Words From the Wise

Jack Bogle

John C. Bogle, founder of The Vanguard Group and author numerous books on investing, recently sat down with Antti Ilmanen and Rodney N. Sullivan of AQR to discuss contemporary challenges facing investors. This is the third in a series of “Words From the Wise” interviews to be published on AQR.com. Following is an executive summary of the full interview with Mr. Bogle.

Jack Bogle may be the only investment luminary with “groupies” dedicated to his investment philosophy — they call themselves Bogleheads. That such a community exists, and thrives, is hardly a surprise. He is a remarkable, inspiring man with powerful intellect, and a true industry pioneer. Jack is the founder of the Vanguard Group of mutual funds and creator of the first index mutual fund. In 2000, he turned his attention from building a great firm to building a better industry as president of the Bogle Financial Markets Research Center. He is widely recognized for his unparalleled zeal in pursuit of this cause. In 2004, Time named Jack as one of the world’s most powerful and influential people and Institutional Investor presented him with its Lifetime Achievement Award. In 1999, Fortune named him as one of only four “investment giants of the 20th century,” and in 1997 CFA Institute gave him its highest honor, the Award for Professional Excellence. Jack has authored 10 books on topics ranging from investing and the investment profession, to governance and capitalism. His penetrating insights and ideas present a sensible platform for successful, intelligent investing. For all these reasons, the Bogleheads — and so many others around the world — actively seek out his timeless investing wisdom.
Executive Summary

Jack Bogle, a giant among business giants, discusses in detail his raison d’etre: building a better investment industry in support of investment success for individuals and societies — a mission he plunges into with enthusiasm and vigor like no other has before or perhaps ever will again. We begin by discussing the mutual fund industry as it was in 1951, when Jack entered the business, and now. We see how the industry has grown with dramatic changes in leadership. We also learn how Jack revolutionized the fund business with the first index mutual fund but also how he launched some active management funds which have demonstrated long-term success; today Vanguard is seeing inflows for both passive and active management. Jack also makes clear a longing for the days when investors’ interests were foremost to the mutual fund industry. In his view, it was a time when investment management was at first a profession with elements of a business, rather than a business first with elements of a profession, as exists today. Also, we learn about his criteria for any asset management firm to successfully serve both clients and business needs.

We then discuss Jack’s thoughts on portfolio theory and the benefits of diversifying investments globally as well as across alternative asset classes and strategies. Here, he argues for simplicity and prefers a “plain vanilla” 60/40 U.S. equity/fixed income, balanced index portfolio as appropriate for most investors, including his own 12 grandchildren.

The conversation then turns to expected-returns modeling. Though he strongly advocates sticking to a 60/40 index approach, Jack has shown amazing prescience over many years in producing rather accurate long-term return forecasts for stocks and bonds. We delve into his expected return model and get his prognostications on returns for the decade ahead (hint: not stellar).

As we have discussed in prior “Words From the Wise” articles, there are daunting challenges facing the community of defined-benefit (DB) and defined-contribution (DC) plans. It is well known that Jack favors market solutions, but among his policy recommendations is to establish a federal retirement board to create rules and guidelines to help individual investors succeed by encouraging intelligent investing while discouraging errors.

We conclude with a story on the “mistake” that ultimately led to the founding of Vanguard, and hearing from Jack about his heroes and role models.
Rodney Sullivan: You’ve discussed your 1951 Princeton thesis and your belief that the investment industry was better back then than it is now. What was the investment environment like at that time that made it better?

John Bogle: Later this year, I am giving a talk to the Securities and Exchange Commission for the 75th anniversary of the ’40 Act,\(^3\) where I plan to discuss how the industry has changed from 1951 to today. I believe that our industry is not as good now as it was in 1951. First, there’s the matter of explosive growth. As shown below we have grown from a $3 billion industry when I came into it, to now a $16.9 trillion industry. That’s a 64-year growth rate of 15% a year.

