John Bogle on Active Management, Diversification, and the Future of the Mutual Fund Industry

John C. Bogle founded the Vanguard Group, Inc., in 1974 and served as its CEO until 1996. He is now President of its Bogle Financial Markets Research Center. In 1999, *Fortune* named Mr. Bogle as one of the four "Investment Giants" of the 20th century and, in 2004, *Time* named him among the world's 100 most powerful and influential people. His latest book, *The Little Book of Common Sense Investing,* is available through Amazon. We interviewed Mr. Bogle on August 10, 2007.

Your book makes a very compelling case for investing in index funds. Do you believe the question of whether it is possible to identify funds that will outperform the market is now completely answered? Are people who research this question just wasting their time?

All the statistical data suggests that investors are wasting their time trying to pick active managers. Money manager Ted Aronson says that to be even 75 percent sure a manager is skillful, you'd have to track his performance for between 16 and 115 years. Let's assume that an investor owns five actively managed funds over the portion of their investing lifetime—which might be 65 years for a twenty-year-old today. Yet on average, mutual fund managers last about five years. That means that an investor might have 65 managers over their investment lifetime. To truly believe that you're going to pick 65 managers that will outperform the market defies credulity.

Morningstar has built a business around showing investors how to identify superior active managers, but without great success. However, it is possible to buy funds that have a fighting chance of winning, provided you follow the guidelines of low costs, no loads, low turnover, and broadly diversified holdings, but even then costs will eventually eat away at your returns. There are not a large number of these funds. I say 'be my guest' if you want to try to beat the market, but it is largely a waste of time.

Take the case of the Massachusetts Investment Trust, which was founded in 1924 and has the distinction of being the oldest mutual fund in the nation. As a traditional mutual fund, it was owned by its shareholders, and operated for their exclusive benefit, so the fund had extremely low costs by today's standards. In the 1960s, its expense ratio was 0.19 percent. But in 1969 it made the fateful decision to de-mutualize. They changed their cost structure, and eventually the expense ratio increased to 1.2 percent, resulting in dramatically poorer returns for it shareholders. Can you imagine how the market would have reacted to this kind of a price increase in something other than a mutual fund? But in the mutual fund industry, this sort of thing happens often.

These comments about the role of costs relate to equity funds. When we talk about bond and money market funds, the arguments are even more compelling.

Data show that individual investors index somewhere between 3% and 15% of their assets. Given your thesis, and the overwhelming body of academic literature, are investors naïve, uninformed, or irrationally overconfident in the ability to beat the market?

All of the above – largely because hope springs eternal. Research in behavioral finance shows that we overrate our abilities; we believe we are a lot smarter than we really are and this makes us better investors. We are naïve. If we are sick we call a doctor, if our car is broken we call a mechanic. We are used to going to a professional to solve our problems. But not in the stock market. The professionals are playing against each other, but the average investor still thinks he or she can beat them.

Individual investors tend to get caught up in what's "hot" at the moment in the market. But studies show that recent trends mean nothing. In fact, they may mean the opposite at the sector level – i.e. you could do well buying sectors that have underperformed, expecting a kind of reversion to the mean. But this strategy wouldn't work at the fund level, because the funds at the bottom are often there because they have higher costs, and these costs will keep them at the bottom. Investors are naïve about the power of costs, and this is quite disgraceful.

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What's more, we fail to look at real returns. Funds report their returns in nominal dollars, not real dollars, which take into account the effect of inflation. If the stock market returns 7% nominally in the coming decade, investors could still lose

2.5% to inflation, reducing the real return to 4.5% annually. Fund expenses of 2.5% would reduce that return to 2.0 percent (even ignoring taxes), and these are the dollars that the investor ultimately gets to spend.

If we accept that indexing is the best strategy, why not use a leveraged index fund? There are funds that offer 2.5x exposure to the S&P 500, without a margin account. If an investor has a long time horizon and can withstand the volatility, would this be a good strategy?

