Financial Management: Profession or Business?

Keynote Address by
John C. Bogle
Founder, Vanguard Group
CFA Society of Philadelphia – 70th Anniversary Gala
The National Constitution Center, Philadelphia, PA
September 25, 2013

It’s wonderful to speak before this capacity crowd as you celebrate the 70th anniversary of the CFA Society of Philadelphia’s founding in 1943. You are a Philadelphia financial institution that has been around longer than I have, but only a bit longer. In July of 1951, I started my business career at Wellington Management Company, so we go back a long time together—62 years! The topic I’ve selected for my keynote remarks is “Financial Management—Profession or Business?”, a shared interest among all of us here this evening.

Let me begin by totally endorsing the stated mission and values of the CFA Institute: “to lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society.” This statement about professionalism and responsible behavior by CFA members reminded me of an article I read in Daedalus, the Journal of the American Academy of Arts & Sciences, in 2005.1 Its theme was that, over the previous 40 years, the nation’s professions had gradually “been subjected to a whole new set of pressures, from the growing reach of new technologies to the growing importance of making money.”

The authors listed a number of attributes that all professions share, including these three that are especially relevant to the work we all do: 1) a commitment to the interests of clients in particular, and the welfare of society in general; 2) the developed capacity to render judgments

---

with integrity under conditions of ethical uncertainty; and 3) the development of a professional community responsible for the oversight and monitoring of quality both in practice and for professional educators. The article concluded with these wonderful words: "the primary function of any profession [is] to serve responsibly, selflessly, and wisely … and to establish [an] inherently ethical relationship between the professional and the general society."

This evening, I will build on that theme in four specific areas: 1) my own life and career; 2) the history of the CFA Society of Philadelphia; 3) the development of the international CFA Institute; and finally, 4) my perspective on the failure of capitalism’s gatekeepers, specifically including the failures of too many security analysts, money managers, and corporate stockholders to do their part in maintaining the standards of our profession.

I. My Life and Career in Finance

Let me begin with a few words about my credentials to stand before you. While I may well be known as the founder of what is now a very large manager of other people’s money, and as the creator of the first index mutual fund, I’m not typically thought of as a security analyst nor portfolio manager. But I’ve actually been engaged in those fields throughout my career at Wellington, where I began in 1951. Then, we ran only a single mutual fund, Wellington Fund.

Early in my career, I worked with our bond and stock analysts, helping them with basic data on corporate balance sheets, income statements, and other financial statistics, later serving on our Investment Committee. While I should have known better, I’m afraid I was largely responsible (though well-intentioned!) for our firm’s ill-fated change in focus from long-term investment to short-term speculation, beginning in 1966. My decision to merge Wellington Management Company with a much smaller Boston firm of hot managers of that “go-go” era was simply stupid. It had unfortunate consequences for our funds, including Wellington Fund, our crown jewel. To my everlasting regret, I came to believe that these new managers could outperform the market forever. (Yes, I did!) But it quickly became apparent that they could not meet that lofty standard. All too soon, I came to realize the obvious: there is no such a thing as a permanently superior long-term mutual fund manager: Good, rarely; superior, never.

Within eight years, the merger fell apart. But it was the new partners who fired me as the CEO of Wellington Management in January 1974. Within months, I came back as CEO of the
Wellington Funds, and started Vanguard as a mutual company that would be responsible for the funds’ operations and the ongoing appraisal of their managers (including, of course, the firm that had just fired me). I quickly took on the task of restoring Wellington Fund to its traditional balanced focus.

With the board’s consent, I directed Wellington Management to return Wellington Fund to its original investment values—less focus on growth and more focus on income. Indeed, I presented to Wellington a sample stock portfolio designed to produce a 70 percent increase in the fund’s annual *income* income dividend over the subsequent five years, and set that goal as our objective. The fund’s portfolio manager was not amused, but he complied, the dividend soared, the objective was met, and the strategy worked. Restoring Wellington Fund to its founding investment values saved it, and today it is once again the industry’s largest balanced fund ($75 billion).

