Investing with Simplicity

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Many of you have heard the ancient Chinese curse—curse, mind you—that says, "may you live in interesting times." Curse or not, surely this is as interesting a time as it is possible to imagine. The extraordinary volatility in the financial markets is just one example of the stepped-up pace of our lives in an era—a new era, to be sure—in which the technology revolution, the information explosion, and the rise of global interdependence have altered almost every activity in our daily lives.

In important measure, it is these developments that have brought most investors unprecedented prosperity and wealth accumulation, and helped make mutual funds the investment of choice among American families. You now have all the information you could possibly need—except, of course, information about the future course of events and markets—to make investment decisions. But you should not mistake information for knowledge...nor should you ever, ever mistake knowledge for wisdom, the ultimate weapon of the intelligent investor.

During this "Personal Finance" conference, you'll hear a lot of good common sense. Pay attention to it. But you'll also hear a considerable amount of investment wizardry, financial legerdemain, and tempting solutions, often from the apparently omniscient. Disregard it.

My keynote message this morning, I suspect, will be the most basic: to earn the highest returns that are *realistically* possible, you should invest with simplicity. Rely on the ordinary virtues that intelligent human beings have relied on for centuries: common sense, thrift, realistic expectations, patience, and perseverance. Call them "character." And in investing, over the long run, character will be rewarded.

The great paradox of this remarkable age is that the more complex the world around us becomes, the more simplicity we must seek in order to realize our financial goals. Please underrate neither the majesty of simplicity nor its proven effectiveness as a long-term strategy for productive investing. Simplicity is the master key to financial success. The old Shaker ballad got it just right:

> "Tis the gift to be simple;
> Tis the gift to be free;
> Tis the gift to come down;
> Where we ought to be."

This morning let me give you some ideas that should help you "to come down where you ought to be" in your quest for investment success. Given both the nervousness you doubtless felt in last summer's sharp stock market decline, and the excitement you likely felt in the splendid fourth quarter, I want to begin by reaffirming four fundamental investment principles—four principles designed to keep you from the dangerous practice of acting on those emotions. **First principle: Balance**. The simple idea that investors should balance their stock holdings with bond holdings was drummed into me by the dean of the mutual fund industry, Walter L. Morgan, who founded Wellington Fund in 1928 and lived to see it become America's largest balanced fund. The recent death, at age 100, of my hero, my mentor who gave me the job that began my mutual fund career in 1951, and my great friend for nearly half a century(!) was heart-breaking for me. But Wellington's success—and his long life—serve as a testament to the durability of his investment principles.

The bear market of last summer—one of only three 20+ percent drops in the past 20 years—has been reversed with a 25 percent gain that has now taken the market to new all-time highs. Surely we've never had it so good! But these spasms themselves remind us of something vital to recognize. **The second principle: Markets Fluctuate**. Many mutual fund investors seem to forget that fundamental reality. When stocks tumble, they push the proverbial panic button. Net cash flow *into* equity mutual funds, previously running at $18 billion a month, turned negative in August, with *outflows* of $11 billion, the first month of outflow since 1990. Those billions missed the recovery—and even at the lower stock prices of August and September, fund investors continued to pull money out of stock funds, albeit in smaller amounts. But after stock prices snapped back by 25% in the fourth quarter, large inflows began again in January. Taking money out of the market at lows and putting back in at highs is *not* the best way to make money.

What was in truth not much more than a short-term blip on the stock chart—and a blip that was certainly long overdue—seemed to change investor confidence in a meaningful way. In addition, the decline increased investor activity in stock funds to a level even higher than the microscopic three-year average holding period prevailing earlier—a shocking short-term orientation for investors in what I believe is the finest medium for long-term investing ever devised. So, I remind fund investors, and the fund industry, both so focused on short-term returns, of the need for long-term thinking. **The third principle: Invest for the Long Term.** It applies to mutual funds and investors alike, but in both cases it is honored more in the breach than in the observance.

The wild and wooly decline and the subsequent powerful recovery, I think, have got fund investors focusing on the short-term when they should be focusing on the long-term. So I'd now like to take a look at what might be realistic expectations for long-term returns on stocks.

