at that.

"Agitated Moral Indignation"

But perhaps the secret to Jack's impact is his ability to bring drama into the equation. A lot of that derives from his state of constant agitated moral indignation about the plight of the investor. Most of us today are done with moral indignation; we've had as much as we can take. But Jack has unparalleled reserves of moral indignation. He's a master of high dudgeon. His work brings in a real unique Manichean view of good versus evil, right versus wrong. There's no gray in Jack's thinking. It's moral absolutism.

There are plenty of villains in Jack's stories, but they are rarely individual people. He talks about practices that deserve to be vilified. And if you're doing those practices, you know who he's talking about. And even if you're not doing any of those things, because of the questions he makes you ask yourself, you wonder if in fact you are. You ask yourself, "Am I really living up to Jack Bogle's standards?" And they're hard to live up to. So, Jack does succeed by introducing drama.

"Imagination and Courage"

All of the factors that I've described bring together Jack's real strength, which is his credibility in the marketplace, which has been built over his 60-year career. There are three elements of that I'd like to discuss. The first is the leadership aspect. Australian Prime Minister Paul Keating defined leadership as imagination and courage. Those are two things that Jack Bogle brings, but he brings a lot more than just imagination and courage. He brings a sense of humility, and a sense of the responsibility that leadership justifies, in a way that really touches us as individuals.

Next, he brings common sense to a world that's largely lacking it. And he breaks through with common sense. If I had to pick any one phrase to describe what I love about Jack Bogle and his communications, it's that common sense aspect. Finally, the third aspect of Jack's communications credibility is that he actually walks the talk, and he's been doing it for as long as he's been talking. So these factors and more about Jack Bogle's style reflect on what a character he is . . . and what character he has. The title of his book, *Character Counts*, sums up both uses of the word.

Chapter 2: A Conversation with Paul Volcker and John C. Bogle

The main event of the John C. Bogle Legacy Forum brought together two living legends—both Princeton graduates—for a lively and wide-ranging discussion. The Forum's namesake, Vanguard founder Jack Bogle, and Paul Volcker, the former chairman of the Federal Reserve who tamed runaway U.S. inflation in the late 1970s and early 1980s and remains a formidable voice for the reform of our nation's financial system, were joined onstage by moderator and Bloomberg News journalist Kathleen Hays. Bogle and Volcker entertained and enlightened the crowd with anecdotes and insights from their long careers. The discussion was a memorable one for all those in attendance. Presented here is a lightly edited transcript of this momentous conversation.

KATHLEEN HAYS, BLOOMBERG NEWS: My first question, gentlemen: I need to know the secret. You're both into your 80s. You're both going strong. In many ways, you're at the top of your game. You both went to Princeton. Is there a link? Is there a secret you can share with us?

BOGLE: Yes, go to Princeton.

"He's still living off an undergraduate thesis . . . 50 years later."

PAUL A. VOLCKER, 12th chairman of the Board of Governors of the Federal Reserve, and chairman of President Barack H. Obama's Economic Recovery Advisory Board: I thought it would be "get a new heart." Speaking of Princeton, this guy has a unique experience. He's still living off an undergraduate thesis that he wrote at Princeton. He got the thing reprinted, and it sells 50 years later. Now, who else wrote an undergraduate thesis at Princeton and made a career out of it?

BOGLE: Well, never underestimate the power of luck. But I think most people don't know the thesis story. There would be no Vanguard if I hadn't gone to Princeton. There would be no Vanguard if, back in 1949, I hadn't been sitting in the Firestone Library, the big new library we built during my freshman year, and I tried to keep up with the financial news. I was majoring in economics (without particular success at first). I happened to read the December 1949 issue of *Fortune* magazine.

