Chapter 9

Ten Simple Rules for Investors and a Warning for Speculators

> Many shall be restored that are now fallen and many shall fall that are now in honor.
>
> —*Horace*[1]

Summing Up

In the course of this book, I've taken you through the hazards created in our financial system when short-term speculation takes precedence over long-term investment. When a value-destroying culture of salesmanship overwhelms a value-enhancing culture of stewardship, of course there's a clash. I've illustrated the problem that speculation engenders by describing its impact on today's financial environment and on our society at large, driven by our complicated new double-agency society in which a

[1]Benjamin Graham used this same quotation from *Ars Poetica* in the first edition of *The Intelligent Investor* in 1949.

powerful symbiotic relationship had developed between corporate executives and institutional money managers. It is high time that we challenge this happy conspiracy that focuses on short-term stock returns over long-term intrinsic values.

The solutions to these formidable problems begin with the development of a statutory federal standard of fiduciary duty outlined in Chapter 3. While I'm disinclined to advocate for further regulations that are detailed and precise, the present application of standards of fiduciary duty that have been on the books for decades has been weak, if not nonexistent. It's time to make it express and clear: *the agent has a duty to put the interests of his principal before his own interests*. (The Investment Company Act and the Investment Advisers Act, both enacted in 1940, establish this noble principle, but it's yet to be enforced.)

Until our government takes action—no mean challenge as long as our Congress is characterized by our intransigent, deadlocked, shockingly self-interested, parochial, and money-driven elected representatives—investors will have to look after their own interests. I have earlier explored how mutual fund investors can do so more effectively by seeking out funds that already measure up to essential fiduciary principles, presenting in Chapter 5 a "stewardship quotient" checklist that investors can use to establish guidelines for their selection of a mutual fund family, and choosing among the mutual funds it supervises.

Buy Broad Market Index Funds

Another major positive step is focusing on index funds as the core of your portfolio. Owning an index fund is simply a decision to buy and hold a diversified portfolio of stocks representing the entire stock market, both U.S. and possibly non-U.S. companies. Such an index fund is the paradigm of long-term investing, and the antithesis of short-term speculation. That was my concept when I created the first index mutual fund way back in 1975, and the growth of indexing over the past 37 years has attested to its soundness—and then some!—over the decades that followed.

But the inherent validity of broad market indexing represented by the traditional index fund (TIF) and its success in serving fund investors—as well as in the marketplace—have paved the way for a new and different kind of index fund—the exchange-traded fund (ETF)—notable for huge turnover of its shares and short-term investor focus (ironically, on long-term investment portfolios), which I describe as speculation. The vast majority of ETFs have high trading volumes day after day, and there are a plethora of ETFs that invest in narrow market segments: ETFs using new and unproven "beat-the-index" strategies, and now explicitly actively-managed ETFs; ETFs trading in currencies and commodities; and ETFs with high leverage. (They typically claim to triple the stock market return, up or down. Take your choice!) Consistent with the broad trends discussed earlier in this book, speculation has come to seriously challenge the original investment concept of the index fund—the total-stock-market-based fund, designed to be bought and held, well, forever.

Wellington Fund and the Index Fund

In the previous chapter on the history of the Wellington Fund, I've also shown that the clash of the cultures is anything but theoretical. It's a real-world chronicle that describes the impact on individual investors in the Fund as it moved from one culture to the other, and then came home again. Wellington's rise from 1928 to 1966 succeeded because it focused on long-term investment. When the Fund turned its focus to speculation in 1966, it was soon hit by the 1973–1974 market crash and experienced a dramatic decline in returns. Its renaissance began in 1978, when it went "back to the future," and returned to its original focus on investment, establishing firm guidelines on the balance between dividend-paying stocks and investment-grade bonds. That change worked wonders, and Wellington Fund has now reclaimed its status as the world's largest balanced fund.

My conviction remains that broad market indexing in stocks and bonds is the only sure way for you to capture your fair share of the returns of the stock market and/or the bond market. But the renaissance of the actively managed Wellington Fund provides some important lessons. Consider the ingredients of success:

- A long-term investment policy, focused on a broadly diversified portfolio of high-quality stocks and bonds and low portfolio turnover, is essential.

- Clarity of investment strategy and dividend policy must be shared by fund directors (acting on behalf of fund shareholders), understood by the fund's investment adviser, and overseen by the fund's executives.
- Mutual understanding by both fund directors and the managers of the adviser that it is absolutely essential for advisory fees and other fund costs to be held to the bare-bones minimum.

As you review these standards for a successful actively managed fund, you probably observe how close they come to the standards for passively managed index funds: long-term focus, clarity of strategy, wide diversification, rigid rules for portfolio selection, and, yes, minimal costs.[2]

No less an investment icon than Jeremy Grantham, a founder and principal of institutional money manager GMO, echoes my conclusion about both indexing and active management in his fourth quarter 2011 letter to shareholders.

> To be at all effective investing as an individual, it is utterly imperative that you know your limitations as well as your strengths and weaknesses. If you can be patient and ignore the crowd, you will likely win. But to *imagine* you can, and to then adopt a flawed approach that allows you to be seduced or intimidated by the crowd into jumping in late or getting out early is to guarantee a pure disaster. You must know your pain and patience thresholds accurately and not play over your head.
>
> If you cannot resist temptation, you absolutely must not manage your own money. There are no Investors Anonymous meetings to attend. There are, though, two perfectly reasonable alternatives: either (1) hire a manager who has those skills—remembering that it's even harder for professionals to stay aloof from the crowd—or (2) pick a sensible, globally diversified index of stocks and bonds, put your money in, and try never to

[2]In fact, Wellington Fund shares nearly all of the performance characteristics of a balanced *index* fund holding a portfolio consisting of 65 percent of assets in the total stock market index and 35 percent in the total bond market index. The correlation of returns between Wellington and the balanced index over the past decade is a powerful 98 percent. (100 percent would mean perfect correlation.)

look at it again until you retire. Even then, look only to see how much money you can prudently take out.

