The Twelve Pillars of Wisdom

Lessons We Should Have Learned before the Bear Market Arrived, but are Only Learning Now

Remarks by John C. Bogle

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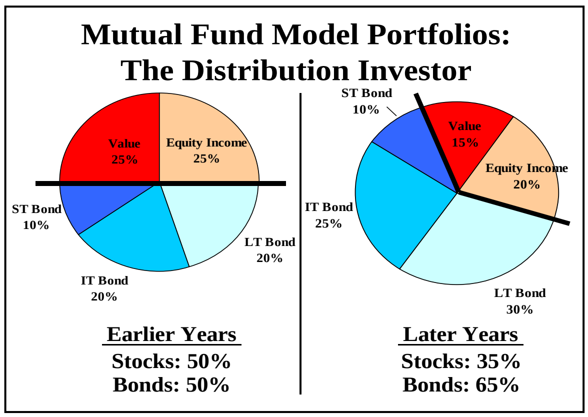
Despite the 15% stock market rally of the past month, a nice rebound from the early April lows, the bear market in stocks that began nearly 14 months ago may yet have some life remaining. But at that scary low point, even if you were a prudent investor, and even if you had seen the decline coming, you may well have had at least two second thoughts: "Why didn't I cut back—or even eliminate!—my equity holdings a year ago?" And "What on earth should I do now?"

As to the first question, I struggle with that one myself. I have been gradually reducing my equity percentage for years, reflecting first my fight for an uncertain survival from congenital heart disease and my desire to assure my wife's financial security, and, second, reflecting my increasing age and declining earning power. With some 75% of my retirement plan and personal account in equities throughout most of my career, I had gradually reduced the ratio to below 45% by last summer. Still, deeply concerned about the NASDAQ bubble and cautious about the outlook for future stock returns, I even wondered aloud at the Morningstar Conference last June why I held any equities at all. But—"physician heal thyself," writ large!—I took no further action.

Why? Certainly inertia was part of it. But even more important was the fact that my own asset allocation was already fully consistent with the sensibly conservative strategy that I've reiterated over the latter part of a half-century. What is more, my lifelong conviction is that while experienced investment professionals may have a pretty good idea of *what* is going to happen in the market, we have no idea of *when*. As I wrote in *Bogle on Mutual Funds* nearly a decade ago, "In an uncertain world, tactical change should be made sparingly, and only if you are prepared to take the risk of being wrong."

In my book, I presented a basic asset allocation model that recommended that older investors, no longer adding to their assets with additional investments and becoming increasingly dependent on income, should focus on a 50/50 stock/bond allocation, reduced to 35% for investors over the age of 75. (No, I'm not there yet, even using my non-heart-transplant age!)



Both model portfolios recommended that the equity position be composed of value funds and equity-income funds, to the exclusion of growth funds, although I have not followed this strategy myself. Instead, I've relied largely on broad-based index funds which weight value and growth equally. In any event, both the 50/50 and 35/65 equity-income and value-based portfolios actually *rose* 14% during 2000 and are now actually up another two percentage points so far this year. (Both had about the same returns.) We should all have been so lucky!

I have no way of knowing how many of you followed my conservative advice, nor how many of you, lured by the boxcar gains turned in by growth funds and tech funds as the stock market reached its high a year ago, abandoned it at just the wrong time. But I believe that if you were guided by the "Twelve Pillars of Wisdom" that was the epilogue of my first book, you've done just fine. In preparation for these remarks, I read them once again, and I found virtually *nothing* I would change today.

Indeed, these twelve sensible guidelines to successful investing are lessons that investors should have learned before the bear market arrived, but that many are only learning now. Bull markets come and bull markets go, inevitably followed by bear markets, which too come and go. But these pillars of wisdom are timeless, and should serve us well in *all* seasons. I'd like to review them with you today.

Pillar 1. Investing Is Not Nearly as Difficult as It Looks.