Up in the reading room of the Firestone Library, I turned to page 116, where I was struck by a story titled, "Big Money in Boston." It was an article about the mutual fund industry. The industry was described as tiny, but contentious. I didn't want to write about Adam Smith or John Maynard Keynes, subjects that had been covered by economics majors time and time again. So here's a tiny but contentious industry, totally untouched by academia or by the press. It was a small industry, but ready to be contentious. So I decided to make the mutual fund industry the subject of my senior thesis. If that fortuitous moment had not happened on that sunny day in Firestone Library, it's fair to say that I would not be here today. We might be here, but we'd be celebrating Mr. Volcker instead of me, which is surely more appropriate.

Why Aren't There More Believers?

VOLCKER: It's quite an innovation you have fostered through the years, and you stuck with it, and I don't know anybody else who could do it so clearly and consistently, and you write with this didactic skill and proved your case over and over again. Why doesn't everybody believe it?

BOGLE: Investors are getting the message more and more. Vanguard's assets are over $1.8 trillion today. We now manage about 17 percent of all of the long-term assets in the mutual fund industry—the highest share in the industry's history. Fidelity reached about 13 percent at its peak. Investors Diversified Services—American Express, as it was later called—peaked at around 13 percent. Massachusetts Financial Services, originally only MIT [Massachusetts Investors Trust], was the first fund company to reach 13 percent. But Vanguard is up to 17 percent, and I don't see this trend slowing down.

But even more significant in terms of momentum is that in the past five years, U.S. investors have added a net $100 billion into equity mutual funds. But $600 billion went into index funds, and $500 billion came out of actively managed funds. I think it was Bob Dylan who said you don't need a weatherman to tell which way the wind is blowing.

HAYS: I want to ask you about that, Jack and Chairman Volcker, because the question we pose here is how to restore investor confidence when it seems to be so broken. Let me ask you, where do we see evidence that investor confidence is broken? In stocks, the Dow is not too far off the recent highs. Bond yields are at record lows. The dollar is still relatively firm. Why do we say investor confidence is broken?

BOGLE: I'd say the data that I just mentioned is a pretty good example. The confidence that active managers can accomplish anything, that they are a panacea to all the investment ills of the average investor, is slowly vanishing, and they're getting used to the idea of owning all of American businesses. That is where returns are created—returns are not created in the stock market. As I said in one of my books, the stock market is a giant distraction to the business of investing. We look at those ephemeral prices every day, but they have little to do with intrinsic value.

"The Stock Market Is a Giant Distraction to the Business of Investing"

So I think investor confidence in active equity management is clearly broken. When you hear someone like BlackRock's Peter Fisher—one of the fine people in this business—say the whole paradigm for bond management is also changing to indexing, the transition is accelerating.

HAYS: Chairman Volcker, what do you see?

VOLCKER: I would add a footnote and maybe a headline to what Jack said. If confidence in the investment markets and financial markets is broken, we face a problem in this country where trust and confidence in the whole country—and its government—are broken. I think this is a very big issue that we are struggling with as a country. It's an issue that's going to overshadow and influence financial markets, as well as our destiny.

Shaky Confidence —20 Percent Trust Their Government to Do the Right Thing

HAYS: Are you seeing that confidence is shaky, and that's affecting the markets?

VOLCKER: There is no question it is shaky. For many years, polling agencies have been asking the question "Do you trust your government to do the right thing most of the time?" The answer these days runs about 20 percent. I read someplace they did a recent poll and the answer was 10 percent. It's a little hard to run a strong democracy if only 10 percent of the people or even 20 percent of the people trust the government to do the right thing even half the time.

HAYS: We'll get to that issue, because I know Jack has some very strong feelings about government, taxes, and more. But first, let's go back to the question of restoring investor confidence. Jack, you've said that in order to do that, we need to fix the financial system. So have we fixed the things that caused the financial crisis? Are the ratings agencies fixed? Do we have a grasp on derivatives? Have we corralled the problem of "too big to fail" at the banks? What kind of grade would you give the U.S. financial system?