To begin with, stocks—by all traditional measures—are very highly valued. Consider these valuations, measured today vs. the start of the great long-term bull market: Prices have risen from 7.9 times earnings to 28 times earnings; dividend yields have fallen from 6% to 1.3%. While, yes, interest rates have tumbled from 13% to 5%, the earnings yield—about equal to the 13% bond yield at the outset—is now only 3.6%—about two-thirds as high as the interest rate (i.e., the ratio has dropped from 0.96 to 0.70).

In this context, then, let's examine the source of the market's astonishing near 21% annual total return during the great, long bull market. Well, 6.0% came from the very high initial yield, some 7% came from earnings growth, and 8% *per year* came from the increase in the price-earnings ratio alone. How much does this change impact the total? Let's just say that if the price-earnings ratio—a measure, not of reason, but simply of emotion—had remained unchanged, the Standard & Poor's 500 Index would today be reposing at a level, not of 1239, but of . . . 345. Almost 1,000 points lower!

As we look ahead for, say, a decade, we know—we know—that the *future* contribution of dividend yield will begin at, not 6%, but 1.3%. As to future earnings growth, perhaps it will be better than the rate of 7% for the past 40 years, but I would not bet the ranch on much more than that—and maybe even less. Together, those *fundamentals* would lead to a market return of 8.3% annually. To do better would require the price-earnings ratio to rise well above its present all-time historic high of 28 times.

So, let's play a little game. With an unchanged p-e ratio, we know that the market return ought to be about 8%—perhaps 1 or 2 percentage points more or less. If the price-earnings ratio falls to, say, 18 times, the total return on stocks would be not 8%, but 4%. And if the ratio rose to 71, the total annual return on stocks would be 18%.

Chart #6 Here

I use 18% because that is the return the market *must* provide over the next decade to meet investor expectations (if we are to believe what mutual fund investors told a Gallup Poll last autumn). I, for one, can't imagine it. But I should tell you that your afternoon keynoter—a man for whom I have the most profound respect—has suggested that a price-earnings ratio of 50 times would not be excessive, and that even a 100 times(!) price-earnings ratio, "using a simple and accepted formula," in his words, might be justified. (His talk will explain "Why the Dow may quadruple" from here—which it would do in year eight if the annual return on stocks turns out to be 18%. And, of course, he might just be right—but I wouldn't bank on it.

The fact is that it is the *fundamentals* of dividends and earnings growth, not *speculative* changes in the price-earnings ratio, that create market returns in the long run. Never forget that essential fact! Nothing could be clearer from this chart comparing fundamental returns with market returns for the past 40 years. Over this long period, dividends and earnings growth averaged 11% per year, and the market return averaged 12%. If you are a long-term investor—and if you are a short-term investor, I have no wisdom to offer you—you should expect far lower returns in the years to come.

However, no matter what the markets give us, my conviction remains steadfast that common stocks should remain the principal asset class in a long-run investment program. If your own program was soundly balanced before the bear market—as it should have been—and you were strong enough to resist the temptation to sell stocks at the bottom of the bear market, there should be no need to change the balance now. **Fourth simple principle: Stay the Course.**

Reliance on the fundamentals of investing means investing in *corporate businesses* for the long run. Reliance on speculation, and gambling on changes in the price-earnings ratio, means investing in stock certificates—*pieces of paper*—for the short run. Sadly, most mutual funds *preach* the long run, but *practice* the short run, turning over their portfolios at a costly and grotesquely tax-inefficient rate of some 90% per year. I urge you to ignore the practices mutual funds follow . . . and attend to the practices they preach.

For the long term investor who wants to stay the course, reliance on a sensible balance of stocks and bonds is essential—more important today, I believe, than for as far back in market history as most of you here can remember. (I'm older!) Such a course will mitigate emotion in investing and emphasize reason and common sense. **Simplicity, then, above all: Balance. Markets Fluctuate. Invest for the Long-Term. Stay the Course.**

Simplicity also gives us a surprising rule for measuring investment success. ***The central task of investing is to realize the highest possible portion of the return earned in the financial asset class in which you invest—realizing, and accepting, that that portion will be less than 100%.***

Why? Because of cost. To state the obvious, we know intuitively that our cash reserves will inevitably earn less than the going short-term market rate. Our CDs and money market funds will yield less simply because the costs of financial intermediaries—transaction costs, information costs, and the cost of convenience—will be deducted from the interest rates paid by the government or corporate borrower.

