The Battle For The Soul Of Capitalism

By John C. Bogle. 2005. New Haven, CT, and London: Yale University Press. Pp. 260, $25, hardcover.

John Bogle is the ultimate critic of the U.S. business scene. The long-time CEO of the Vanguard Group, third-largest U.S. institutional money manager with holdings in excess of $400 billion, has all the credentials, contacts, and honors anybody would desire while enjoying retirement in his 70s. Yet, here he is telling us that capitalism has lost its way during the past generation and setting out to offer corrective steps that will not endear him to his colleagues.

His criticism comes under three main headings. First, control of capital has changed from owners to managers, whose interest is their own aggrandizement rather than the enhancement of owners' equity. Total pay of the average CEO has jumped from 42 times the average worker's pay in 1980 to 280 times in 2004. The invention of earnings "guidance and management" has led to accounting manipulations and outright fraud as regulators, and above all boards of directors, have failed in their supervisory and control duties.

Second, the investment process has been altered and distorted by institutionalization of equity ownership. In just 15 years, 1990 to 2004, the institutional holdings of equities have risen from 53 to 66 percent while direct individual holdings have declined correspondingly. The top 100 managers alone now hold 52 percent of the outstanding equities. (These facts are of course compatible with the rise of individual share ownership, which now stands at about 50 percent of the population in the periodic asset surveys of the Federal Reserve. Individuals are credited with indirect holdings through mutual funds and defined-contribution pension plans.)

The problems in the investment process described in Chapters 4-6 basically relate to the passivity of institutions toward the management of the enterprises they own in a fiduciary capacity.

> With very few exceptions, the only sound we've heard from our investment institutions in response to ... ethical and financial aberrations is the sound of silence (pp. 76).

The silence in turn is caused by the prevalence of conflicts of interest among institutional stockholders. Thus, investment banks often exaggerate the attractiveness of additional public offerings of companies whose securities they hold in their asset management departments. Objective evaluation of stocks and bonds held on behalf of pension and mutual fund clients is suppressed.

The third major section deals with John Bogle's home territory, mutual funds. During 1985-2004, the annual return on the S&P 500 averaged 13.2 percent, but only 10.4 percent for mutual funds as a group. The 2.8 percentage point difference is accounted for by fund charges. There is an almost perfect negative correlation between costs and net yields. Furthermore, the almost universal catering to changing fads in the timing and selection of new funds creates double jeopardy for investors, as "new economy " stocks are far more risky than established equities. The average return to actual mutual fund investors is even less than what can be explained by costs.

The fault lies with the emphasis on managers' earnings rather than shareholder return in mutual fund administration. Fees rise as assets grow so that enlargement of the funds through salesmanship becomes more important than the return flowing through to the owners. The hiring of outside managers to run funds reinforces the misplaced emphasis on administrators' and salesmen's income. In all of this, the stark contrast between the average mutual fund and Vanguard's low-cost offerings helps illustrate what's wrong. The possibility, since a court decision in the late 1950s, to buy and sell the stock of fund management companies—and the subsequent boom in such stocks—shows where money is made.

Throughout this recital, John Bogle cites the numerous illustrations of capitalism gone astray that have become apparent in recent years. If you haven't heard enough yet of Ken Lay and Jeffrey Skilling of Enron, Bernard Ebbers of World Com, Bill Esrey of Sprint, Dennis Kozlowski of Tyco, and more of their ilk, Bogle will treat you to a succinct summary of their sins. The flaws in the investment process are highlighted by the tales of Henry Blodget of Merrill Lynch, Jack Grubman of Salomon Smith Barney, and Frank Quattrone of Credit Suisse First Boston. As to mutual funds, their "governance structure…is a study of institutionalized conflict of interest" (pp.194, approvingly quoted by Bogle from a statement by Senator Peter Fitzgerald of Illinois).

To his great credit, Bogle does not shy away from corrective suggestions.

Their essence is simply a return to basics. Regarding corporations, the Report in 2002 of the Conference Board's Commission on Public Trust and Private Enterprise is endorsed–-emphasize long-term performance in executive compensation; the directors' nominating/governance committee should be independent of management; audit standards should be tightened. (Bogle adds recommendations on options and on strengthening board supervision of management.) The main recommendation on the investment side is the mobilization of institutional shareholders in demands on management–divide board chairman and CEO duties, vote against dilutive stock options plans, endorse SEC proposals to ease the exercise of shareholder rights in director elections. As to mutual funds, a return to the principles of the Investment Company Act of 1940 will do. The fiduciary standards of the Act should have ruled out, from the beginning, the abuses of late trading, soft-dollar handouts, and excessive management fees.

This brief summary cannot do justice to John Bogle's mastery of financial intricacies, his detailed prescriptions, and, above all, his realistic idealism, so unusual for a "member of the establishment." To be sure, he is too ready to generalize from specific misdeeds, and his prescriptions cannot cure avarice and disregard of ethical and legal limits. Yet he speaks loudly and clearly to our fears regarding the deterioration of the cultural and social climate in our financial markets. This book is must reading.