BOGLE: I'd go with "D." I realize how difficult it is to get anything done in Washington, but I happen to be an advocate of bringing back the Glass-Steagall Act, separating investment banks and commercial banks into distinct institutions. That original act required only 37 pages; it doesn't take 198 pages, as with the Volcker Rule, to explain what bankers can and cannot do. It really is quite simple: If you're in the business of deposit banking, you may not be an investment bank. And if you're in the business of investment banking, you may not take deposits.

VOLCKER: I've been preoccupied with this same question myself. I went back and looked at the legislative language in Glass-Steagall. Glass-Steagall deals with some things that aren't relevant here, but with respect to the trading and powers of banks, there are two sentences at the core of the issue. Together, they say that no bank may handle both functions. Yes, there's a lot of debate about the detailed rules proposed in Dodd-Frank. That's less important to me, frankly, than the end result.

HAYS: I want to ask you two quick, specific questions on this. Bank of Canada governor Mark Carney said that the Volcker rule could damage the government bond market. He's talking about the exemption for government bond trading, which he said will favor the United States and will have unintended consequences. How do you address his criticism?

VOLCKER: Well, that's very strange to me, and I'm a bit startled by it. I saw an article in the paper this morning that was set in the cool confines in the mountainous area of Davos. Foreign governments suddenly discovered this is a big problem. I've not heard that before.

"What Is Not Permitted Is a Proprietary Position"

Under Dodd-Frank, trading is permitted and underwriting is permitted. If a foreign entity wants to engage in underwriting, it gets the assistance of an American bank. What is not permitted is a proprietary position.

What I heard out of European governments repeatedly in the past is they're concerned about all the speculative activity in financial markets by hedge funds and taking proprietary positions and destroying their currencies with speculative activity. Do I now understand that they want more of this speculative activity they used to frown upon in their currencies, and it's suddenly become healthy and wonderful for their currencies? There will be plenty of proprietary trading in securities without the half-dozen or so American banks participating in it.

Hedge Funds and the Volcker Rule

HAYS: I want to ask you a question about hedge funds. Chairman Volcker, I'm going to start with you, because it comes out of this question about the Volcker Rule. The Volcker Rule is going to constrain proprietary trading at banks. Are you concerned that it's going to migrate into unregulated hedge funds that get a lot of their financing from the regulated banking system?

VOLCKER: I guess my answer to that is no. How many thousands of hedge funds are there now? They like to take speculative positions; that's what they do. They are financed typically with a very high ratio of equity. The destruction of a hedge fund affects their long-term equity investors and typically should not pose a threat to the banking system or a threat to the normal, essential operations of the banking system—making loans, payment system, safety for your deposits. Hedge funds have a different function. It is a speculative function, and they ought to be allowed to fail, as it will not have the same disruptive influence on the financial system that a breakdown of the banking system does. That is the distinction we are trying to make.

HAYS: On this question of hedge funds, Jack, you stand for long-term investment and reduced cost. You're a champion of index funds and the long-term benefits of corporate growth. When you look at the hedge fund industry (the hot new kid on the block), it's the exact opposite—high costs, big risky bets, and short-term strategies. How do you view this competitor that is the antithesis of what you stand for?

BOGLE: First, a significant portion of hedge fund assets—and I don't think people have spent nearly enough time thinking about this—are held by tax-exempt institutions like endowments and pension funds. One thing I would do to deal with that is have a tax on short-term capital gains whether you're a tax-exempt institution or you are not. That may sound communistic or something to you, but Warren Buffett said it about 15 years ago, and stock exchange volume then was probably one-hundredth of what it is today. It would be an attempt to slow down all this crazy trading. Warren says that it was a tongue-in-cheek comment, but I think that it is an idea whose time has come.

VOLCKER: Market liquidity is not just a costless, wonderful thing. There is a danger that the presumption and the actuality of a liquid market contribute to a short-term trading horizon. You're willing to do things you would not otherwise do because you're convinced you can turn around tomorrow and sell it.