> *The intelligent investor in mutual funds, using common sense and without extraordinary financial acumen, can perform with the pros. In a world where financial markets are highly efficient, there is absolutely no reason that careful and disciplined novices—those who know the rudiments but lack the experience—cannot hold their own or even surpass the long-term returns earned by professional investors as a group. Successful investing involves doing just a few things right and avoiding serious mistakes.*

"Doing a few things right," as I stressed in my book, included focusing on broad-based mainstream equity funds with wide diversification; evaluating funds relative to peers with similar objectives; ignoring short-term performance in favor of performance over at least a decade; carefully considering the drag of high expense ratios and sales charges; paying careful attention to portfolio quality, in stock funds, bond funds, and money market funds alike; and focusing on an asset allocation that is consistent with your own risk tolerance.

"Serious mistakes," I indicated, included such errors as investing in funds with spectacular records ("no investor ever went broke by failing to invest in a hot new product"), as well as those persistently at the bottom of the deck; excessive reliance on narrowly-based funds (say, emerging market funds); and using mutual funds for short-term trading.

As the stock market bubble inflated, some of these dos and don'ts didn't seem especially necessary. Now, after the fall, their validity has been reaffirmed.

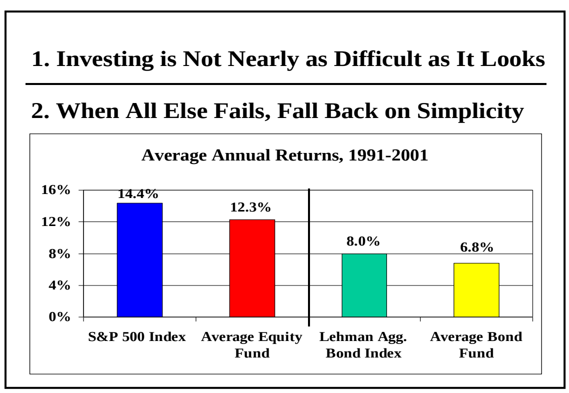
Pillar 2. When All Else Fails, Fall Back on Simplicity.

> *There are an infinite number of strategies worse than this one: Commit, over a period of a few years, half of your assets to a stock index fund and half to a bond index fund. Ignore interim fluctuations in their net asset values. Hold your*

positions for as long as you live, subject only to infrequent and marginal adjustments as your circumstances change. When there are multiple solutions to a problem, choose the simplest one.

Although the stock market's wild and wooly odyssey since I wrote them makes those words seem an eon away, I believe more than ever in that basic principle: *Rely heavily on index funds, and begin with the idea of a 50/50 bond/stock ratio, adjusting the ratio in accordance with your own financial profile*. In my book, I noted that this approach was consistent with the philosophy of Benjamin Graham, author of *The Intelligent Investor*[1]. This simplicity surely has continued to prove itself. During the past decade, the annualized return on a low-cost index fund modeled on the Standard & Poor's 500 Stock Index has been 14.4%, while the average general equity fund has earned +12.3%. The low-cost bond fund modeled on the Lehman Aggregate Bond Index has earned +8.0% annually, while the average taxable bond fund has earned +6.8%.

These solid margins in returns—2.1% per year for the stock index fund and 1.2% per year for the bond index fund—were highly predictable, for they largely reflect the cost advantage index funds hold over actively-managed funds. Once again, the majesty of simplicity—the broadest possible diversification at the lowest possible cost—has proved itself.



Pillar 3. Time Marches On.

Time dramatically enhances capital accumulation as the magic of compounding accelerates. At an annual return of +10%, the total value of the initial $10,000

[1] Benjamin Graham's "standard division" was 50-50, an equal investment in bonds and stocks. Since his classic book was published in 1949, this allocation baseline has far more patina than mine.

investment is $108,000, at the end of 25 years, nearly a tenfold increase in value. Give yourself the benefit of all the time you can possibly afford.