Similarly, we do not—nor should we—expect our bond funds to provide us with higher yields than the average yield of the bonds held in a fund's portfolio. In fact, in bond funds as a group, because of grossly excessive fund fees, most bond funds provide—not 100% but only 75%. The fact is that *nearly* all bond funds are distinctly inferior investments.

Yes, and even in the equity arena, it is simply a mathematical impossibility—a definitional contradiction—for all investors *as a group* to reach 100% of the stock market's annual returns—maybe 85% on average. Indeed, given the excessive costs of equity mutual funds, it is a mathematical *certainty* that, over a lifetime of investing, only a relative handful of investors can succeed in doing so by any significant margin. If this is iconoclasm, so be it. Accepting this reality—that investors as a group will inevitably capture less than 100% of the rates of return provided in any asset class—is the first step in simplifying your investment decisions.

Where should you begin? Consider that the ultimate in simplicity comes with the additional virtue of low cost. For the *simplest* of all approaches is to invest solely in a single balanced market index fund—just one fund. *And it works.* Such a fund offers a broadly diversified middle-of-the-road investment program for a typical conservative investor, allocating about 65% of assets to large growth and value stocks and 35% to high-grade bonds. Over the past 15 years, it would have captured 99% of the rate of return of the combined stock and bond markets. It doesn't get much better than that.

Let me prove the point by comparing the cumulative returns of this industry's balanced mutual funds—a group whose portfolios tend to be quite homogeneous, composed as they are primarily of large stocks with both value and growth characteristics, and good quality bonds with intermediate-to-long maturities. This chart compares the returns of the average balanced fund with the no-load balanced index fund, using the S&P 500 Index with its annual return reduced by estimated costs of 0.2%. Here are the results, based on an initial investment of $10,000 in 1983.

Three key conclusions:

1. **The managed funds provided an annual return of 13.0%, the Index Fund 15.1%—85% of the market's return for the managers, 99% for, if you will, the non-managers.**

2. **After 15 years, the investment in the managed fund was worth $62,700, the index fund $81,900 (wow!). The managed balanced fund provided 71% of the market's cumulative return, versus 97% for the index fund. Time and compounding have joined forces to turn a 2.1 point annual advantage into an advantage of $19,000 in accumulated wealth—twice the initial stake! "Little things mean a lot."**

3. **The superiority of the index fund is accounted for, not by magic, but by *costs*. The heavy costs of the managed funds were primarily responsible for their shortfall.**

The average balanced fund incurred annual operating expenses of 1.2% on average during the period, and perhaps another 0.5% in portfolio turnover costs, a total handicap of 1.7%. The index fund all-in cost was 0.2%, an advantage of 1.5% that made up the lion's share of the 2.1% difference in return.

The fact is that the *unmanaged* index fund had, at the end of this long period, outperformed all but one of the 29 *managed* balanced funds in the list. This almost universal failure of expensive professional managers to earn pre-cost returns sufficient to pay their keep relative to a passively-managed index fund suggests how tough it is to break par in the financial markets.

Nonetheless, like most investors, you may well prefer to control your own investment balance, and you may well prefer *tax-exempt* bonds to the *taxable* bonds held in nearly all balanced fund portfolios. Fair enough. So I turn to a second example of the value of simplicity—a single *equity* index fund for your stock portfolio. The identical conclusions we found in our balanced fund analysis prevail again:

1. **Managed equity fund return 14.0%, index fund return 16.5% (using the Wilshire 5000 total stock market Index, a lower hurdle than the large-cap-dominated S&P 500) percentage of market return. Result: 84% of the market (look familiar?) for managed funds, 99% for index.**

2. **After 15 years, managed fund value $70,900; index fund value, $98,600. (This $27,700 gap is what this industry has cost its equity fund investors during the great bull market.) Final value as percent of market, 67% vs. 97%. This industry consumed one-third of the market return! "My how mightily your money grows when costs are minimized!"**

3. **Costs, again, are the villain of the piece. The 2.5% annual lag compares with about 2.2% in estimated fund expenses and turnover costs.**

As you can see, this 15-year equity fund comparison—just as in the case of the balanced funds—amply justified a simple index approach to capture the highest realistically-possible portion of the market's annual returns—in this case, again, 99%.

