Company Name: Fireside Chat
Event: CECP CEO Investor Forum 5.0
Date: September 20, 2018

<<Richard Edelman, President and Chief Executive Officer, Edelman>>

So Bill and I have talked about long-term investing as the core to the regaining of trust by our business. Do you want to sort of go through your thinking on this and why it's so central to this game change?

<<Bill McNabb, Chairman, Vanguard>>

Yes and there's a lot of threads here obviously and maybe just to step back a sec, we launched this whole strategic initiative on long-termism within CECP. There's really kind of an outgrowth, a lot of the governance work that was being done and many people in this room have actually been involved in lots of elements of that. So whether it was ESG or whether it was the diamond common sense principles and there's I think we counted up 17 or 18 of these sets of principles in place. And what's interesting is a common theme among all of them was Corporate America feels this incredible tension around short-termism versus long-termism. And I don't, by the way, and just as an editorial, so I think it's an or I think we – you have to be really good in the short run or you don't get a chance to play in the long run.

So, it goes back to Mauricio's comment on establishing a foundation. But the one thing that really jumped out was a lot of the talk about long-termism was frankly just that it was talk like – so how do you actually – how do you actually begin to change the dial? And you might say, why are we so interested in and again I'll put myself as Vanguard pad on and as a large investor, both on the active and the index side, but the one thing our portfolios all have in common is a very long-term orientation.

And our average investor in one of our funds is with us for anywhere from 11 to 12 years and so they're not really there for the year or the quarter or whatever. And we began to see – we've certainly witnessed this tension in among investors, because there are legitimate investors who have much shorter term horizons, but sometimes we believed at least that there was more credence and more emphasis being placed on their interest rather than ours and the other like investors.

So you take that observation, you combine it with all those work on governance and Darryl and you and the team came and said we need to really get more engaged in this and let's try to create a platform where companies can actually express their long-term views. And Mark has obviously been leading this effort for us. And we don't know ultimately how this is all going to play out. This is our 5th forum and this is not a scalable model. I'm sure many of you have taken note of that. It's like how do you get 1,000 companies to do this. First of all, you're not going to find 1,000 people engaging as Marcia or Emma.

But second, how do you really do this at scale and we're really trying to figure that out, but we decided to do these forums because we had to have a baseline. So we could learn kind of how to do this well, and get a lot of feedback from all of you and a number of you have been to every one of these. And you know if you were at the first one, the difference between the first one and this one, pretty dramatic. And we're not all the way where we want to be, but we're going to continue to keep pushing there. To link it to the trust thing and Richard knows more about trust, I think than any anybody in this country because he and his firm have studied it so extensively.

This is where this [indiscernible] (0:03:49) converges from my perspective is we believe – and I'm not sure I can prove this, but we believe that people – where there is a breakdown in trust, it's because too many short-term interests are being served and people actually absorb that and they begin to get agitated about what the long run actually may look like. And I have four millennial kids and I got to tell you, this is the conversation around the dinner table all the time and that's very anecdotal, but we talk about it a lot.

<<Richard Edelman, President and Chief Executive Officer, Edelman>>

Feel twice as many people fear the pace of innovation as they're confident about it.

<<Bill McNabb, Chairman, Vanguard>>

Yes. And, you know, I think that's an element here. So to me one of the things about trying to establish really more clarity again, so I'm going to be perfect, but getting more clarity about the long-term is I think it gives people confidence to move forward and confidence leads to trust.

<<Richard Edelman, President and Chief Executive Officer, Edelman>>

But you also said that, you have evidenced that long-term investing as a strategy for Vanguard has paid off.

<<Bill McNabb, Chairman, Vanguard>>

Yes. So, obviously, in two elements. When people think of Vanguard, the first thing they think about is indexing and indexing has obviously become quite the phenomenon in both the retail and the institutional markets. And in the last 15 years, it's been very difficult for active managers to beat their benchmarks if you will. So investing in an index fund over 15 years has beaten out I think 90% of all active funds, something like that.

