

John Bogle on Leadership, Asset Allocation, and the Outlook for 2009

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John Bogle, 79, is the Founder of The Vanguard Group, Inc., and President of Vanguard's Bogle Financial Markets Research Center. He created Vanguard in 1974 and served as Chairman and CEO until 1996 and Senior Chairman until 2000. He has been named by *Time* magazine as one of the world's 100 most powerful and influential people. He is the author of seven books, including his most recent, *Enough. True Measures of Money, Business and Life*. In *Enough.*, Mr. Bogle reflects on the excesses that mark so many segments of our society today, and considers just what "enough" means in money, business, and life. It is available via the link from Amazon above.

We interviewed Mr. Bogle on December 19, 2008.

You are critical of executive compensation based on stock options, arguing that it encourages speculation ("renting stocks" and holding them for the short term) rather than investing (holding stocks for the long term). How will your solution — basing pay on growth in earnings, cash flow, or dividends — be an improvement? Aren't those just as easy to manipulate?

The fact of the matter is that it is exceptionally difficult to manipulate cash flow or dividends. Companies can overpay dividends, but they must get their Boards of Directors to approve those payments. And paying higher dividends than is economically rational is a very costly thing for a company to do.

Earnings can be manipulated, but they are audited and can be looked at critically by investors. Of course, they can be restated, and I would recommend that Boards of Directors use clawback provisions in executive compensation agreements to recapture any bonuses that were paid on earnings that were subsequently restated.

The problem is that the use of options encourages corporate managers to focus on their firm's stock price in the short-term, which often has little to do with the firm's long-term economic growth. You don't have to look very



hard to find many examples of companies that were managed for the short-term, whose managers took on tremendous risk in pursuit of short-term gains. The managers were enormously compensated based on those gains, and then long gone when that risk came home to roost. In the long run, 100% of investor returns come from dividend and earnings growth. Volatility in the stock market adds nothing. The stock market is a giant distraction from the business of investing.

You advocate a five-part plan for reforming the mutual fund industry: (1) reverse the upward trend in fund expenses; (2) increase the focus on long-term performance; (3) lower turnover within funds; (4) move from specialized funds to broadly diversified funds; (5) govern funds by an independent Board of Directors. While very few people would dispute that these are admirable goals, do you believe there are practical steps that can lead to their implementation? How likely is any of this to happen?

It is not a question of likelihood or probability. It is an absolute certainty.

Investors may ignore their own economic interests for the rest of my lifetime, or the rest of their lifetimes, but they won't ignore them forever. It may be a long time in coming. But, in a moderately competitive free market economy (which is what we have now), the will of the investor will ultimately rule.

Investors will eventually wake up and demand that their interests are served. Those fund companies that respond to these demands will survive, and the others will suffer. I'm very confident that Vanguard is one of those firms that will survive.

I have a second solution, which is based on government action. We have become an institutional society – not an ownership society – as institutional ownership of corporate America has grown from 8% of all stocks in 1945 to 75% today. But institutions are not upholding the fiduciary standards they owe the individual investors they represent.

I'm in favor of establishing a Federal standard of fiduciary duty. In 1776, Adam Smith said, "managers of other people's money (rarely) watch over it with the same anxious vigilance with which . . . they watch over their own." We see this clearly illustrated with the Madoff scandal. But it's also visible in the mutual fund industry, with funds turned over at 100% or 200% annual rates, leading, among other things, to incredible tax inefficiency. Would you do that with your own money? Do you think those managers would do that with their own money?



We must also demand that institutions observe the responsibilities of corporate citizenship. This can be achieved through the proxy process and through a more activist approach to investing. The role of governance is to make sure companies are run in the interests of shareholders.

The average mutual fund has 100% turnover and does not care about governance. Eventually, this will change. Investors will demand it.

You have always been highly — almost universally — critical of actively managed funds. Are there exceptions? What are the characteristics of an actively managed fund that investors should seek (other than low costs)?

