Review of "The Battle for the Soul of Capitalism: How the Financial System Undermined Social Ideals, Damaged Trust in the Markets, and Robbed Investors of Trillions – and What to Do About It"

The financial system is supposed to allocate capital and risk efficiently. Some people need more capital than they currently have, to buy a house or to invest in a business. Others have more capital than they currently need, to save for retirement or college tuition. The financial system is the middleman. An efficient middleman, just as in any business, is supposed to make transactions seamless and charge rock bottom and transparent fees, connecting borrowers and lenders, firms and investors, and spreading risk widely and fairly.

Unfortunately, our financial system doesn't always deliver on this promise. In *The Battle for the Soul of Capitalism*, the book's author and former CEO of Vanguard John Bogle points to a market environment where "financial shenanigans," "profound conflicts of interest that permeated the field of financial intermediation," and "the triumph of salesmanship over stewardship" rob investors of trillions of dollars. You may think you know where the story is going. This must be the story of greedy mortgage brokers, originators, underwriters, the wizards of structured finance, ratings agencies, right on up to the leaders of Merrill Lynch, Bear Stearns, Citigroup, and the rest of the Wall Street Banks. Bogle is going to tell us why the subprime mortgage market collapsed, and why credit spreads have widened for traditional residential and commercial mortgages, for the leveraged loans that fueled the private equity boom, and for corporate bonds of all types.

Not quite. The book was published in 2005, not 2008. This is the story of the Internet and telecom boom and bust. But, it might as well include an epilogue on the global credit crisis. Yes, the salacious details are different. Yet the more powerful

message is in documenting a shift in the financial landscape: From what Bogle calls *owners capitalism* – running business largely for the benefit of the providers of capital – to a new set of norms where managers run business largely for their own benefit. And, the credit crisis, brought on by a move from traditional bank lending to an alphabet soup of structured investment vehicles and collateralized debt and loan obligations, fits his thesis nicely. In the good old days, loan officers doled out loans as if they were risking their own capital. In the new financial system, the link between lender and borrower has become increasingly tenuous. How else could mortgage loans emerge with no income documentation and dramatic interest rate resets built in? How else could leveraged loans appear with so few covenants?

Apparently, too few readers took to heart the message of Bogle's book, and too many missed the declining standards emerging in a new part of the financial system. The attention here is on mutual funds and the so-called "new economy," not structured finance and mortgage lending. Bogle puts the intermediaries on trial: selfish managers, investors with short horizons who stand idly by, analysts who produce more hype than analysis, and mutual funds that create and sell new financial products that cater to the demands of naïve retail investors. Where are the real owners in all of this? Bogle calls the principals – literally into battle with the "trumpet I sound" – to stand up and discipline this unruly group of agents, and thereby win the battle for the soul of capitalism. Almost no one is spared. Even Bogle's beloved Vanguard, while holding the line on fees, must bear culpability in failing to use its ample capital to rein in executive pay. An index fund manager, while not corrupt, has an explicit mandate to be passive and maintain a broadly

diversified portfolio, with little hope of actively monitoring of hundreds, if not thousands, of corporate management teams.

Bogle succeeds in presenting vivid accounts of market failures and calls attention to the flaws in corporate governance and financial intermediation that are in critical need of public discussion and debate. In the end, the book is more effective in highlighting the problems we face than in proposing realistic solutions. Bogle can hardly be criticized for a lack of effort, proposing about 60 remedies, but the central challenge that remains is how or even whether to protect investors from themselves.

Bogle presents a well organized case against corporate, investment, and mutual fund America, written in three thematically related parts. The first focuses on the misdeeds and excessive compensation of corporate managers. The second describes the misdeeds and excessive compensation in financial intermediation, including investment banking, equity research, and investment management firms. And, the third marks the misdeeds and excessive compensation of one type of financial intermediation that Bogle knows intimately: mutual funds. Thematically, each part heralds an increasing distance between individual investors, the ultimate providers of capital, and corporate managers, the eventual users of capital. The consequence of distance is expropriation by a chain of middlemen and an individual investor who keeps less and less of the return to capital.