And part of the reason for that, by the way, is that because index funds have such lower turnover and lower cost over the long run, long-term again, that those advantages really compound out. But the interesting thing that people don't know, we also in front of a lot of active equity and when we study active managers, and again, nothing is over 100%, but our best active managers have very low portfolio turnover in general, which means their holdings are – if you take the universal portfolio turnover at your length of time that you're in an investment. I'm looking at one of my – one of our sub-advisors out here, Wellington management runs a lot of money for us, Mark Mandel, who's sitting in the audience.

Vanguard health care fund, one of the two or three best track records over 30 years, brilliant portfolio manager. So let's not take anything away from them, but their portfolio turnover is average like 10% or less. The average active manager turns a portfolio over 90%. So we've observed this as investors and there are lots of investors in the room and I'm sure people will take – will push back on some of that, but the data are actually pretty overwhelming.

<<Richard Edelman, President and Chief Executive Officer, Edelman>>

So Bill, why do universities and other institutions invest with Dan Loeb and Bill Ackman and others? And are they a force for good or not?

<<Bill McNabb, Chairman, Vanguard>>

Well, that's a setup question.

<<Richard Edelman, President and Chief Executive Officer, Edelman>>

Not ghost.

<<Bill McNabb, Chairman, Vanguard>>

So look, I think that the – and without commenting on any of those specific individuals. If you were to look at those kinds of investors, they take very concentrated positions, so actually a tremendous amount of risk. Now the upside is if they're correct, the returns are extraordinary and the downside is if they're wrong you really get crushed. I actually think and this is a whole topic for a whole another discussion, if you talk about the future of active management, I actually think more concentrated portfolios is going to be what you see more and more of. So you will actually see sort of a barbells more barbelling. So you'll see the continued rise for highly diversified portfolios.

I think you're going to see more indexing, more quantitatively oriented strategies and I think on the active side, you actually are going to see more concentration. So these universities picked these kinds of investors because the concentrated risk gives them an opportunity for outsized performance. And I have lots of opinions on how endowments and foundations invest. This audience probably doesn't want to hear all those at this point, but, you know, I think they make things a lot more complicated than they need to. But, that's like a topic for another day.

<<Richard Edelman, President and Chief Executive Officer, Edelman>>

But let's talk about the board. So, if you're a board director, should you be pushing your CEO for long-term performance or for short term performance?

<<Bill McNabb, Chairman, Vanguard>>

I would say “and”.

<<Richard Edelman, President and Chief Executive Officer, Edelman>>

Okay.

<<Bill McNabb, Chairman, Vanguard>>

And again, so let me step back a little bit. You know, again, another one of the reasons for us being so energized by this topic is if you look in the last 15 years, the number of public companies has shrunk from $8,000 to $4,000. And there's a lot of reasons for that and it's not all nefarious or anything like that. There's, there's some structural things going on, but when you talk to private companies in particular, those owned by private equity firms, you hear two things, you literally, I've done this, I've gone into board rooms and some of these. And I said what's the difference between being in this boardroom and being in the boardroom of a Fortune 500 company? And they say, look, not all Fortune 500 companies are the same, but if we had to generalize, we'd say we're way more long-term oriented and we're way more agile. And, that's kind of, that's kind of a killer combination.

And so, I actually think boards need to always be focused on what's happening in the current environment, but they shouldn't be sacrificing the long-term to benefit the short-term solely. And that's where you see a lot of – in my view, mistakes you see, you do see companies and boards so maniacally focused on the short-term, in a sense the long-term it's like it's out there. We don't have to – we don't have to worry about it. We're just going to get this quarter or this year, correct.

And that's where I think there's a problem. And again, it's not universal, but, we've heard from a lot of – lot of CEOs now in these five forums, how they're actually trying to manage these two elements. And I think, again, for me at least, it's, it's very encouraging that the discussions are taking place.

<<Richard Edelman, President and Chief Executive Officer, Edelman>>

And Bill, it seems that this activism has sort of moves sector to sector. So Mauricio sector, now it's the CPG and food sector is sort of, whatever the vogue is and somehow to force sale like Campbell Soup or whoever else. Is this sort of whack-a-mole. What's the kind of thing?