Reversion to the Mean (RTM) is a Virtual Certainty

Time and again, I have tried to drive home to investors the need to select prudent stewards to manage their funds, and to rely heavily on low-cost market index funds as the core (or even 100 percent) of their portfolios. Yet too many investors believe that "it's easy to find funds that have done better, and I know how to do it," or, "it's easy to beat the market, so why settle for boring mediocrity." They don't realize how much better off they would be with the boring mediocrity that index funds offer. Sadly, when investors try to beat the market, they select funds that have done well in the past, with the expectation, or at least the hope, that the past will be prologue to the future.

But in the world of investing, the past is rarely, if ever, prologue. All throughout the modern history of the mutual fund industry, investors have been all too willing to "bet on the wrong horse." This behavior, alas, has been formulated and encouraged by too many fund sponsors focused on salesmanship of the latest "hot new idea." It began with "Go-Go" funds in the mid-1960s, and continued with the "Information Age" boom in technology funds and dot-com funds during the late 1990s.

It remains to be seen whether the boom in gold funds and emerging market funds in recent years, or the excitement of using funds to trade "all day long, in real time" that is reflected in so many of today's ETFs will result in the same unhappy outcome for fund owners. But history tells us that is exactly what has happened in the past. Experience shows that fund speculators who hopped on the bandwagon of "hot" performance have lost tens of billions of dollars by their counterproductive behavior. Logic and common sense tell us that the same patterns will recur in the future.

Let me be specific. On the next few pages, I present eight examples of how some of the top-performing funds of the past succeeded in achieving market-beating returns—often over long periods—but finally faltered: Reversion to the mean (RTM) writ large. Paraphrasing economist Herbert Stein, former head of the Council of Economic Advisers in both the Nixon and Ford administrations, "If something can't go on forever, it will stop."

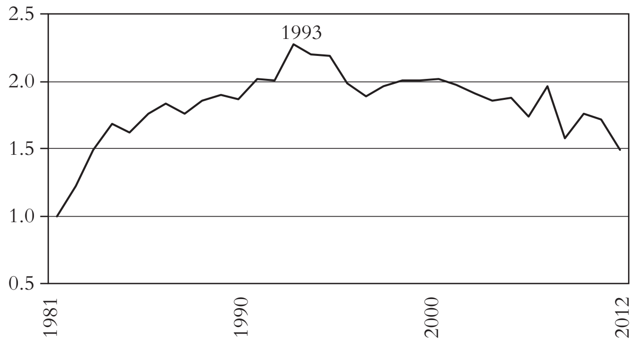
Nothing Is Forever: Eight Sobering Examples of Reversion to the Mean

The "telltale charts" that follow present the past investment performance of some of the most successful funds of the industry's modern history. They are devised simply by dividing the cumulative return of each fund into the return of the broad stock market (in this case, the S&P 500). The line begins at 1.00. As it rises, the fund is outperforming the market. As it falls, the fund is underperforming. The funds presented in this analysis include many of the funds that are more prominent examples of the pervasive presence of RTM.

CGM Focus Fund (1998–2012)
Cumulative Return vs. S&P 500

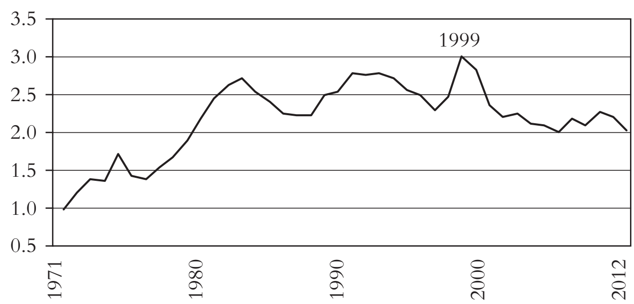
CGM Focus Fund is the classic short-term RTM fund. . . . Sole portfolio manager, Ken Heebner. . . . Assets grew from $100 million at start to $6 billion in 2007, only to tumble to $1.7 billion by 2012. . . . Fund return in 1998–2007, +917 percent; S&P 500 return, +78 percent; Great! . . . Then the music stops. . . . Fund return in 2007–2011 –51 percent, S&P 500 –6 percent. . . . Fund annual return for full period, 12.2 percent. . . . With a return of more than 18 percent per year, the Fund was the best performing U.S. stock fund of the decade. However, "the typical shareholder lost 11% annually." (*The Wall Street Journal*, December 31, 2009.)

Fidelity Magellan Fund (1981–2012)
Cumulative Return vs. S&P 500



Fidelity Magellan Fund is the classic long-term RTM fund. . . . Offered publicly in 1980, following annual returns averaging 22 percent as a Fidelity "in-house" fund since 1964. . . . Managed by stock-picking legend Peter Lynch until 1990, with 588 percent return versus 268 percent for S&P 500. . . . In 1990 assets of $12 billion, rose to $106 billion in 1999. . . . Return 1990–2011, 368 percent; S&P 500 487 percent. . . . In 2012 assets of $15 billion, down 85 percent from high of $105. . . . Fund annual return has lagged S&P since 1983—19 years. . . . Fund 9.7 percent, S&P 10.2 percent (for more detail, see Exhibit 5.5).