No, it would be a *perfect* strategy. But most investors do not have long time horizons, and very few can stand the volatility such as we had yesterday. [Ed. Note: The Dow had declined by 387 points the prior day]. It makes theoretical sense, but only a lunatic would do it in practice. In addition to behavioral biases and emotions, the need for liquidity creates problems, for investors may need to withdraw funds at inopportune times. The overwhelming majority of investors should have nothing to do with leverage.

A world in which investors have a long time horizon and can withstand volatility doesn't exist. Too many investors follow trends and investor emotions take over. We know that only two of the 200 most popular funds in the market bubble of 1998-2000 provided asset weighted returns that were superior to the returns reported by the funds themselves. These asset weighted returns are weighted based on the cash flows into and out of the funds. So when investors chase performance, they end up putting money in at the top of the market, and taking money out at the bottom—precisely the opposite of what common sense would tell you to do. Investors are their own worst enemy, although some active mutual fund managers give them a run for their money.

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Your book focuses on indexing the US markets. But the US market is just 42% of the world market. Should investors be more broadly diversified and, if so, what is the best tactic?

First, don't forget that about half the earnings from the companies in the S&P 500 come from abroad, so you are already diversified internationally if you simply own a 500 Index fund. There is an argument that says "sure, that is true, but international markets fluctuate differently." But I believe that, in the long run, international market returns will be fairly similar to the US market's return. The global market is a big arbitrageur, and returns from different countries and regions tend to balance out over time.

Don't forget, too, that there is no better haven, in terms of liquidity, stockholder protections, and property rights, than the US markets. Also, the notion that you're gaining a great deal of diversification by investing internationally seems a bit overblown to me. The correlation between domestic and international stock markets has increased appreciably in the past decade. What's more, international diversification lets us down when we need it the most—in times of sharp market declines. In the last couple of days, the US took a big sneeze and the rest of the world got pneumonia [Ed. Note: While the Dow had declined about 2% the prior day, EFA (a diversified non-US ETF) declined by about 3%].

International diversification will reduce the standard deviation of your portfolio, but most investors won't be aware of this. The reduction is too small to have an observable impact. Nonetheless, there are new companies outside the US that are solid investments. I don't have a problem with international diversification, but don't overdo it. If investors put 15%-25% of their equity portfolio into non-US holdings, that ought to be enough.

Does your indexing strategy work during the de-accumulation phase? How would you invest a retirement portfolio that makes distributions of 4% to 5% per year?

This question is not about indexing, but about the role of equity funds in general during the retirement years. During the de-accumulation phase, the dynamics of the portfolio are different, and investors can pay a big price if they have to take money out at the wrong time. But they have the same problem with actively managed equity portfolios in this scenario, so it is not an indexing issue, per se. Saying that an investor should consider actively managed funds rather than index funds at this stage of their life implies that mutual fund managers have demonstrated an ability to mitigate losses in bear markets, but there's absolutely no evidence that they have that skill.

An indexing strategy works very well at all stages of your investment lifetime. Obviously, the asset allocation is particularly important when you reach retirement. There's no one-size-fits-all allocation for someone reaching the stage in their life when they'll be spending down their nest egg, but having about half of a portfolio in equities at retirement, with the rest in bonds, seems a reasonable place to start.

In this respect, indexing is no different than any other strategy. It gives you higher returns during pre-retirement, when, presumably, you have a higher allocation to stocks, and a lower return

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during retirement when you need to increase your bond position. By the way, there is no better way to buy bonds than through bond index funds. Actively managed bond funds are outrageously overpriced.

Investors who reaped the benefits of compounding during their working career should be very well aware that compounding does not help, to the same degree, in the de-accumulation phase. Investors must have some bonds to moderate the potential decline in the equity portion of their portfolio, making bad equity markets more tolerable. [Ed Note: You may want to contrast this with the views of Harold Evensky, who we interviewed in July.]

Studies have shown that investors can achieve fairly effective diversification with a portfolio as small as 20 holdings. Accepting your data about the pernicious effect of unnecessary costs, should investors consider a do-it-yourself index with the top 20 holdings in the S&P 500, as a way to drive down their costs even further?