<<Bill McNabb, Chairman, Vanguard>>

Well, again, the term activist is a tough one because it covers such a range of investors and you know, there are those who have very long-term orientations, there are people who are classified as activists who know their average holding period is 10 years and they've never waged a proxy fight. So, and then there are people who, their average allocations maybe for a year or two and they're constantly in the news on trying to push a proxy – proxy fights.

So, and there's everything in between. But what I think the common element is they look for companies that have underperformed for a prolonged period of time and they try to understand why those companies are underperforming.

And this is actually a change. You know, Richard, the first activists, if you will, in the late 80s and early 90s where the other term that was often used were the green mailers. And, basically they would go, they go rushing in, they'd see a company that was undervalued perhaps for short-term tactical reasons, or tactical effects. And they would say, hey, with a little financial engineering here and some patching, we can boost the stock price 20%, 25% in six months and that's a great return for our investors and we're going to do it.

And they might, the company's long-term prospects might be actually harmed by that and we actually saw that. Then you got into – there, there was a period certainly as interest rates plummeted where financial engineering was really a big driver in a lot of these activities.

But today, I would say, by and large, you're seeing much more strategic approaches by many of these investors. One of the things, we say to boardrooms when we're talking to them is you need to think like an activist, you need to look at your portfolio, you need to look at what's happening within your competitive landscape and imagine what would somebody do, what would, how would they think about it? And, I actually know a decent number of companies who've actually invited activists into the boardrooms and basically said, talk to us.

<<Richard Edelman, President and Chief Executive Officer, Edelman>>

So, Bill, you don't think a company has to declare itself a B Corp in order to behave in a long-term way?

<<Bill McNabb, Chairman, Vanguard>>

I do not. I really do not. I mean, it's – the question that came up earlier about, some of – some of the regulatory requirements and so forth and the burdens there. I actually would take a slightly different tact and Mauricio did I agree with everything he said, but I would add to it. I actually do think there are issues there. I do think some of the reporting requirements, I do think, you know, some of the regulatory burdens that are on public companies have made them a little less aggressive in some areas and they could be in terms of thinking long-term.

<<Richard Edelman, President and Chief Executive Officer, Edelman>>

So, do you think this long-term plan presentation by Emma, Mauricio, et cetera, should be a standard for corporations and if so, what should be in it?

<<Bill McNabb, Chairman, Vanguard>>

Yes, so I do. What I would love to see from a framing standpoint is, every public company does four calls quarterly call or whatever. First, I'd like to see them eliminate guidance. That's a whole another topic. You didn't ask that question…

<<Richard Edelman, President and Chief Executive Officer, Edelman>>

No, I asked to just now.

<<Bill McNabb, Chairman, Vanguard>>

Okay. Okay. Yes. So I'd like to see them do that, but I'd like one of the calls to be focused on long-term and you don't need a new long-term strategy every, every, every year, but an update on how you're progressing toward your long-term aspirations I think would be very valuable and then a refresh when it's called for. And, I think having a framework to do that and again, the easiest one I've been able to think about is take one of your calls and say, read, read our press release.

You'd get all the things you need. But with all due respect to all the analysts, I don't want to talk about what's happening this quarter. I want to give you an update on the long-term plan and I want to walk through that. And those are the questions we want to answer.

I think, that's a way that this thing begins to scale. Now, what's in it is, I think a lot of the content that we've been evolving toward here, you know, the seven questions that we outlined to CEOs when we invited them to come in and do this as a good starting point. But, in every industry in every sector of the economy is going to have a different set of really meaningful metrics. But, what are those long-term aspirational objectives and what kind of progress are you making? And again, I'm too simple minded. So I have to use examples. It is theoretical for me.

So, at Vanguard we're not a publicly traded company. We have this weird ownership structure like we're a mutual, mutual fund company. I think many of you know that. One of the things we had to do was create some meaningful metrics for our people when we talked about our long-term plan and you know, we measure everything, we're investors, we love and we're data geeks. So we have thousands – our scorecards are ridiculously complicated and our Board reminds us of that all the time.

