

Common Investor Mistakes and Other Investing Insights

An Interview With John Bogle

Article Highlights

- The two biggest mistakes investors make is focusing on past performance and not considering inflation-adjusted returns.
- High-frequency trading systems have created systematic risk, but they've also driven down the cost of trading.
- The mutual fund industry places priority on the interests of fund management company shareholders over the interest of mutual fund shareholders.

John “Jack” Bogle founded the Vanguard Group of mutual funds. In this second of two excerpts of our conversation, we spoke about the common mistakes he’s seen investors make, high-frequency traders and his concerns about the ownership structure of most mutual fund companies. The first excerpt of our conversation appeared in the June 2014 AAI Journal (“Achieving Greater Long-Term Wealth Through Index Funds”).

—Charles Rotblut



Anyone with a Morningstar database is able to say, “Yeah I know about the index fund, but this fund does better.” What he should be required to say is “this fund has done better in the past,” because the past is not a prologue. That’s the big mistake, and it’s documented by Morningstar, which measures the returns earned by fund shareholders, compared to the returns earned by the funds themselves. The investor returns

are asset-weighted, versus the time-weighted fund return. The typical fund investor lags the fund return by 2.5 percentage points a year. That’s huge!

The second biggest mistake is considering returns in nominal dollars. We often talk about the average 9% long-term return on stocks. In real terms, it’s more like 6%. A reasonable expectation for the nominal long-term return on stocks for the next decade is likely about 7% per year, because the dividend yield is currently about 2% rather than the long-term average of 4.5%. But after you account for inflation of, say, 2.5% per year, you’re going to realize a real return of maybe 4.5%. In recent years, inflation has probably been a little bit lower than it will be in the future—maybe a lot lower. Then take the fund expenses, which can easily be about 2%, and you’re down to 2.5%. If you pay a financial adviser, say, 1% per year, you’re now down to a real return of 1.5%. Then take out your bad investor behavior of about 2.5% and you’re left with a net real return of –1%. That’s based on the lessons of history. Realizing an annual return of –1% is not a good return. Is that clear?

Charles Rotblut (CR): I’m sure you’ve seen a lot of bad investor behavior over the years, a lot of emotional behavior. Could you comment on what you see as the most common mistakes, and give suggestions on how investors can now try to avoid repeating them in the future?

John Bogle (JB): The biggest mistake investors make is looking backward at performance and thinking it’ll recur in the future. I mentioned earlier the concept of reversion to the mean (in “Achieving Greater Long-Term Wealth Through Index Funds,” *AAI Journal*, June 2014); it happens, it’s documented decade after decade. The winners in decade one tend to be the big losers in decade two, and the losers may be the bigger winners. This isn’t true in every instance, but it happens often enough to have a very distinctive pattern. So don’t pay that much attention to the past, don’t invest based on past performance, don’t listen to a salesman out there, or an adviser, who says: “You think the index is any good? Well, here’s a fund that did better.” Today there are probably 100 funds or 200 or maybe even 1,000 funds that have done better over some period in the last year, the last five years, the last 10 years, etc.

So, investors should look at returns in real terms, and then deduct the known costs. None of these are certain, but 2% is a decent number for all the costs of mutual funds—expense ratios, plus all those other things, transaction costs, cash drag, and so on. It's not perfect, but it's close. [Editor's note: See Table 1 for breakdown of mutual fund costs.] Then an adviser may or may not come into the picture, and that's maybe another 1%. After deducting all of those costs, you get down to a very low return. What I would say very clearly is, don't think that a single percentage point doesn't matter. Come back to that compound interest of the 7% nominal return versus the 5% real return. On a nominal basis, each dollar grows to \$30 dollars over 50 years versus about \$10 on an inflation-adjusted basis. It makes a huge difference. You can easily do this sort of compounding on your computer for a 70-year investment lifetime. (Hint: At 7%, \$1 grows to \$114 over 70 years; at 5%, it grows to only \$30.)

Indexing works because the math is correct, and that's all there is to it. Yes, you give up your chances of doing better than the market, and, yes, you also eliminate your chances of doing worse. I believe it was Eugene Fama and Kenneth French who had an article in one of the academic journals saying that the average mutual fund has a 3% chance of beating the stock market over an investor's lifetime. A 3% chance means there is a 97% chance of falling short of the market. Those just aren't odds I'm particularly smitten with.

CR: I wanted to ask you about high-frequency traders. Obviously that's been in the news, with Michael Lewis (author of *Flash Boys: A Wall Street Revolt*, W.W. Norton & Company, 2014) coming out on "60 Minutes" and calling the market rigged. What are your thoughts about the high-frequency traders and dark pools? Do you think they're running up the transaction costs or creating an uneven playing field?