Of course, time has marched on since I wrote those words. Even taking into account the sharp market decline during the dismal past year, the decade-long 14.4% return on the S&P 500 index fund has already carried the value of an initial $10,000 investment in the index fund to $38,400. While the 25-year period that I noted in the book is not yet half over, Pillar of Wisdom #3 is looking pretty good. Even a modest return of 7.2% on stocks during the *next* 15 years—one-half the rate of the past decade—would result in the realization of that 10% target and the accumulation of the resultant $108,000 of capital over 25 years.

Surely this example of the march of time bears out the words of the poet Maya Angelou: *"Since time is the one immaterial object which we cannot influence, neither speed up nor slow down, add to nor diminish, it is an imponderably valuable gift."* And so it is that time provides among the most valuable of all gifts in investing. Do your best to ignore the short-term events that, day after day, seem to overwhelm our thinking, and follow the very first principle for managing your money: *Give yourself all the time that you possibly can*.

Pillar 4. Nothing Ventured, Nothing Gained.

It pays to take reasonable interim risks in the search for higher long-term rates of return. The magic of compounding accelerates sharply with even modest increases in annual rate of return. While an investment of $10,000 earning an annual return of +10% grows to a value of $108,000 over 25 years, at +12% the final value is $170,000. The difference of $62,000 is more than six times the initial investment itself.

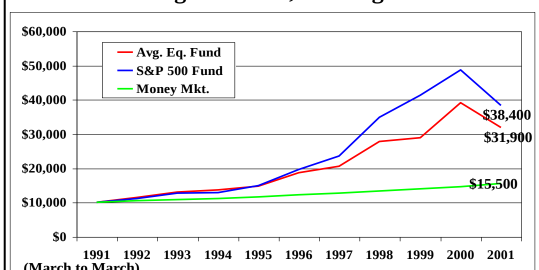
Over the past decade, that a two-percentage-point differential I chose in my book characterized almost *exactly* the spread between a low-cost S&P 500 index fund (+14.4% per year) and the average U.S. stock mutual fund (+12.3%). Final value of an initial investment of $10,000: *Index* mutual fund $38,400; *Managed* mutual fund $31,900. And, I should note, that substantial increase in reward came hand-in-hand with *no increase whatsoever in risk.* In fact, the index fund was some 15% *less* volatile than the average equity fund.

You might as well enjoy that moderation in risk, for the stock market is a risky place. Even the value of the index fund fell 28% from the March 2000 high to the recent low. The $10,000 investment in the S&P Index had grown to $48,700 by March, 2000, only to tumble to $38,400 a year later.

But consider, if you will, the risk of *not* being willing to assume market risk. $10,000 invested in a money market fund a decade ago would be worth but $15,500 today—a $5,500 profit that was less than one-fifth of the $28,400 appreciation in the index fund, even *after* the sharp market decline. These numbers reinforce the reputation of equities both as productive investments and as risky ones—a reminder that is both valuable and long overdue.

3. Time Marches On

4. Nothing Ventured, Nothing Gained



Note: Return required on S&P 500 to reach $108,000 in 2016 is 7.2%

Reasonable expectations suggest to me that we might see stock returns in the 6% to 10% range during the coming decade. If that seems too modest an expectation for common stocks based on past history, don't forget that a possible 8% return on stocks would take each dollar to $2.16 by 2011, while a possible 4% future return on savings would take each dollar to $1.48, less than half the gain. Eschewing the risk of stocks, therefore, carries a risk of its own. Yes, "nothing ventured, nothing gained."