But the four big things that we talked about were employee engagement. What's does it look like over 10 years? Fund performance, which is why people are with us. How do we do on a relative basis over 10 years? What kind of client engagement we use the client loyalty score, many of you are familiar with net promoter methodology that was the one we zeroed in on. And then we had a financial metric around the cost to serve because for us that's actually been the key to our success. Four things we laid out, we were at a starting position and what where we thought we can get in 10 years and we talked about it every single meeting.

Q&A

<A – Richard Edelman>: Perfect. So now we're at zero, so we're now into Q&A, first.

<A – Bill McNabb>: You are up, just go for it.

<A – Richard Edelman>: We can hear you Bill.

<Q>: [Question Inaudible]

<A – Richard Edelman>: Oh yeah the mic is at this telecast, sorry.

<Q>: It might have been interesting to have a public company CEO of an asset management firm too, because they face different challenges than you do. And one of them is voting shares, like the proxy voting. And I don't know that many big asset management firms have taken a strong position about voting the shares, is because it's a fiduciary contradiction, you can't represent all the people that own these. And where do you see that going?

<A – Bill McNabb>: Yes. Great question. So everybody heard the question. How do we plan? Can I broaden it a little too, how do we think about voting? I've got a couple of guys sitting in the back there who can do this way better than I can. So if I'm – if I don't completely fulfill the answer here, Glen Boreham and Brian Thomas, John Reynolds, are sitting in the back corner, they'll take you through like chapter and verse.

So from a purely fiduciary perspective, just to start there, every fund has to do what's in the best interest of its long-term – of its investors. And for us those are long-term investors. So that's where we start from. And then, we believe it's our responsibility to vote those shares in a sense to best benefit the fund investors and we have to make judgments there. And that's, we've got a huge team now, growing team I should say to, to really think that through. And you know it's interesting. You can get – you can take a simple example like a merger two different Vanguard funds may vote differently on it because the benefit of the merger or perhaps detrimental effects of the merger may be quite different for shareholders in those two funds. And so you'll actually see us split vote in those situations.

If I were to talk about how we vote, for example, in our big index funds where we're a permanent shareholder, again this is one of the differences certainly between traditional active and indexing. If you're a traditional active management, you really don't like what's going on from a governance standpoint. You can sell the stock and you can move on and find something else. For us, we can't do that. So we actually have to use the vote to express our opinion. And we're not trying to micromanage, we're not trying to cross any lines from governance if you will into management. But what we're really trying to assess is how well is the Board governing that company.

And so most of the way we think about voting revolves around that question and it's around the composition of the Board, it's around the Board's engagement on strategy, and risk, and talent evaluation, and so forth. And what are the kinds of processes that they can evidence so that – because they're standing in the room if you will on behalf of all investors and among other stakeholders if you want to broaden it. So when we think about how we're going to vote, it's always with that kind of framing and it becomes a really, it's one of those things you can do 100, you'll do 50,000, 60,000 votes a year, 95% of them, 98%of them will be very administrative, appointing, accounting firms, and so forth.

But there'll be 400 or 500 a year that are actually pretty controversial and you really got to spend time. And the last thing I'll say on that is Vanguard’s CEO and a handful of the top executives sit

on what we call our Proxy Oversight Committee, every tough issue comes to them ultimately from our governance team. Does that help?

<A – Richard Edelman>: He's next, you're next.

<Q>: Thank you. Terrific presentation. I think you mentioned the average holding period of your clients is over 10 years. I suspect most CEOs of public companies would dream to have investors like that. I think I saw somewhere that the average holding period now for investors is more like 60 days. So if someone were to come in and say, look, let's leverage this company, create a huge dividend and of course it'll hurt your long-term investment plans, it will make you more risky, but your stock price might go up. 80% of your shareholders are saying, they're short term, they think about the next 60 days you could have the speaking ability of a Southern Baptist preacher, it'd be hard to convince people not to vote for that. What do you see as a strategy around that? Thank you.