Some of you may think of me as the “anti-analyst” because I came to focus on the simple math of investing, the tautology that led to Vanguard’s formation of the world’s first index mutual fund in 1975. Simply put, gross return in the stock market, less the costs of active investing, equals the net returns earned by investors as a group. So the winning strategy was obvious: own the entire stock market (without any security analysts!) and cut costs to the bare bones. That’s it! It really *is* that simple!

I was also mindful that the new firm needed not only solid arithmetic, but also high principles. As it happens, in my Princeton University senior thesis, way back in 1951, I had cited these principles: that mutual funds should be managed “in the most efficient, honest, and economical way possible;” that “funds can make no claim to superiority over the market [indexes];” that funds must concentrate “on a reduction of sales charges and management fees;” and that the funds’ “prime responsibility must always be to their shareholders.” When the new firm was founded in 1974, those tenets became Vanguard’s mantra. As they say, “the rest is history.”
II. The Philadelphia Society

My long involvement with your CFA Society of Philadelphia, originally known as the Philadelphia Society of Security Analysts, has been only tangential in my career. But when I first entered the mutual fund industry, I observed that most of our area’s analysts were employed by bank trust departments and insurance companies. At the top of the list was Girard Trust, led by a remarkably distinguished group of investment professionals, ranging from Francis Nicholson to F.W. Elliott Farr to Frank Block—all top-grade, integrity-laden pros.

Sadly, Girard is now long gone, taken over by Mellon Bank in 1983, which itself was absorbed by Citizens Bank in 2001. In fact, few of those old trust companies exist today—no Girard, no First Pennsylvania, no Provident Bank, no Fidelity Trust Company. They were succeeded by analysts at the few large-sized investment managers that remain here, including Wellington Management, Vanguard and just a few others. With $2.2 trillion of assets under management, and over 100 members of the CFA Society of Philadelphia, Vanguard has become the elephant in the room.

Originally, our local money managers all worked in the city, but then started to move west of the city limits. Wellington moved to Valley Forge in 1974 when Vanguard began, and other firms followed. But we all remained part of the Greater Philadelphia region. This area continues to provide the perfect environment for growth—excellent colleges and universities, world-class health care facilities, and remarkable cultural institutions (including our National Constitution Center). Keeping our roots firmly planted in the Philadelphia region was—and still is—the perfect choice for Vanguard and many other financial organizations and this region remains a major factor in the financial firmament.

Back in the 1950s and 60s, investment management was focused on long-term time horizons and minimizing the impact of high taxes—capital gains taxes were an especially important consideration for the trust companies. The professional culture was based largely on prudence and fiduciary duty. As I think about these days, I remember many of my friends from Wellington Management who served as presidents of the CFA Society of Philadelphia: Robert Ogilvie (1951-52); Edwin Crysler, CFA (1959-60); John Neff, CFA (1971-72); Paul Mecray
(1991-92); and the first Vanguard crew member to serve as your president, Walter Lenhard, CFA (2007-08).

Perhaps because of my creation and leadership of Vanguard, along with my voluminous writings on finance and investing, in 1991 your Society invited me to introduce Walter L. Morgan, founder of Wellington Fund and my great mentor, when he was honored with your Lifetime Award of Distinction. Two years later, I was honored to receive that same prize from your Society.

To my humble delight, your award was presented to me by the late Elliott Farr (mentioned earlier), the paradigm of the trust officer whom we would all, well, trust. Some of his words were prophetic. Referring to the “Boston situation” I described earlier, Elliott said it was “probably a serious business mistake at the time, but it ultimately engendered something much more dynamic than if the original combination had been reasonably successful. Restructuring is now a buzzword, but Vanguard’s creation and evolution represents the quintessence of dynamic restructuring before the word had any currency at all.” You were right, Elliott, and I’m honored to remind today’s analysts of the high standards you set for our profession.

III. The CFA Institute

Now, I’d like to turn to the development of the international CFA Institute itself. To do that, I’ll take you back in time in the annals of financial analysis. During the 1920s and 1930s, there was little consideration of security analysts as a separate part of the investment business. The people performing analytical functions were known as “statisticians.” One observer said “analysts were statisticians with the professional rating and financial rewards of third-class library clerks.” Slowly, however, our statisticians began to develop some of the techniques of modern security appraisal. In those days it was not a glamorous job. Analysts were considered "back-office men who were expected to keep the salesmen posted on bond ratings, earnings, and interest coverage.” They were considered overhead, quickly terminated when commissions declined.