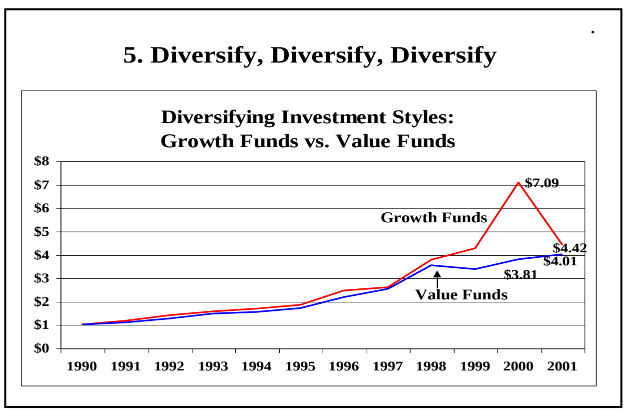
Pillar 5. Diversify, Diversify, Diversify.

By owning a broadly diversified portfolio of stocks and bonds, specific security risk is eliminated. Only market risk remains. This risk is reflected in the volatility of your portfolio and should take care of itself over time as returns are compounded.

As the bear market of the past year makes clear, investing in stocks is risky:

- *First, there is individual stock risk.* We have seen some stocks soar and some plummet, with little means of knowing which stock will do which, and when. Who would have expected that Cisco, whose $500 billion market capitalization a year ago made it the largest stock in the world, would soon plummet by 80%, erasing $410 billion in value?

- *Second, there is style risk*. Growth funds trumped value funds during the first nine years of the decade, rising an amazing 609% through last March, more than double the 281% increase for value funds. Since then, growth funds have fallen 38% on average, while value funds have actually risen 5%, erasing nearly the entire growth fund and their cumulative records are now virtually identical. Who among us is wise enough to know how to "time" those changes?



- *Third, there is manager risk*. A growth fund manager, for example, may outpace his peers, or may fall short, and the difference is apt to be *enormous*. Consider that in the past decade, the top decile of growth fund managers produced an average annual return of 17%, almost three *times* the 6½% return for the bottom decile. How would *you* go about picking the winners in advance?

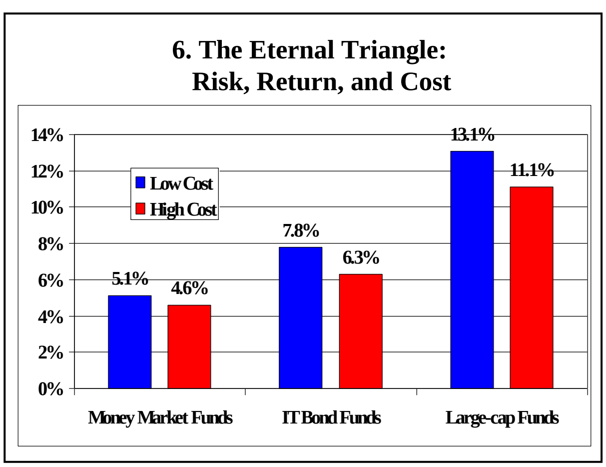
Happily, each and every one of these three risks can be *easily* eliminated. For when you own the entire stock market through an index fund, there is neither individual stock risk, nor style risk, nor manager risk. *Only market risk remains*. If the past year, demonstrates nothing else, it surely demonstrates that stock market risk, standing alone, is quite substantial enough, thank you.

So if you can't be certain about the future—and who among us can?—"diversify, diversify, diversify" remains the essence of wisdom.

Pillar 6. The Eternal Triangle.

Never forget that risk, return, and cost are the three sides of the eternal triangle of investing. Remember also that the cost penalty may sharply erode the risk premium to which an investor is entitled. You should understand unequivocally that investing in a fund with a relatively high expense ratio—more than 0.50% per year for a money market fund, 0.75% for a bond fund, 1.00% for a regular equity fund—bears careful examination. Unless you are confident that the higher costs you incur are justified by higher expected returns, select your investments from among the lower-cost no-load funds.