JB: Well, I never saw such a PR campaign for a book—or for the alternate exchange he mentioned, IEX—in my entire career. Now, my career only spans

Table 1. "All-In" Investment Expenses for Retirement Plan Investors

	Actively Managed Funds	Index Fund	Index Advantage
Expense Ratio (%)*	1.12	0.06	1.06
Transaction Costs (%)	0.50	0.00	0.50
Sales Charges/Fees (%)**	0.50	0.00	0.50
Cash Drag (%)	0.15	0.00	0.15
"All-In" Investment Expenses (%)	2.27	0.06	2.21

**Data from "The Arithmetic of Investment Expenses," by William F. Sharpe, Financial Analysts Journal, March/April 2013.*
***The 0.50% estimate for sales charges/fees is the midpoint of the range between 0% for do-it-yourself investors and (at least) 1% for investors who pay sales loads and fees to brokers and registered investment advisers. I have chosen not to include the "service charges" for loans, withdrawals, etc., often paid by investors in 401(k) retirement plans.*

Source: John Bogle, "The Arithmetic of 'All-In' Investment Expenses," Financial Analysts Journal, January/February 2014.

63 years, so take that for what it's worth, but the discussion is everywhere. It's on the "Today" show, there are articles in The New York Times, The Wall Street Journal, on "Charlie Rose" and even on "60 Minutes." You don't get that kind of attention by understating anything. So Lewis overstates.

He's right about there being problems. He's right in general, although we don't really know, about the perils of the system in which transaction orders are entered. I think Lewis said somewhere that 80% of the orders that are entered by high-frequency traders are canceled—a lot of gamesmanship there. He's right about, although I don't think he discusses this much, the systemic risk in these high-frequency trading systems. We saw this in the flash crash of 2010. The market just fell apart because some computers couldn't handle the volatility. Technological risk is high, and that's a problem, a real problem. The cancellation of orders is a real problem. The lack of public information and the lack of transparency are big problems. There shouldn't be any dark pools. Every trade should be reported, no matter where it's executed, in my opinion.

On the other hand, the good part of high-frequency trading is that the intense competition between high-frequency traders had driven the costs of trading to very close to zero. They've never been cheaper, so maybe sometime I'm going

to have to rethink the idea that trading costs reduce the returns of investors. They've come way down. I go back to the day when, say, a \$25 stock had a quarter-point bid-ask spread, 25 cents, plus another 35 cents for commission. That is 60 cents, more than a 2% trading cost. We've come so far that it's remarkable. The fact of the matter is that it's a great advantage, but it comes with all this baggage. So can the system be fixed? Does it need more regulation? Yes, it must be fixed, and yes, it must be more regulated. Simply bringing all this trading out into the open is the first step. So I salute Michael Lewis. I wish I'd raised as much hell in my books as he has raised in his.

CR: You're doing a pretty good job calling out the industry's flaws. You express concerns in your book *"The Clash of the Cultures"* (John Wiley & Sons, 2012) about mutual fund companies operating as for-profit organizations instead of adhering to a mutual setup, in that they are trying to serve both their shareholders and their clients, correct?

JB: Right, the shareholders of the management company versus the shareholders of the mutual fund. It's a direct conflict of interest.

CR: Is there anything shareholders can do about it, other than gravitating toward a fund or toward a family like Vanguard that's owned or set up as a mutual structure?

JB: This is not going to be an easy system to change. I tell a story in that book about my attempt to get Putnam Investments, a perfect candidate, to mutualize. Marsh and McLennan was going to sell the business for \$4 billion, and I said to the directors of the funds, “Don’t let them take \$4 billion from the fund shareholders. Just mutualize and give everyone a raise. The company will work better than ever. Go no-load. You get a new lease on life and Putnam will prosper as a growing firm.” And they just wouldn’t do it.

The second-best opportunity for change is persuading fund directors that something must be done. Probably the only way it can be done is if shareholders put a lot of pressure on the funds to internalize or mutualize. Shareholders need to put the pressure on the directors, who could do it almost overnight. The directors are just such captives of management in the mutual fund industry, and every other industry for that matter, that you can’t really rely on them to depart from management’s recommendations. In other words, the conflict of interest that exists is even worse than many perceive it to be.

You don’t see an independent board that will stand up and be counted. Because they’re all nice people, they’re all probably smart people, they all think they can stand up and be counted, but they won’t. When management controls the information, the board member ethic is, “I’m getting paid a couple hundred thousand dollars a year for serving on a mutual fund board and I don’t want to jeopardize that by being a bad guy in the board meetings.” There are economic incentives at play here too. So it’s going to be very difficult to make the required changes.

