

The Battle for the Soul of Capitalism

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John Bogle, retired founder of global Vanguard mutual fund group, believes that traditional “owners capitalism” has “pathologically mutated” into “managers capitalism”, where executives and intermediaries have robbed mainstream American investors of a fair reward for their invested capital.

This hard hitting book focuses in turn on Corporate, Investment and Mutual Fund Americas. It addresses what has gone wrong, why and how it can be fixed.

- Recently enacted US reforms address many issues raised here, but future work is needed

The book is considered by many, including Eliot Spitzer (US Attorney General) and Arthur Levitt (25th Chairman of the US SEC), one of the most important of its kind in the post-Enron, dotcom period.

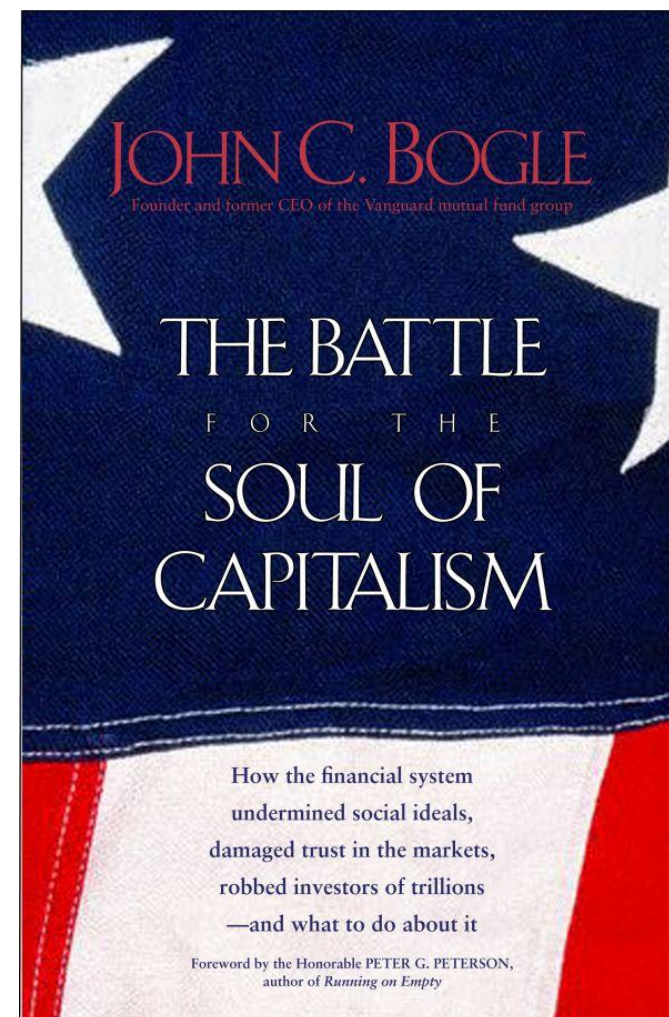
Although this book is written about America it offers important lessons for others including Australians

- Arguably, Australia has not suffered to the same excess as the US, but we must still be vigilant

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Executive Summaries



Yale University Press

What went wrong with Corporate America?

“Enormous transfer of wealth from public investors to business leaders, corporate insiders, and financial intermediaries”

- **average CEO compensation peaked at 531x average worker in 2000, up from 42x in 1980, and is now at 280x in post-boom 2004**
 - **grew at 12% pa (11x) from 1980 to 2004 while earnings grew only 6% pa**
 - **excludes “perks” incl. personal travel, (forgiven) loans, large termination payments, generous retirement benefits, charitable contributions, entertainment**
 - **Bogle is not afraid to hi-light individual excess including Jack Welch at GE**
- **1997-2000 revenues paid to investment banking and brokerage firms exceeded \$1t**

Drove increased concentration of wealth: from 1% owning 18% in 70’s to now 40% (matched only during Robber Baron era, eg. Rockefeller) – a source of future instability?

Executive options pressured many to “manage” earnings – contributing to stock boom, which sucked in money from mainstream investors and went out as exercised options

- **1570 companies have since restated 2000-2004 earnings (7x those who did in 1990-94)**
 - **“haven’t heard of a single instance in which overpayments returned to stockholders”**
- **Manipulating (corporate) pension plan assumptions was a favourite tactic; “cookie jar reserves”, proforma earnings and off-balance special purpose enterprises also popular**

Why and how to fix Corporate America?