A Tiny Industry Grows Into a Behemoth
1951-2014

In the last 15 to 20 years, industry growth has been nearly a straight line upward, particularly for equities, which have come to dominate the industry. Bond funds have also grown rapidly to become a very important part of today’s market.

Overall, about $8 trillion of the more than $16 trillion in total growth has been driven by net cash inflows and the other $8 trillion by exceptional returns in both stocks and bonds. Yes, bull markets deserve much of the credit for the surge in mutual fund assets.

Interestingly, the assets of the mutual fund industry witnessed a 43% decline in ’73-’74; the industry’s assets fell from a high of $60 billion to a low of $34 billion. For the next ten years, the money market fund essentially saved this industry.

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\(^1\) We thank David Kabiller and Michael Nolan for useful comments and suggestions and Jennifer Buck, Nora Maloney and Mark Stein for their excellent copyediting and production support.

\(^2\) Statistics mentioned in this interview are from various sources including Bogle Financial Markets Research Center, Investment Company Institute and others as cited.

\(^3\) The Investment Company Act of 1940.
**Sullivan:** What was market sentiment like after that fall?

**Bogle:** A lot of people thought it was the end of the industry. There was a headline in *Time* somewhere saying, “Buy Stocks? No Way!” That’s always a good sign of a market bottom. There has been a big change in composition since the 1950s. As the above exhibit shows, by 1981, money market funds came to dominate the industry as the largest single segment, comprising about 75% of total industry assets. However, money market funds are now way down to about 15% of total assets. Currently, it’s still mostly an equity-dominant industry as in the 1950s, though bonds have increased in proportion from 6% of assets in 1960 to more than 20% today.

**Sullivan:** What has been the impact on the mutual fund industry?

**Bogle:** Well, for one, industry leadership has changed. Twelve of today’s 20 largest firms did not even exist (or did not manage mutual funds) in 1951. But some of the big funds from then do remain big players today. Vanguard Wellington Fund, for example, was the firm’s only fund in 1951 (with about $200 million in assets), but today is but one of over 170 Vanguard funds. Its present assets of almost $90 billion represent about 3% of Vanguard’s $3 trillion total. On the other hand, Mass Investors Trust (Massachusetts Financial Services now) was the largest firm at $472 million in 1951, but the firm is now 19th in assets under management.

Along with these changes came new leadership. Firms like Fidelity, T. Rowe Price and American Funds, though they were around in 1951, have increased in prominence; while firms like BlackRock, PIMCO, State Street Global and JPMorgan were either not around or not managing mutual funds in 1951, but are now among the largest players. Also, over this same time period, the number of funds has grown substantially, from 103 to 9,000.

**Sullivan:** How has index investing impacted the fund industry?

**Bogle:** Currently, indexing represents about 33% of equity fund assets and 19% of overall industry assets, a totally new entrant that’s changing the composition of the industry. At over $3 trillion AUM currently, Vanguard, which did not exist until 1975, has quickly grown to become among the largest firms in the mutual fund industry. About 75% of Vanguard’s long-term assets are in index funds. So, there’s been a big change in leadership and in investment strategies.

**Sullivan:** What has been the impact on the mutual fund industry management?

**Bogle:** The first thing that will strike you about the fund industry in 1951 was that most managers ran only a single fund, or maybe two. Wellington was the only fund Vanguard had until 1958, and Fidelity, Putnam, T. Rowe Price, all had one fund. Dreyfus, big back then, also had just one fund. American Funds broke the pattern by having twice that many: two. Mass Financial Services (M.I.T. then) the largest fund firm in 1951, had two funds, but their second fund (Mass Investors Second Fund) was tiny.

So the 10 major fund groups of that time managed 1.7 funds on average with $1.5 billion in assets. Today, those same firms manage an average of 120 funds per fund group, with $5.5 trillion in assets—a very striking change.
change.