In the first two months of this year (2014), Vanguard accounted for about 80% of the industry’s net cash flow. Eighty percent. The boards of other fund firms should try and compete. This really summarizes it, I think, very well: If you want to do a better job for your shareholders, you’re going to have to reduce costs. If you want to do a better job for your management company’s

shareholders, hold costs where they are or increase them if you can, even though it’d be worse for fund shareholders.

There can be no conflict greater than in this mutual fund system, where you have to represent one set of shareholders or the other, but you can’t represent both. And it’s pretty obvious that it’s the shareholders of the management company itself that have become the first priority of the fund directors, who also control the management company. Day after day, these companies are losing market share to Vanguard. Vanguard’s market share is now very close to 18% of the industry. No one has ever gotten over 13% or 14% before, and we’re at 18%. We’ll probably be at 20% in a couple of years. It’s a force whose time has come and nobody knows how to resist it.

The intelligent business decision for your company is to wring as much out of your investors as you can and hope they don’t notice. But investors are starting to notice. Every year, more investors figure it out and invest with firms that will act in the investors’ best interest. The cash cow that many fund firms are sitting on, generating all this

John Bogle’s 10 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
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!

Source: “The Clash of the Cultures: Investment vs. Speculation,” by John C. Bogle (John Wiley & Sons, 2012).

cash year after year, may last for 30 years or more. And then they’ll quietly go out of business. But what a 30 years it’s going to be, with all that money coming in. It’s the correct business decision, but the wrong fiduciary decision. Nothing could pose the starkness of this conflict better than the biblical quotation, “no man can serve two masters.”

CR: *Is there anything I haven’t asked you that you’d like to bring up or that you think is important for individual investors to think about or consider?*

JB: Investors should consider far less trading activity. We have a financial system built on activity.

I’ll close with a little story from an investment adviser I talked to some years ago, out in Milwaukee. He said, “Look, Mr. Bogle, I know you’re right. You could just stand there and do nothing, put 65% in the stock index, 35% in the bond index and never change anything. So I tell my client to do that, and he comes back a year later and says ‘What do I do now?’ and I say, ‘Nothing.’ And he comes back a year later and he says ‘I didn’t do anything last year, not

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Taxes on Retirement Withdrawals

Once you turn age 70½, you must take a required minimum distribution (RMD) from your tax-deferred retirement accounts, including 401(k) plans and traditional IRAs. RMDs must also be taken from a Roth 401(k) plan. A penalty applies if the RMD is not taken when required.

Withdrawals from a tax-deferred retirement account are taxable at your prevailing ordinary income tax rate, which may be higher or lower than what it was when you made the contributions. The tax is applied to the amount withdrawn, not the amount contributed. So, if your \$5,500 contribution grows to \$20,000 and you withdraw \$10,000, you will be taxed on the full \$10,000 withdrawal. An additional 10% penalty generally applies to withdrawals made from a retirement savings account before age 59½.

Withdrawals from Roth IRAs are not taxable, as stated previously. Roth IRAs are exempt from RMDs as well. A Roth 401(k) plan can be rolled over to a Roth IRA prior to retirement to avoid the mandatory distributions.

the primary determinant of your investment decisions. When determining when to buy or sell any investment, make your decision based on the investment's current characteristics and its appropriateness for your portfolio.

The tax code allows for considerable flexibility in what type of account an investment can be held in. This allows you to use what is known as "asset location" to your advantage. You can put the investments likely to incur the lowest tax rates and the fewest number of taxable events in your taxable accounts and those that are likely to result in the highest or more frequent tax bills in your retirement accounts. (See "Do's and Don'ts of IRA Investing" by Robert Carlson in the March 2010 *AII Journal* for information on what can and cannot be held in an IRA.)

Finally, understand that the tax code is complex. Our annual "Individual Investor's Guide to Personal Tax Planning" (most recently in the December 2013 *AII Journal*) provides a good overview of the prevailing tax rates, retirement savings account contribution limitations, and changes to the tax law. Neither it nor this article can cover every specific area of the tax code that may affect you. If you have questions about your personal situation or a specific type of investment, consult with a tax professional.

—By Charles Rotblut, CFA, Editor, *AII Journal*

Three Additional Points

Though no one likes paying taxes, taxes should never be

Feature: Mutual Funds

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one change. What do I do now?' The answer remains, 'Nothing. Do nothing again.' And he comes back again a year

after that, it's now the third year, and he says, 'What should I do now?' I again answer, 'Do the same thing. Nothing.' Then the client says, 'What do I need

you for?'" The adviser asked me, "How do I answer that question?" I said, your answer is, "You need me to keep you from doing anything." ▲

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