The villains in the first section are corporate managers, who pay themselves well, manage earnings – to further pad their pay with inflated stock sales – and occasionally resort to outright fraud in the case of Enron and Worldcom. As in Bertrand and Mullainathan, Bebchuk and Fried, and Yermack, Bogle points to pay without performance, saying that “the power of the CEO seems virtually unfettered.” While little

new ground is covered here, the discussion is neatly summarized in a small number of pages.

The villains in the second section are analysts and investment managers. Analysts are given a familiar dressing down for generating more hype than reliable information. As Womack and LaPorta among others have shown, analysts move markets with recommendations, but annual earnings estimates and long-term growth forecasts are systematically too optimistic. Analysts often act as if they are paid by the firms they are covering – and it turns out they were, as Bogle rightly points out, taking a slice of investment banking revenue. This has reemerged with S&P and Moody's, who are explicitly paid by issuers of debt instruments. A key question, though, is who should pay for coverage, if not the issuer. Getting institutional investors to pay has proven to be a challenging business model. And, which is worse, a world with biased research or one with no widely disseminated research at all?

Unlike the analysts, investment managers are the dog that didn't bark. Bogle speculates that conflicts of interest are behind their silence – if Fidelity runs GM's 401-K plan, so how could they publicly discipline its CEO. A less sinister explanation is a free rider problem. The benefits of monitoring GM are shared by all investors, while the costs might only be borne by Fidelity. Perhaps the sensible answer is to move toward more concentrated ownership, and so Bogle might applaud this aspect of the private equity boom and the rise of activist managers. But, this has its costs. Private equity investors act in their own interest, too, buying assets on the cheap at the expense of other investors and extracting fees that can make corporate pay seem quaint.

The villains in the third section are mutual funds, who overcharge investors for average performance. The market timing scandals, where mutual funds allowed some investors to trade at stale prices at the expense of the rest, are but the most salient example of what Bogle terms a move from stewardship to salesmanship and profit maximization through the exploitation of small investors. Here Vanguard scores well, delivering a transparent product at a rock bottom price. Most of the rest of the industry has seen a striking 50% increase in fees, from an asset weighted expense ratio of 60 basis points in 1950 to 92 basis points in 2004, despite enormous economies of scale.

If we go back to the textbook definition of the financial system, this is all a failure of the middleman. How do we get the intermediaries – corporate managers, investors, and mutual funds – to be more efficient and keep less for themselves?

The first option is conscience. There is perhaps no one better on the planet to make this case than John Bogle. After all, he created a hugely successful, low cost firm that lives up to the mutual part of managing its mutual funds, one that "honors the highest principles of fiduciary duty and the interests of investors." Surely, he has done well. But, unlike most of the rest of the industry, he has not kept the rents for himself. We would all benefit from more Bogles in the financial services industry. But, appealing to Wall Street to "make a decent profit decently" – as the Edwin Gay, the first dean of Harvard Business School, once said – seems unlikely to work.

The second option is reputation. Consumers put companies with bad products out of business, and voters toss out corrupt politicians. The main prescription in the book is to facilitate this process in the financial system, to tilt the playing field toward longer term active investors and away from managers and intermediaries, by improving

independent governance, encouraging proxy fights, and increasing disclosure. The key ingredient for democracy and markets to work is intelligent participants, who aggressively pursue their own economic interests.

But, how smart are the participants? Not very, it seems. Individual investors overpay for active investment management, paying high fees for below average performance. Individual investors chase returns, moving aggressively into technology at just the wrong time. Why aren't investors smarter? The process of learning in financial decisions is not very efficient. A defective refrigerator is immediately apparent when milk spoils. Bad investment advice is hard to recognize and even harder to prove. Businesses fail for legitimate reasons all the time, so poor investment performance is not, on its own, a reason to fire your investment advisor. The upshot of an uninformed herd is speculative bubbles. These can get started quite easily, whether in tulips, technology stocks, or Florida real estate. And this, more than anything else, is what allows corporate managers and entrepreneurs to sell overvalued stock, investment bankers to pocket underwriting fees, and mutual funds to profit in spite of mediocre performance.