But then you have a crisis. If you can't turn around and sell it, all the structural faults in the system are suddenly exposed. Liquidity is partly a state of mind: whether you think you can sell something instantaneously. It is not like holding a Treasury bond. A more prevalent form of liquidity today is the thought that you can sell a bond tomorrow or sell some complicated structured instrument tomorrow.

It's interesting that there is more and more academic analysis of the fact that we want tradable markets. We want markets that have some liquidity, but is there such a thing as too much liquidity? It can lead people into investment behavior that's actually damaging to the economy. The most eloquent person on this—he writes so well and is worth reading—is the head of the FSA [Financial Services Authority] in London, Adair Turner, who wrote a long essay about a year ago on this point. Is there social utility to liquidity? He says yes, up to a point. Can there be too much liquidity? Yes, at some point it becomes socially destructive instead of socially useful.

"Liquidity Is the Last Refuge of the Scoundrel"

BOGLE: I agree with Paul. Let me add some perspective. For inspiration, I go back to London to the days of Samuel Johnson. He had a saying, "Patriotism is the last refuge of the scoundrel." In this new fast-moving market, I'd advance the idea that *liquidity* is the last refuge of the scoundrel.

All this trading creates no value—in fact, it subtracts value. If you want to get some perspective on how our economic and financial systems work, you must go back to the fundamental role of Wall Street: It raises capital. The main function of the financial system is to direct capital to its highest and best uses; to companies with the greatest prospects for future growth; to companies creating the best goods and services at the lowest price. We might ask the question: How much of that actually happens?

We *know* how much of that happens. IPOs—initial public offerings—and secondary offerings have provided about $250 billion per year over the past five years. That's the financial industry's primary economic function. I'll call that investment. Compared to that, how much liquidity or short-term speculation do we have? Over that same span, we've had $33 trillion of annual trading in U.S. securities. There's 130 times as much speculation as there is investment. Or, to put it another way, speculation accounts for 99.2 percent of what Wall Street does, and investment accounts for merely 0.8 percent. That just isn't getting us anywhere. In fact, it diverts returns from Main Street to Wall Street.

HAYS: Does the high level of liquidity have anything to do with global central banks, with very high balance sheets, with zero interest rate policies, et cetera?

"Putting Real Liquidity Into the Market"

VOLCKER: No, they're putting real liquidity into the market. They're putting short-term assets into the market—their own liabilities. Indeed, it is beyond comprehension that they will not be respected. If you have a short-term liability of a central bank, you have true liquidity. That's quite different from having a bond or a complex instrument that you want to sell tomorrow. You want to be able to easily sell that short-term asset; you shouldn't necessarily be able to sell the long-term asset.

Let me return to this business about the government securities market and foreign securities. Here we have European governments that are debating over whether to put a so-called Tobin tax (financial transaction tax) on trading in their own market because they think there's an excess of speculation and liquidity. I read that on page one of the newspaper.

Then I read on page two that they're worried about a loss of liquidity because the United States' banks can't trade Greek bonds—or they can trade them, but they can't hold them in a proprietary position. They can't speculate in them. I wonder how populated Davos is with lobbyists who are explaining to these foreign countries how much they're going to lose from the Volcker Rule. I don't think they're going to lose anything important.

The Financial Transaction Tax

HAYS: The transaction tax is something you both support?

BOGLE: I do support a very modest transaction tax, maybe 0.1 percent of the value traded. I believe it should be paid, not within the financial markets, because I think that would be bad for liquidity, but should be paid by the firms that are trading. The cost of each share that a given mutual fund buys would be 0.1 percent higher than the unit price that's paid.