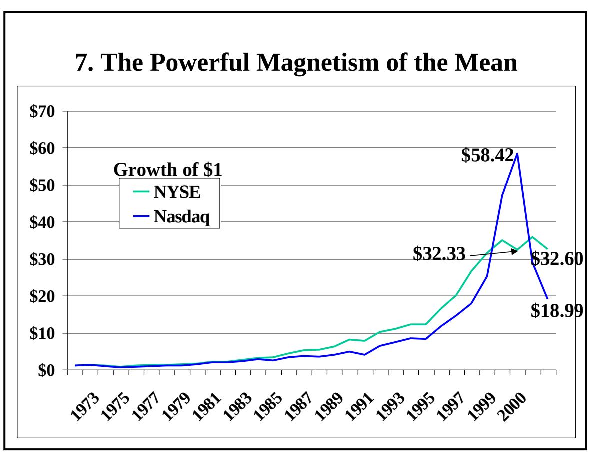
Up-to-the minute evidence reaffirms exactly what I demonstrated in my book. During the past decade, the lowest-cost decile of money market funds provided an average annual return of 5.1%, 11% above the return of 4.6% for the highest-cost decile. For the lowest-cost decile of intermediate-term bond funds, the return was 7.8%, 24% above the return of 6.3% for the highest-cost quartile. And for the lowest-cost decile of large-cap equity funds (excluding index funds), the average return was 13.1%, fully 18% above the return of 11.1% for the highest-cost decile. (Low-cost bond *index* funds and low-cost stock *index* funds, I should note, provided even higher returns than their *low-cost* counterparts that were actively managed.) *The eternal triangle of risk, return, and cost is too powerful to ignore.*



Pillar 7. The Powerful Magnetism of the Mean

In the world of investing, the mean is a powerful magnet that pulls financial market returns toward it, causing returns to deteriorate after they exceed historical norms by substantial margins and to improve after they fall short. Reversion to the mean is a manifestation of the immutable law of averages that prevails, sooner or later, in the financial jungle.

In the boom-and-bust bubble we have just witnessed in the NASDAQ Index, we have a wonderful example of reversion to the mean (RTM). After closely tracking the NYSE Index of all *listed* stocks from the mid-1970s through the end of 1997, the *unlisted* stocks in the NASDAQ Index took off in 1998, rising 230% (!) though the first quarter of 2000, eleven *times* the 20% gain in the NYSE Index. Then, reversion to the mean promptly wreaked its havoc, and with a vengeance. Since then, the NASDAQ has tumbled 67%, compared to a loss of but 7% for the NYSE Index. At the high last March, a dollar invested in NASDAQ Index in 1972 had soared to $1.80 for each dollar in the NYSE Index. But it has now fallen to just 58 cents. RTM strikes again, and, I'm confident, not for the last time.



Pillar 8. Do Not Overestimate Your Ability to Pick Superior Equity Mutual Funds, nor Underestimate Your Ability to Pick Superior Bond and Money Market Funds.

> *In selecting equity funds, no analysis of the past, no matter how painstaking, assures future superiority. In general, you should settle for a solid mainstream equity fund in which the action of the stock market itself explains about 85% or more of the fund's return, or an low-cost index fund (100% explained by the market). But do not approach the selection of bond and money market funds with the same skepticism. Selecting the better funds in these categories on the basis of their comparative costs holds remarkably favorable prospects for success.*

While I've shown you earlier the near-causal relationship between costs and returns among fixed-income funds, the futility of picking stock funds based on their past returns has seldom been more forcefully demonstrated than in the past two years. Among the twenty top-performing equity funds for the year ending March 31, 2000, 15 of the Top-20 tumbled to ranks ranging from #3453 to #3891 among 3896 funds during the year that followed. Only one fund even ranked higher than #1000. Picking equity funds on the basis of past performance is not a good idea!

