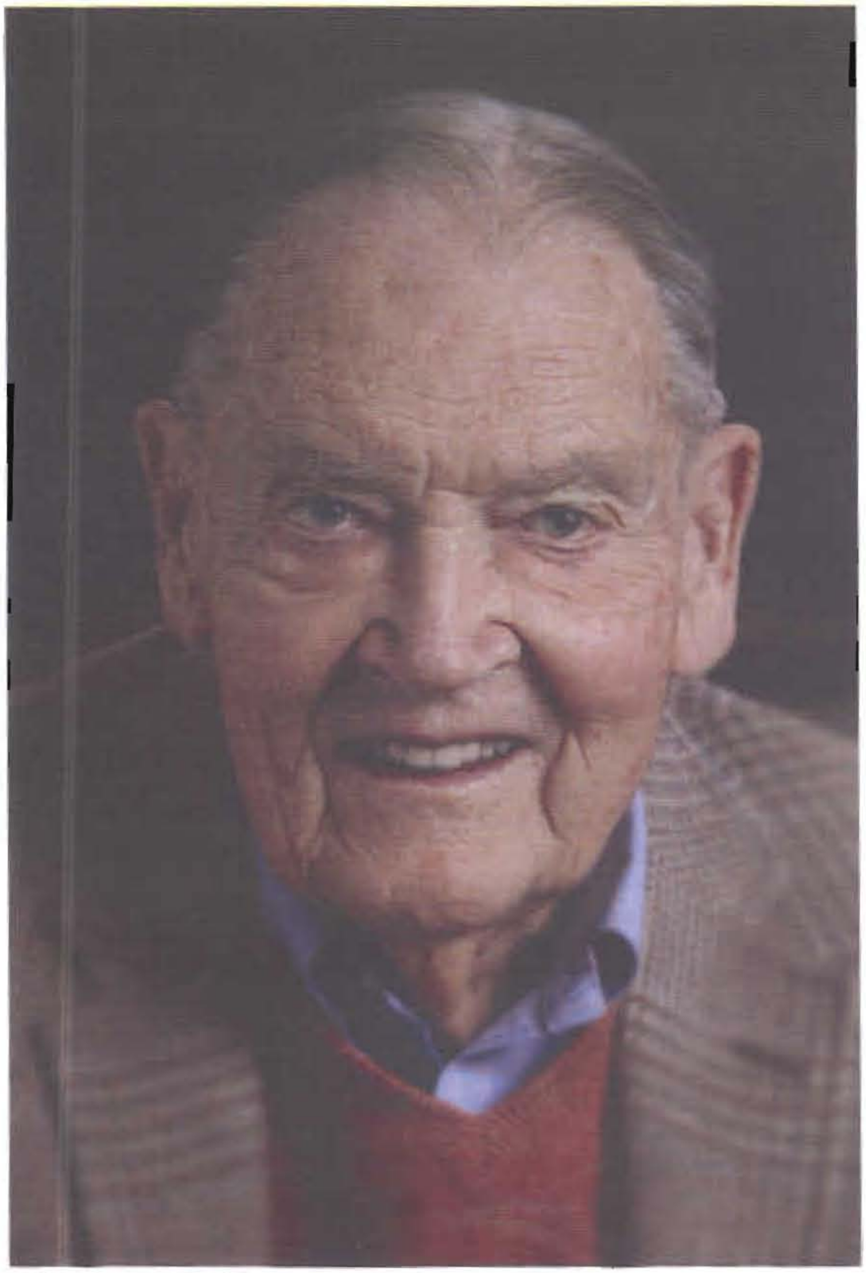
The Scourge Of Speculation

In uncertain times for the global trading community, John C. Bogle, founder of the Vanguard Group, comments on the fundamental difference between investing and speculation.



John C. Bogle, *Founder, Vanguard Group*

Can you give a brief overview of your position on the investment versus speculation debate?

The great British economist John Maynard Keynes drew a stark distinction between investment and speculation, and I echo his sentiments. He separated "forecasting the prospective yield of the asset over its whole life" (what Keynes called enterprise) from speculation — "forecasting the psychology of the markets." These concepts reflect two radically different views of the fundamental nature of investing. Investing refers to the real market of intrinsic business value; speculation is all about the evanescent expectations market of momentary stock prices. And as I've said many times before, the stock market is a giant distraction from the business of investing.

Today, the wisdom of prudent, long-term investment has given way to the folly of short-term speculation. This change has led to deterioration in the conduct, values, and ethics of our financial market participants. Speculation distorts not only the stock market, but the way businesses are actually run. To meet the demands of speculators who value short-term results and predictable earnings in an inevitably unpredictable world, corporate managers are pressured to lay off workers, cut corners, slash research and development, and pursue mergers just to "make the numbers."