It is fair, of course, for you to say: "Well, the index fund is always fully-invested in stocks, so why not hire a manager, who can reduce stock holdings in anticipation of market declines?" It's a sound principle, but a failed practice. In fact, fund managers have done precisely the reverse. For example, equity funds held an average cash position equal to about 12% of assets at the start of the great bull market. Near the recent market highs, fund cash had been cut to only 5% of assets, providing little protection against the decline that ensued. Being bearish when you should be bullish, and bullish when you should be bearish, is not a formula for investment success!

Chart 12

The case for indexing, then, is the very essence of simplicity: owning the entire U.S. stock market or bond market; putting aside the fruitless attempt to select the best manager; holding the asset allocation fairly constant; making no attempt at market timing; reducing transaction activity, minimizing taxes; and eliminating the excessive costs of investing that characterize most mutual funds. *And it works.*

But, I'm a realist. I recognize that in the real world, lots of all-too-human traits get in the way of a simple, all-encompassing index fund approach. "I'm better than average;" "I can pick the best funds;" "Even if the game is expensive, it's fun;" "It can't be that simple"—are all too common refrains in the minds of investors—am I speaking for you?—who choose to pursue the conventional strategy of relying entirely on actively-managed funds to implement their investment strategies. "Hope springs eternal."

But if the beginning of simplicity is the index fund, it need not be the end. After all, in a given decade, about one of every five actively managed funds has outpaced the total market index (after taxes, only one of nine). These are powerful, but not insurmountable odds. And there are some simple common sense principles that should help you to select funds that can earn a generous portion of the market's return, although, all too likely, less than 100%—and maybe a lot less. If there are long odds against outpacing the market, at least going about the task of fund selection intelligently can help to ensure against a significant failure. Even master investor Warren Buffett, a strong proponent of the index approach, concedes that there may be other ways to construct an investment portfolio:

> **Most investors, both institutional and individual will find that the best way to own common stocks is through an index fund that charges minimal fees.**

They are sure to beat the net results delivered by the great majority of investment professionals.

Should you choose to construct your own portfolio, there are a few thoughts worth remembering. Intelligent investing is not complex, though that is far from saying that it is easy.

The Prussian General Clausewitz has said, "the greatest enemy of a good plan is the dream of a perfect plan." And I believe that an index strategy is a good strategy—and a *very* good one at that. But many of you, I'm confident, seek a better plan, if not a perfect plan, no matter how great the challenge, no matter how overpowering the odds against implementing it with extraordinary success. So, much as I would not hesitate to urge you to commit your investments to an all-index-fund approach—or at least to follow an approach using index funds as the core of your portfolio—I'm going to offer you another simple approach—"a few thoughts worth remembering," eight basic rules to make it easier for you to make intelligent fund selections for your investment program. Here we go:

Rule 1. Select Low-Cost Funds. I've said "costs matter" for so long that the portfolio manager for one of our funds gave me a Plexiglas pillar with the Latin translation: *Pretium Refert*. But costs *do* matter. If you don't believe me, hear Warren Buffett again:

> Seriously, costs matter. . . . Equity mutual funds incur operating expenses—largely payments to funds' managers—that average about 100 basis points (1%), a levy likely to cut the returns their investors earn by 10% or more over time.

Sadly, Mr. Buffett was misinformed. The average equity fund now carries total annual expenses not of 100 basis points, but of upwards of 200 basis points (2%), "a levy," if I may revise the master's words, "likely to cut the returns their investors earn by *20%* or more over time." Such costs are, well, unacceptable. And bond fund all-in costs—unbelievably—*average* some 1.2%, a simply unjustified levy on *any* gross interest yield. In fact, such costs would cut today's yield of 5.1% on the long U.S. Treasury bond to 3.9%, or nearly 25%. Why would *anyone* buy a high cost bond fund?