Bogle recognizes this. He agrees that "as a group [individual investors] still seem oblivious to the benefits of having funds run in their own interest." And, he does his part for financial literacy with "seven pillars of wisdom." These are right on target, and also right out of the Vanguard playbook: none of us can beat the market, so be humble and do not try. But, capitalism needs more wisdom still – investors with real sophistication, access to information, and their own money to invest. Oddly, the success of Vanguard played its own small role in the technology bubble. Index funds, and speculators front running index funds, bought Yahoo in huge volumes when it was added to the S&P 500,

pushing its price up 60% in a matter of days. And, as long as capital is distributed across millions of people, developing real wisdom and skill at investing is not going to be a worthwhile proposition for the typical individual investor.

Improved disclosure might help. But, it is not clear how much "disclosure modifies behavior," as Bogle claims. Disclosing corporate pay has not stopped its rise. Perversely, disclosure might reinforce a process where boards set pay based on the industry median, ratcheting up compensation. And, disclosure of conflicts of interest often has unintended consequences. Behavioral economists Cain, Moore, Loewenstein say that disclosure can embolden conflicted advisors and falsely reassure consumers.

Next, consider proxy fights and improved governance. Intelligent investors must have the tools to stand up to management. But, in what way? Bogle recognizes "our institutional investors are far from perfect in the way that they manage themselves." He focuses instead on what seems like low hanging fruit of governance improvement, separating the role of chairman and CEO, for example, preventing auditors from providing other consulting services, removing board members from the crucial governance committees if they are not truly independent, eliminating staggered boards and poison pills, and so on. These are good ideas that should be adopted in greater numbers. But it is worth pointing out that the academic evidence is light. It has proven remarkably hard to document value creation.

The third option and the last resort is more heavy handed regulation. Sarbanes-Oxley is a move in this direction. And, there are now calls for similar oversight of mortgage banking. No doubt, regulation can help restore trust, and prevent a spiral from excessive optimism to pessimism. The concern is an intervention that has unintended

consequences and delivers measurable costs for immeasurable benefits. This sort of tension appears in Alan Greenspan's recent memoir and in recent explanations of the credit crisis: Should the Fed, the Treasury, and the SEC be more activist regulators, attempting to stop bubbles before they start? There is no easy, quantifiable answer here.

Bogle is generally not willing to go too far in this direction, though he is happy to quote Monks call for "government [to] affirm that creating an effective shareholder presence in all companies is in the national interest" and Warren Buffett for suggesting (tongue in cheek) a "100 percent tax on short-term capital gains, paid by all investors" to curb speculative excess, extend investor horizons, and thereby engage them in the governance of firms. Bogle also proposes a "national commission composed of our wisest, most respected, and best-informed citizens." But, there is no clarity on the specific mandate and powers, and the risks of political intervention and regulatory capture are not discussed. FASB is just this sort of commission, with the goal of producing accounting standards. FASB was slow, albeit in response to pressure from lobbyists and Congress, to require the expensing of options and to rein in the creative accountants at Enron and Worldcom.

Bogle should be applauded for detailing market failures and looking hard to find solutions. But Winston Churchill's line (quoted on p. 61) that "democracy is the worst form of government except all the others that have been tried" is instructive. The same can be said about capital markets. Widespread participation, for example, has costs and benefits. In an earlier era and in other parts of the world, there are fewer, but more activist owners – a good thing – but also a higher cost and lower access to capital for firms, and the spoils of capitalism delivered to a smaller number of owners. Similarly, the

world of lending before securitization involved less distance between lenders and borrowers and higher standards – a good thing – but also banks that were more constrained by their own balance sheets, making loans costlier and more difficult to obtain. The financial system is supposed to allocate capital actively and intelligently and to share risks and rewards broadly. Sometimes, these two goals are at odds. We can and should hope for a financial system that can deliver the best of both, but the global credit crisis is the latest reminder that this is a battle that will be hard to win.

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