John C. Bogle Remarks: The Union League and the World Affairs Council

The Investment Outlook and Strategies in our Global World

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In this booming stock market, it sometimes seems like everyone is getting rich. That's a bit strong, but the fact is that the 36% of U.S. households that own mutual funds are indeed getting richer--seemingly every day. We are at the pinnacle of an historic fifteen year bull market. The question I'll try to address to is: Where do we go from here?

The first half of the 1990s decade began with five "so-so" years of mediocre equity returns averaging 8.7% annually. But in the two and one-half years since then—three-fourths of the 1990s have now flown by—annualized returns have averaged an incredible 33%. The Dow Jones average which advanced from just 2700 to 3800 during the five full years 1990-95 has now, in a period half that length, soared above 8000.

I don't know of a single pundit who forecast gains of this magnitude, nor, for that matter who forecast the earnings gains that underlie this boom. Earnings on the companies in the S&P 500 Index, after going literally nowhere—unchanged at $25 from 1988 to 1992--have nearly doubled to an expected $46 in 1997. (The bulls say $48.)

Putting it all together, market valuations have reached extraordinary—and to me, worrisome—levels. Even since the fairly high valuations that were in place when stocks took off (again) early in 1995, the basic ratio of market price to book value has risen from 4 to 6.5 times; the price-earnings ratio has risen from 15 to 20 times; dividend yields (yes, I'm old fashioned enough to believe that dividends still matter) have fallen from 2.7% to 1.6%. (And only at the 1929 peak, the 1973 peak and the 1987 peak did dividend yields *ever* get as *low* as 2.7%.)

To make matters worse (from the standpoint of most investors), the passive, invisible hand of the market is putting to shame the returns earned by the active investment professionals who don't "buy the market" (or so they say), but "buy stocks." (They allege "it's not a stock market; but a market of stocks," as silly a statement as one could possibly imagine.) For example, while our passive Standard & Poor's 500 Index fund is up *104%* in 2 1/2 years, the average actively-managed mutual fund is up but *76%*. (Given our global focus today, I should note that the average international fund is up just 37%).

As an aside, given the stiff competition of the index funds, the average fund manager is, I think, making it even stiffer, by vigorously buying the giant index stocks in which mutual funds are underinvested. Mutual funds, which own nearly 20% of *all* stocks, own "only" 3% of Coca-Cola, 6% of Procter and Gamble, 7% of GE, 7% of Microsoft, and 8% of Merck, five of the very largest firms in the S&P 500 Index. These stocks are up 40% on average this year, far above the 25% gain in the index. (It's not, it seems, that index funds are the problem, but that envious non-index funds, anxious less they fall still further back, are the problem.)

In all, similarities with 1929 abound, and I don't hesitate to haul up the warning flag. The worrisome signs include not only the high valuations I have described, but the similarity of the words we read today with those of that now-forgotten era. For example:

> A U.S. President who says, "No Congress ever assembled, on surveying the State of the Union, has met with a more pleasing prospect than that which appears at the present time. In the domestic field there is tranquillity and contentment . . . and the highest record of years of prosperity." (Calvin Coolidge, December 4, 1928.)

> A financial article states, "the establishment of mutual funds by banks and independent groups has almost become a fad. The public appetite for them grows even more rapidly than the funds can. They represent buying power in the market that appears to be without a saturation point." ("New Levels in the Stock Market," August 1929.)

In short, *speculation* (betting on higher valuations) is the drivers seat. *Investment* (betting on the fundamentals of dividend yields and earnings growth) is in the back seat—perhaps even in the rumbleseat. But while speculation drives stock returns in the short run, it is the crystal clear lesson of history—at least of the past 200 years—that in the long-run fundamentals drive returns.

And so the tension must be resolved. Two extreme possibilities:

> One: a market drop of, say, 35%. This would lower price-earnings ratios to a more normal level of 13 times. And, at 5200 on the Dow, we would still repose--I might add, "fat, dumb, and happy"-- where we sat in January 1996, but a year and one half ago. *This would hardly be a doomsday scenario*.
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> Two: a New Era, in which stock returns average 15% (14% earnings growth plus a 1% dividend yield), rather than the long-term historic norm of about 10.5% (6.5% earnings growth plus a 4% dividend yield). In short, a new era of boom times and high valuations that would justify today's price levels.

Indeed, Barton Biggs, the eminent if volatile guru at Morgan Stanley, bearish as he has been for so long ("Famine will follow feast, as it always has.") entertained this idea a few months ago in a paper entitled "A New Higher Mean to Revert to?" (He did at least include the question mark.) He tranced on a new real mean of 10% (after inflation), but finally fell back on a 7%-8% range, not nearly enough, I think, to justify today's price levels.

The bull's case is exemplified by a recent article in *Wired* magazine (www.wired.com/5.07/longboom/closed) for July 1997. It is entitled, of all things, "The Long Boom," with the subtitle "We're Facing Twenty-Five Years of Prosperity, Freedom, and a Better Environment for the Whole World. You Got a Problem with That?"

