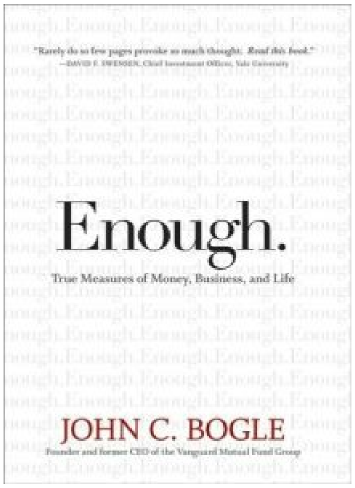

Book **Enough.**

True Measures of Money, Business, and Life

John C. Bogle
Wiley, 2008
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Recommendation

This inspiring work by John C. Bogle, one of the great financial innovators in American history, sounds like an echo of the distant past. Indeed, he calls for a return to 18th century values, and uses such words as "virtue" and "character" to describe his vision of how the financial system should be constituted. Many of the themes Bogle strikes will be familiar to readers acquainted with his other works. However, with the American financial system in crisis, his critique gains a new resonance. Indeed, readers may detect a striking parallel between author Bogle's call for professional responsibility in the financial services industry and President Barack Obama's call for greater responsibility within society at large. Let *BooksInShort* be the first to confirm that this book is clearly a product of its times.

Take-Aways

- What matters in life is not success but rather character and virtue.
- The financial system subtracts value from society.
- Within the financial services industry, self-dealing has eclipsed client service.
- The scandals of egregious CEO compensation and the high fees investment managers get whether their clients prosper or not are symptoms of a rot in the financial system.
- CEO compensation should depend on long-term performance, not on stock price moves or peer group polls.
- The mutual fund industry has become a sales machine, to the detriment of investors.
- Investment managers should work for the long-term best interest of clients, not for their own short-term gain.
- Professionalism means working for the good of others and of society. The investment industry must regain professionalism.
- Success is a poor measure of one's overall performance.
- The things that matter most in life are the things that counting cannot capture.

Summary

Why *Enough?* Authors Joseph Heller and Kurt Vonnegut were attending a party hosted by a hedge fund manager. Vonnegut told Heller that their host earned more in a day than Heller had earned in years from the royalties on his bestselling novel, *Catch-22.* Heller replied, "Yes, but I have something he will never have...enough." This story, recounted in a poem by Vonnegut, greatly impressed author John C. Bogle, because it expressed his sense that the monetary excesses of recent decades are a symptom that many people in the financial system do not know what "enough" means. Because their appetites know no bounds, they have sacrificed professional ethics, personal character and moral values in the pursuit of more – always more.

> "For a critical element of our society, including many of the wealthiest and most powerful among us, there seems to be no limits today on what enough

entails."

John C. Bogle comes from a family with a long history in the United States and in business. His great-grandfather, Philander Bannister Armstrong, was a business leader and a strong critic of corruption in the insurance industry. His grandfather, William Yeats Bogle, founded a forerunner to the American Can Company. His family lost its fortune in the 1929 stock market crash and Bogle grew up having to work. He attended Blair Academy on a scholarship and went on to Princeton University. His senior thesis on the mutual fund industry won him a job at Wellington Fund, a mutual fund management firm funded by a Princeton alumnus.

> "We focus too much on things and not enough on the intangibles that make things worthwhile; too much on success (a word I've never liked) and not enough on character, without which success is meaningless."

Bogle joined Wellington in 1951, and by 1965 learned he was heir apparent to the founder. To get the company out of financial trouble, Bogle merged it with a Boston firm. A bear market ensued in the early 1970s, and Wellington fired Bogle. He founded a new company named after the *HMS Vanguard*, the flagship of great British admiral Horatio Nelson. He decided that the Vanguard funds would not try to beat the market by picking stocks and other investments, because his Princeton research had demonstrated the futility of that approach. Instead, Vanguard would simply seek to replicate the returns of the market average by buying and holding a market-representative portfolio. At first, the SEC refused to allow this new fund concept, but it eventually approved. Vanguard became the biggest fund management firm in the U.S., largely because of its focus on delivering real value for investors instead of capturing wealth for fund managers.