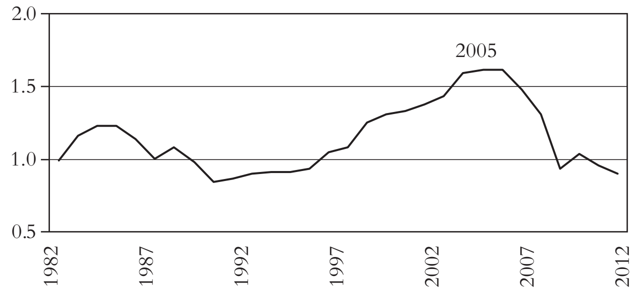
Janus Fund (1971–2012)
Cumulative Return vs. S&P 500



Janus Fund made its mark as one of the "hottest" funds of the Information Age bubble of the late 1990s. . . . An 18.5 percent annual return for 1971–1999. . . . Assets up from $400 million in 1998 to

$43 billion as 2000 began. . . . Investors jump on the bandwagon. . . . Becomes principal buyer of large-cap tech stocks. . . . Subsequent cumulative return –28 percent, with S&P 500 up 7 percent. . . . Investors depart in droves. . . . In 2012 assets $7.5 billion, off 82 percent from peak. . . . Since 1983, Fund annual return 9.6 percent, S&P 500 10.6 percent.

Legg Mason Value Trust Fund (1982–2012)
Cumulative Return vs. S&P 500

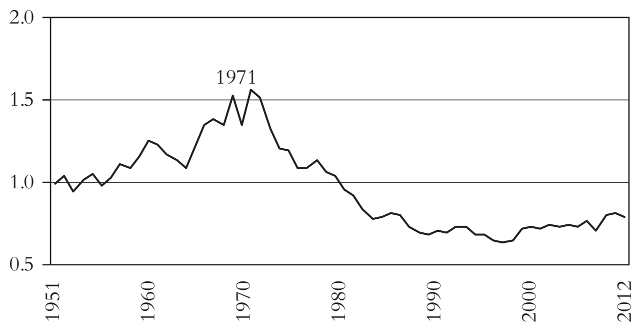


Legg Mason Value Trust Fund was managed by investment pro Bill Miller from inception through early 2012 . . . only portfolio manager in fund industry history to outpace S&P 500 for 15 consecutive years (1991–2005 inclusive). . . . Assets soar from $600 million to $20 billion. . . . In 2006–2008, Fund cumulative return –56 percent loss compared to –22 percent for S&P 500. . . . Assets collapse to $2.5 billion. . . . Over entire history, Fund almost matches the market; annual return of 10.3 percent versus 10.6 percent for S&P 500.

PBHG Growth Fund (1986–2004)
Cumulative Return vs. S&P 500

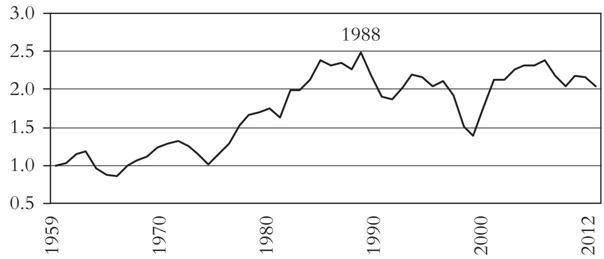
PGHG Growth Fund was run since inception in 1986 by Pilgrim Baxter's Gary Pilgrim. . . . When fund assets only $180 million in 1993 and turnover of 200 percent, validity of performance hard to establish. . . . As 671 percent cumulative return soars above S&P 500s 300 percent in 1988–1996, assets leap to $6 billion. . . . RTM strikes in 1996–1998, with a cumulative return of 6 percent versus 64 percent for S&P. . . . Even a monster (reported) gain of 92 percent in 1999 doesn't stem the tide. . . . In 2000–2003, Fund return of –56 percent far exceeds S&P 500s –20 percent drop. . . . In 2003 Pilgrim and partner Harold Bradley settle charges of fraud and breach of fiduciary duty brought by the SEC. . . . When assets shrink to $800 million in 2004, Fund ceases operation.

T. Rowe Price Growth Stock (1951–2012)
Cumulative Return vs. S&P 500



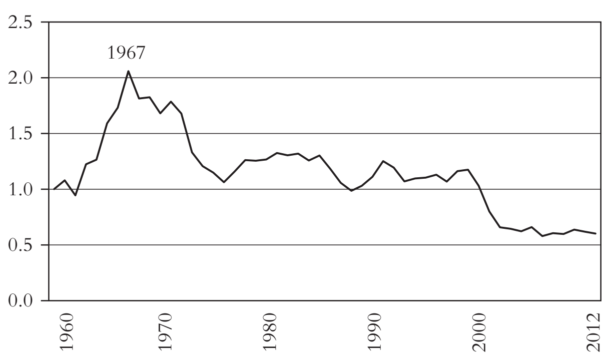
T. Rowe Price Growth Fund is a classic growth fund managed by a classy organization, but couldn't avoid the ravages of RTM. . . . Started in 1950 by (yet another) investment legend, T. Rowe Price, by 1971 the fund's cumulative investment return of +1648 percent surpasses the S&P 500 return of +1021 percent by more than 600 percentage points. . . . Assets soar to $1.2 billion—first no-load fund to reach the $1 billion milestone . . . RTM then begins. . . . Huge shortfall in 1971–1988—fund +172 percent, S&P 500 +470 percent. . . . Since then, Fund reverts almost precisely to the market mean. . . . Fund lifetime annual return +9.5 percent versus +9.2 percent for S&P 500. . . . A fund's long-term return can't be too much closer to the market mean than that!

