THE VULNERABLE ECONOMIC MAINSTREAM

The Depth and Breadth of the Financial Scandals

Interview with John Bogle

It is much more than a few bad apples, says this Wall Street legend. Scandal is rife in the United States, and John Bogle says there is much for government to fix to make sure it does not happen again.

Q When did these financial scandals in corporate America and Wall Street really begin?

A. The financial scandals were revealed in corporate America in 2001, in investment banking and brokerage in 2002, and in mutual funds in 2003. But they had actually been going on for a long time, at least since the mid-1990s and probably the early 1990s.

Q. Did the Street generally have a good sense that these scandals were occurring before they came to light?

JOHN BOGLE *is founder of the Vanguard Group and the author of* The Battle for the Soul of Capitalism *(New Haven: Yale University Press, 2005).*

Challenge, vol. 49, no. 2, March/April 2006, pp. 23–32.
© 2006 M.E. Sharpe, Inc. All rights reserved.
ISSN 0577–5132 / 2006 $9.50 + 0.00.

A. Take mutual funds, one of the easier ones to tackle. We know how much money is going in and out of any particular mutual fund each year because it reports new flows and redemptions in its annual report. So, did anyone know about the behavior? Let me give you the example I used in the book—Alger Funds. This was a $2 billion fund group that had $9.2 billion in redemptions in 2002. In the old days, redemptions equaled about 8 percent of assets. At Alger, redemptions were 400 percent of assets. Is it possible that market timing was going on here? $9.2 billion in new sales, followed by a similar amount of redemptions. It should have been obvious to a fool.

Q. Could you explain this further?

A. Redemptions, or liquidations, refer to money taken out of the fund. Every day people add money to or withdraw money from a mutual fund, like taking money out of the bank. What typically happened was that a hedge fund or another large client would approach a mutual fund manager and offer to invest a substantial amount of money in, say, one of the firm's bond funds. In return, the manager would allow the hedge fund to "time" the market, actively trading one of their international funds, or allow it to make trades after the markets had closed. The profits that the hedge funds made by these illicit maneuvers—and they could be quite large—diluted, dollar-for-dollar, the profits earned by the fund's long-term investors.

Q. Hedge funds and others kinds of investors?

A. Individual investors did this kind of trading also. Three professors from New York University wrote an article in the *Financial Analysts Journal* about how much they could have made trading mutual funds on the basis of international time-zone trading, as they call it. They did not do the after-hours trading that some hedge funds did (they probably failed to imagine that anyone would be so bold as to actually do that), but it is the same idea. In time-zone trading, investors were taking advantage of the fact that the stock market in Japan, for instance, closed long before the U.S. market did, which is when mutual funds are priced. But both markets are highly correlated, so if the U.S. market

jumps by two percentage points on a given day, all these investors had to do was purchase an international fund at the end of the day and get the benefit of the international market's rallying the next day. Then they sell it, lock in their profit, and do it all over again. It is not very complicated, and it was widely known. The Securities and Exchange Commission estimates that nearly 400 hedge funds used this strategy, all to the detriment of regular fund investors.

Q So, when you see all these liquidations that are equal, in effect, to the sales, you know that something fishy is going on.

A. Yes. And there were a lot of variations. There were even some wonderful e-mails back and forth between people who work for the manager of the mutual fund saying, I know this is terrible for our fund's shareholders but it is good for the us, and doing this will lead to—and this is an actual quote—"increased profitability to the firm."

Q. So the business scandals, in general, are exemplified by the mutual funds, but did the scandals in other areas catch you or other knowledgeable people by surprise?

A. No, not at all.

Q In your book, you emphasize that this was not the work of just a few bad apples.

A. I list sixty-three giant corporations that had to restate their earnings after the scandals uncovered dubious practices. They may have reported to the public that they earned, say, $3 a share, but when the auditors or the regulators went over their books, they found accounting errors, and the $3 earnings were actually $2.40, meaning that they overstated earnings to shareholders. To give you some perspective, the market value of just the sixty-three companies I listed as restating earnings was $3 trillion. That is about a quarter of the U.S. stock market. In all, there have been 1,500 earnings restatements over the past four years. One also wonders how many managers reduced their bonuses from prior years based on those restated earnings. There

is no record of any manager who had been paid a bonus on overstated earnings giving any money back. As for the mutual funds, perhaps 80 percent of the firms large enough to engage in market-timing practices did so. In fact, the seven largest publicly held management (or conglomerate-owned) companies were involved in the timing scandals. In the brokerage scandals, eight of the ten largest investment banking firms were implicated.

Q In the fund business, how did the pressure work?

A. The hedge fund says, in effect, "we want to give you some extra money to manage if you let us trade this way," and the mutual fund manager, who is interested in maximizing its own earnings, too often readily agreed, and the fund shareholders were the losers. But there are other disturbing practices in the mutual fund industry. One is the setting of the management fee. On average, it is much too high. I think mutual fund managers get paid about $80 billion a year. By my standards, they overcharge by about $25 billion a year, year after year. That is a far bigger scandal in dollar terms, and there is no one to protect the interests of the fund shareholders.