Over time, the rules of the game have changed. For instance, it’s hardly reasonable to expect fund directors to even know the names of the funds they are directors of. This is also true for Vanguard’s 170 funds. This broad breadth of responsibility raises an important question of fiduciary duty. How can one be a fiduciary if you don’t even know the names of the funds you represent? So, as I’ve pointed out to the SEC, what has happened in that transition from 1951 to 2014 is a change in the appropriate regulatory unit. At first, it was the mutual fund itself. That’s what the ’40 Act is all about. Today, the regulatory unit has to be the manager, the fund sponsor that controls the funds. So, that’s a huge change, with great consequences.

Though many suggest that expense ratios are going down, the major funds of 1951 had an average expense ratio of 0.62%, unweighted. Today that expense ratio is 1.13%. The expense ratio is up 80%. So, for that group of funds, their annual revenues were $7 million on average, and today, their revenues average $41 billion. So, one might think, if you’ve got an extra $40-plus billion to spend on investment talent and research, surely your performance must be better, but the evidence simply is not there.

Sullivan: Is part of the cost increase due to funds being more diversified now?

Bogle: No, that would be a relatively small cost. The major change has been a staggering increase in management profitability. But yes, I think a lot of investors are over-diversified. The average individual investor owns four mutual funds compared to three a few years ago. They’re way over-diversified. If you want to be highly diversified, you don’t need four funds to do that.

Sullivan: Right, one could buy the Vanguard Total World Stock Index Fund, as opposed to the Vanguard 500 Index Fund.

Bogle: Even better, you could buy a single balanced index fund that is 60/40 stocks/bonds. Importantly, the average manager lasts eight years, and in recent years some 50% of funds have been going out of business every decade. So, when you start with four funds, you’re probably going to have maybe 30 managers by the time you retire. So, you’re fighting not only the number of managers, but the frequent replacement of one manager by another.

Fama and French say you have a 3% chance to own a fund that beats the market over a long time, about 50 years. So, you have a 97% chance of losing to the market. You don’t need that many managers. When you come into, say, the Vanguard 500 Index Fund, we guarantee that you will have the same “non-manager” when you retire as you had when you first started investing. That may sound a bit funny, but it is true.

So, I believe that there’s a better way. The difference between plus 80% and minus 69% means we now have a cost standard that others cannot beat.

So, investors as a group can count on being average — earning the stock market’s return before fund costs. Index funds keep those costs at rock-bottom levels. Index funds win on lower expense ratios, lower turnover costs, no loads, no cash drag. Index funds tend to earn the market’s gross return and should win by about 1.5% to 2.5% a year in net return. Then, the total value of an index equity fund ought to be about 20% higher in a decade than a fund with average costs

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4 Fama and French (2010).
5 See Bogle (2005) for more on this.
without taking on a scintilla of extra risk. So, it’s appears to be an unbeatable model, and the
industry’s cash flow trends are showing that.

Sullivan: You’ve also spoken about fund redemptions.

Bogle: Yes, another important change as shown below is that shareholders used to redeem their
funds at a 6% annual rate when I came into the industry. Currently the rate is 25%, four times as
large. Redemptions rose to an all-time high of 73% of assets in 1987. These spikes in redemptions
happen because people panic in a rapid crash. Despite a market decline of almost 25% on a single
day (October 19, 1987), remarkably, the market was up for the year by about 3%.

Redemption and Exchanges Out as a Percentage of Average Net Assets (1951-2014)

So, that’s a lesson for today: if we get a big market decline — and we will, one day, inevitably —
we’ll most likely see much higher redemptions.

Although index funds are gaining in market share, it’s important to warn people that indexing
means you should only get market returns, whether those returns are good or bad. I have called
that “candor as a marketing strategy.”

Antti Ilmanen: Do you believe that the rise in the 1990s to roughly 40% redemption in early 2000s
was due to technology-related mutual fund flows or the mutual fund market timing in
international fund pricing?

Bogle: Certainly both the tech boom (and bust) and time-zone trading played a role. But the data
show that it was primarily due to the timing of pricing in international mutual funds, which
stopped when Eliot Spitzer took it on. It should have stopped much earlier. It was a disgrace.
Industry people knew it was going on. After all, the redemption rate on international equity funds
reached almost 80% in 2000 and 2002. Their redemption rates have since declined back to around
25%.