I think what people don't understand is there has been this incredible reduction in the frictional costs of investing—taxes and trading costs. Decimalization of security prices was a big part of it. Today, it's almost free to trade. I suppose you could argue, as my son does, that if transaction costs were zero, I shouldn't be against it. But they're not zero, because the rate of trading activity has gone up so much faster—at least as fast as the costs have declined. So while the commission cost has gone down, increased volume has driven total costs up. That leaves us with a negative impact on the overall wealth of investors. So I don't see it does anything constructive. The system just doesn't seem to be working in the interest of investors.

HAYS: Chairman Volcker, regarding the Volcker Rule, one of the criticisms is that if foreign banks don't have the Volcker Rule, U.S. banks will be at a competitive disadvantage.

VOLCKER: This argument about competitive disadvantage goes both ways. The American banks have been saying that they are at a competitive disadvantage because of the proposed capital rules, and European banks argue they're at a competitive disadvantage for other reasons. Of course, there are some core issues that you have to decide, as a matter of national sovereignty, regarding what kind of a banking system you want. The United States has a big banking system. It's important internationally. But just because it might put the banks at a disadvantage, I don't think we have to permit proprietary trading. That's not a detriment to the American economy.

The objective of these changes is to have a stronger global banking system, one less vulnerable to crisis, and that will be a plus for the American banking system. If other banks are weaker and more speculative, so be it.

The Bond Market Index—Too Much in Treasurys?

HAYS: Jack, you are one of the pioneers of index funds, and also index bond funds. A large portion of the trillions you manage at Vanguard, some 17 percent or 18 percent of all long-term mutual fund assets, is invested in bonds. I want to ask you a broad question about the bond market. We've got rates at historic lows. We've got the Federal Reserve trying to stimulate the economy. We've even got some Fed officials and policy makers or academics close to the Fed saying we could use some more inflation. You're a long-term bond investor. What is your view on this issue, and what does it mean for bond investors?

BOGLE: For me, the bond market is the essence of simplicity. If you simply take today's yield on a given bond or a given bond portfolio, you have established a very reasonable expectation for returns on bonds over the next decade. For long-term investors, it's not possible to have a bond bubble. After all, people that are holding even those 2 percent 10-year Treasurys have basically agreed to accept 2 percent as their return for the next 10 years. If they don't trade, that's the way it will be. It could be 2.25 percent; it could be 1.75 percent. But it's not going to be 15 percent, and it's not going to be zero. So the bond market is even more basic than the stock market in setting reasonable expectations for future returns.

Defining the Bond Market

Now, I do confess to being a little bit troubled with how we define "the bond market." We started the first bond index fund in 1986. I recently looked at its first annual report and saw that about 72 percent of its holdings were in U.S. Treasurys, agencies, and Treasury-backed mortgages. That number has remained fairly stable; it's about 70 percent today. I think investors in bond market index funds ought to be very conscious of the fact that that index is dominated by U.S. government investments.

The bond market index does have very high quality, and it's also quite short in maturity, because Treasury bills and shorter Treasury notes and bonds are very dominant in the overall Treasury picture. Ginnie Maes are in some ways even shorter because of the buyer's ability to "put" the mortgage back to the lender before it matures.

So I think we should be trying to expand our bond horizon just a bit. I'm not suggesting a portfolio that consists solely of corporate bonds, maybe A-rated, but a portfolio that is maybe 30 percent in U.S. government credits and 70 percent in corporate bonds. That would take the yield up by about 100 basis points, fully 1 percent. So you can't really talk about the bond market without breaking it down into these segments of Treasury and government-related and also maturity.

Low Interest Rates: Great for Borrowers, Terrible for Lenders and Savers

The banks have given us a system where the savers of America are basically being ruined. A three-year CD may yield about 1 percent. In money market funds, most managers—excluding Vanguard because we operate at rock-bottom costs—are subsidizing the yield by waiving their fees. That can't go on forever, and they still have negligible yields.

So our banks, having gotten us into all this trouble, are in Fat City. Everybody says, "Let's have lower interest rates." That's great for borrowers, but terrible for lenders—another reminder that everything we do in the securities business has two sides.