<A – Bill McNabb>: Yes. And again, I think that question is actually at the heart of a lot of what's going on. And again, so I'm speaking for Vanguard and I think there are a number of firm representing certainly in this audience who – they are not that 60 days. By the way, the 60-day gets a little skewed because of the algorithmic trading, and so forth and some of the quantitative – quants. I would tell you most of those constituents don't really care. But you're right, if they came to a – it actually did come to a vote for something like that. They're like, hey, I'll take the money and run. If you're a long-term investor, the only thing you care about is long-term value creation.

And again, I believe we have a fiduciary obligation to represent that. I think the reason – one of the reasons we began to get very engaged on this topic was we felt that we didn't have that voice. And there are significant long-term investors in many, many companies and it felt like their voices were being drowned out by sometimes smaller investors, but who had a very loud platform. It won't always resolve the way you want it to that's capitalism. But I think it's very important that that voice be heard.

<A – Richard Edelman>: Right behind. And then we'll go over here, lady ma'am, I don't know your names. Ma'am.

<Q – Jill Baker>: Hi, Jill Baker from Terra Alpha Investments. Do you have – you had talked about long-term value creation. And one of the things that we believe in is that preparedness for climate change and making sure that you have sustainable infrastructure within your firm, etcetera are good long-term strategies. Do you in your proxy voting policy have anything specific with regard to a climate change – climate risk?

<A – Bill McNabb>: Yes so again, a really good question. I would say yes and no. So from what we're looking for from a climate change standpoint is to see how companies disclose the risks in a sense to their business, their business model, and their consumers, and so forth. And the idea there is so that investors can actually better evaluate the true value of that company in terms of assessing how they're evaluating those risks.

So again a practical example is we ended up on another side from the management recommendations with a large integrated oil because they just basically said, we're not going to disclose how we think about climate risk, where many others had.

And so what we ended up doing is basically voting in favor of the shareholder proposal that would require more disclosure. That wasn't really making the jump that you made in your comment, which is a very fair point that, you believe very strongly that I take it from you, the way you asked the question that this is – this will affect the long-term value of a company.

I would say I'm agnostic. I don't know that. But what I do know is if it's not adequately disclosed how people are thinking about climate change as well as any other large risks you want, it's very difficult to act, really assess the true future value of that company. And if you – the less well you can value a company if you will the less likely you are to create long-term value for your end investor.

So that's been sort of the way we've looked at it. And I think it's, again, it gets back to a lot of the work that's going on, whether it's SASB, whether it's the embankment project. A whole series of other initiatives to create more comparable disclosure so that investors can adequately evaluate how companies are thinking about these very difficult, complex questions.

<A – Richard Edelman>: Lady in the back. And then, man, man, we're going to do a lightening round. So we have four minutes left so quickies.

<Q – Nili Gilbert>: My name is Nili Gilbert. I'm a cofounder of Matarin Capital. It's often said that index funds have low turnover and in that sense, our long-term and focus. But I have a question about whether passive strategies can do more to encourage long-term business practices of the corporate management teams who shares they own because the intention behind owning the shares isn't really rewarding long-term focus or strategy and many passive strategies.

<A – Bill McNabb>: Yes. So I actually, I'll go back to what I said at the very beginning. I think that's why we're up here. I think that's why we're so engaged in this initiative because I actually think it's incredibly important for us as fiduciaries of index funds to encourage companies to think long-term, because they're being pulled by other forces into shorter term focus.

And like as I said earlier, that's not to delegitimize other forms of investing but for our investors, it's all about the long-term. And you know there's a – there is a perception out there that indexing or passive investing. I actually like the term indexing better because I think passive implies that you're passive in all things. I actually think it's very important for us to be active on the governance front, even though we may be matching a benchmark from an investment perspective.

So for me, before 10 years ago, these conversations didn't occur anywhere with a handful of exceptions. A couple of them in this room, a few of the socially responsible investors were beginning to talk about this sustainability and long-termism. But most traditional active managers, index managers, nobody was talking about it. And it really was this, kind of ah-ha moment where I think – I'd like to, I'd like Vanguard to take a little bit of credit for it. I think

Black Rock had a lot to do with it. I think State Street had a lot to do with it. But a recognition that there was this tremendous tension out there and that short-termism was winning. And at least on behalf of our investors, we felt like you had to take a different – we had to take a little bit of a stand on it.