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Leading Bull Market Equity Funds in a Bear Market

Rank Year-end 3/31/2000	Rank Year-end 3/31/2001*	Rank Year-end 3/31/2000	Rank Year-end 3/31/2001*
1.	3,784.	11.	3,881.
2.	277.	12.	3,603.
3.	3,892.	13.	3,785.
4.	3,527.	14.	3,891.
5.	3,867.	15.	1,206.
6.	2,294.	16.	2,951.
7.	3,802.	17.	2,770.
8.	3,815.	18.	3,871.
9.	3,868.	19.	3,522.
10.	3,453.	20.	3,566.

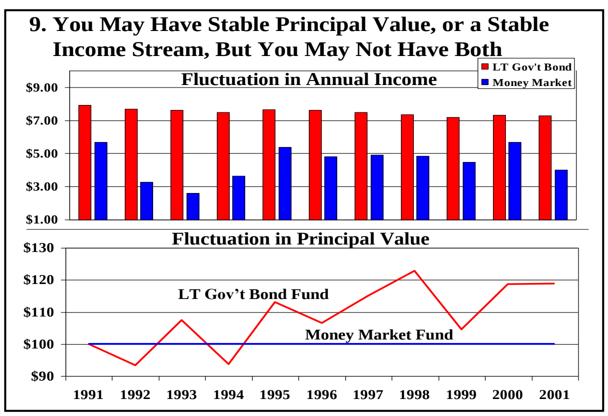
*3,896 Total Funds

Yet too many mutual fund investors did exactly that, pouring a staggering $242 billion into growth and technology funds during the twelve months ended March 31, 2000, and actually *withdrawing* $42 billion from the lagging value funds. Yet as the earlier chart on style diversification showed, that was *exactly* the period when investors should have been moving *out* of growth and technology funds and *into* value funds. What folly! When it jumps on the bandwagon of past performance, *the crowd is always wrong*.

Pillar 9. You May Have a Stable Principal Value or a Stable Income Stream, But You May Not Have Both.

> *Contrast a money market fund—with its volatile income stream and fixed value—and a long-term government bond fund—with its relatively fixed income stream and extraordinarily volatile market value. Intelligent investing involves choices, compromises, and trade-offs, and your own financial position should determine the most suitable combination for your portfolio.*[2]

As 1991 began, the yield of the average money market mutual fund was just under 6%, and the yield on a long-term U.S. Treasury bond fund was just over 7½%. During the ensuing decade, the value of a $1,000 investment in the money market fund never varied, while $100 invested the bond fund fell to as low as $93 (in 1992) and rose to as high as $123 in 1998. *Stable principal vs. variable principal*.



But the annual income on the $100 money market fund investment was not to approach $6 again until 2000. Indeed, with declining interest rates, annual income is now on the way to the $4 level. The annual income stream on the $100 initial investment in the long-term bond fund, on

[2] In my book, I compared a 90-day U.S. Treasury bill with a 30-year Treasury bond.

the other hand, began at $7.91 in 1991, and has remained above $7.10 each year. It should be about $7.20 in 2001. *Variable income vs. stable income*.

Is stable income or stable principal the higher priority for you? Or some of each? Be clear on what you plan to achieve in your defensive holdings, and invest accordingly.

Pillar 10. 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 extended, past. They seek stocks after stocks have emerged victorious from the last war, bonds after bonds have won. They worry about the impact of inflation after inflation, having turned high real returns into so-so nominal returns, has become the accepted bogeyman. You should not ignore the past, but neither should you assume that a particular cyclical trend will last forever. None does.