Vanguard Windsor Fund (1959–2012)
Cumulative Return vs. S&P 500



Vanguard Windsor Fund was Wellington Management's first equity fund. . . . Formation makes headlines in 1958. . . . A rare mutual fund that has made it through more than a half-century with objectives essentially intact. . . . A 7 percent annual return lagged the 10 percent return of the S&P 500 during 1958–1963. . . . Yet another legendary investor, John B. Neff, becomes the Fund's manager. . . . Returns soared through 1988 . . . with $4 billion of assets in 1985, became the industry's largest equity fund. . . . Then closed to new investors to avoid handicap of excessive assets. . . . With remarkable 31-year annual return of 14 percent versus 11 percent for S&P 500, Neff retires in 1995. . . . Assets grow to $21 billion in 1997, even as performance falters badly in 1997–1999, only to recover nicely in 1999–2000. . . . Assets dwindle to $12 billion in 2012. . . . Post-Neff annual returns: Fund 6.5 percent; S&P 500 6.5 percent. . . . Inferior returns turn to superior; then back to inferior; then average. Yet again, RTM strikes.

Vanguard U.S. Growth Fund (1960–2012)
Cumulative Return vs. S&P 500



Vanguard U.S. Growth Fund began in 1958 as Ivest Fund. . . . Wellington Management acquires its manager in 1966. . . . Cumulative return during 1961–1967 best in the entire mutual fund industry; 327 percent versus 108 percent for the S&P 500. . . . Pummeled in the 1973–1974 crash: −55 percent versus −35 percent for the S&P 500. Pedestrian recovery. . . . Cumulative return 1960–1976: Fund 238 percent; S&P 218 percent. RTM strikes again. . . . Name changed to Vanguard Growth Fund in 1980, then became a separate U.S. Growth portfolio. . . . New manager in 1987. . . . Fund and S&P 500 both rise 18 percent per year in 1987–1999. . . . Then fund falters again in 1999–2012. . . . Fund return −45 percent versus +7 percent for the S&P 500. From first in 1967 to worst in 2003.

Box 9.1

If You Pick Actively Managed Funds . . . The "Four Ps" in Evaluating Fund Managers

P + P + P + P (+ P)

Picking past fund winners—especially funds with outsized gains in short periods—has almost always proved to be a loser's game. So on what else can the investor who prefers actively managed funds to passively managed index funds rely? How can a motivated investor increase the odds of selecting a competent manager?

Way back in 1984, when Vanguard was seeking an active manager for a new growth fund, I faced this very question. We evaluated, and then hired, the young PRIMECAP Management Company, run by former portfolio counselors at the American Funds group, and agreed to use their firm's name for the new fund. In Vanguard PRIMECAP Fund's 1985 annual report, I explained our decision to shareholders, measuring the manager against a standard that I called "the four P's." Here are the four key questions I asked, and excerpts from my answers:

(*Continued*)

1. **People.** Who are the managers of the fund? "The people of PRIMECAP are outstanding investment professionals with a sterling reputation, who have, collectively, some 85 years of experience."
2. **Philosophy.** What are they seeking to accomplish? "The implementation of an investment philosophy with a growth orientation." (I also loved the managers' low portfolio turnover, reflecting their focus on the long term.)
3. **Portfolio.** How do they go about implementing their philosophy? "The pension portfolios managed by PRIMECAP include a mix of blue-chip stocks, some with a growth orientation; some with generous yields; companies deemed subject of takeover bids, and stocks in businesses deemed interest-sensitive."
4. **Performance.** What has their record been? I emphasized that "past performance wasn't the first criterion, but the last. Important, yes, but only in the context of the other three factors."

How did it all work out? At the end of the fund's first full year, as I reported to shareholders, PRIMECAP had outpaced 151 of the industry's 171 growth funds. A good start indeed, for a record, viewed in retrospect 26 years later, that began one of the highest-achieving—and most consistent—funds in Vanguard's history. Among the 94 growth funds that survived the quarter-century-plus-period, the Fund outpaced 89 of them. This record is a special tribute to Howard Schow, cofounder of the firm, who died at age 85 in early 2012. He deserves our salute and a hearty "thank you and bless you" from shareholders for the long partnership we enjoyed.[3]

[3]It was not all peaches and cream. In 1987 through 1990, the fund's return of 32 percent lagged the S&P 500's return of 57 percent, with later lags in 1996–1997, and again in 2010–2011. But the overall extraordinary annual return of 12.9 percent vs. 10.4 percent for the S&P speaks for itself.

Morningstar Ratings

In 2011, my "four P's" were eerily echoed by a new set of Analyst Ratings produced by Morningstar, the respected fund analysis organization. "Our (new) ratings (Gold, Silver, Bronze, Neutral, and Negative) reflect a synthesis of each fund's fundamentals, (grouped) into five pillars: People, Process, Parent, Performance, and Price." The first four "Ps" Morningstar listed were virtually reiterations of my own scorecard of a quarter-century earlier. (Simply because Vanguard had completed a tough negotiation on fees with the adviser leading to an extremely attractive scaled-down fee schedule, I hadn't mentioned that "fifth P"—"Price"—in my PRIMECAP Annual Report letter. So now we have *five* Ps.) A few excerpts from Morningstar's standards:

1. **People.** We think about what advantages they have over their peers along the lines of expertise, experience, and demonstrated skill, and assess how much a manager has invested in the fund; to assess firm-wide expertise; how much experience, and whether there's turmoil or stability in the ranks.
2. **Process.** Is the manager doing something that anyone can do or doing things that are hard to replicate? Is the strategy a proven one or a new, untested formula? Just as important is how well the process is matched to the manager and firm's skill set.
3. **Parent.** When you invest for the long haul, you realize just how important the company behind the fund is. We look at manager turnover at the firm, the investment culture, quality of research, ethics, directors, SEC sanctions, and more. . . . You want a partner you can trust for many years to come.
4. **Performance.** We focus on performance under the current manager. The longer the record, the more predictive of future relative performance. We care about the strategy and

(*Continued*)

holdings, and how a fund has performed in different market environments, its risk profile, and consistency of returns over time.