Expense Ratios: A low expense ratio is the single most important reason why a fund does well. If you select actively managed funds, emulate the index advantage by choosing funds with low operating expense ratios. In fact, the surest route to top quartile returns is bottom quartile expenses, a fact reaffirmed in all investment equity styles—small-or large-cap, growth or value—and all bond fund maturity ranges as well. Lower expense ratios are the handmaiden of higher returns. Once again, "little things mean a lot."

Transaction Costs: In addition, with today's average fund portfolio turnover at an absurd 85% per year, transaction costs reduce returns by as much as 1/2 to 2.0 percentage points *over and above fund expenses*. What is more, it carries enormous tax costs. So favor low turnover funds. **Taxes:** If your fund holdings are in taxable accounts (i.e., other than in a tax-deferred IRA or a thrift plan), high turnover can not only cause you to pay full *income* taxes on short-term gains, but also deprive you of the extraordinary value of the deferral of capital gains taxes. (By the way, while high fund turnover *hurts* taxable investors, there is no evidence whatsoever that it *helps* tax-deferred investors). The odds against active managers outpacing the *after-tax* returns of index funds become enormous for taxable investors. *So, never forget that taxes are costs too.*

Rule 2. Consider Carefully the Added Costs of Advice. It is the essence of simplicity for the self-reliant, intelligent, informed investor to purchase shares without an intermediary salesman or financial adviser. Their costs should consume the lowest possible proportion of your future returns.

But millions of investors require guidance. If you do, you can use either registered advisers or brokerage account executives, and some good ones are available at a fair price. Select them with care! Good advisers give you their personal attention, help you avoid some of the pitfalls of investing, and provide worthwhile asset allocation and fund selection services. But, like any of us, they must earn their keep, providing services of sufficient value to you to make it worth your while to invest through them. You should know *exactly* how much their services will cost. But I do not believe that they can pick, *in advance*, the top performing managers—no one can!—and I'd avoid those who make extravagant claims of future performance.

How much does it cost? **"Fee-only" investment advisers.** Their brokerage firms usually charge an annual fee beginning at 1% of assets. Typically, they charge sales commissions of 6% or more on fund purchases—okay for a long-term investor, but *devastating* if you hold your shares for short periods and switch funds around. (A bad idea, anyway!)

You should know that there are lots of *hidden* loads out there. **12b-1 Fees.** Even some apparently no-load funds have sales charges known as 12b-1 fees that are deducted from your returns *each year*. These fees are used to promote a fund's sale by aggressive advertising and marketing programs. The fund *shareholders* pay the freight, but they receive *no* benefit *whatsoever* in return. *Caveat emptor of 12b-1 fees!*

There is still one final cost you *must* understand. **"Funds of funds" and "wrap accounts".** These fund-pickers charge additional annual fees of up to 2% *over and above* those paid by the underlying funds. Don't go there—categorically. The fact is that there is no there there. It's just too expensive a package. Combined costs of up 4% a year simply destroy even the most remote chance you have of reaching 100% of the market's return. Too much dead weight.

My third rule comes to grips with the first element that catches the eye of most investors—whether experienced or novice—the fund's past "track record." (The implied analogy to a horse race is presumably unintentional!) But track records, helpful as they may be in appraising how thoroughbred horses will run, are usually hopelessly misleading in helping you appraise how money managers will perform. There is simply no way under the sun to forecast a fund's future returns based on its past record. **Rule 3. Do Not Overrate Past Fund Performance.**

Now, I must contradict myself ever so slightly. For exceptional funds with exceptional past returns that are substantially superior to the market *will* regress toward, and usually below, the market in the future. Regression to the mean—I call it the law of gravity in the financial markets—is measurable and apparently almost inevitable. For example, in two studies of returns over consecutive decades, a remarkable 99% of top quartile funds moved closer to—and even below—the market mean from the first 10-year period to the subsequent 10-year period. There was only one single, solitary exception to the rule, a fund that ruled the world during the 1970s and 1980s alike. But so far in the 1990s, it has regressed magnificently, falling far below the market's return. Sometimes mean reversion requires patience!

