The CLASH of the CULTURES

INVESTMENT VS. SPECULATION

JOHN C. BOGLE

The Clash of the Cultures

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To all of those human beings who have helped to shape my character, my values, and my career—my ancestors; my parents—especially my beloved mother—and my brothers; my loving wife Eve and my children and grandchildren; my teachers; my pastors; my classmates in school and college; my bosses and mentors in finance; my guardian angels in medical care; my truth-seekers in the academy; my colleagues and believers at Vanguard; the Vanguard shareholder/owners, who have given me their trust; and my friends from all walks of life.

"No man is an island, entire of itself."

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Foreword

By Arthur Levitt

There is a motto that Jack Bogle uses from time to time (and he uses it in this book): "Even one person can make a difference." And while he uses it to elevate and praise the contributions of a single, relatively powerless person, that motto applies uniquely to Jack Bogle.

Here is a man whose contribution to American finance was not just a well-executed idea—the index fund—but a well-executed philosophy of investing and life. It is a philosophy that has the dual merit of simplicity and proven success.

Having known Bogle for several decades, I have come to appreciate his unique ability to speak to investors in a language that is accessible, lyrical, and yet also bracing. He points out with clarity the inherent conflicts present throughout our financial markets, most notably between the investor's interests and those of many financial professionals.

This is a critical complaint in his discussion of mutual funds. Many investors are under the mistaken impression that mutual funds are a secure and relatively matter-of-fact way to gain the benefit of diversification at low cost. In reality, as Bogle richly details here and elsewhere, mutual funds have a large incentive to benefit from the economics of their businesses, rather than look after their investors' long-term wealth. Thus we see some mutual funds not only charge outsized fees, but also practice portfolio management strategies that leave investors behind market index averages and overexposed to certain equities, sectors, and strategies.

That Bogle has stood against such practices for decades is no surprise to anyone who knows this man. He is a person of great courage, wisdom, and forthrightness. He has never lost the zeal or ability to go against conventional wisdom, and is strengthened by those moments when he stands alone. Jack Bogle is brilliant and persuasive, and his ability to get to the heart of often complex issues of finance and markets is one of his greatest gifts.

He loves investing and loves what investing can do. He marvels at the miracles possible when corporations and their owners and managers jointly pursue long-term shareholder return to the exclusion of all else. He is the free market's greatest friend: a faithful ally. And yet when he sees the corridors of finance and investment turned into a den of speculation and greed, he does not hold his tongue. He knows the stakes are great.

The Clash of Cultures is definitional, and could well serve as a philosophic and academic grounding for investors of every age. Throughout, his language is disarmingly straightforward. Because of his respect for the investor, he sidesteps glibness and oversimplification. He defines the difference between risk-taking and recklessness. He correlates costs to returns. He explains why indexing works, and why active management usually doesn't. He traces the roots of today's markets to the rise of corporate agents and then investment managers—both of whom form an impenetrable and expensive "double-agency" layer separating the real investor-owners from active control over their assets.

While some Wall Street professionals may not agree with every word here—or even some of the words—I hope they read it. One of the greatest threats to the strength of financial markets is groupthink. When regulators, market professionals, investors, and policymakers all share the same assumptions, emerge from the same trading floors, nod to the same broad arguments, and expect the same outcomes, the result is as predictable as it is disastrous. Jack Bogle's iconoclasm is a useful tonic to groupthink. We need more like him.

There are many villains in this book: auditors, regulators, politicians, rating agencies, the Securities and Exchange Commission (which I led), the Federal Reserve, sell-side analysts, and the media. And their collective (as well as individual) sins have one primary victim: investors.

And he is right. Investors must remain the focus of any efforts to improve our financial markets. No matter the regulatory reform, the market practice or the new financial product, if the investor's interests don't trump all others, we ought to question what purpose we are serving. One thinks of rules requiring ever more volumes of disclosures. The result is not better-informed investors, but the opposite. The disclosures, written in legalese and printed in agate type, might as well not exist to most investors. What we need is transparency: ways for investors to see information, understand it, and weigh the potential risks and opportunities of their investment options.