Lower cost subsumes it all. If you accept the thesis that almost all the activity in the market consists of fund managers trading with one another then, by sidestepping these costs, you should improve your return.

Lower cost includes lower expense ratios, lower turnover (I consider a turnover of 50% too high), and no loads. The typical mutual fund is held for five years, and, if you pay a 5% sales charge, you are adding 1% per year to your costs. With a 1% expense ratio, 1% sales charge, and at least another 50 basis points from 100% turnover in the portfolio, investors are paying 2.5% annually in costs. The notion that a fund manager can successfully overcome that annual drag and outperform the market over the long run is dubious, to put it mildly.

A fourth source of costs is the tax liability generated by the incredibly inefficient way most mutual funds trade. Studies have shown the government makes more than investors across the fund industry - tax liabilities exceed fund returns.

Investors should look for very broad diversification – no concentration in large cap growth or small cap value. They should look for funds that capture 97% of the market's return. The average fund, in comparison, gets only 80% of the index return.

If you want to win, look for a reasonably consistent long-term track record and a manager that can articulate his or her philosophy. You must realize that a winning manager will lose at least one year out of three. Be prepared for disappointment. This year has been disappointing for Longleaf, Dodge & Cox, and Chris Davis, to name a few, and their investors should have been prepared for this. But these managers will get hit with redemptions nonetheless, because investors will not take an appropriately long-term view.



Your book discusses the characteristics of good leadership: nurturing the “soul” of the organization, focusing on values, and “pressing on, regardless.” Which leadership skills will be most important for President-elect Obama once he takes office?

There is not a generalized set of leadership skills. When crew members at Vanguard meet with me, I advise them not to attempt to emulate anyone other than themselves. Be who you are and use your own style.

I believe Obama has exactly the right credentials and temperament. He is highly intelligent and an excellent communicator – both in writing and orally. He possesses the integrity, sincerity, hope, and confidence this nation needs. That is why I voted for him.

In late 1999, you adjusted your equity allocation from 65% to 35%, reflecting your concern about the “speculative” nature of stock prices at the time. But you also admonish the practitioners of market timing. How do you reconcile these views?

This presents a little bit of a challenge, but not as much as you think. At that time, I was no longer running Vanguard and not making a significant amount of money. I was concerned with protecting what I had earned. An old rule of thumb, which I follow, is that your bond position (as a percentage of total assets) should roughly equal your age. At the time I was 70 years old, so that adjustment made sense.

But I freely confess it was also a market timing move. Market values had deviated from their intrinsic values by a degree that investors might experience three or four times in a lifetime. Price-to-earnings ratios were at 35 and it was clear they would not double to 70. Dividend yields were 1%, so how much lower could they get?

Since then I have not made a single change to my asset allocation. I don't rebalance; I let my allocations run. With the bond market up 70% since then, and the stock market down 25%, my asset allocation is now 80% bonds and 20% stocks. Here I am, about to turn 80 in May, and I am still in tune with that target. As you grow older, you have less time to recoup losses, and income becomes more important, which is why bond allocations should increase with age.

Investors should not be concerned with a slavish obedience to numbers. Common sense is what rules.



In an essay cited in your book, Peter Bernstein (in 2001) advocated the 60/40 solution “for the long haul,” and you suggest that equity investors should expect a nominal return of 5-7% over the next decade. Should investors today “press on, regardless” (to use one of your catchphrases) with 60% equity allocations, when the bond markets seem to be offering much greater returns?

Yes, I would still do that. The bond markets are offering the best returns we can remember, but also some of the worst returns. Ten year Treasury bonds are yielding 2.04% and 30-year Treasury yields are 2.52%. Yet single A-rated corporate bonds are yielding 7% or more. The corporate bond market does not operate with a lot of pricing precision, so that may mean the yield is between 6.5% and 7%. One thing this says is that the anticipated default rate is higher than normal. Some of this spread will be eaten up by those failures – perhaps as much as 1.5% of this yield.

Because of the risk of default, I still believe in the total bond market mutual fund, which has outperformed 95% of actively managed bond funds.