Make no mistake about it: the record is clear that top performing funds inevitably lose their edge. This industry is well aware of that certainty. Yet fund sponsors persist in promoting their most successful (past) performers. Such a strategy defies all reason except for this one: promotion of such funds brings in lots of new money, and lots of new fees to the adviser. But such promotions, finally, lead investors in precisely the wrong direction. Ignore them.

So, be sure to disregard "lump sum" performance comparisons. But follow the next rule. **Rule 4. Performance to Determine Consistency and Risk**. Studying the *nature* of past returns enables you to determine *consistency*. Look at a fund's ranking among peer funds with similar policies and objectives (i.e., a large cap value fund with other large cap value funds, a small cap growth fund with other small cap growth funds, and so on).

Morningstar makes this easy. It shows, in a simple chart, whether a fund was in the first, second, third, and fourth quartile of its group during each of the past 12 years. For a fund to earn a top performance rating means, in my mind, at least six to nine years in the top two quartiles and no more than one or two in the bottom quartile. This information—shown in this example of two real-world funds that reflect the standards I've set forth—is ignored by too many investors.

CHART 19

The "good" fund is in the top half in 10 years, in the bottom quartile but once. The 'bad" fund is in the top half six times, (all in the early years—a significant factor) but in the bottom quartile four. Interestingly, for the full period both funds had similar annual returns of about 16%, and both ranked among the top one-third of their peers. But it is *consistency* of return, not *aggregate* return, that tells the important story to the intelligent investor.

Careful analysis of past performance can also tell us a lot about risk. *Risk is a crucial element in investing.* The *Morningstar* risk rating gives you a rough guide to how much risk the fund typically assumes relative to its objective group and relative to all equity funds. This table shows, for example, that the average large cap value fund has carried but one half of the risk of its small cap growth fund counterpart.

Chart 20

I should note that while, over time, relative fund *returns* vary randomly from one period to the next, relative fund *risks* carry a healthy degree of consistency. So, especially in these volatile, speculative days, ignore risk at your peril.

Given the recent emergence of fund portfolio managers as stars, I now turn to the next rule. **Rule 5. Beware of Portfolio Manager "Stars."** Alas, the fact is that this industry, as it painfully happens, has had precious few—if any—superstar managers who have had the staying power of Michael Jordan or Jack Nicklaus or, yes, Mark McGwire (though it's not clear that he'll repeat his feats over the *next* 15 years). And the precious few managers who may have fit into this category were never, as far as I know, identified *in advance* of their accomplishments. Who had ever heard of Peter Lynch or John Neff or Michael Price in 1972, before their splendid records had been achieved?

To make matters worse, even our industry's temporary superstars seem to have a limited longevity with a given fund. The *average* portfolio manager in this business lasts but five years at the helm of a fund, and when the new manager takes over, the result is high portfolio turnover, costly and tax-inefficient. Fund stars, in truth, are more like comets: they brighten the firmament for a moment in time, only to burn out and vanish into the dark universe. Seek good managers if you will, but rely on workmanlike professionalism, experience, and steadfastness rather than stardom.

Be careful too about "Morning-Stars." We exist today in a system in which funds want you to think that if their fund has 4 or 5 "Morning-stars" it is a success. But star systems don't always work. Indeed, the editors of *Morningstar* candidly acknowledge that their star ratings have little short-term predictive value. Higher star ratings often—but not always—can give clues to future success, but for sensible investors Morningstars are the beginning of fund analysis, not the end.

Funds can get too big for their own britches. It is as simple as that. **Rule 6. Beware of Asset Size.** So, avoid large fund organizations that have no history of closing funds to new investors, and those that seem willing to let their funds grow to seemingly infinite size, beyond their power to differentiate their investment results from the crowd and irrespective of their investment goals.

What is "too big" is complex. It relates to fund style, fund management philosophy, and fund portfolio strategy. A broad-based market index fund should be able to grow without any size limits whatsoever. A giant fund—say $20 billion—investing in large cap stocks, with very little portfolio turnover, can be managed effectively, albeit not for truly exceptional returns. For a fund investing aggressively in micro-cap stocks, $300 million might be too large. A multi-manager fund can be successful at larger asset levels than a fund supervised by a single manager. There are no easy answers.