Is all speculation to be avoided, or is there a difference between retail investors and institutional investors on the levels of risk and return they should target?

As a group, individual and institutional investors share many common attributes, but individually, wide variations occur. One cannot make broad generalizations about the appropriate level of risk for individual or institutional investors; the problem of risk is much more nuanced than that.

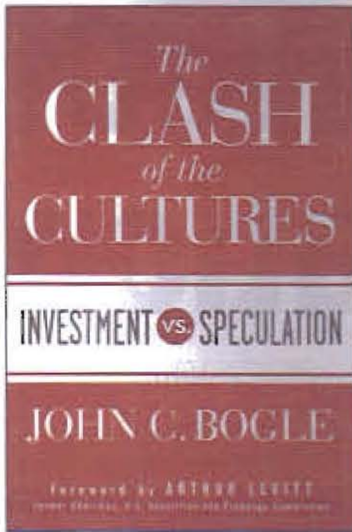
However, the question is never whether or not to take risk, for risk is everywhere. While some individuals may sleep better with dollar-safe investments in a savings account, those dollars are far from safe. They are highly exposed to the ravages of inflation. Over the long-term, those safe dollars will almost surely fail to meet investors' capital accumulation goals. While money invested in equities is much riskier in the short term, if properly diversified and kept in low-cost investments, it should provide remarkable growth over the long term.

Equities are struggling, what other investments should people look towards to meet their growth targets? Or is being long on equities enough of a potential return?

In today's low interest rate environment (the 10-year Treasury is at 1.80% as of this writing), the returns on equities over the coming decade are likely, but hardly certain, to afford a solid return, albeit below historical norms. The timeless sources of returns for equities are the initial dividend yield, earnings growth, and speculative changes in the amount investors are willing to pay for those dividends and earnings.

While equity yields are attractive relative to investment-grade bonds, they are quite low by historical standards. Without a speculative mania in the near future, the 8% return target sought by many of our nation's pension funds will be far out of reach.

However, quality alternatives do not abound. Hedge funds are often simply cleverly repackaged equity portfolios, albeit with egregiously high costs. What about commodities? Well, they are not an investment at all! We know that dividend yield and earnings growth are the sources of long-term returns for equities, and bond returns are based largely on the initial coupon when purchased. Commodities, on the other hand, just sit there. There is no internal rate of return, simply the hope that some other speculator will come along and pay a higher price than you paid for the same ounce of gold, copper, pork belly, or whatever.



The CLASH Of The CULTURES: Investment Vs. Speculation

The rise of speculation, is it a result of technology, regulatory change, or a wider attitudinal and cultural change on the markets?

Regulatory changes paved the way for changes in technology that have allowed speculators to trade stocks at lightning fast speeds, increasing risk and complexity for all market participants. It sometimes feels like the algorithms are in control of the investors, and not the other way around!

But these are symptoms, not causes. The cultural change towards short-termism, focused on ephemeral stock prices rather than enduring intrinsic value, is the fundamental cause of the rise of speculation. Today, far too many of our largest investors don't own stocks, they merely rent them. As a result, they have no interest in corporate governance (as renters, why should they?). This gives our corporate manager/agents the green light to shower themselves with lavish compensation packages and put every politician in sight in their back pocket.

How could the fiduciary duty be established? What effect would this have on trading?

A federal standard of fiduciary duty is absolutely essential to returning investment management from a business focused on asset gathering to a profession focused on the financial needs of clients. And no financial professional should fear a fiduciary standard, *unless their business model depends on putting their own interests ahead of their clients.* I've met with SEC Chairman Mary Schapiro on this topic, and I encouraged her to push forward with establishing a standard of fiduciary duty for managers of pension funds and mutual funds as well as financial advisors to individuals.

Where do you see the future of the stock market and investing heading?

As I mentioned earlier, returns are likely to be below historical averages over the next ten years due largely to the current low interest rate environment. Equity yields are at about 2% and corporate earnings can reasonably, if optimistically, be expected to grow at about 5%. P/E ratios are consistent with long-term historical averages, so I do not see changes in valuations either naturally increasing or decreasing the likely annual return of about 7% for equities over the coming decade.

Bond returns, on the other hand, are easier to project. When we buy a 10-year bond today, we know exactly how much we will earn over the next 10 years. We need simply look at the yield on the date of purchase. With that said, I think it is reasonable for investors to overweight in investment-grade corporate bonds right now. High-grade corporate bonds provide an attractive, but not stellar, premium over government bonds, which are at historically low rates. I think a well diversified portfolio of government and corporate bonds, overweighted to the corporate side, can be expected to provide a 3% annual return over the next ten years.

Open For Discussion

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