This is an unusual yield environment. I personally don't like long maturities, where investors are not adequately rewarded for the spreads in the market and there is too much volatility. I have my own investments in limited term municipal bonds and shorter term corporate bonds.

At the end of 2007, you warned that “2008 will be a year for investors to be especially careful.” What warnings do you offer for 2009?

2009 will be an unusual year. But nobody should invest for 2009. You would be a damn fool to invest with a one-year time horizon and not for the long term.

Investing now presents an unusual dichotomy. The recession will get more serious, but will not be a Depression. It will be one-and-a-half to two years before the economy moves up. This is a laymen's guess, but it is probably more accurate than what most economists have to say. These are troubled times and it is not going to get easier.

The stock market is down 50% from its high. The probability is that the stock market has over-discounted the economic difficulties. The market is a far more attractive value than a year ago. The dividend yield is up to 3.5% and is higher than the Treasury yield for the first time since 1957 – over 50 years ago!



The value of the S&P index ultimately derives from the balance sheets and book values of the 500 corporations that comprise the index. Back in 2000, investors were paying \$6 for every dollar of invested capital (i.e., book value) in the index. Now that number is down to \$1.80 for each dollar of capital. The market is demonstrably much cheaper.

This has been a wonderful market for buyers at the same time as it has been a terrible market for sellers. I expect equity investors will realize 8-10% returns over the next decade. But probabilities are not certainties. As in the lessons of Pascal's wager, investors need to consider the consequences of their investing decisions, in addition to the probabilities. If you cannot afford to take a risk, don't take it. If you can't stand a 15% further decline in market values, then get out. This is ultimately an individual decision.

[Ed. Note: Pascal's wager concerns a hypothetical situation where you are told there is a 50/50 chance that God exists, and you can choose to live your life accordingly. If you choose to live as if God exists, and you are wrong, you lose nothing. If you choose to live as if God does not exist, and you are wrong, you are far worse off. Given the consequences of losing this bet, it is much more prudent to assume God exists. The point is to look not just at the probabilities of a particular outcome, but also at the consequences of being wrong.]

What worries you the most about the economy and the markets?

My number one concern is the freezing of the credit markets, but I am equally concerned with the slapdash way the Treasury is trying to fix the problem. The troubled asset relief program (TARP) should have been called the toxic asset relief program, but they have yet to buy a single asset. They are injecting capital into banks, but are doing so at a very high price. If the government of Dubai were making these investments, they would have wanted a price that was one-third of what our government paid. We have not been good negotiators.

We need to help out the people that have really been hurt, especially those with lower incomes and those that were hornswaggled. To the extent we can, we should develop a program to ease the pressure on foreclosures and give incentives to firms that are willing to extend the terms of loans and reduce interest rates.



You mention that you give half of your annual income to philanthropic causes. How has the focus of these efforts changed over time, and how do you expect them to change in the future?

My philanthropic efforts are not going to change very much. I am not as wealthy as some people apparently think I am, and I can't give everything to everybody. I have given to those institutions that have meant a lot to me in my life. This includes my high school, Blair Academy, and my college, Princeton University, as well as two or three hospitals that have been involved in my medical care. I donate toward research in arrhythmogenic right ventricular dysplasia (ARVD), which is something that has afflicted members of my family. I give to our church, my wife's schools and colleges, and smaller amounts to other causes.

One nice thing about my 50% target is, since everyone wants more money, I can say "if I give to you I will have to take it from one of these other causes."

I have also created a foundation for my taxable investments, including my retirement plan, so that these philanthropic pursuits can become part of my legacy.

Have you had enough? What is next for you?

I am happy living life one day at a time. I wake up early in the morning and look forward to tackling my work with as much energy as I can muster. Some things slow me down a little bit. But I did three or four television programs this week, as well as an NPR interview, which has an audience that is a wonderful fit for my message and my books.

Sometimes I look at my work with the solitude and loneliness of a long-distance runner. I know there are a very large number of people that are somewhat appalled that I am as outspoken as I am, and I make no apologies for this.

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