Often, checking the fund's quartile rankings over time can reveal this impact. One of today's large funds, for example, has had four top quartile rankings in its first five years, when its assets were as low as $3 million(!). But in each of the past three years, as assets moved past $2 billion and reached $6 billion, it fell into the fourth quartile. While its discredited "momentum" strategy accounted for part of the problem, size also proved a major handicap.

Chart 23

Excessive size will likely kill any possibility of investment excellence. All too easily, funds that are successful at modest asset levels grow large and become "closet index funds," with most of their assets in index companies. They perform much like index funds, but their high costs preclude matching the index returns. Pay no attention to self-serving management denials that they have become closet index funds; just look at the portfolio and look at the record. "If it looks like a duck and quacks like a duck and walks like a duck, it probably *is* a duck.

The record is clear that, for the overwhelming majority of funds, their best years came when they were small. "Small *was* beautiful" . . . but "nothing *fails* like success." When funds catch the public fancy—and are vigorously hawked to a public unsuspecting of their potential exposure to the problems of size—their best years are behind them. Unbridled growth should be a warning to any intelligent investor.

How many funds should you own? If a single *ready-made* 65%/stock-35%/bond index fund can meet the needs of many investors and if a pair of stock and bond index funds with a *custom-made* balance can meet the needs of many more, what is the optimal number of funds for investors who elect to use *actively-managed* funds? Probably no more than four or five equity funds. Owning too many funds can easily result in a dangerous combination of over-diversification and excessive cost.

A recent study by *Morningstar*—to its credit, one of the few publications to systematically take on issues like this one—concluded essentially that owning more than three funds, randomly chosen, didn't reduce risk appreciably. **Rule 7. Don't Own Too Many Funds.** As shown in this chart, risk remains fairly constant all the way from 3 funds to 30 funds (an unbelievable number!). Note also that owning only a *single* large blend fund—given its lower risk—could provide a *lower* standard deviation risk measure than any of the multiple fund portfolios. So could a single all-market index fund.

Chart 25

I'm not at all sure what the real point is of owning as many 20 diversified funds in a portfolio (i.e., 5% of assets in each fund), and thus owning, at excessive cost, perhaps 2,000 individual common stocks. Perhaps a simple balanced portfolio with five stock-funds and a bond fund like this one would suit the needs of investors seeking a portfolio that varies from those of the market itself.

This portfolio would be somewhat riskier than an all-market balanced index fund—less in large caps, more in small caps, perhaps a specialty fund (in healthcare, or technology, or real estate), and some international stocks. Because of costs, the odds are against its adding value. But it might, provided you select the funds on a rational basis. (These rules I've presented should help.)

Chart 26

Nonetheless, don't assume that successfully selecting a portfolio of a limited number of funds is easy. Five expert investment advisers have been picking equity funds for an initial $50,000 model portfolio for *The New York Times* during the past five years, and not one of them has even come close to matching the record of a low-cost S&P index fund. (The standard chosen by The *Times*.) **The advisers' portfolios provided an annual return of 14.1%, capturing only 60% of the market return, compared to 23.1% for the index, capturing 99.5%. The final, astonishing, capital accumulation: $103,000 for managed funds picked by knowledgeable advisers, and $156,000 for merely picking a non-managed fund without any advice at all.** Clearly, wisely selecting a winning portfolio of funds, even by persons of intelligence and experience, following sensible policies, is a tough challenge.

These rules are for selecting stock funds. **Rules for Bond Funds.** They are similar but easier. First, it's up to you to decide on how to balance your income needs against your risk tolerance. Short-term bond funds provide stable returns but varying income; in long-term bond funds, variable returns but higher income; intermediate term bonds are in-between. But whatever profile fits your needs, place special emphasis on two things: **Low Cost and High Quality**. Cost is the single-most important determinant of a bond fund's future standing relative to its peers. What is more, in their struggle to earn competitive returns, high cost funds tend to hold lower quality bonds. For high consistency in returns and low risk, stick to low-cost funds investing in Treasury bonds or high-grade corporate bonds. Take your risks in the stock market, not the bond market. And when you look for this delectable combination of low costs, high quality, and superior performance, there's a good place to begin. ***Bond* Index Funds.** They can operate at a minuscule cost of as little as 0.20% annually (compared to all-in costs of 1.25% for the average managed fund), all the while bringing you the benefits of maximum diversification and low risk.