Sullivan: Do the high redemption rates, especially during market turmoil, make the case for a
fund or an approach that provides more-stable returns over time so that investors can be more
comfortable with long-term investing; and thus discouraging investors from potentially doing the wrong thing at the wrong time like selling at the low and buying at the top?

**Bogle:** That’s a really a good question. The answer is yes. I answered it practically the day Vanguard opened its doors. From the outset, our strategy was to offer funds that had high “relative predictability,” rather than offering funds with aggressive, high-risk strategies — comets that ultimately burn out.

While I’m known as an indexer — and I am — I did a number of things that I am especially proud of in the active management area. First, I restored Wellington Fund’s original income-oriented strategy in 1978, directing a move away from its growth-oriented strategy that had failed so miserably during 1966-1976. Since 1978, the fund has outperformed the average balanced fund by about 2.0% a year. (But before you get very excited about my “brilliant management judgment,” we earn about 1.0% of that advantage per year on our low expense ratio versus our balanced-fund peers.)6 Also, back in the ’80s I started Vanguard’s Health Care Fund and PRIMECAP Fund, closed Windsor Fund to new cash flows and formed Windsor II as a sort-of-clone fund. They’ve all done rather nicely for their shareholders over this three-decade interval.

We have made many exceptions to the traditional single-manager format by using multiple managers. A fund with five or more managers should inevitably going to earn about the same gross return as, say, a 50-fund peer group. So we win because of our substantial cost advantage. I call these multi-manager funds “virtual index funds.”

**Sullivan:** In what sense?

**Bogle:** High R² (the percentage of a fund’s return that is explained by the return of the fund’s benchmark). Wellington has a 97 R². About 45% of our active equity mutual fund assets are in funds with an R² above 96. So, if you call them “virtual index funds,” which I do (to the consternation of our managers), and add to that the 75% of all Vanguard assets that are in broad stock and bond index funds, as well as our index-like municipal bond funds, then roughly 90% of Vanguard’s fund assets earn returns that are essentially predictable relative to the an appropriate market index and/or their peers. That original strategy of “relative predictability” has stood the test of time.

**PORTFOLIO THEORY AND DIVERSIFICATION**

**Sullivan:** Should investors diversify more aggressively by considering low correlation strategies and asset classes that offer excess returns over time? Would this allow investors to dampen those portfolio swings over time, and, hopefully, eliminate the tactical asset-allocation timing that folks are attempting — as you point out, unsuccessfully — to do?

**Bogle:** My answer would be, don’t bother. I just don’t think that anyone can identify asset classes that will offer excess returns in the years ahead. (Yes, I’m aware that small-cap and value stocks

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6 Source: Vanguard, Bogle Financial Markets Research Center.
have done so in the past.) Further, if you’re investing for, say, 50 years, correlations don’t really
matter very much. To avoid bad behavior, instead keep part of your portfolio in bonds or
something similar. You don’t really need an alternative cash position as a permanent part of your
holdings for your 75-year investment lifetime (from age 20 to 95). With the demographics the way
they are, you’ll still be alive at 95. So, why own a market-neutral fund when the risk premium on
equities is a continuing thing over a long period of time, although admittedly it can behave in a
very peculiar manner in the short term, and get way ahead or way behind itself.

As I noted, many of our active funds have as many as five managers or even more. So the chance
that these funds will earn returns that are significantly below — or above — their peer groups are
small. But, given our material expense-ratio advantage, low-portfolio-turnover strategies and no-
load distribution, we have been able to win by 100 to 150 basis points on cost alone. A return
premium without a risk premium.

Sullivan: How about alternative asset classes, such as commodities, real estate?


Sullivan: Care to elaborate on your rationale for us?

Bogle: The justification is an easy one. Stocks are good investments because they have an
expected internal rate of return based on dividend yields and earnings growth. Bonds also have an
internal rate of return: the interest coupon, year after year after year. On
the other hand, the expected internal rate of return on commodities
such as gold is zero. When you buy a commodity, you’re betting that you
can sell it for more than you paid for it. Maybe you can; maybe you can’t.
That is an almost perfect definition of speculation.