HAYS: I would like Chairman Volcker to weigh in on this, too. Jack Bogle is blaming the banks. But it's the Federal Reserve that has a zero interest rate policy; they're happy with low interest rates. More recently they're implementing policies to lower long-term rates, as well.

VOLCKER: Well, it's an unhappy situation to have such low short-term and long-term rates when you consider the desirability of savings, what it means for defined-benefit pension funds, and what it means for defined-contribution 401(k) plans and IRAs. But interest rates are a symptom, of course, of an economy that's operating way below capacity. The effort to stimulate our economy takes priority over the immediate needs of savers and investors. So let's hope that we'll get back to a more normally operating economy in which investors can earn a positive real return on their savings. In the short run, the Fed can't operate monetary policy on the basis of what's most convenient for investors when we have a major economic crisis on our hands, which we've had.

HAYS: Does it restore investor confidence if the discussion at central banks—like the Federal Reserve—focuses on more inflation, higher nominal GDP, et cetera?

VOLCKER: You're asking *me* whether it's a contribution to confidence to have more inflation?

HAYS: I sure am.

VOLCKER: No, that answer's too predictable. No, the worst thing the Fed can do is, in an already very uncertain situation, raise questions about whether they're going to stimulate inflation. Of course there is some discussion in the Fed about it. But I think those that are casual about inflation risk and actually aim for a higher rate of inflation are simply wrong and potentially destructive.

HAYS: Is there something wrong with the economy that needs to be fixed, Jack? Again, we're talking about restoring investor confidence. Do we have to fix the economy? We've talked about regulation. We have to talk a bit about government. But if the economy were healthier, wouldn't investors be confident again?

Deleveraging Is Necessary in Our Consumer Economy

BOGLE: Of course a stronger economy would help. But it's going to take time. We went through roughly a decade of ever-growing indebtedness—leverage on the part of our homeowners and consumers in America. Something like $4 trillion or $5 trillion was borrowed against people's homes and spent on consumption. So that inflated normal purchasing habits and the consumer share of GDP, and probably helped inflate things. That leverage is now being reversed very slowly.

But deleveraging is necessary in our consumer economy—to say nothing of our government sector—whether we like it or not. It's happening right now. Despite short-term interest rates that are close to zero, the saving rate in the United States is the highest it's been in seven or eight years.

VOLCKER: The rate just went down again, unfortunately.

BOGLE: None of this is easily explicable, except to say that consumers have to get out of this leveraged position and get their balance sheets in order before we restore earlier levels of economic growth.

VOLCKER: The Federal Reserve has just hardened its language about the 2 percent inflation rate. And you can argue whether 2 percent is too high or could be modified. But presumably, they've done that to reinforce to the market that 2 percent and no more is acceptable, even desirable.

HAYS: But the Fed has a dual mandate now. They've got to keep their eye on unemployment.

"2 Percent Inflation Is It"

VOLCKER: Yes, they must consider employment, but they recently came out and said 2 percent inflation is it. They mentioned employment, but they are now to reinforce that regardless of what some governor said; the judgment of the Federal Reserve is that the inflation rate shall not go above 2 percent. Maybe they're wrong, but that's what they're saying.

HAYS: Let's get to government, and I want to open it up to some audience questions, because you started out by saying, Chairman Volcker, that what you see is broken-down confidence in government, and that is one of the big negatives hanging over the financial markets. Jack, I know that you said basically the same thing—that our biggest problem right now has to do with our government.

BOGLE: Yes, it seems as though we've lost the ability to govern ourselves. You don't have to watch those wonderful, enlightening, Lincoln-Douglas-style debates among our presidential candidates (only kidding!) that we see almost every week to believe that our politicians care more about sound bites than about solutions. So our ability to govern ourselves is fading. I'm not sure it's worse than it's ever been, but it's worse than I've ever seen.