> "On balance, the financial system subtracts value from our society."

Even though he founded a top U.S. mutual fund management company, Bogle does not appear on the lists of the nation's wealthiest people. Accumulating personal wealth was never his goal. He always invested a portion of his salary in Vanguard funds, and continues to invest 15% of his annual retainer from the firm. The Vanguard management company earns a zero net income. Its purpose is to deliver income to its shareholders, not its managers. Bogle funds scholarships at Blair Academy and Princeton, and supports several charities.

The Financial System Destroys Value

The American financial system is a value destroyer, not a value creator. Returns to investors depend on the underlying performance of businesses – after financial managers and traders take their increasingly larger cut. The real, long-run return to investors is a matter of economic performance, but, in contrast, speculative returns depend on transient emotional conditions. Speculation is a zero-sum game. A speculator can only win when someone else loses. Speculative returns are unreliable and unpredictable. The market benefits from some speculation, but when it gets out of hand, as it has in recent years, the financial system is at risk. Although investment returns depend on a business's performance, the tail seems to be wagging the dog. Financial transactions and considerations dominate management's attention. Companies often try to increase their earnings by acquiring existing companies, rather than by expanding their sound underlying business.

The Danger of Complexity

Complex financial instruments, such as collateralized debt obligations and derivatives, have devastated the financial system. Citigroup sold so-called structured investment vehicles to customers with a guarantee that the customers could sell these instruments back at the sale price. This right to sell the instruments back to the bank was called a "liquidity put." Robert Rubin, the former U.S. Treasury Secretary who chaired Citigroup's executive committee at the time, later said that he had never heard of a liquidity put. Clearly, bankers were not paying adequate attention to the fundamentals of their business.

> "That is the issue on which I want you to focus: the disconnect between cost and value in our financial system."

Mutual funds have returned relatively little to investors, compared to what they've returned to their managers. Watch for these "innovations," which may do investors more harm than good:

- Exchange-traded funds have proliferated as speculative vehicles.
- Fundamental indexing funds tout their use in market timing.
- Absolute return funds are copycat funds that emulate strategies of successful hedge funds, endowments and the like.
- Commodity funds suggest that commodities are investments. They are speculations.
- Managed payout funds do not serve investors as well as simply increasing their income by reducing their fund management expenses.
- International and emerging markets funds, so-called BRIC funds and other international funds, tend to be risky, speculative and, over time, less successful than U.S. equity funds.

The Erosion of Trust

U.S. government statistics are no longer reliable. Questionable numbers undermine trust. In May, 2008, *Harper's* published an essay by Kevin Phillips noting several distortions in government economic data, including:

- The gross domestic product (GDP) figure of $14 trillion includes $1.8 trillion in very questionable imputed income items, such as the value people receive from free checking at their banks or from living rent-free in their own homes.
- The Bureau of Labor Statistics omits many nonworking people from its unemployment numbers, including the disabled, part-timers who can't find full-time work, and those who have despaired of ever finding a job and so no longer look.
- The Consumer Price Index (CPI) uses questionable adjustments, such as "hedonics" (the branch of psychology that deals with pleasurable and unpleasurable states of consciousness) to understate the real rise in prices.

> "Today, if fund managers can claim to be wizards at anything, it is in extracting money from investors."

However, the government is not the only source of highly questionable data. The financial services industry uses historical returns to project future returns. In truth, historical returns provide no guidance about the future, but through the use of sophisticated mathematical techniques, such as Monte Carlo simulations, financial services marketers give the false impression that these numbers are somehow meaningful and sound.

> "Basing compensation on increasing the intrinsic value of business would be a far better way than flighty stock prices to reward executives for durable long-term performance."

CEOs' projections of corporate performance are perhaps understandably biased, yet Wall Street analysts use these projections to overestimate growth prospects. The use of "operating earnings," which leave out evaluations or write-offs, skew growth estimates, as do references to "pro forma" earnings, which provide a very rosy picture. Loose accounting standards and dicey auditing have led to a nearly 20-fold increase in the number of corporate restatements of earnings.

