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John Bogle's lament for investing's culture clash

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The fund pioneer has witnessed tremendous growth in the mutual fund industry since he came into it in 1951. His latest book delves into its evolution from a 'profession with elements of a business' to 'a business with elements of a profession'

When John Bogle rails about what's wrong with mutual funds, he knows what he's talking about. He practically invented the stuff.

The 83-year-old fund pioneer ("Jack" to all who cross his path) has been in the business for 61 years, when mutual funds were still a tiny niche investment product with a mere $2.5-billion (U.S.) in collective assets. The fund colossus he founded in 1974, Vanguard Group Inc., by itself now oversees nearly $2-*trillion*.

There, he created the world's first index fund – now a $120-billion giant that delivers the S&P 500's returns to mainstream retail investors at an annual management expense ratio of a minuscule 0.05 per cent.

He's also penned nine books, including the new release *The Clash of the Cultures: Investment vs. Speculation*. Its main argument is that the investing industry, and mutual funds in particular, have lost their focus on long-term wealth generation for clients, in the pursuit of short-term profit for themselves.

The Globe and Mail talked with Mr. Bogle about his new book and his views on the state of the investing business. Here are the highlights.

This "Clash of the Cultures" in your book – long-term buy-and-hold investing versus short-term speculation – how has this affected the mutual fund industry?

The culture of the mutual fund industry, when I came into it in 1951, was pretty much a culture of fiduciary duty and investment, with funds run by investment professionals. The firm I worked with, Wellington Management Co., they had one fund. That was very typical in the industry ... investment professionals focused on long-term investing.

Today, that profession with elements of a business [has become] a business with elements of a profession – and not so many elements. The typical large manager today runs around 225 different mutual funds. ... That's the traditional definition of marketing – find out what people want and give it to them. Well what a stupid way to invest! Because people always want the wrong thing at the wrong time – usually, when it's hot ....

A lot of retail investors who are in for the long term can't help but feel like the market's patsies. The people controlling the market are making short-term trades that take advantage of the long-term investors' gullibility...

I don't think there's much to that ... I think the average hedge fund is average. The average mutual fund is average. The average trader is average.... In all these cases, they're average, before costs. With all these smart guys – and they are brilliant out there, particularly the [quantitative analysts] – I don't think there's an inside track to picking investments. There's a *huge* inside track to getting paid a lot of money for picking investments.

What I was trying to get at was the volatility driven by speculative trading that makes the long-term investor feel sideswiped.

I don't think so. The fundamental investment return is the current dividend yield plus the subsequent earnings growth. Today, it's about 6 or 7 per cent. The long-term norm is around 9 per cent – 4.5 per cent dividend yield, 4.5 per cent earnings growth. Today, we have about a 2-per-cent dividend yield. So returns will be lower in the future; that [trend] line will still be going up, but in a slower rate. If you picture that line in your mind, over [the past] 100 years, the market is going above and below that line all the time ...

The ETF industry has drifted away from its early mentality of low-cost, broad index funds, and increasingly toward more exotic, actively managed, narrow, niche products. What's your thinking?

What scares me about ETFs is when you can trade them all day, you're apt to get out of that fund at the very worst time possible ... In a period of great [market] stress, the owner of the ETF will be more likely to say, "Oh my God, it's all over, I'll get out, call the broker" – and that will accelerate the decline even further.

There's nothing the matter with an all-stock-market ETF, or all-bond-market, or all-international-developed market, or even all-emerging-markets.... But most of the others are too narrow – too narrow industry sectors, too narrow country sectors.

And then there are these idiotic things that have triple-leverage, which invite you to come in and bet on how the market's going to do every day. They won't last forever, because the people who do them will ultimately lose all their money, and they won't have any more clients.

Pension funds have portrayed themselves as victims of the speculative market – that they got caught like the rest of us in bubbles that burst. Is this a fair portrayal of what happened?

They did it to themselves.

The last decade, a typical balanced portfolio should have earned around 6 per cent ... that's not horrendous. But if you're counting on 8 per cent, it is.

In the coming decade, if equities do 7 per cent a year – a reasonable enough number – and bonds will be doing less than this because interest rates are so much lower, say 3 per cent a year – and you have 60 per cent in equities and 40 per cent in bonds, that's 5.5 per cent. Then you take out costs, call it 1 per cent, that's 4.5 per cent. They never talk about costs – they talk about market return. That's just stupid. To think you can capture the market return [after costs] – nobody does!

You have to take a very large risk to even consider 8 per cent, and make outlandish assumptions about what [their pension funds] will earn [from alternative asset classes], and about what the manager can add to that return – knowing that the average hedge fund manager is not going to add a couple of hundred basis points a year in extra return.

The average hedge fund manager is going to earn zero per cent in extra return.

This interview has been edited and condensed.