No, "I got no problem with that." Who among us could possibly have a problem with "watching the beginnings of a global boom on a scale never experienced before. We've entered a period of sustained growth that could eventually double the world's economy every dozen years and bring increasing prosperity for--quite literally--billions of people on the planet . . . that will do much to solve seemingly intractable problems like poverty and ease tensions throughout the world, all without blowing the lid off the environment."

The thesis, as you might imagine, is based on the triumph of the United States and the end of major wars, new technology, a truly global market, corporate restructuring, high economic growth, and waves of technology. A virtuous circle, driven by an open society in an integrated world. As a result, the article continues, the Fed finally lifts its foot off the brake, productivity soars, biotechnology revolutionizes agriculture, alternative sources of energy abound, Europe is integrated by 2002, Russia has a solid economy by 2005, and China develops the world's largest economy by 2020. In all, "a radically optimistically meme." (A word I had to look up . . . but failed to find.)

Well, of course it could happen . . . but I wouldn't bet the ranch on it. The U.S. stock market, however, seems to be betting just that way. It is priced for the best of times, and *only* the best of times. But what of global stock markets--are they a better bet? Alas, ever the skeptic, I'm a bit doubtful of the global thesis: essentially that, since the U.S. represents 40% of the value of the $20 trillion world stock market, a fully diversified portfolio, invested 40% in the U.S. and 60% in Europe, Pacific and Emerging Markets, should provide the highest future "risk adjusted" returns. (Risks should be lower because global markets tend to fluctuate in different magnitudes, at different times, than U.S. markets.)

But here history cannot help us very much. In the 1970s and the 1980s, for example, U.S. investors in foreign stocks earned returns of 17% per year versus 11% in the U.S.--without much difference in volatility risk. Precedent? Hardly. Precursor? No. So far in the 1990s, U.S. stocks are up 17% per year, foreign stocks up just 5%, and no one can predict which pattern, if either, faces us in the years ahead.

To buttress the skeptical case, foreign returns earned by U.S. investors are heavily influenced by changes in the value of the U.S. dollar--every bit as easy to predict as stock prices and interest rates (i.e., not at all). In the 1970s and 1980s, a weak dollar *increased* strong foreign returns by 20%. So far, in the 1990s, a strong dollar has *reduced* weak foreign returns by a further 30%. In the long run, my best guess is that the dollar will be a neutral factor. The returns will depend on how foreign corporations perform, and whatever else may be said, I'm dubious that those in France, England, Germany and Japan will outpace those in the U.S. (I may be exhibiting a bit of Jingoism here.) The emerging markets? Perhaps, but risks there clearly abound and are notoriously unpredictable.

Skeptical as I am, however, I will concede there *is* a place for international investing from a diversification standpoint. Indeed, I have no hesitancy recommending an international position--say, from 5% of equities to no more than 20%, given the extra economic and financial risks and the ever-elusive ability to forecast the strength of the dollar.

In all, we have been favored with the fruition of the ancient Chinese *curse*: "May you live in interesting times." But especially interesting they are, with stocks soaring to unprecedented heights as new forces of technology and globalization permeate our world. We can't walk away from this moment, so let's deal with it. To this end, let me close with five simple principles of investing which may help you:

> First, invest you must. The biggest risk is the long-term risk of not putting your money to work at a generous return, not the short term--but nonetheless real--risk of price volatility. Even though stocks seem very high, consider what I said in my book "never think you know more than the market does." You're apt to be wrong.
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> Second, give yourself all the time you can. At the extremes, if you're in your twenties, begin to invest in stocks even if you only have a small amount to invest; if you're in your sixties, invest more in bonds and less in stocks. Compound interest is a miracle, and *time is your friend.*
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> Third, have rational expectations about future returns, and be mentally prepared for market

declines. Always remember--in good times and bad times alike--"this, too, shall pass away." (I spent a full page on that sage piece of wisdom in my book.) Your emotions can kill you. You should keep them out of your investment program, *for impulse is your foe.*

Fourth, rely on simplicity. There are too many witch doctors in this business . . . with too many patent medicines. Basic investing *is* simple--a sensible asset allocation to stocks, bonds, and reserves; a middle-of-the-road selection of diversified funds; a careful balancing of risks, returns and (lest we forget) costs, which can kill long-run returns. Don't disregard low-cost index funds. (Warren Buffett just happens to agree on the importance of cost and the value of indexing--a nice "third person" endorsement.)

And fifth, when you've followed these four rules--as I've said, and meant, a thousand times--"stay the course" no matter what happens.

Good luck in your investing during these interesting times.

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Flash: A bright Vanguardian just provided me with the definition of "meme": A contagious idea that replicates like a virus, passed on from mind to mind. Memes function the same way viruses do, propagating through communication networks and face-to-face contact between people . . . the basic unit of cultural evolution.