<A – Richard Edelman>: Serve, serve one, two and quick because we're in Daryl time.

<Q – Ulysses Smith>: Ulysses Smith, Telos Governance Advisers. About a month or two ago, I guess. I think there was a flurry of discussion. I think as a result of a presidential tweet, if I remember right, about the elimination of quarterly reporting requirement by the SEC. I'd just be curious to hear your kind of bottom line assessment of that and what the gains versus the losses in terms of less transparency might be if we lose that quarterly reporting?

<A – Bill McNabb>: Yes. So from a theoretical standpoint, I don't think quarterly reportings all that valuable, there are other regimes around the world in the developed world where they actually don't have it and it doesn't seem to affect the capital markets in the functioning of capital markets.

That said, it's so deeply embedded here from a transparency perspective, I don't think you're going to be able to roll it back and I think people want it. But what I would do, I would be very clear in really talking seriously about eliminating guidance, because I think that's actually at the heart of it. Having the information is one thing. But then – but having this tremendous flurry of activity around whether a company misses or beats by a penny, it's guidance, to me, it just is so counterproductive.

And I think it's a monumental waste of time for management and monumental waste of time for investors. And I think it's actually driven much more by commercial interest of the sell-side and so forth as opposed to what, where real value is being added from an investment perspective.

<A – Richard Edelman>: Sir, last question.

<Q>: I'll be quick.

<A – Richard Edelman>: Pleasure.

<Q>: Yes, you made me forget my question. IR departments like to have sell-side coverage. And so your typical earnings call, all the sell-side questions are answered and then if there's time leftover, they take questions from buy-side. And the sell-side doesn't make a lot of money from people like Vanguard. The sell-side makes money from people who trade a lot. And so obviously their questions are going to be oriented toward people who trade a lot. And that's one of the big drivers of short-termism in earnings calls. And so if you want to get longer term earnings calls, you've got to break that bond somehow and how do you do that?

<A – Bill McNabb>: Yes. So I don't know how you do it, but your analysis is a thousand percent correct. Probably the way to break it is for – and again it's not to say that there's not an elements of legitimacy there, but it's just, it's overwrought at this point. And I think the buy-side needs to

be much stronger and the buy-side needs to take much stronger stances. And one of – again, one of the reasons for doing this initiative is, it's much more driven by the buy-side and by companies.

And because we're hearing the same thing inside of boardrooms and inside of management teams that something needs to give. And so I think by creating a structure that allows companies to talk about their long-term perspective and really begins to change the dialogue. It doesn't completely eliminate all the issues that you just described, but it begins to at least move the dial in the right direction.

<Q>: So Bill last, last is going to be from the field. How much focus does Vanguard place on ESG factors when building an index fund and do these factors more mitigate or risk or improve returns?

<A – Bill McNabb>: So today zero. I mean, just to be blunt because the way benchmarks are constructed, if they're all constructed by third parties, I mean and I say zero except for the ESG oriented index funds. We have one in a couple of that we're about to roll out. So those use ESG factors in the construction. But when S&P creates the S&P 500, to my understanding they're not using any ESG factors in the construction of the S&P 500.

Our job is to match that when you look at the FTSE International or MSCI whatever, they're not – in their broad based indexes, which is what we do. Richard, they're not actually using ESG factors to impact the construction of those indices. You could ask the question about whether they should, that's probably a whole separate conference. We could probably spend an entire day talking about that.

<Q>: We're cutting into lunchtime.

<<Richard Edelman, President and Chief Executive Officer, Edelman>>

We’re all heading to lunchtime. You can do it at lunch. So I just want to thank Bill, to thank everyone for coming. And also just a quick personal anecdote, I came up via Cortlandt Street Subway stop today. And it's the first time in 17 years. I've been able to do that. And I just felt so happy. So on that basis, the long-term plan of Calatrava and the rebuild has worked. And it's so great to see Wall Street people here, just to say. So anyway, small point but let's go, have lunch.