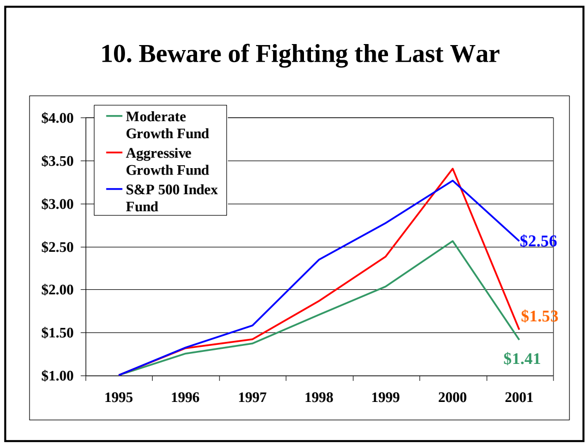
When I wrote my book, inflation was at the forefront of investors' minds. But, ever the contrarian, I raised a *caveat emptor* suggesting that "it would be foolish to assume that inflation would be an eternal fact of life." Sure enough, inflation, having averaged 5.7% during the fifteen previous years, has run at less than one-half that rate (2.6%) since then. "The last war," it turned out, was over.

Similarly, stocks in high-tech companies soared during the late 1990s, and large-cap tech stocks came to dominate the portfolios of growth funds. The belief that technology companies would *continue* to soar captured the mind of many inexperienced investors. One fund manager even wrote a *book* describing why he had cast his vote with the crowd, assuring his readers that his funds had jumped aboard the fast-moving large-cap, high-growth, high-tech bandwagon.

He applied his new strategy to the equity funds he managed, and his aggressive growth fund leaped by 82% during the two years through the first quarter of 2000. His moderate growth equity fund rose 51% during the same period. That performance was nonetheless insufficient to give him a victory in a bet I'd made with him that an index fund would do better during the five years ended March 31, 2000. (The index fund won by an imposing 70 percentage points--+226%

vs. +156%.) When I wrote to thank him for sending me the $25 to settle our bet (huge for me!) I expressed my opinion that his new strategy was "fighting the last war".

And so it quickly proved to be. In the year since then, the manager's two growth funds have plummeted by 45% and 55% respectively, more than double the 22% decline for the index fund. But 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.



Pillar 11. You Rarely, If Ever, Know Something The Market Does Not.

If you are worried about the coming bear market, excited about the coming bull market, fearful about the prospect of war, or concerned about the economy, the election, or indeed the state of mankind, in all probability your opinions are already reflected in the market. The financial markets reflect the knowledge, the hopes, the fears, even the greed, of all investors everywhere. It is nearly always unwise to act on insights that you think are your own but are in fact shared by millions of others.

Well, here we are again, in the grip of a bear market, and worried about whether it will get worse. *No one* knows when it will be over. Maybe it *is* over. Nonetheless, provided only that your asset allocation *going into the bear market last March* had been set in accordance with (a) your risk tolerance, (b) the years you have remaining to build your investment, (c) your wealth level, and (d) your income needs, you shouldn't change the allocation. *Times of market duress* *are almost always terrible times to change investment strategies.* The market, however fickle, has usually taken into account almost every eventuality.

Pillar 12. Think Long-Term.

> *Do not let transitory changes in stock prices alter your investment program. There is a lot of noise in the daily volatility of the stock market, which too often is "a tale told by an idiot, full of sound and fury, signifying nothing." Stocks may remain overvalued, or undervalued, for years. Patience and consistency are valuable assets for the intelligent investor. The best rule: Stay the Course.*

During the past two years, the stock market's noise has been the loudest in history as volatility has reached record highs. Millions of *speculators* are scared half to death, as they should be. But long-term *investors* must realize that, as greed turns to fear, much of the worry is already reflected in the lower level of stock prices. And even if it turns out we *should* be reducing our stock position until the decline is over, where on earth would we ever get the insight that tells us the right time to get back *in*? One correct decision is tough enough. Two sequential correct decisions—both made at the right moment—are nigh on impossible. Impulse is your enemy, and patience and consistency are your friends. Of my twelfth pillar of wisdom—*Think Long-Term*—I can only say, "Amen!"

Please keep these Twelve Pillars of Wisdom in mind. I'm confident that they will serve investors every bit as well in the years ahead as they have since I set them down nearly a decade ago. Good Luck, and Happy Investing!