Transparency is at the core of effective market regulation, precisely because it empowers investors. Sadly, most efforts to improve transparency are fought by a well-funded mutual fund lobby and its related allies. One recent SEC proposal, to have money market funds mark to market their holdings every day, is one such example. This basic idea would not only give investors greater insight into their holdings. It would also impose a healthy appreciation for liquidity among mutual fund managers. Yet the mutual fund industry predictably has fought the idea.

The industry would be wise to consider what Jack Bogle and others observe: If investors do not feel that mutual funds are protecting their interests, they will not participate in markets—and the markets themselves will suffer. If mutual funds wish to remain the gold standard for investor protections and stability, they ought to take seriously—and adopt—reforms and practices that add to those protections and stability. We are but three years removed from one of the biggest financial crises of history, brought about by an excess of risk-taking, leverage, and opaque financial products, combined with lax regulation. Surely mutual fund managers can see the value in avoiding a repeat of that catastrophic period. And if not, they can expect to reap what follows. Surely Jack Bogle and others inside the industry have done enough to raise the alarm.

Never is this clearer than in his insistence that fees and costs are draining all the promised value out of the pockets of investors. Investors must know that they inevitably earn the gross return of the stock market, but only before the deduction of the costs of financial intermediation are taken into account. If beating the market is a zero sum game before costs, it is a loser's game after costs are deducted. Which is why costs must be made clear to investors, and, one hopes, minimized. Pointing this out routinely surely cannot earn Jack Bogle many friends among Wall Street, which depends on the mystery surrounding financial innovations—as they are called euphemistically. But Bogle doesn't care much about "stirring the pot." His friends have long learned to appreciate that his truth-telling is the key to his personality.

Jack Bogle has spent a lifetime in study and active participation in financial markets. The amount of self-dealing and self-enrichment he has seen qualifies him to bear witness against not just a few individuals, but entire firms and certainly an entire industry. They should be glad that Jack Bogle is merely an expert witness, and not the judge and jury as well.

Acknowledgments

This book is my attempt to provide a living history—replete with personal anecdotes—of some of the most significant elements of an era in which the character of our financial system changed. And not for the better. We must understand what went wrong in finance in order to take the necessary steps toward building a better system. Only if we serve "individual and institutional investors in the most economical, efficient, and honest way possible"—a phrase from my 1951 Princeton senior thesis—can we again honor the standard of fiduciary duty that once largely prevailed among the trustees of Other People's Money.

Readers of my earlier books—nine in number—will hardly be unfamiliar with many of the themes that I sound in this tenth book. Indeed, I've deliberately reiterated not only some of the themes from earlier books, but even a few of the earlier passages. For readers of my earlier books, I reasoned that if I said it well then, why say it less well now? For new readers, there's no way to tell this story without doing so. Nonetheless, the vast majority of the material in *The Clash of the Cultures* breaks totally new ground—with additional data, up-to-date information about the continued deterioration in financial industry standards, and an author who has become rather more assertive and less fearful of candor.

I take this opportunity to thank the three members of my staff for their skill, their support, their patience, and their unflappability. Emily Snyder, who has now been at my side for 23 years, did her usual yeoman's job. So did Sara Hoffman, well-seasoned to the hurly-burly of our small office despite only seven years at her post. Michael Nolan, a 10-year Vanguard veteran who joined us only a year ago, has done a fantastic job in providing and checking the data, helping to edit my manuscript, and organizing my information sources. His remarkable skills in the use of information technology have been essential to the entire process of producing this book.

Special thanks, too, to Pamela van Giessen of John Wiley & Sons, my publisher, and to Leah Spiro, who served as editor. Leah's job was not an easy one, but she came through with flying colors, helping to make this book better than it otherwise would have been. My former assistants, Kevin Laughlin and Andrew Clarke, both now back in the Vanguard mainstream, also made valuable suggestions. I continue to be in debt to these two long-time friends.

Speaking bluntly is not always the way to please others, so I give special thanks to John Woerth, Vanguard principal in charge of public relations and my colleague for 25 years. John made a series of recommendations from the standpoint of the firm's policies, and I did my best to respond. Nonetheless, some of my opinions may not represent the opinions of Vanguard's present management. Sometimes reasonable people can disagree!