5. **Price.** Costs are a good predictor of future performance. They aren't everything, but they are a crucial piece in the puzzle. We look at a fund's expenses relative to its peer group, asset size and in some cases its trading costs.

The echoes of my "4 Ps" (really 5) and Morningstar's "5 Ps" continue to resonate. These touchpoints are sound, and can be helpful to investors selecting active fund managers. Following similar guidelines should provide investors the best opportunity to earn optimal returns on the actively managed funds in your portfolio, albeit with long odds *against* surpassing the after-cost, after-tax returns of an all-market index fund. Now, let's cut to the chase, and consider 10 rules for long-term investment in equity mutual funds, rules that ignore the noise created by short-term speculation.

Ten Simple Rules for Investment Success

The 10 elements of a simple strategy that follow should help you decide your optimal course of action for the years ahead. I wish I could assure you that the investment strategy outlined below is the best strategy ever devised. Alas, I can't promise that. But I can assure you that the number of strategies that are worse is infinite.

1. Remember Reversion to the Mean
2. Time Is Your Friend, Impulse Is Your Enemy
3. Buy Right and Hold Tight
4. Have Realistic Expectations: The Bagel and the Doughnut
5. Forget the Needle, Buy the Haystack
6. Minimize the Croupier's Take
7. There's No Escaping Risk

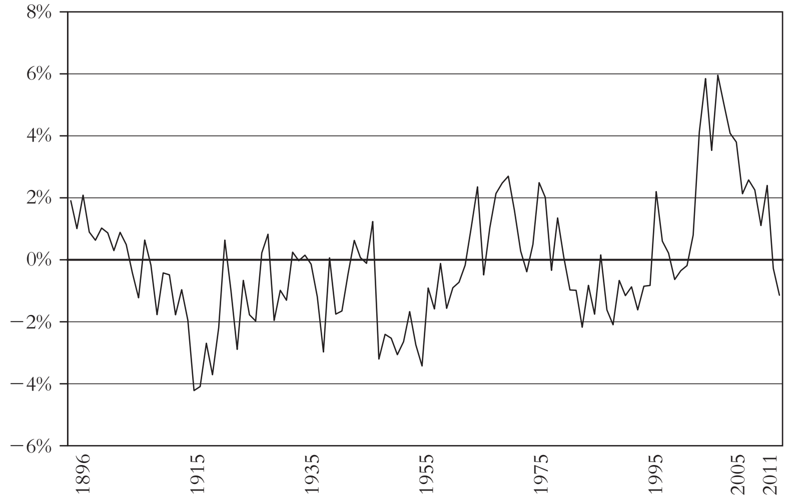
8. Beware of Fighting the Last War
9. The Hedgehog Bests the Fox
10. Stay the Course!

Rule 1: Remember Reversion to the Mean

After what I've focused on earlier in this chapter, it will not surprise you that "Remember RTM" is the first of these 10 rules. The message is that selecting your fund for tomorrow by picking a winner from yesterday is an exercise fraught with peril. No, the past is not prologue. This RTM concept applies not only to fund managers, but to fund objectives. Yesterday's growth fund leadership is often tomorrow's value fund leadership. The same is true with large-cap funds and small-cap, and with U.S. stocks and non-U.S. stocks.

RTM is also true of the stock market itself. Simply because of dividend yields and earnings growth, the fundamental value of stocks is highly likely to increase over time. But when stock market returns substantially exceed the investment returns generated by dividends and earnings during one era, the market tends to first revert to and then fall well short of that norm during the next era. Like a pendulum, stock

Exhibit 9.1 Stock Market Returns Revert to Fundamental Returns. Rolling 25-Year Periods, 1896–2011



prices swing far above their underlying values, only to swing back to fair value and then far below it, and then converge again. When returns in the stock market get way ahead of the fundamentals—or way behind—RTM will strike again, sooner or later.

This illuminating chart makes it clear—admittedly, in retrospect—how attractive stock prices were before the great bull markets of 1954–1973 and 1977–1999, and how unattractive stock prices had become in the late 1990s. Only time will tell whether those patterns will repeat in the decades to come, but I am highly confident that this lesson of history—repeated over and over again in the past—will prevail. Finally, long-term value, not short-term price, rules the world, simply reinforcing the classic Graham principle about the voting machine and the weighing machine.

Rule 2: Time Is Your Friend, Impulse Is Your Enemy

Never forget that time is your friend. Take advantage of it, and enjoy the miracle that is compound interest. If, over the next 25 years, stocks produce an 8 percent return and a savings account produces a 2 percent return (in mid-2012, both are fairly aggressive numbers), $10,000 would grow by $58,500 in stocks versus $6,500 in savings. (After 2 percent inflation, $33,000 versus zero in real spendable dollars.) Give yourself all the time you can, and never forget the risk of inflation.

Impulse is your enemy. Realize that one of the greatest sins of investing is to be captivated by the siren song of the market, which can lure you into buying stocks when they are soaring and into selling stocks when they are plunging. Impulses like these can destroy even the best of portfolios. Why? Because market timing is impossible. Even if you turn out to be right when you sell stocks just before a decline (a rare occurrence!), where on earth would you ever get the insight that tells you the right time to get back in? One correct decision is tough enough. Two correct decisions in a row are nigh on impossible. And a dozen correct decisions over your investment lifetime is unimaginable.