“Ugly deviations from fair play of recent*, represent a new breed of corruption. It required only two ingredients:

1. Diffusion of corporate ownership among a large number of investors, none holding a controlling share of the voting power
2. Unwillingness of the agents of the owners – the boards of directors, ...”
 - Enron board voted 3rd best in America in 2000 by *Chief Executive* magazine
 - “Values: Communication, Respect, Excellence and Integrity. We continue to raise the bar for everyone”
 - “Independent auditors became partners of management”, many to protect consulting fees which were greater than audit fees
 - “Wall Street proved to be utterly worthless as a responsible gatekeeper”
 - Analysts conflicted and “joined the marketing arm of their firms”
 - Lobbied legislators allowed relaxation of regulations and standards

Fixable by increased corporate citizenship, better separation of ownership & management, changing (incl. expensing) options and performance pay, better accounting disclosures and returning to a long term focus (eg. away from quarterly earnings)

Investment America

Despite 66% of all US equities now “owned” by institutions (public and private retirement funds, mutual funds, endowment funds, banks),(and the top 100 owning 52%), fundamental conflicts prevent institutions acting in the best interest of owners and beneficiaries

- **Bogle provides a long list of institutional investors failing to act, incl. not ... sponsoring opposing proxy resolutions, testifying to Congress about expensing options or Sarbanes Oxley reform bill, speaking about rights of shareholders**

Move from investors to speculators further cause many to have a disinterest in governance

- **Passivity in governance also helps corporate profits (reduces cost)**

“Sell side” research analysts make recommendations “to enhance firms ability to support initial public offerings they underwrote and to attract new clients”

- **8 of 10 largest investment banks involved in Attorney General’s complaint**

100,000 army of money managers and security analysts on the “buy side” appear to not have taken their responsibilities seriously

- **They have a “clear conflict of interest managing the retirement plan assets of the very corporations whose shares they own”. “Managers with reputations as [pests] aren’t likely to attract corporate clients”**

Various reforms are suggested including the need to instil a strong ownership ethic

“Almost without realizing it, we have developed a system of circularity in which the owners are owned”

Mutual fund America : In summary

“By placing their interests as managers ahead of the interests of fund owners, fund operators allowed abusive market timing by favoured investors, engendered a major increase both in fund expenses and costly portfolio turnover, and focused on fund proliferation and marketing. Together these actions resulted in a staggering lag in the long-term results earned by the average equity fund compared to the returns available in the stock market itself, and an even larger lag suffered by the average equity fund shareholder”

“Dominated by the interest of its managers, fund organizations focused on salesmanship over stewardship, abandoned traditional investment committees in favour of flashy portfolio managers, engaged in ever more risky investment policies, and provided new funds to meet the fads of the day, only to quickly dispatch them when they had outlived their usefulness”

“We need a new fund structure that will at least give fund owners strong representation on fund boards. We also need a federal standard of fiduciary duty for fund directors and for regulators to do a long overdue study of the industry”

On Mutual Fund America

Firms implicated in market timing scandals manage ¼ of long term fund assets; 30 hedge funds publicly defined their strategy as “mutual fund timing” !

- **Fund market timing allowed investors to “bet on a horse after the race finished”**
- **Estimated to cost total \$3b to investors in funds involved**

Speculation, rather than investment, has become omnipresent

- **Average shares held for 2 ½ years in 2002 not 12 years from 1950-75**
 - **For some funds (Alger, Bank of America, Janus) turnover was 300-400%**

Equity fund direct costs rose 1.5x times asset growth (economies of scale not shared)

- **From \$15m in 1950 to \$37b in 2004, from 0.77% to 1.56% (excl. sales charges)**

From 1985-2004, return on average mutual fund was 10.4% vs. 13.2% for S&P500

- **2.8% lag an estimate for total costs incl. fees, brokerage and ongoing sales costs**
- **Average investor further lagged average fund by 3.3% by poor market timing (ie. Investing \$460b in NASDAQ and selling \$100b of old economy shares)**
 - **“Fund investors must accept a large part of the responsibility for their own costly foolishness. Nonetheless, fund managers too... [for promotion]”**

“During my half-century plus career in the fund industry, I’ve seen this field move from being primarily a profession of investment management to becoming largely a business of product marketing”

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