There's no reason to assume that the costs of operating an "S&P 20" index fund are less than that of the Vanguard S&P 500 index fund. That fund has an expense ratio of about 15bp, of which 14bp are operating costs and only 1bp is the cost of administering the fund's investments. You can't operate and administer your own fund much less than that. And if there aren't cost savings in less diversification, why not get the maximum possible diversification? So I don't agree with the notion that a portfolio of twenty stocks is a reasonable substitute for a broad market index fund. Funny things can happen with imperfectly constructed indices. You may be unwittingly exposed to unsystematic risk – the kind of risk that should be eliminated through diversification. A decade ago, such a portfolio could have easily included stocks like Enron, WorldCom, Tyco, or Time Warner—choices that would have devastated your performance, but had but a relatively small impact on the S&P 500 Index.

Your book contains testimonials to the virtues of indexing from investors such as Warren Buffett, Jack Meyer and David Swensen. But these same individuals are very successful active managers, a success they achieved without heavy reliance on index funds. How do you reconcile this?

Let's take David Swensen, who is someone I know and respect. He is a superior guy in every sense of the word. His compensation is small in Wall Street terms, although it is quite a bit larger than the average American's. As an active investor, he has many things going for him – a brilliant mind, a large and highly capable staff, an infinitely long time horizon (Yale will never retire), a tax exempt status, and a patient Board of Trustees. The average investor – even the HNW or UHNW investor – does not have these resources at their disposal.

Andy Golden does the same work at Princeton, with a similar level of success. Andy has stated that his staff devotes at least 400 person-hours to investigate and perform due diligence on a new alternative investment manager, plus another 70 person-hours per year for oversight. The average investor cannot do this. Let's say someone has $1 million in their portfolio and wants to invest 20% in hedge funds. With minimum investment requirements, they might be able to invest $100,000 in each of two funds. But look at the record on hedge funds in general. It's underwhelming, to say the least. They looked good in a down market, but over time hardly look impressive. I'm not sure how their results will fare with current levels of volatility and the problems in the credit markets, but the recent evidence is little short of alarming. "Handle with great care" if you decide to plunge into these risky waters.

Looking at the data on pages 80-82 of The Little Book of Common Sense Investing, it seems significant that one out of 14 (7%) funds you studied outpaced the market by more than 1% per year. And, of course, every advisor reading this has had success choosing funds for clients that beat their benchmarks. (No one buys the "average" fund.) What do you say to people who are convinced that with little knowledge and due diligence they can be successful in choosing the better-performing funds?

I don't buy it. It looks too easy in hindsight. Investors wait to see good records before they invest, and then they turn sour which is, for example, the history of the Magellan Fund. Sure, advisors will find some funds that win, but I am still a skeptic. Not many funds are durably good. There are exceptions – Longleaf, Bill Miller, Chris Davis, and Dodge & Cox to name a few. [Ed Note: Dodge & Cox funds (DODFX and DODGX) are among the most popular mutual funds in the Advisor Perspectives universe as well as among the Largest Accounts.] But your broker always says 'here is a fund that wins,' never 'here is a fund that has done well in the past.' All past performance numbers are period dependent, since they are based on a selected period. There is never a guarantee that these prior periods will repeat themselves.

Secondly, performance numbers do not properly reflect sales charges. Look at what happens with American Funds. Their A shares are often said to be in the top quartile in performance, but their B shares (which properly reflect sales charges) drop them into the second quartile. American Funds is a great company, but

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even they have difficulty overcoming those costs. American Funds are admirable for their low turnover; their positions are so big they sometimes take a year to unwind, which ironically seems to help their performance. Running more than a trillion dollars in equities and trying to distinguish yourself is not a game for sissies.

So my advice is to make the index fund the core of your portfolio, because it will guarantee the market's returns. Then, if you want to use your judgment, buy a couple of market -like funds, like a Vanguard Windsor II or Primecap or a Dodge & Cox fund. You may do a little better, but this excess return could be erased if you pay sales charges and by tax inefficiencies. If you really like a value strategy, you can buy the Vanguard Value Index Fund, which has a fine lifetime record.

How is your own portfolio invested?