Contrarily, I fear that some readers will look at the over-all thrust of the book as too biased toward the firm that I founded, and that the book is some sort of Vanguard "commercial." To that criticism, I can only respond that I have been as objective as is humanly possible. The data are the data! More broadly, I hardly need apologize for the investment strategies and human values on which I founded Vanguard, for these strategies and values have met the test of time.

Please enjoy the book and let me know what you think. Read my blog at www.johncbogle.com.

John C. Bogle
Valley Forge, Pennsylvania
June, 2012

About This Book

In 1951, when I began my career, long-term investing was the mantra of the investment community. In 1974, when I founded Vanguard, that tenet still remained intact. But over the past several decades, the very nature of our nation's financial sector has changed—and not for the better. A culture of short-term speculation has run rampant, superseding the culture of long-term investment that was dominant earlier in the post–World War II era. These two very different cultures have existed in the world of capital markets and capital formation all through history. But today's model of capitalism has gotten out of balance, to the detriment of the investing public—indeed, to the ultimate detriment of our society.

As strategies focused on short-term speculation have crowded out strategies focused on long-term investment, the change has benefited financial sector insiders at the direct, arguably dollar-for-dollar, expense of their clients. In truth, that tension between investment and speculation is at the very heart of the great challenges we now face in Investment America and in Corporate America, challenges that could ultimately undermine the functioning of our financial markets and threaten the ability of our individual investor/citizens to build their wealth.

So, I'm deeply concerned with today's ascendance of a culture of speculation over a culture of investment in our financial markets. I'm concerned as a member of the financial community, I'm concerned as a member of the community of investors, and I'm concerned as a citizen of this nation. Inspired by the British author C. P. Snow, I describe this change as "The Clash of the Cultures." A half-century ago, C. P. Snow described a parallel contrast. In his book *The Two Cultures*, Snow focused on the ascendance of the culture of science—of precise measurement and quantification—over the culture of the humanities—of steady enlightenment and reason. Similarly, *The Clash of the Cultures* contrasts the culture of long-term investing—the rock of the intellectual, the philosopher, and the historian—with the culture of short-term speculation—the tool of the mathematician, the technician, and the alchemist.

Resisting this new dominance of speculation over investment might seem to fly in the face of our ever more scientific and technological world. After all, innovation, information, instant communications, and competition have brought great benefits to our society. But I see our financial system as somehow separate and distinct from the other business and commercial systems that permeate our world.

"Value-Creating" and "Rent-Seeking"

There is a difference—a difference in kind—between what economists describe as "value-creating" activities that add value to society and "rent-seeking" activities that subtract value from society on balance. One provides new and improved products and services, delivered through ever more efficient channels and at prices that are more competitive, and the other simply shifts economic claims from one set of participants to another. Think of the law: one side wins, the other loses, but the lawyers and the legal system profit, and diminish the amount of money that changes hands between the actual litigants. Government operates this way, too: Before being dispensed as expenditures, tax revenues are reduced by the intermediation costs of the bureaucracy. The financial system is the classic example, in which investors trade with each other and one is a winner and one a loser. But the costs of trading create an obvious economic drag that results, for investors as a group, in a net loss from trading activity.

Yes, today's financial system also creates value—innovation, real-time information, vast liquidity, and a certain amount of capital formation. But technology cannot eliminate the frictional costs of the system. While unit-trading costs have plummeted, trading volumes have soared, and total costs of the financial system continue to rise. Too many innovations have served Wall Street at the expense of its client/investors. Pressed to identify useful financial innovations created during the past quarter-century, Paul A. Volcker, former Federal Reserve Chairman and recent chairman of President Obama's Economic Recovery Board, could single out only one: "The ATM." (Mr. Volcker recently told me that if the period of evaluation had been the past 40 years, he would have also included the creation of the index mutual fund in 1975 as an important and positive innovation that has served investors well.)