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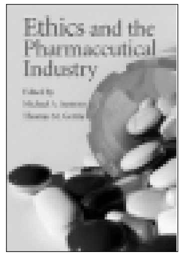
Ethics and the Pharmaceutical Industry

By Michael A. Santoro and Thomas M. Gorrie, eds. 2005. New York, NY: Cambridge University Press. Pp. 492, hardcover $40.



We live in a time when the public image of the pharmaceutical industry has fallen very low, and many readers will look at the title of this new book, *Ethics and the Pharmaceutical Industry,* and wonder how "ethics" and "pharmaceutical industry" can be used in the same context. That decline is part of a broader and growing dissatisfaction with the whole U.S. health care system — a dissatisfaction, I believe, that has been fueled by regular negative media stories that often ignore context and complexity.

This volume could help shed a little light on that context and complexity and perhaps create a little more balance. *Ethics and the Pharmaceutical Industry* is a useful book with 24 chapters authored by scholars and experts from a wide range of viewpoints and backgrounds. They explore varying aspects of health policy, research, access, and ethical issues. While the title implies that the book deals with the convergence of ethics and pharmaceuticals, many chapters are only tangentially related to the pharmaceutical industry.

The chapters have been loosely organized into four topics: research and clinical trials; marketing and the efficient use of resources; patents, pricing and access; and health care in the 21st century. If all that sounds a little disparate, it is. There is not a natural flow to the chapters or the book. Many of the essays will be helpful to people looking for background, history and context to clinical, research, and access issues. For example, there are chapters dealing with the ethical and legal issues relating to including children in clinical research.

Also, there is a chapter on "Racial and Ethnic Inclusiveness in Clinical Trials," an issue that isn't well understood by the public. Drugs are chemicals that work differently in different people, a problem that can be exacerbated by racial and ethnic differences. As Valentine J. Burroughs puts it, " ...pharmacogenetic research shows that drug effectiveness and toxicity can vary substantially among racial and ethnic groups." That medical variation creates problems for groups whose desire to end political and economic inequality leads them to downplay biological differences. How do we as a society address that issue while aggressively pursuing the highest quality clinical research? The book provides more background than it does answers to some of the thorniest ethical questions.

Having served voluntarily for ten years (1992-2002) as an ethicist on a major medical school's institutional review board for human experimentation—the committee that oversees all of the medical school's human research clinical trials—I had ample opportunity to observe the process. And lots of challenging ethical issues emerged.

Should a patient with, say, a serious mental illness such as schizophrenia or depression be allowed in a placebo-controlled trial? If so, for how long? Eight weeks? Twelve weeks? Should placeboes ever be used when there is already a "standard of care" drug available? Should pregnant women with a terminal medical condition be excluded from a trial of an experimental drug that might save her life if the drug might cause harm to the baby? That last one was the source of endless discussion on my committee. If the woman is excluded, she dies and perhaps the baby with her. But some think that is a better option than giving her a drug that might save her, along with the baby, but has a chance of causing birth defects. The point is that the book largely misses some of the liveliest and challenging ethical debates.

There are chapters, however, that get closer to what the reader might expect to find in a book exploring the intersection of ethics and drugs: "Who Should Get Access to Which Drugs?" and "The Application of Cost-Effectiveness and Cost-Benefit Analysis to Pharmaceuticals." One of the most useful sections for me looked at pharmaceuticals and intellectual property (IP) rights. This section is at the cutting edge of economic policy because it encompasses innovation (and how we keep it coming), international trade, and property rights.

India is investing millions of dollars to develop an online database known as the Traditional Knowledge Digital Library in an effort to compile all of India's folk medicines, plants, and traditional healing practices (including yoga). So if a pharmaceutical manufacturer were seeking to patent a drug with a molecule that may have been used in India by indigenous people thousands of years ago, the patent officer will see that there is "prior art" and deny the patent. Of course, if a company does commercialize the drug, India intends to use the database to demand a share of the profits.

The author of the chapter on IP rights and "traditional knowledge" argues that patents and other sources of intellectual property build on prior knowledge, just like traditional knowledge, and so they should be viewed similarly. I'm not convinced, but it's an interesting presentation.

Of course, with a growing number of uninsured, no book on ethics and health care would be complete without raising the issue of access. Several of the authors appear to believe that others—but especially the poor—have a fundamental right to receive the drugs and health care they need at little or no cost. I've never been sure where that right comes from, but many of the authors have found it.

Co-author Michael Santoro falls in this camp, as he writes in his introduction to the last section:

> Many of the authors have in one manner or other made the case that the interests of the pharmaceutical industry and society are imperfectly aligned. What is good for the bottom line of the drug companies is not always good for society. In this volume we have seen numerous examples of this divergence, such as research agendas that are guided by market size rather than medical need; marketing practices and objectives that emphasize increasing sales without regard for the medical priority of conditions treated; and monopolistic pricing policies that maximize revenue at the explicit cost of broad access.

I would argue, in contrast, that creating blockbuster drugs that help millions of people, and not coincidentally boost market size, actually make it possible for the drug companies to give away billions of dollars of their products to low-income people and nations. And that's exactly what they do.

Suffice it to say the book has something in it for almost everyone interested in health care, ethics, and pharmaceuticals. You will learn something from some of the authors, while others will likely make you mad. But they all make you think. ■

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