2 Many of the comments contained in this section of my remarks are based on Nancy Regan’s superb 2012 book called The Gold Standard—A Fifty-Year History of the CFA Charter. I hope all you will give it the close attention it deserves.
In the 1940s, the landscape started to change. The SEC mandated disclosure of corporate financial information and required companies to make information available publicly. Many brokerage firms expanded their research departments. In 1934, Benjamin Graham and David Dodd published *Security Analysis*, based on the work they were doing at Columbia University. To this very day, I keep a mint condition copy of *Security Analysis* on my desk. Its essential message remains relevant. More than any other single person, it was Benjamin Graham who developed the idea of the professional financial analyst as a major factor in the emerging field of money management, leading the charge from his position as president of the New York Society of Security Analysts.

**The Two Great Debates**

The first great debate concerning financial analysis took place in 1945. Benjamin Graham favored professional ratings, and Wall Street trader and NYSSA President Lucian Hooper took the other side. It was a standoff. But by 1950, the push for a certification program for the National Federation of Financial Analysts Societies began in earnest, and would play a major role in the professionalization of the asset management industry over the years. As its Professional Ethics and Standards Committee confronted this issue, the Federation did what any responsible organization does when faced with a challenge—they appointed a new committee to study the issue of professional standards, and recommend a future course of action.

A. Moyer (“Abe”) Kulp, Senior Vice President of Wellington Management Company, was named to lead the committee. I was proud to be a colleague of Mr. Kulp. He was a highly respected professional and a strong believer in a certification process for security analysts. He recognized that other professions set specific standards for their members, and firmly advocated that a challenging and meaningful examination process should be instituted for security analysts. Eventually, a favorable consensus developed. The first CFA exam took place in 1963. 268 candidates were awarded CFA charters. Abe Kulp and Elliott Farr were among those who became the first CFAs in our field. (The 94 percent pass rate on that first test has been exceeded only once, as the exams got longer—and tougher.)

The second great debate came in 1990. It centered on whether the profession would be better served by having a single professional organization. The two major organizations, the
ICFA (Institute of Chartered Financial Analysts) and the FAF (Financial Analysts Federation, including the regional societies) had overlapping constituencies. But in form, function, and culture, they were very different. The ICFA, focused solely on the CFA program, was robust, growing, and fiscally sound. The FAF had grown significantly since its origins and had a broader mandate, but was struggling financially.

**Mergers are Never Easy!**

The debate over the merger continued for two years. It was at times heated and not always pleasant. In 1992, the final meeting regarding the merger was described as “contentious,” “frank,” “eloquent,” “fierce,” and “tense.” It also involved some old-fashioned, back-room “horse trading” for votes. At last, the initial deadlock was broken; the final vote 6 to 4 in favor of the merger—in my terms, a “landslide.” That’s a word I kept in mind during the various contentious board decisions that we faced in the creation of Vanguard, often a messier process than you could possibly imagine. But any victory, however narrow, was (for me) a landslide.

The process of creating Vanguard and the CFA merger have many similarities. Both remind me of the song “Bui Doi” from the musical Miss Saigon, which describes the children of American soldiers born in Vietnam as "conceived in Hell and born in strife.” After our respective births, however, both the CFA merger and Vanguard’s creation proved to be remarkably durable. (Elliot Farr was right.) The new analysts’ organization was called the Association for Investment Management and Research (AIMR), a somewhat awkward formulation that was later superseded by the organization’s current name, the CFA Institute. (My friend Ted Aronson, the last person to hold the title of President of AIMR in 2003-04, led the charge to get that wise change approved.)