A 60-Year Perspective

My primary purpose in writing this book is to sound the alarm about the shocking change in the culture of finance that I have witnessed firsthand during my now 60-year career in the financial field—the gradual but relentless rise of the modern culture of speculation, characterized by frenzied activity in our financial markets, complex and exotic financial instruments, and trading in derivatives of various securities (rather than in the securities themselves). These characteristics dominate today's burgeoning financial system, peppered as it is with self-interest and greed. Somewhere down the road—if not already—the consequences to our investors, our society, and our nation are almost certain to be extremely harmful.

This newly dominant culture of short-term speculation has made huge inroads into the traditional culture of long-term investment that I found in finance when I began my career in 1951. Actually, my work started early in 1950, when I began a study of the mutual fund industry for my Princeton senior thesis. I began by reading the four-volume, 1,059-page SEC report to the U.S. House of Representatives, chronicling the events that led to the passage of the Investment Company Act of 1940. That Act was the legislative response to the remarkably similar (as it turned out) transgressions in the investment company field during the 1920s, and the collapse that followed in the 1930s. While that history did not *repeat* itself during the recent crisis (to paraphrase Mark Twain's likely apocryphal formulation), it *rhymed*.

In midsummer 2011, as I began to write the manuscript for this book, I quickly came to realize that I had been more than a mere eyewitness to these six-plus decades of financial history. In fact, I was one of its most active participants. As it turns out, I was privileged to be in a position to actually influence many of the important issues that have been my focus during my long career. So I write out of a sense of history, lest the stories that are told by others who are mere observers come to dominate the discourse. *The Clash of the Cultures* is not another book on the financial crisis that began in 2007, but rather an examination of the tumultuous changes that have taken place over the long sweep of history in the business and financial sectors of our nation and of the world, within the context of free-market capitalism and capital formation.

The Big Picture

In Chapter 1, I begin with the ideas that culminated in the "Clash of the Cultures," an essay I wrote for the *Journal of Portfolio Management* in the spring of 2011, itself a product of my lecture at Wall Street's Museum of American Finance just a few months earlier. The essay focused on how a culture of short-term speculation came to dominate a culture of long-term investment. One example: In recent years, annual trading in stocks—necessarily creating, by reason of the transaction costs involved, negative value for traders—averaged some $33 trillion. But capital formation—that is, directing fresh investment capital to its highest and best uses, such as new businesses, new technology, medical breakthroughs, and modern plant and equipment for existing business—averaged some $250 billion. Put another way, speculation represented about 99.2 percent of the activities of our equity market system, with capital formation accounting for 0.8 percent.

Chapter 2 examines what I consider the proximate dual cause of the various failures of capitalism I've witnessed—the "Double-Agency

Society," in which our giant corporate manager/agents interact with our giant investment manager/agents in a symbiotic "Happy Conspiracy" to focus on the momentary fluctuations of evanescent stock prices rather than the building of long-term intrinsic corporate value. In our double-agency system, both our corporate manager/agents and our investment manager/agents have been unable to resist the temptation to look first to their own interests.

Alas, as I report in this chapter, our "Gatekeepers"—the courts, the Congress, the regulatory agencies, the public accountants, the rating agencies, the security analysts, the money managers, the corporate directors, even the shareholders—largely failed in honoring their responsibilities to call out what was going on right before their eyes. The wild and risky "innovative" securities of the era, financial shenanigans by some of our largest corporations, and Congressional sanctioning of excessive mortgage debt by ill-qualified homebuyers are but a few of the myriad examples.

In Chapter 3, "The Silence of the Funds," I describe the failure of our institutional money managers—mutual fund managers and their affiliated pension fund managers, which together manage the lion's share of our nation's pension fund assets—to step up to the plate and exercise the rights and responsibilities of corporate governance in the interests of the fund shareholders and plan beneficiaries whom they are duty-bound to serve. I use as examples two current issues to illustrate the shortfall of these managers of "Other People's Money"—the rampant abuses in executive compensation, and corporate political contributions. It's high time that these managers stand up and be counted and put the interests of their clients first.

Mutual Funds

Going, in a sense, from the general to the particular, I describe in Chapter 4 the change in the culture of the mutual fund industry, the focus of my career for the past 60 years. During that long span, fund assets increased by nearly 5,000-fold—from $2.5 billion to $12 trillion. A *profession* once focused largely on investing became a *business* largely focused on marketing. Of course such growth makes change inevitable. But the counterproductive form of change that developed was fostered by a sea change in the industry's culture, from private ownership to largely public ownership and the near-pervasive control of fund managers by financial conglomerates. For fund shareholders, it was a tragic change.