And gerrymandering has produced a bad system where there are too many safe seats in our Congress. We have the ridiculously inflated role of money in our elections. The *Citizens United* case opened the door to silent contributors to campaigns. Of course, the campaign itself has "no idea" of what's in those ads; there's no communication at all, if you believe what they say. I don't believe it.

It's a little bit like restoring confidence in the financial markets. We need to have the electorate stand up and be counted. This is a democracy—really a republic with democratic aspects—and we have to have an informed electorate, just as we have to have an informed investor base.

Would Co-Czars Help Restore Confidence?

As I look at solving the confidence problem on the investor side—which should be a little easier—we need to give investors the right information about how the markets work and have them focus on the long term, have them focus on low cost, have them focus on diversification, and have them focus on some kind of a reasonable asset allocation. This information is really all that most investors need. If you go much beyond that, it usually confuses the average investor.

The same principle is really true of government. We're getting into these tiny, midget kind of regulations, and we should be looking at the whole system and say, "You know, it's broken." And so I have a pact with Paul, and if we're asked, we will agree to be the co-czars of the entire securities industry, so we can't be second-guessed by Congress.

VOLCKER: We're going to limit it to the securities industry?

BOGLE: No.

HAYS: These two guys will take over everything.

VOLCKER: There was a comment made this morning that lobbying had become a cottage industry. I think that comment is wrong. It is no longer a cottage industry. It is a big industry. You can't go to Washington, D.C.—where I've been going in and out for 60 years—without recognizing that Washington is a big, prosperous city. Why is it prosperous? It's filled up with lobbying firms that have buildings that cover a whole city block. The amount of wealth in that city is tremendous, and it's in an attempt to influence the government.

BOGLE: The Supreme Court tells us that the Founding Fathers would have loved this. I don't happen to believe that.

HAYS: You guys are in your 80s.

BOGLE: Don't mention that, please.

VOLCKER: What I say all the time is, "Oh, to be 80 again."

HAYS: I hear you. But are you a lost breed? Are there more Paul Volckers and Jack Bogles in the subsequent generations? Are you voices crying in the wilderness?

"There Is More Sense Now . . . That Something's the Matter"

VOLCKER: Well, I've got a feeling the wilderness is a little less than it used to be. We've gone through this great financial crisis, while in Washington political ideologies still reign. There is more sense now—and Jack is very articulate about this—that something's the matter and something has to be done in a way that was not evident five or six years ago, when everything seemed to be so wonderful with the stock market rising and everybody making a lot of money and taking home tens of millions or a billion or two a year. That was part of a seemingly prosperous, growing economy, and a political system that worked.

It doesn't look like that way now. And I think there are a lot more young people, in my sense, who are reacting by saying, "Yeah, something's the matter, and I want to be part of fixing it," whereas 10 years ago, everybody wanted to go to Goldman Sachs.

Now, a lot of those people are saying, "No, I want to see whether I can do something in government or at least nonprofit institutions and make things better." I think it's a distinct change in attitude, and is promising for what's a very bad situation.

Is Financial Engineering Really "Engineering"?

BOGLE: I do worry about the growing use of complex mathematics, even physics, in our financial system. For example, almost all universities with engineering departments—and certainly at Princeton University, where I have the data—we have moved away from, for example, mechanical engineering, civil engineering, and electrical engineering being the drivers of the engineering department. Now, for four or five years, the fastest-growing and largest major has been financial engineering.

When you're investing other people's money that way, you don't feel the same constraint. As Adam Smith wrote a long time ago, in 1776, one doesn't manage other people's money with the same prudence and care with which one manages one's own. Maybe 25 years ago, investment banks were private partnerships with unlimited liability. They were betting their own money.

Believe me, in those days investment bankers would not have a whole lot of junk on their balance sheets. That's just not the way it works. But when you're investing someone else's money, public shareholders take all the risk and the firm's executives take the annual compensation. It's an agency problem. We have agency problems here in corporate America. We have agency problems in investment America.