Now, sometimes it’s going to work. But in the long run, because they
have no internal rate of return, commodities should underperform
stocks by a lot. And it’s even worse. Because investors are so good about shooting themselves in
the foot, they will jump into commodities after they have risen and then suffer poor returns as
their returns inevitably revert to the mean or below.

Think about what a stock is. Its value is a derivative of the intrinsic value of a corporate business.
Stocks, then, are derivatives. Sometimes the price of a given derivative is at a big premium,
sometimes at a discount. But underlying it all is investment return — dividend yield plus earnings
growth. Once you get away from an internal investment return, you’re just speculating, and the
odds for a successful long-term investment program investing in commodities are low, maybe
even zero.

Sullivan: Very interesting. I once raised this same question with Bill Sharpe. To paraphrase, he
replied that the way he thinks about it is in the context of CAPM, in which investors seek a
diversified set of assets that co-vary with the overall economy and behave differently in various
economic states. Of course, the market mix of these assets results in the efficient market portfolio.
So, for him, that was the justification for owning alternative asset classes, such as commodities in
a diversified portfolio, because of that co-variance with the macro economy.

Bogle: By adding commodities, you may get lower risk (at least in terms of short-term volatility),
sure, but you also get lower returns. The value of an extra percentage point of return is priceless,
and the value of a lower percentage point in volatility is really meaningless. So, why would one favor the meaningless over the priceless?

Also, these CAPM theories don’t quite have me on board. I think they’re nice. They’re interesting. But I’m not sure what to do with the efficient frontier curve, because every time you draw it it’s different. So, what is an investor supposed to do? Look at the most recent curve? That’s probably counter-productive. I don’t know. Maybe look at the long term?

Sullivan: Yes. Cliff has a paper called “Efficient Frontier ‘Theory’ for the Long Run” where he discusses this exact issue. He explores the efficient frontier at five-year increments and then over the full long-term period from 1970 to 2014. As you suggest, at five-year increments, they often look very little like the theory suggests, certainly not what an efficient frontier should look like. But over the long term, which is your point, the efficient frontier does map out remarkably in accordance with the theory and our expectations.

Bogle: Well, mark me down as the apostle of simplicity and thrift. In my opinion, you will be well rewarded if you can save 1.5% per year in fees; and the main way to do that is in an index fund. I mentioned that when I wrote my presentation to the board of directors in 1975. I knew of no one who had done this exercise before. I took the industry’s major funds (there were probably about 60 of them at the start of the period) and compared their returns with the S&P 500 for 30½ years (January 1945-June 1975). The S&P won by an average of 1.6 percentage points (11.3% vs. 9.7%). If you do that same 30-year study today, beginning in 1985, you’ll see that the S&P again won by 1.6 percentage point (11.2% vs. 9.6%). So, where have we gotten with all of this? The average is the average, and the total return that we all divide up is the market return, minus the cost. Investors, all together, own the entire stock market.

MARKET EFFICIENCY, INDEXING AND GOVERNANCE

Ilmanen: Given, as you say, it’s a zero-sum game, ignoring for a moment the costs of trading, if a group of investors lose with poor timing decisions, what group do you think gets those gains?

Bogle: A really good question, one that’s so seldom asked. If the mutual fund shareholders are losing — who’s winning? In one example, it was entrepreneurs and corporate insiders. Back in the ’98, ’99, 2000 era, when mutual fund investors were buying tech and internet stocks, corporate entrepreneurs were selling. They made a fortune at the expense of public investors. In investing, there are always both winners and losers.

Ilmanen: Yes.

Bogle: Unfortunately, it’s almost impossible to identify which class of investor is consistently winning at the expense of the mutual fund shareholders. We are stuck with this conundrum.

Corporate executives also often outperform, since they exercise their stock options when prices rise, but ignore them when prices fall. The reduction in investor returns caused by the stock options lottery for executives should clearly be a major public policy issue.