The creation of Vanguard and its truly *mutual* (fund-shareholder-owned) structure has been the so-far-single counterexample to this pattern. I explain why this structure has worked so well, and why it must ultimately become the dominant structure in the industry. To bring this once-fine industry back to its traditional roots, I propose in this chapter a change designed to fix what is broken: the establishment of a federal standard of fiduciary duty that places the interests of fund shareholders first.

Now, we all know what investment fiduciary duty means: *placing the interests of investor/principals who provide the firm's capital ahead of the interests of the manager/agents who invest it.* Since fiduciary duty may be difficult for investors to measure intuitively, Chapter 5 is designed to help mutual fund investors measure their own fund managers, evaluating them on 15 different points of judgment. This chapter will likely prove contentious, for I set down my own evaluations—flawed and subjective though they may be—of what I call the "Stewardship Quotient" for Vanguard and for three other fund managers.

The Index Fund

In 1975, I created the first index mutual fund, now known as Vanguard 500 Index Fund. Then, as now, I considered it the very paradigm of long-term investing, a fully diversified portfolio of U.S. stocks operated at high tax efficiency and rock-bottom costs, and designed to be held, well, "forever." It is now the world's largest equity mutual fund. In Chapter 6, I chronicle the Fund's formation, its investment advantages, its minimal costs, and its remarkable record of performance achievement. It is these factors that underlie the growth of index funds to their dominant position in today's mutual fund industry, holding 28 percent of total assets of equity funds.

But a funny thing happened on this long road toward the dominance of the index fund. Beginning in the early 1990s, a new kind of index mutual fund—one that could be traded "all day long, in real time" was created. In essence, the ETF (exchange-traded fund) makes it easy for investors to engage in short-term speculation—not only in the S&P 500 Index, the standard for the first ETF, but across a mind-boggling array of 1,056(!) different so-called indexes, sometimes hyped with high leverage risk. This focus stands in sharp contrast to the TIF (traditional index fund) that I designed for long-term investors all those years ago. In the second half of Chapter 6, I express my views on the manifestation of this radical and astounding change in the culture of indexing. The ETF is surely the greatest marketing idea in finance so far in the twenty-first century. Whether it proves to be a great—or even a good—idea for investors remains to be seen. (Remarkably, the assets of ETFs now exceed those of TIFs.)

Our Retirement System: Potential Train Wreck

America's retirement system, too, has been bitten by the speculative bug, though in ways ignored by many financial leaders who should have known better. As I explain in Chapter 7, the linchpin of the system is Social Security, and its participants really have little choice but to speculate on whether we have the national will to fix the system or face the consequences. (The simple fixes, which I identify, are hardly vast; they can be done in small increments. The failure of our politicians to act before it's too late is a disgrace.) Similarly, our corporate and local pension funds are speculating that they will earn annual future returns in the 8 percent range, a grand illusion ultimately fraught with severely negative economic consequences.

What's more, given the trend away from defined-benefit (pension) plans to defined-contribution (savings) plans, the choices being made by plan participants also reflect the dangers of speculation on (1) the returns the plans earn over the participant's lifetime; (2) which active managers will win; (3) the performance of the stock of a single company ("employer stock"), and even its survival; and (4) asset allocation. (Many participants are far too conservative; many are far too aggressive. That the average between these two polar extremes is quite sensible is, of course, irrelevant.) I conclude that unless we reform the very structure and implementation of both our public and our private retirement systems, we face a financial train wreck.

Wellington Fund

It is with both embarrassment and pride that I offer a firsthand example of the change in the culture of one of America's oldest, proudest, and now most successful mutual funds. In Chapter 8, I present the history of Wellington Fund. I joined the Fund when I graduated from college in 1951, and have stayed the course with Wellington to this day, first as an employee, then as an officer, then as CEO, finally moving to "honorary" status in 1999. Since its founding in 1928, Wellington Fund had held high its traditional culture of long-term investment ("a complete investment program in one security"), but, under new management in 1966, we gave way to the new culture of speculation reflected in the "Go-Go Years" of the stock market. As I acknowledge, this foolish change was in part my responsibility. But in a blistering memorandum that I wrote to the Fund's portfolio managers as the stock market peaked late in 1972, I railed against it.