When you think long term, you'll be less likely to allow transitory changes in stock prices to alter your investment program. There is a lot of noise in the moment-by-moment volatility of the stock market, which too often is, as Shakespeare wrote in a different context, "a tale told by an idiot, full of sound and fury, signifying nothing." If you allow your impulses to take over your rational expectations, of course impulse is your enemy.

Rule 3: Buy Right and Hold Tight

The next critical decision you face is getting the proper allocation of assets in your investment portfolio. Stocks are designed to provide growth of capital and growth of income, while bonds are for conservation of capital and current income. Once you get your balance right, then just hold tight, no matter how high a greedy stock market flies, nor how low a frightened market plunges. Change the allocation only as your investment profile changes. Begin by considering a 50/50 stock/bond balance, and then raise the stock allocation if:

- You have many years remaining to accumulate wealth.
- The amount of capital you have at stake is modest (for example, when you make your first investment in a thrift plan or an IRA).
- You have little need for current income.
- You have the courage to ride out booms and busts with reasonable equanimity.

As you age, *lower* your stock allocation accordingly. You have fewer years remaining to build your retirement; you likely have much more wealth; you'll soon need to spend your investment income rather than reinvest it; and (if you're like me) you're not quite so relaxed about violent market volatility. But, in your asset allocation, don't forget to include as a bond-like component of your wealth the value of any future pension and Social Security payments you expect to receive.

Rule 4: Have Realistic Expectations: The Bagel and the Doughnut

These two different kinds of baked goods—the bagel and the doughnut—symbolize the two distinctively different elements of stock market returns. It is hardly farfetched to consider that the bagel of the stock market is *investment* return—dividend yields plus earnings growth. The investment return on stocks reflects the bagel's underlying character: nutritious, crusty, and hard-boiled.

By the same token, the spongy doughnut of the market is *speculative* return wrought by any material change in the price that investors are willing to pay for each dollar of earnings. When public opinion about stock valuations changes from the soft sweetness of optimism to the acid sourness of pessimism and vice versa, that's evidence that the doughnut's essence has taken charge. While the substantive bagel-like economics of investing are almost inevitably productive, the flaky, doughnut-like emotions of investors are anything but steady. Indeed, as noted in Rule 2, these emotions are almost always counterproductive.

In the long run, it is investment return that rules the day. In the past 40 years, the annual investment return was 9 percent, almost precisely equal to the stock market's total return of 9.3 percent. The speculative return on stocks was just 0.3 percent. In both the first and last of those decades, as I noted in Chapter 2, investors soured on the economy's prospects, and tumbling price-earnings ratios provided a negative annual speculative return averaging –5.3 percent, reducing a solid annual investment return of 7.7 percent to a market return of just 2.4 percent. In the 1980s and 1990s, on the other hand, the outlook sweetened, and a soaring P/E ratio produced a sugary 7.4 percent annual speculative boost to an investment return of 10.1 percent. Result: an unprecedented total return on stocks averaging 17.5 percent per year during two consecutive decades.

Combining all four decades, the stock market return has averaged 9.3 percent annually, totally dominated by the 9 percent investment return, very close to the 100-year average of 9.0 percent. (Talk about the power of RTM!) The lesson: Enjoy the bagel's healthy nutrients, and don't expect the doughnut's sweetness either to enhance them or its sourness to erode them over the long run.

What does the future hold? Of course we can't be certain. But reasonable expectations for stocks suggest an annual return of about 7.5 percent for stocks and 3.5 percent for bonds in the decade that began on January 1, 2012. In Box 9.2, I explain where those numbers come from.

Box 9.2

Reasonable Investment Expectations for the Coming Decade

Relying on the *sources* of market returns has proved in the past to be an exceptional way to establish reasonable expectations for the future returns on stocks. The initial dividend yield at the start of the decade is already a known factor, and corporate earnings are more likely than not to grow at a rate related to the growth of our nation's GDP.

While the level of the price-earnings multiple a decade hence can hardly be known in advance, we know more than we think. For RTM comes heavily into play once again. When the P/E was below 12 at the start of a past decade, it was highly likely (90 percent probability) to rise by its conclusion. If the P/E was above 18, it was highly likely (80 percent probability) to decline over the decade.

So let's look at what we might expect in the decade beginning in early 2012. The dividend yield on the S&P 500 is 2.1 percent. Annual earnings growth in the range of 5 to 6 percent (perhaps a bit less) seems a reasonable likelihood. Result: a possible *investment* return averaging 7 to 8 percent per year.

With outstanding earnings in 2011, the P/E now stands at around 16, close to the long-term historical average. I don't expect that P/E to be a lot different when 2022 begins. Result: a *speculative* return of zero, more or less. Combining the two sources, reasonable expectations suggest an annual *total stock market* return in the range of 6 to 9 percent during the coming decade.

A few words about bond returns. The interest rate at the beginning of a given decade has proved to be an exceptionally reliable basis for establishing reasonable expectations for the decade that follows. The entire source of the fundamental return over any subsequent decade has been the interest rate at the

(*Continued*)

outset. Assuming a bond portfolio composed of one-third U.S. Treasuries and agencies and two-thirds investment grade corporate bonds, with a combined average maturity of 10 to 12 years, you could expect a *fundamental* return near today's yield of around 3 percent. If held for the full 10 years, the final value of the bond portfolio is likely to center on its initial par value (assumed to be 100). So there should be no significant *speculative* return (positive or negative) affecting the calculation, and income will call the tune. Result: an annual *total return* on bonds of 2 percent to 4 percent.