And that's where we are today. The CFA Institute has proved to be a huge step forward in the professionalization of the industry, thanks to its leadership, beginning with is first president Eugene Vaughan, who each year at Christmastime sent his many friends in the industry good wishes and inspirational quotations from poets and philosophers. Gene was later succeeded by Darwin Bayston, who often expressed his high opinion of my essays in the Financial Analysts Journal (now eight in number, including one soon to be published). In the early 1990s, he was asked by a Dow-Jones-Irwin editor, “who could pen a ‘home run’ book about mutual funds?”
Darwin identified me. Given his persistence, I finally caved in and in 1993 wrote *Bogle on Mutual Funds*. Darwin quickly wrote back “Jack, you hit a home run!” A fine memory indeed. That bestseller was, I imagine, partly responsible for my being honored in 1998 with the CFA Institute’s highest honor: the Award for Professional Excellence. I was introduced at the awards dinner by both Warren Buffett and John Neff.

**IV. Has Our Profession Lived Up To Its Potential?**

My fourth and final subject is our too-frequent failure to meet the high standards of professionalism that we have put in place. We have the right mission, but we have often fallen short in practice, especially in recent decades. Yes, security analysis has been professionalized, but too many participants in our financial system, including financial analysts, have lost sight of some of their basic professional responsibilities. For one thing, far too many analysts have focused on ephemeral stock prices, giving short shrift to intrinsic corporate values. As a result, during the recent era we’ve seen the folly of short-term speculation crowding out the wisdom of long-term investment.

Well ahead of his time, Benjamin Graham saw it coming. In his 1958(!) presidential address at the National Federation of Financial Analyst Societies, he warned his colleagues with these prescient words:

> In the past, the speculative elements of a common stock resided almost exclusively in the company itself; they were due to uncertainties, or fluctuating elements, or downright weaknesses in the industry, or the corporation’s individual setup. . . . But in recent years a new and major element of speculation has been introduced into the common-stock arena from outside the companies. It comes from the attitude and viewpoint of the stock-buying public and their advisers—chiefly us security analysts. This attitude may be described in a phrase: primary emphasis upon future expectations.

> Mathematics is ordinarily considered as producing precise and dependable results; but in the stock market the more elaborate and abstruse the mathematics, the more uncertain and speculative are the conclusions we draw therefrom. . . . Whenever calculus is
brought in, or higher algebra, you could take it as a warning signal that the operator was trying to substitute theory for experience, and usually also to give to speculation the deceptive guise of investment.

**Benjamin Graham, Right Again**

Graham was right (of course!). It is hardly news to this audience that the emphasis on future expectations noted by Graham continues to be pervasive today. The desire to quantify and model all aspects of our financial lives has carried the day. Even our learned financial journals are peppered with papers offering abstract models that purport to beat the market. But for me, I’m reminded of Albert Einstein’s famous observation:

“Not everything that counts can be counted, and not everything that can be counted counts.”

As investment professionals, money managers, and security analysts, we ought to focus primarily on *investing* based on long-term intrinsic corporate value rather than *speculating* on short-term, even momentary prices in the stock market. It is not the ephemeral perception of the price of a stock that varies from moment to moment that counts; it is the enduring reality of intrinsic value—however difficult to discern that counts. Make no mistake, the worth of a corporation is still neither more nor less than the discounted value of its future cash flows. So financial professionals need a new primary focus—on *security* analysis rather than *market* analysis. But we also need more candor and involvement in understanding the process of valuing stocks. *It is our corporations that create value, and the stock market is merely a derivative of that value.*

In my 2012 book *The Clash of the Cultures: Investment vs. Speculation*, I noted the failure of 10 sets of gatekeepers, each of which failed in its role to ensure that our corporate system works in the interests of investors. Three of those failed gatekeepers are especially relevant to all of us here this evening: corporate managers, money managers, and security analysts. Of course, the ultimate gatekeepers are the shareholders themselves. But in today’s agency society—with 70 percent of all U.S. corporate shares held by financial institutions—the manager/agents of those shareholders have been largely unwilling to stand up and be counted.
Where Were the Analysts?

One might think that the professional security analysts of our giant financial institutions would have been the principal line of defense against the accounting scandals that we have witnessed over the past decade. But our sell-side analysts (i.e., advice-givers representing investment banking firms) are confronted with obvious conflicts of interest, and they largely failed to report the financial shenanigans that were taking place on the books of the companies whose stocks they were covering. Conflicts of interest were rife, especially when the firms employing them—for huge compensation—were engaged in public offerings of the very companies for whose stock coverage they held responsibility.