The overheated stock market of that era, of course, would soon collapse, and Wellington's assets shriveled by almost 80 percent. I owed it to my career-long friend and mentor Walter L. Morgan, Wellington's founder, to restore the Fund's original culture and its hard-won reputation. In a 1978 memorandum, I articulated how to do exactly that, and, with the support of the fund's board, I forced a return to the culture of long-term investment. I articulated the new strategy, and even provided a sample stock portfolio. The fund's adviser accepted the change, and implemented it well. (Excerpts from both the 1972 and 1978 memos are included in this chapter.)

For readers of *The Clash of the Cultures*, I sought a clear, real-world confirmation that short-term speculation is apt to lead to failure and long-term investment to success. My career had placed me at the very heart of both sides of this issue; the history of Wellington Fund fit that mold perfectly. In 1966, I had made a huge error in succumbing to the foolish stock market passions of the day; I paid a large price (I was fired from my job); and in my new role at Vanguard was given an incredible opportunity to fix what I'd helped to break. The renaissance of Wellington Fund that followed has been one of the greatest joys of my long career.

"The Man in the Arena"

This book began as an historical tract by an interested observer. But it became, in major part, a personal memoir by an active participant in the world of finance. The many anecdotes that I have recounted in these chapters remind me once again of the incredible delight that I've experienced during my long career, the opportunity to reflect on the many challenges I've faced, and—despite my many weaknesses and the mistakes I've made along the way—the strength and determination I've brought to the task of building a better world for investors. Yes, even as I recognize that they were often born of the many defeats that I've suffered, I admit that I'm proud of the many victories I've won.

In this context, I cannot help but be reminded of "The Man in the Arena," the individual that President Theodore Roosevelt described with these classic and inspiring words:

> It is not the critic who counts; not the man who points out how the strong man stumbles, or where the doer of deeds could have done them better. The credit belongs to the man who is actually in the arena, whose face is marred by dust and sweat and blood; who strives valiantly; who errs, who comes short again and again, because there is no effort without error and shortcoming; but who does actually strive to do the deeds; who knows great enthusiasms, the great devotions; who spends himself in a worthy cause; who at the best knows in the end the triumph of high achievement, and who at the worst, if he fails, at least fails while daring greatly, so that his place shall never be with those cold and timid souls who neither know victory nor defeat.

Of course the jury is still out on my legacy. But I confess that I can't worry about how others may appraise it. Yes, I've erred. Yes, I've come up short more times than I care to count. But if, at the end, I'm deemed to have failed, at least I will have failed despite the rush of great enthusiasm; despite the high achievement of having my most important ideas—the *mutual* fund structure, the single-eye focus on rock-bottom costs, the index mutual fund, the abandonment of sales loads, and the creation of a new structure for bond funds—proven beyond doubt; and despite championing the worthy cause of serving our nation's citizen/investors "economically, efficiently, and honestly"—the very words that I cited in my Princeton University thesis more than six decades ago. All too soon, it will be time for history to be the judge.

Some Investment Guidance

Yes, I've lived in an era where the many weaknesses of capitalism have come to the fore, and the challenges of building a better world for investors remain profound. Unless we undertake a serious reform of our financial system, the problems are likely to get even worse. So I conclude with the hope that this perspective on American capitalism, especially today's dominance of short-term speculation over long-term investment in the culture of finance, will help make you a more concerned citizen, a more aware investor, and a successful accumulator of assets for a more secure financial future.

But even despair over today's new culture of finance should not—*cannot*—preclude your participation in the world of investing. First, because *not* investing is the only way to guarantee that at the end of the line you'll have nothing. But second, beyond the crazy world of short-term speculation, there remain commonsense ways to invest for the long term and capture your fair share of the returns that are earned by our public corporations.