Over the coming decade, that difference between stocks and bonds matters. If stocks return 7 percent, capital would increase by almost 100 percent. If bonds return 3.0 percent, capital would rise by about 35 percent. For a 60/40 balanced portfolio earning 6 percent, the increase would be about 70 percent.

CAUTION: These numbers reflect *nominal* returns. Should inflation average 2.5 percent annually, the return on the balanced portfolio would decline from 5.4 percent to about 3 percent before investment expenses. Should those all-in costs come to 2 percent—a typical number for mutual funds—only 1 percent would remain for the investor. That's largely why index funds (0.1 percent cost) are such a reasonable option.

All of these figures are merely my rational expectations. While I can easily guarantee an uneven path for such a balanced stock/bond portfolio along the way, I can't guarantee the final outcome. For in mid-2012, economic and market conditions together constitute as challenging a combination as I have seen at any time during my 61 years in finance (a milestone I reached on July 7, 2012).

Economic conditions in the U.S. and around the globe are, bluntly put, threatening. The battle has been joined between Keynesians demanding that governments borrow and spend to increase aggregate demand for goods and services, and Hayekites (disciples of the Austrian School of Economics) calling for fiscal austerity. It's premature to guess how a compromise might be reached. For the political will to save both the Euro from fragmenting and the dollar from inflation by taking strong action to redirect our nation's enormous overlay of debt seems stymied by partisan interests. Our economic future depends on resolving these seemingly intractable issues.

Financial market conditions, too, are unusually difficult. While the U.S. stock market seems reasonably valued, its long-term performance—let us never forget—is ultimately dependent on the course of our economy. In many earlier eras of challenge, bonds provided not only a haven against stock market risk, but solid yields while you waited. Today, bond yields are, well, awful. The yield on ten-year U.S. Treasury notes is just 1.6 percent, and the yield on the total bond market index is just 2.03 percent, only slightly above the stock yield of 2.0 percent.

My unvarying advice continues to be to accept the yield environment as it exists (no matter how painful). Most investors should avoid reaching out on the risky limbs of higher-yielding junk bonds and high-dividend stocks. With U.S. Treasury yields so low relative to investment-grade corporates, however, a holder of the total bond market index (72 percent in government-backed issues), might seek some increased exposure to corporate bonds, as suggested a few paragraphs earlier. Invest you must, however, for *not* investing is an iron-clad formula for failure.

The Academics Speak. I've been using the sources of return to establish reasonable expectations for future stock and bond returns for as long as I can remember. But it was not until early 1991 that I formally published my findings, spelled out in my article "Investing in the 1990s" in the spring issue of *The Journal of Portfolio Management*. In a follow-up article entitled "Occam's Razor Revisited" in the fall edition of *JPM*, I revisited the subject. Despite the demonstrated soundness of my methodology, it has been rarely noted in the academic literature.

Two exceptions: Writing in Barclay's *Investment Insights* in July 2002, Dr. Kenneth Kroner and Dr. Richard Grinold, former chairman of the management science faculty of the University of California at Berkeley, explained essentially my same thesis for stocks in this (to me, complex) equation:

$$R = D/P - \Delta S + i + g + \Delta PE$$

where:

$D/P - \Delta S$ is Yield (including share repurchases)
$i + g$ is Earnings Growth (inflation plus real earnings growth)
ΔPE is repricing (i.e., impact of change in P/E)

They also forecast that "the return to the 10-year government bond over the next 10 years is just the yield on that bond."

While Grinold and Kroner failed to mention my 1991 publication that introduced essentially the same methodology more than a decade earlier, Professor Javier Estrada of the IESE Business School was extremely gracious in this regard. In his article from the journal *Corporate Finance Review*, "Investing in the Twenty-First Century: With Occam's Razor and Bogle's Wit," he concluded "Sir William of Occam taught us to focus on the essentials, and Bogle showed us how to apply that lesson to forecasting the long-term returns of stock markets.[4] Taking a cue from both, I evaluate the forecasting ability of two simple models, and show that they are surprisingly successful."

Also generous in recognizing my methodology are Princeton professor Burton G. Malkiel and professors Earl Benson and Sophie Kong of Western Washington University, along with investment analyst Ben D. Bortner. In the Fall 2011 issue of *JPM*, Benson, Kong and Bortner applauded my 1991 formulation as "a rather elegant, yet simple, method of estimating the expected [long-term!] return on common stocks—using 'the Bogle model.'"

Rule 5: Forget the Needle. Buy the Haystack

It was Cervantes who warned us, "Look not for a needle in a haystack." While that phrase has become deeply imbedded in our language, it has yet to gain acceptance from most mutual fund investors. Too many of us spend countless time and effort poring over fund records, getting information from news articles and television interviews and friends, and from hyperbolic fund advertisements and well-intentioned fund rating

[4]I explain Occam's Razor more fully in Chapter 6.

services. In substance, all of these statistics describe the past returns of mutual funds with decimal-point precision, yet have no predictive power to forecast the future returns that a fund may earn. As it turns out, we are looking for a very small needle in a very large haystack.

When we look for the needle, we seem to rely in our search largely on finding fund needles based on past performance, ignoring the fact that what worked yesterday so often fails to work tomorrow. Investing in equities entails four risks: stock risk, style risk, manager risk, and market risk. You can easily eliminate the first three of these risks simply by owning the entire stock market—owning the haystack, as it were—and holding it forever.

Yes, market risk remains. It is quite large enough, thank you. So why pile those other three risks on top of it? If you're not certain that you're right (and who can be?), diversify. Owning the entire stock market is the ultimate diversifier for the stock allocation of the portfolio. When you understand how hard it is to find that needle, simply buy the haystack.