Even worse, we in the mutual fund business operate it as a marketing business rather than a management business. So we keep bringing out speculative funds, and when they get hot streaks, we advertise them and bring in a lot of money. In the recent bubble, we took something like $600 billion of new capital into these most aggressive new-economy funds in telecommunications, technology, and similar areas, only to see those values collapse by about $400 billion. Pretty obviously, the industry was going haywire.

Q Right. What about the prestigious stock brokerage companies themselves?

A. Eliot Spitzer, the New York attorney general, offered the brokers a settlement, and ten of the giant investment banking firms finally decided to accept it. That is really the whole industry, not just a few

bad apples. It was epitomized by the Henry Blodgetts and the Jack Grubmans of the world, research analysts who were basically manufacturing favorable research reports on corporations just because it is a great marketing device for their investment banking departments. If you want to get banking business from, say, WorldCom, your analysts, who are supposed to do objective research, plug the stock. You have to do it. That is the way the business works. Can you imagine trying to earn a company's investment banking business when one of your analysts has a "sell" rating on the company's stock? There would be a lot of very unpleasant losses of clients if the research department said this stock, well, "stinks," as they did in their private e-mails to one another. That is why investment banking and research have to be separated.

Q. Legally separated?

A. Legally separated.

Q So, you do not think that reversing the Glass-Steagall laws [Depression-era legislation that separated investment banking and commercial banking] was a good idea.

A. A section in my book asks, "Bring Back Glass-Steagall?" I would answer the question: Yes—the sooner the better. As you know, under Glass-Steagall, the commercial banks were not allowed to enter the mutual fund business. But now the mutual fund business is largely controlled by banks and other financial institutions. Forty-one of the fifty largest firms in this industry are publicly held. These huge firms got into the mutual fund business to earn a return on *their* capital. Earning a return on it as a mutual fund shareholder was a lower priority.

So, the conglomeration of the mutual fund industry is almost certain to break down. Indeed, it is breaking down a bit already. American Express is spinning off its mutual fund arm. Citibank is getting out of the management side of the business and sticking to the distribution side. Morgan Stanley is said to be talking about doing the same thing, and Merrill Lynch is reportedly removing its name from

the funds it offers, perhaps a precursor to a spin-off. The conflicts of interest in selling your own mutual funds in a corporation that is in business to increase its earnings per share is just plain counterproductive to fund shareholders. From all the data we have, the one thing we know with crystal clarity about the mutual fund industry is that the more the managers take, the less the investors make. It is a system that must be fixed.

Q As you know, what you are saying is anathema to a lot of people on Wall Street, to business in general, and, indeed, to many economists who believe that somehow—even in the mutual fund business—profit maximization will generally lead to the maximization of wealth for most, as well as productivity. How do you respond when people get angry at you?

A. To repeat what David Swensen wrote in a very critical book called *Unconventional Success,* "just look at the record." Funds have done worse than the overall market, with a 10 percent average annual gain over the past twenty years in a stock market (S&P 500) that gained 13 percent. Also, investors often buy at the wrong times. So fund *shareholders* do much worse than the funds themselves, paying a terrible penalty both in the timing of their fund investments and in the selection of funds. They buy the hottest funds, often near their highest prices. The record is clear that over the past twenty years equity fund investors have captured only about 25 percent of the cumulative return of the market. Terrible!

When you think about it, the market for financial services, broadly speaking, has not worked well for some time. Take life insurance, which was the nation's most important financial instrument when I wrote my senior thesis at Princeton in 1951. How do you get big in the life insurance business? You get big by paying the salesmen the most. Economists call it "information asymmetry." The seller knows everything, and the buyer knows nothing. So the seller is out there trying to make a living. You can say that is his right, and I would say that is his right. But when his living comes largely from selling high-priced products to ill-informed clients, it is not right.

Q Because you deal with these people, you know them. Tell me, what drives them to do this? What drives them to relax their ethical standard?

A. The industry leaders whom I know are smart, well-educated, ethical people. But they all seem to lack introspection about what has gone wrong in the fund business. "If everybody is doing it, then it's all right for me to do it." But in my mind that is not nearly a tough enough ethical standard.

Q. How do your peers view you?

A. I am looked at, I think, as a knave or a maverick. "Apostate" might be the best word. It is not popular to say that fund managers as a group all promise to beat the market but that they cannot because of their high costs—fees, sales charges, portfolio turnover expenses—and their giant size.

Q You have been observing these industries since the early 1950s. Is this the worst it has ever been?

A. Yes. When I came into this business, it was essentially a profession with elements of a business. I am not naive, and I freely concede that every profession has elements of a business. It is a question of degree. Something important was lost when we became a business with elements of a profession. In the early days, we were small, privately held firms run by investment professionals. Today we are largely giant publicly held firms and conglomerates, run by people who do not have anything to do with the investment process. The conglomerators are corporate entrepreneurs trying to build their own monuments.