Once you decide on your long-term objectives, define your tolerance for risk, and carefully select an index fund or small number of actively managed funds that meet these first seven Rules. Then follow the final rule. **Rule 8: Hold Tight**. Stay the course. Complicating the investment process merely clutters the mind, too often bringing emotion into a financial plan that cries out for rationality. I am absolutely persuaded that investor emotions such as hope, greed and fear—if translated into rash actions—can be every bit as destructive to investment performance as inferior market returns. To quote the estimable Mr. Buffett again, "inactivity strikes us as intelligent behavior." Never forget it.

The key to holding tight is buying right. Buying right is *not* picking funds you don't fully understand; it is *not* picking funds on the basis of past performance; it is *not* picking funds because someone tells you they're hot or because they have star managers or five Morning-stars; and it is most assuredly *not* picking high cost funds. If you avoid these fundamental errors, simply keep an eye on your fund's performance—if you picked intelligently in the first place, once a year ought to be just fine—and patiently tolerate periodic non-extreme shortfalls within its objective group. A major event—an extended aberration in a fund's performance, a radical shift in its policy, a merger of its management company, a fee increase or the imposition of a 12b-1 fee, all should set off alarms. But, if it's wise to "investigate before you invest," it's equally wise to "investigate before you *divest*."

No matter what, don't select funds as if they were simply individual common stocks, to be discarded and replaced with the inevitable ebb and flow of performance. Select a fund with the same thoughtful consideration you would give to appointing a trustee for your assets and establishing a lifetime relationship. That approach is the very essence of simplicity.

In this complex world, if you invest with simplicity, you will be given "the gift to come down where you ought to be." Buy right and hold tight. To the extent you decide indexing is not for you, my eight rules should afford you considerable advantage in the quest for solid long-term returns. However, I fear that you will find a fairly small number of funds that filter through my screens. There ought to be lots and lots more. This industry needs to get its house in order. So demand that funds measure up to your standards. If you make your own investment decisions with common sense and intelligence, the industry will be *forced* to change and serve shareholders more efficiently and effectively, reducing costs, risks, turnover, and hyperbole alike. Finally, fund shareholders—you, the owners of the fund—must be served.

Even if, or when, that great change comes, however, the low-cost index fund cannot be ignored. Indexing works so well—in stock funds and bond funds alike—only because most managed funds—burdened by excessive costs, promoted based on outlandish claims of performance success, and managed with strategies that call for a short-term focus—*don't* work very well. It is for that reason alone that the index fund has proved to be the optimal way "to realize the highest possible portion—albeit slightly less than 100%—of the return earned in the market." But it need not be—it should not be—the *only* way.

Indexing, just like politics, "makes strange bedfellows." My own endorsement of index funds can hardly surprise you—after all, 24 years ago I founded the first index fund. But, as you now know, Warren Buffett, the greatest stock picker of our age, shares my view. Three other bedfellows may be even more surprising.

One is the founder of the largest mutual fund supermarket casino—designed for actively trading more than 1000 mutual funds, with the emphasis, relentlessly advertised on television, on funds with hot records . . . in the past. But his heart belongs to indexing. Heed his words: "...I'm a firm believer in the power of indexing." As they say here in the Nation's capital: "Follow the money." And that's where his money is.

Another strange bedfellow is "The Motley Fool." "If you've had trouble with your investments, use an index fund," they state categorically: "we don't think there's any other fund out there worth buying."

And even active fund managers now accept the reality of the index message. The former CEO of one industry giant recently made light of my comments about the scarcity of funds that beat the index. "People ought to recognize," he said, "that the average fund can *never* beat the market."

To sum up this keynote talk on "Intelligent Investing," I've tried to show you both the value of simplicity as it is reflected in the fundamental principles of investing, in market indexing, and in the rudiments of how to select funds successfully. If you decide to follow these simple approaches, you will have acquired **"the gift to be simple"** from an investment standpoint, and **"the gift to be free"** of the cacophony of information and emotion that, seemingly without remission, pounds our minds. And you will, I am confident, then be given **"the gift to come down where you ought to be"** in your long-run financial plans.