Mike Mayo, a long-time banking and finance analyst, and author of *Exile on Wall Street*, candidly describes his observations of the analyst community. Here are some of his Mayo’s blunt and perceptive words:

*Analysts are supposed to be a check on the financial system—people who can wade through a company’s financials and tell investors what’s really going on. There are about 5,000 so-called sell-side analysts, watchdogs over U.S. companies. Unfortunately, some are little more than cheerleaders—afraid of rocking the boat at their firms, afraid of alienating the companies they cover and drawing the wrath of their superiors.*

While the buy-side analysts employed by our financial institutions have fewer profound conflicts, there is little evidence that they delve deeply into the failure or our corporate system. But finally, of course, it is the stock owners who must be the ultimate gatekeepers. The very futures of the corporations whose shares they own are at stake. The greatest mystery of all is how and why our powerful institutional investors with such dominant ownership of all corporate shares—holding absolute voting control over virtually all of our nation’s public corporations—have remained largely silent. The record is clear that these institutions stand on the sidelines on proxy issues related to the governance of our corporations.

What are these agent/owners thinking? Have they forgotten their fiduciary responsibilities? How could they vote for so many corporate managers and directors engaged year after year in the financial engineering of a firm’s earnings? Do they even care that the corporations that they control are too often operated with the interests of their managers taking
precedence over the interests of their shareholders? Do they exercise their rights and responsibilities of ownership to demand corporate governance in the interest of the shareholders whom these institutional managers represent?

**Executive Compensation and Political Contributions**

The failure of our gatekeepers has lead to massive failures of corporate governance in cases such as Enron and WorldCom in 2001-02. (Don’t forget them!) But other important failures remain. Today, two of the most significant corporate governance transgressions relate to executive compensation and corporate political contributions. In the case of executive compensation, our stockowner/gatekeepers seem particularly reluctant to take on this issue. By failing to do so, they must assume at least partial responsibility for the ridiculously high salaries, bonuses, deferred compensation, stock options, and other compensation paid to corporate CEOs, numbers that have been driven to amounts beyond reason—aided and abetted by the executive compensation consultants. Yet how many of the highly paid CEOs of these large institutional investors have dared to cast the first stone? Yet one more agency conflict.

Another major emerging issue on corporate affairs relates to political contributions. The Supreme Court’s decision in the 2011 *Citizens United* case opened the door to virtually unlimited political contributions by our corporations. This issue could well be of great importance to our country’s already unbalanced political system. So far, money talks! Disclosure of political contributions seems to be developing, but we need more than voluntary corporate disclosure. The institutional investor community ought to act even more forcefully. Before we even consider appropriate standards for disclosure, we must insist that shareholders have the right to decide whether they should allow corporations to make any political contributions whatsoever. It is the shareholders, after all, who own the company, and it is their right to decide company policy on political spending.

**Wrapping Up**

Let me close by summing up my message. I’ve given you a lot of interlinked history—much of which I’ve observed first hand—the story of my investment career; my frequent interfaces with your Philadelphia Society; and my support for the CFA Institute. I’ve named some of the financial pioneers and leaders who have helped to build our profession, and who
have set demanding standards for those of us who follow in their footsteps, lest history forget that even a handful of dedicated idealists can move the world forward. I’ve also offered some provocative ideas on improving corporate governance, a mission in which true professionals must lead the way in bringing about needed reform.

Today, the CFA Institute has an enlightened mission—providing “the highest standards of ethics, education, and professional excellence for the ultimate benefit of society.” We’re reaching for those stars, but our reach inevitably will exceed our grasp. (That’s the way the world works.) But tonight, on the 70th Anniversary of the CFA Society of Philadelphia, I ask you for something more than ethics, and education, and excellence. As essential as those goals are, I ask each of you to develop a keener awareness of the “big picture” of our financial system; a profound introspection into how we can make it better, a sense of our long and proud history, and a deep involvement in giving our profession the high character it requires if it is to serve investors effectively and honestly in the years ahead. Yes, these are idealistic goals. But what would our profession be without a healthy dose of idealism? Indeed, a bright future for finance—in Philadelphia and across our nation—depends upon it.