Q The late Walter Wriston, who built Citicorp, would say that we need financial conglomerates to diversify and spread risk. If we spread risk, it will ultimately work to the benefit of the customer.

A. I think that is a very dubious statement. Just look in the record book and consider the evidence. The funds run by Citicorp, Morgan

Stanley, JP Morgan Chase, Bank of America, Sun Life of Canada, and Marsh and McLennan have distinctly poorer returns than those that are managed by privately held firms. Of the largest fifty fund groups, all of the ten worst-performing fund groups are managed by publicly held firms, and all eight of the best-performing fund groups are run by privately held managers. Do you see a pattern there?

Q So what should we be doing about this? How can we begin to rein in the businesses that are placing their own interests over those of their fund investors?

A. In my book, I offer two general solutions. One would involve the appointment of a blue-ribbon federal commission to do two things. First, to study the agency problems that are now endemic in our financial services system and recommend solutions. Second, to clean up the mess in our retirement system, with its grotesquely underfunded pension plans and poorly funded 401(k)s and individual retirement accounts (IRAs). Investors are making bad choices. We need a simple, coordinated system for retirement savings, and then we need a low-cost system for investors.

We also need to do one additional thing: re-enact a statute that establishes a federal standard for fiduciary duty, one that requires pension trustees and mutual fund directors to put the interests of their beneficiaries first. That is what we will call "the government solution."

There is also another solution. Let us call it "the private solution," which is to wake up investors to their own economic interest. If investors were aware of what was going on in the fund industry and of the value of diversification and the value of asset allocation and the crucial importance of low cost, they would gravitate toward the better mutual funds and other investment vehicles. There is no law that requires them to be victimized by firms in this industry that are putting their own financial interests ahead of those of their fund shareholders.

Consider the numbers: our financial system now costs about $400 billion a year. Since gross returns in the financial markets (the stock

and bond market returns listed in the newspaper) are reduced every year by that huge cost before investors receive whatever remains, costs must come down. Investor education may well gradually reduce those costs. But that is slow progress, so I think we need a federal solution as well. Investor education cannot get us where we need to be fast enough.

Q That is reform for mutual funds and retirement plans, but what about reform for the great corporations themselves?

A. It is a big problem. Why? Because in a lot of respects, corporations own themselves. There is a lot of circularity of ownership. Our corporations, first, in effect, control their pension fund investments. So Citibank, for example, owns 1 percent of Citibank, but it also owns 1 percent of General Motors and probably 1 percent of everything else. And then General Motors, through its pension plan, owns 1 percent of General Motors and 1 percent of Citibank, and so on. There are all kinds of conflicts of interest. Nearly all of these shareholder votes are with management. Now, is that because managers think that management is right on these issues?

Q. You believe that better rules to support shareholder democracy can make a big difference.

A. Yes. It is a very big part. It is easy to say that the members of the Board of Directors act as the final gatekeeper. Surely the auditors and the attorneys should be involved, but the directors have the ultimate authority. But why should they have the ultimate authority? It is the owners who should really have the ultimate authority. So where are the shareholders? Well, there are two problems. The first is that 68 percent of the shareholders are not direct shareholders; they are agents for shareholders—pension fund trustees and mutual fund managers. So they do not pay nearly enough attention to their duty to represent the shareholders. They are thinking about their own business interests rather than the interests of the shareholders. We now have an agency society rather than an ownership society. The ownership society is gone, and it is not coming back.

In a sense, the other problem is even worse. Even if these agents acted like owners, they hold the stock for an average of only one year. When I came into this business, they held the stock for an average of six years. So, you are a trader; you are a speculator, but you are not an owner. Ironically, in this scenario it makes perfect sense for you not to give a damn about corporate governance. You are speculating on the price of the stock, which is pretty much unrelated to governance or the intrinsic value of the stock. When an own-a-stock industry becomes a rent-a-stock industry, the idea of stewardship goes out the window. What we need, and need urgently, are reforms that give shareholders more power over the corporations whose shares they own, so that the real owners are in charge.

Q But even if we were an ownership society, why would owners be more honest than agents or money managers?

A. Owners should be looking after their own interests, but managers are trying to serve two masters. As Matthew said in the Bible, "no man can serve two masters." And the master in the fund industry and in corporate America is not the manager who is supposed to represent the fund shareholders and pension beneficiaries but the master who pays you—the managers of the funds and the corporations. In corporate America, we have outrageous compensation schemes that tempt one to manipulate earnings. Over the past two decades, corporate executives have promised us 11 percent annual earnings growth and delivered 6 percent, half of what they promised in an economy that has grown at 6.5 percent on average. They are even lagging the economy, yet on average their compensation has risen from 20 times that of the average worker to 475 times that of the average worker.

Recently, I looked at something that Peter Drucker, the late management guru, wrote in 1970 in a book called *Management.* He said that management compensation should be about ten times that of the average worker. What would he think today?

To order reprints, call 1-800-352-2210; outside the United States, call 717-632-3535.