So for Chapter 9, the final chapter, I decided that the readers who have had the stick-to-itiveness to read through my ideas and histories and anecdotes deserve a modest reward: some rules (10, in fact) that will help those of you who are long-term investors reach your financial goals. The most important of these rules is the first one: the eternal law of reversion to the mean (RTM) in the financial markets. Most of us think that we can pick tomorrow's top funds by looking back to yesterday's winners. But I chart just eight examples of major mutual funds that once led the way in the mutual fund industry, only to falter, and even to die. (The same RTM principle prevails between the returns generated by the stock market itself and the investment returns earned by our public corporations, which I chart over the past century.) The only advice I have for short-term speculators is this warning: Stop!

Whether you endorse the theme of *The Clash of the Cultures* and seek a better financial system than the one we are stuck with today or whether you don't; whether you are satisfied or dissatisfied with the state of American capitalism today, *invest you must*. One day, we shall get our broken corporate/financial system fixed. For finally, "you can always count on Americans to do the right thing," as Churchill pointed out, "but only after they've tried everything else." So my final chapter offers some guidance intended to help you negotiate your way through the thicket that is today's financial system. My conclusion: "Stay the course."

So, if it meets your test of common sense and wisdom, please accept my advice for living through the coming era of booms and busts, where the debasement of ethical values and greed that enriches the insiders and diminishes the returns of investors will gradually recede. Then become part of the army of investors who will stand up and be counted, deal with the powerful challenges that await our society, and serve our great nation in the years ahead. "Press on, regardless."

Chapter 1

The Clash of the Cultures

> When enterprise becomes the bubble on a whirlpool of speculation . . . [and] when the stock market takes on the attitude of a casino, the job [of capitalism] is likely to be ill-done.
>
> —*John Maynard Keynes*

Throughout my long career, I've observed firsthand the crowding-out of the traditional and prudent culture of long-term investing by a new and aggressive culture of short-term speculation. But the personal experiences that I've outlined in the introduction to this book require deeper discussion—a broader view, an historical perspective, persuasive data—not only of the problems created by this change, but also of recommendations for fixing the nation's financial system. Those are the subjects that I intend to pursue in this chapter.

Let's begin by observing the consequences of the change in the culture of our financial system. When applied to the physical world, scientific techniques have been successfully used to determine cause and effect, helping us to predict and control our environment. This success has encouraged the idea that scientific techniques can be productively applied to all human endeavors, including investing. *But investing is not a science*. It is a human activity that involves both emotional as well as rational behavior.

Financial markets are far too complex to isolate any single variable with ease, as if conducting a scientific experiment. The record is utterly bereft of evidence that definitive predictions of short-term fluctuations in stock prices can be made with consistent accuracy. The prices of common stocks are evanescent and illusory. That's because equity shares are themselves merely *derivatives*—think about that!—of the returns created by our publicly held corporations and the vast and productive investments in physical capital and human capital that they represent.

Intelligent investors try to separate their emotions of hope, fear, and greed from their trust in reason, and then expect that wisdom will prevail over the long term. Hope, fear, and greed go along with the volatile market of short-term expectations, while trust in reason goes with the real market of long-term intrinsic value. In this sense, long-term investors must be philosophers rather than technicians. This difference suggests one of the great paradoxes of the financial sector of the U.S. economy today. Even as it becomes increasingly clear that a strategy of staying the course is inevitably far more productive than market timing, or than hopping from one stock—or a particular mutual fund—to another, the modern information and communications technology provided by our financial institutions make it increasingly easy for their clients and shareholders to engage in frequent and rapid movement of their investment assets.

The Rise of Speculation

The extent of this step-up in speculation—a word I've chosen as a proxy for rapid trading of financial instruments of all types—can be easily measured. Let's begin with stocks and their annual turnover rate, which is represented by the dollar value of trading volume as a percentage of market capitalization. When I entered this business in 1951, right out of college, annual turnover of U.S. stocks was about 15 percent. Over the next 15 years, turnover averaged about 35 percent. By the late 1990s, it had gradually increased to the 100 percent range, and hit 150 percent in 2005. In 2008, stock turnover soared to the remarkable level of 280 percent, declining modestly to 250 percent in 2011.