I have no alternative investments, and all my investments are at Vanguard. Approximately 60% are in bonds and 40% in equities. Of the taxable bond portion of my tax-deferred retirement account, about 90% is indexed. In my personal (taxable) account, our Vanguard municipal bond funds are quasi-indexed with no guessing on maturity or compromising on quality. On the stock side, 75%-85% is indexed, and the remaining 15%-25% is held in some active funds that I've held for decades, including Wellington, Windsor, Explorer, Wellesley Income, and the Vanguard Growth and Income fund (the latter being the first quantitative mutual fund, introduced in 1986).

I have had a defined contribution plan since 1951—first at Wellington Management and then at Vanguard. After 56 years, it is worth a fortune through regular tax-deferred investments in low cost funds and in index funds, largely in our equity funds through the late 1996s, and now it is more heavily in our bond funds.

So, on the whole, probably 90% of my investments are in index and index-like funds.

Is the essential problem with the mutual fund industry due to fee structures? For example, if an active fund were willing to charge performance-based fees based on its return in excess of the S&P 500, would you recommend or invest in such a fund?

No, I would not. I like incentive fees, and Vanguard was probably the first firm to use incentive fees. But incentive is an odd word, since all managers have an incentive to win. I am very skeptical of the linkage between incentive fees and returns. Funds have tried this and failed and then dropped their incentive fees. If incentive fees were adopted throughout the industry, it would bring fees down, since it must be obvious that most funds would fail to earn them.

The problems of the fund industry go far beyond the fee structure. The corporate structure is flawed. Most fund companies are owned by financial conglomerates, and fund managers must serve two masters, their firms' owners and their funds' shareholders. They end up serving those that are paying their salary, the fund management company. The central problem is that managers' interests are served by gathering assets. Most managers know this. The way to make money is to bring in more assets, often by bringing out new funds. We are a marketing industry, and we make what we can sell. Fees are very high on many of these newer funds. The manager is supposed to act as a fiduciary to the shareholders, but is acting as a marketer, giving the public what it wants. That is what marketing is all about, but it is not the way you should be running a business when entrusted with other people's money.

Given their advantage of tax efficiency and lower costs vis-à-vis index funds, will broad-market-index ETFs (e.g. SPDR) eventually replace index funds as the best option for long term investments, especially in taxable accounts?

I don't believe that ETFs have either tax efficiencies or lower costs. The costs of the Vanguard ETFs are around 8 or 9bp, as compared to a regular index fund, which is 11 or 12bp with a $100k investment. But you must pay a commission when buying an ETF, and this will erase the difference. There are a lot of ETFs with costs of over 100bp, so they are not uniformly low cost alternatives, especially once you add in those commissions. [Ed. Note: See our recent article on the tax effects of ETFs.]

I have the same doubts about tax efficiencies. How efficient can you be if you are a trader? The SPDR is no more tax efficient than the traditional Vanguard index fund. ETFs are like the famous Purdey shotgun, which is supposedly the best around. It is a great instrument for big game hunting but it is also great for suicide. ETFs offer the flexibility to get in and out fast, but this is silly. It turns mutual fund investing into mutual fund speculation, trading funds as if they were individual stocks, and I don't consider this progress. Only 12 of the 690 ETFs on the market today invest in broad market indices, and the rest are focused on narrow market sectors.

As perhaps the most eminent figure in the mutual fund industry, what large scale structural changes do you foresee for funds over the next 10-20 years? Will

actively managed equity funds eventually disappear, or do they have a justifiable role in the long term picture?

We will unequivocally move to a greater emphasis on passive investing and indexing. This will be most obvious in bond funds, but will be apparent with equity funds as well. A reporter once asked me if I was optimistic about whether the trend toward indexing will triumph. I said I was not optimistic; I was absolutely certain. Investors may ignore their self-interest when they are young, but they will not ignore their own economic interests forever. They will put their funds on autopilot, which will guarantee their fair share of whatever returns the stock and bond markets are generous enough to provide. They will not peek; they will know their returns by observing broad market trends. They will not keep changing their portfolios. I personally have not made any significant change in my portfolio over the last seven years. Investors will come to realize, as I have, that successful money management is about owning businesses, not about trading stocks.

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