> "Here are two pieces of advice: One, look before you leap. Two, don't leap until the fund has produced an actual 10-year track record."

Traditionally, capitalism was a matter of owners putting money on the line and reaping rewards for success or penalties for failure. The development of the corporation introduced a large dimension of agency risk. That is, corporate managers, who should be agents of the companies' owners, serve their own interests instead. Consider the scandal of CEO compensation. Although corporate earnings have remained fairly constant as a proportion of GDP, CEO compensation has almost doubled, though CEOs are not doing a much better job. Directors selected by CEOs agree to pay the CEO out of the shareholders' pocket. The directors' lack of accountability to shareholders abets the cozy, compliant relationship between directors and CEOs.

> "Success...can be measured not in what we attain for ourselves, but in what we contribute to our society."

Many institutional investors are short-term speculators with little concern for a company's long-term fate. Institutional investment entities, such as pension funds and mutual funds, hold corporate shares in a fiduciary capacity for their investors. However, these entities often also sell services, such as pension fund management, to those same corporations. This conflict of interest makes them disinclined to protest board actions or CEO pay. CEO compensation should be contingent on long-term shareholder returns and performance. Basing it on short-term stock price increases or on the earnings of other CEOs is a mistake.

> "The great game of life is not about money; it is about doing your best to join the battle to build anew ourselves, our communities, our nation, and our world."

The scandalous compensation given to Citigroup CEO Charles Prince ($138 million), Merrill Lynch CEO Stanley O'Neal ($320 million) and Bear Stearns CEO James E. Cayne ($232 million) rewarded their failures. These executives cashed in on illusory profits. When the truth came out, they paid no financial penalty whatsoever. The American financial system encourages such self-dealing and self-serving practices. Investors don't get what they pay for and the system's costs are far out of proportion to the value it provides.

A Plea for Professionalism

Professions, as distinct from businesses, emphasize client interest and social welfare. The true professional is a value creator, not a value grabber. However, business principles have eclipsed professional principles in many fields. Professionalism is waning, even in medicine, where doctors have become mere "providers."

A Plea for Stewardship

The mutual fund industry should be a steward of assets on behalf of investors. Instead, the industry has become a sales machine. Funds' returns are far higher than their investors' earnings. Why the difference? The cost of fund management – managers win at the expense of shareholders. They win when shareholders win and, all too often, they also win when shareholders lose. Fund management companies offer the market highly questionable investment propositions simply because they can sell them, and they seem indifferent to the fact that buyers are likely to lose. Instead, the mutual fund industry should adhere to these five ideals:

1. **Play fair with shareholders** – Stop gouging people and roll back costs.
2. **Provide lifetime management not short-term speculation** – Invest for retirement.
3. **Manage for the long-term** – The short-term speculative focus in the financial services industry deprives the U.S. economic system of the benefits of genuine investment.
4. **Serve shareholders, not share traders** – Offer solid diversification and trust accounts instead of so-called fun products.
5. **Put the shareholder in charge** – Educate shareholders, and put independent shareholder representatives in effective control of fund management companies.

A Plea for Leadership

Organizations need good managers and leaders. Bogle taught his Vanguard managers these 10 principles of leadership:

1. Care, because caring gives an organization its soul.
2. Act like you and your employees are a ship's crew, where members pull together for the good of each other and of the ship.
3. Live up to high standards. Vanguard focused on humility.
4. Repeat and remember the organization's values.
5. Demonstrate by your behavior that you live by these values.
6. Give people the freedom they need to flourish. "Don't over manage."
7. Honor individual excellence.
8. Be loyal to each other.
9. Lead the business for the long term.
10. Persevere no matter what.

What Matters in Life

The most important things in life are unquantifiable. Virtue and character are what really matter. America needs a return to its 18th century values, to the example of Benjamin Franklin and his peers. Character is more important than success, or wealth, or winning.

About the Author

John C. Bogle is the founder of the Vanguard Mutual Fund Group and president of Bogle Financial Markets Research Center. This is his seventh book.