In short, we must have a federal standard of fiduciary duty. We need a standard of fiduciary duty for both our investment manager/agents and our corporate manager/agents.

A Question from the Audience

HAYS: Let's take some audience questions.

MICHAEL PENTO, PENTO PORTFOLIO STRATEGIES: I'm very curious about your comment about an impossibility of a bond bubble. If you look at what is happening in Portugal and in Greece, they were borrowing a tremendous amount of money because they had the German balance sheet behind them, and now their yields are skyrocketing.

And likewise, the Federal Reserve has indicated we're going to have a zero interest rate policy for probably about six years, if you go back from when it started until the end of 2014, at a minimum. So I'm very much concerned about an interest rate shock. And why do you feel that we're not going to have a bond bubble here in the United States? Thank you very much.

BOGLE: Well, in part, I stand corrected. When I talked about there not being a bond bubble for long-term investors, I was talking about here in the United States where credit risk is relatively low. (I may be wrong on that.) But obviously in Greece and the other "PIIGS" countries—Portugal, Ireland, Italy, Greece, and Spain—there's clearly a possibility that a bond bubble could burst. Interest payments may not be made.

In the United States, the credit of our corporate sector is strong, and eventually there will be enough sense of reality in Washington to take the steps that will finally strengthen the credit standing of our Treasury. So, when I say that the bond market for long-term investors—not traders—is not a bubble, I mean that investors have entered into a contract that says, "This bond is going to pay me, say, 3 percent interest each year over the next 10 years, and if interest rates rise to 7 percent, I'm still going to get my 3 percent." In fact, if that happens, the investor will probably get 4 percent, because the higher reinvestment rate will increase the total return. So that's my position. I don't think yours is without merit at all. But if you look at it as a contract between a creditworthy borrower and an informed long-term lender, there's no bubble.

VOLCKER: We're still borrowing too much as a country, as others are. I don't know that you'd call it a bubble, but I don't want the lack of a bubble to mean that we're not borrowing much more than is sustainable over a period of time.

BOGLE: I agree with Paul that today's level of government borrowing is not sustainable, so we ought to be thinking about how to slow the growth of debt throughout our system. Should we allow interest to be deductible at the corporate level? It just adds leverage to corporate and consumer balance sheets at the expense of equity. That's the way it works when bond interest is deductible and dividends are not.

HAYS: Chairman Volcker, I just have to ask you, because I've been following your words for a very long time. You used to warn back in the 1980s about excessive borrowing and crowding out in the credit markets. Now you seem to be warning that you see something more akin to a crisis that could occur. Could we have some kind of crisis in the bond market? Maybe that kind of crisis is what Washington needs to get something done on the budget.

Facing Up to Our Long-Term Problems

VOLCKER: Well, we're not close to a real crisis, but we're close enough that we have time to take action to deal with it. But in the political environment that we were both describing earlier, that's the big challenge. Obviously, you don't want to be too aggressive right at the moment when the economy is in the doldrums and recovering—but recovering at a rather slow pace, kind of slog, that appears to be where we will be for some time. But there's no reason why we can't be putting in place legislation to deal with some of our longer-range problems, not only with Social Security and Medicare, but also: How big do we want defense spending to be? How much money should we have left over for discretionary spending, which isn't very big to start with? We ought to be working to resolve these problems.

HAYS: Thank you, Chairman Volcker. Thank you, Jack.

VOLCKER: Thank you, Kathleen.

BOGLE: Thank you, Kathleen. I wanted to close by reminding the audience that my book *Enough. True Measures of Money, Business, and Life* is available, gratis, thanks to our sponsors. I'll be signing copies at the back of the room.

VOLCKER: I will say that it's been terrific being on this program in honor of Jack Bogle, who's stuck with his very sensible comments and disciplines for year after year in a way that just is without precedent. Thank you.

BOGLE: Thank you, sir.