Rule 6: Minimize the Croupier's Take

The resemblance of the stock market to the casino is hardly far-fetched. Both beating the stock market and gambling in the casino are zero-sum games—but only before the costs of playing the game are deducted. After the heavy costs of financial intermediation (commissions, spreads, management fees, taxes, etc.) are deducted, beating the stock market is inevitably a loser's game for investors as a group. In the same way, after the croupiers' wide rakes descend, beating the casino is inevitably a loser's game for gamblers as a group. (What else is new?) I reiterate what I've emphasized often in this book, investors as a group must and do earn the market's return before costs, and lose to the market by the exact amount of those costs.

Your greatest chance of earning the market's return, therefore, is to own the market itself, and reduce the croupiers' take to the bare-bones minimum. When you read about stock market returns, realize that the financial markets are not for sale, except at a high price. The difference is crucial. If the stock market's return is 8 percent before costs, and intermediation costs are approximately 2 percent, then investors will capture a net return of 6 percent. Compounded over 50 years, a 6 percent return increases capital of $10,000 by $174,000. But if investors earn the full

8 percent, their final value would leap by $459,000—more than two and a half times as much, merely by eliminating the croupier's take. Yes, in mutual funds performance comes and goes, but expenses go on forever. So I reiterate that, in the mutual fund industry, *you not only don't get what you pay for, you get precisely what you don't pay for.* Therefore, if you pay *nothing*, you get *everything* (i.e., the stock market's gross return).

Rule 7: There's No Escaping Risk

When you decide to put your money to work to build long-term wealth, you are not deciding whether or not to take risk, for risk is everywhere. What you must decide is what kind of risk you wish to take. "Do what you will, the capital is at hazard," just as the Prudent Man Rule assures us. Written by Justice Samuel Putnam of Massachusetts way back in 1830, here's how he expressed that classic rule:

> All that can be required of a trustee to invest is that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion, and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of the capital to be invested.

Yes, money in a savings account is dollar-safe, but the value of those safe dollars are virtually certain to be substantially eroded over time by inflation, a risk that almost guarantees that you will fail to reach your capital accumulation goals. And yes, money in the stock market is very risky over the short term. But if your portfolio is well diversified, it should provide remarkable growth over the long term. Why? Simply because our public corporations have huge amounts of capital to employ. They earn profits on that capital that can be distributed as dividends, reinvesting the remainder in the business to earn additional returns. So your capital is almost certain to be safer in real-dollar terms over the long term than those "safe" dollars in your savings account.

Rule 8: Beware of Fighting the Last War

Too many investors—individuals and institutions alike—are constantly making investment decisions based on the lessons of the recent, or even the remote, past. We seek technology stocks after they have emerged victorious in the great bull market of the "Information Age." We worry about high inflation after it becomes the accepted bogeyman, and it then recedes. We flee stocks after the stock market has plunged, and then miss the subsequent recovery.

You should not ignore the past, but neither should you assume that a particular cyclical trend will last forever. None does. Just because some investors insist on "fighting the last war," you don't need to do so yourself. It doesn't work for very long.

Rule 9: The Hedgehog Bests the Fox

The Greek poet Archilochus tells us that *the fox knows many things, but the hedgehog knows one great thing*. The fox—artful, sly, and astute—represents the financial institution with investment professionals who know many things (or at least sincerely believe that they do) about complex markets and sophisticated strategies. The hedgehog—whose sharp spines give it almost impregnable armor when it curls into a ball—is the financial institution that knows only one great thing: Long-term investment success is based on simplicity.

The wily foxes of the financial world justify their existence by propagating the notion that an investor can survive only with the benefit of their artful knowledge and professional expertise. Their assistance, alas, does not come cheap. The costs it entails tend to consume any value that even the most cunning of foxes can add. Result: The annual returns earned for investors by financial intermediaries such as actively managed mutual funds have averaged less than 80 percent of the stock market's annual return—a huge loss when compounded over decades.

The hedgehog, on the other hand, knows that the truly great investment strategy succeeds, not because of its complexity or its cleverness, but because of its simplicity and its low costs. The hedgehog diversifies broadly, buys and holds, and keeps expenses to the bare-bones minimum. The ultimate hedgehog is the all-market index fund, operated at minimal cost and with minimal portfolio turnover, which virtually guarantees that you will capture nearly 100 percent of the market's return. The index fund wins because its concept is both priceless and price-less. In the field of investment management, foxes come and go, but hedgehogs are forever.

Rule 10: Stay the Course!

The secret to investing is that there is no secret. When you consider the previous nine rules, you realize what they are *not* about. They are not about magic or legerdemain, nor about forecasting the unforecastable, nor about betting against long and ultimately insurmountable odds, nor about learning some great secret of successful investing. For there is no great secret. There is only the majesty of simplicity. These rules are about elementary arithmetic, about fundamental and unarguable principles. Yes, investing is simple. But it is not easy, for it requires discipline, patience, steadfastness, and that most uncommon of all gifts, common sense.

When you own the entire stock market through a broad stock index fund, all the while balancing your portfolio with an appropriate allocation to an all-bond-market index fund, you create the *optimal* investment strategy. While it is not necessarily the best strategy (as I conceded at the beginning of this chapter), the number of strategies that are worse is infinite. Owning index funds, with their cost-efficiency, their tax-efficiency, and their assurance that you will earn your fair share of the markets' returns, is, by definition a winning strategy. As the financial markets swing back and forth, do your best to ignore the momentary cacophony, and to separate the transitory from the durable. This discipline is best summed up by the most important principle of all investment wisdom:

Stay the course!