I am constantly confronted with this mystery. Everybody talks about executive stock buy-backs being the same as dividends, but the question is how many of those stock buy-backs are just buy-
backs in order to offset the dilution from issuance of stock options. I’m not saying there aren’t net buy-backs. It seems like there are. I once did a crude study, and it looked to me that pretty close to 100% of the buy-backs in the “Old Economy” — Dow Jones Average kind of stocks — were simply offsetting that dilution. But for Silicon Valley firms, the “New Economy,” it looked like almost none were done for that reason. There were many more options created than accounted for by buy-backs.

Sullivan: Unfortunately, many of those same executives also argue against expensing those stock options.  
Ilmanen: How much active management is needed to make the markets informationally efficient?  
Bogle: First, if there were no active management because everybody indexed, we would have chaos in our markets. There’d be no liquidity, by definition. There would also be no daily valuations, for better or worse. So, there would be no way to exchange your interest in the long-term flow of dividends for immediate capital, and vice versa. But that’s the very nature and purpose of liquidity.

What is the likelihood that 100% of all investments will be indexed? Well, zero. Of course. Indeed, it seems that while indexing continues to gain share in equity mutual funds (now about 33% of assets), it is now shrinking a bit in American pension funds (about 26% of assets). Today, many pension funds are finding that the traditional stock market/bond market portfolio won’t provide enough return in the future to meet their projections of about 7½%. (I agree, it won’t.) We already know that pension plans as a group own the market, and can’t collectively earn more than the market return. So the lower index fund position represents the hope that “alternative investments” will make up the difference. This may work for a few pension funds, but it is not possible for all of them.

Consider this: if the market went to 50% indexing, that would mean 50% of the activity in the stock market would be eliminated. I see no problem with that impacting market efficiency. Turnover would decline from 200% to 100%. It was 25% when I came into this business. So, given the nature of the world today, it’s not something I worry about.

I’ll put a stake in the ground and say that the market may get less inefficient at 80% indexed. That’ll make it easy, so it is said, for active managers to win. But, of course, it’ll also make it easier for active managers to lose. On average, the two of them have to net out to zero (less costs), right? That’s how the math works. It’s pretty unyielding. So, it’s not just me that’s unyielding!

Ilmanen: With the tendency of fund investors to buy recent years’ winners and sell the losers, would having business diversification across multiple funds better support business success in asset management?  
Bogle: Well, the problem goes beyond investor behavior. This industry has thrived on a huge marketing system, largely broker/dealers in the early decades. In 1977, Vanguard went no-load and abandoned that system when I realized that we had no realistic alternative. It didn’t make sense to...
be the low-cost provider and still have a substantial sales charge. The world is now evolving away from a broker/dealer model, but it’s basically what has driven the industry from the very beginning.

So, if someone says, I’m switching to indexing instead of using active managers, the broker says, wait a minute, here’s a fund that’s done twice as well over the last 10 years. (They’ve always got a fund that has won in the past.) So, brokers have a powerful marketing advantage over the less-informed investors. It’s called “information asymmetry.” You see ads saying, we’re in the top 10, or saying we have 5 4- and 5-star funds. They don’t tell you about the 75 other 1-, 2-, and 3-star funds they manage. So, as long as salesmen are able to tell only half-truths, our industry has a problem on its hands.

Ilmanen: What else is driving people toward lower-cost indexing?

Bogle: Before I answer that question, let me spend a moment on the huge role that index funds have played in Vanguard’s growth and success. Our pioneering bet on indexing took a long time to catch hold. The 1976 IPO for First Index Investment Trust (now Vanguard 500 Index Fund) was an amazing flop. The underwriters were able to raise only $11 million, despite a goal of $150 million. That then-tiny index fund represented only 0.8% of Vanguard’s stock and bond fund assets. A decade later, in 1986, our index share had slowly edged up to 2.5%. The growth then began to accelerate, quadrupling to 10% in 1991, then doubling to 20% in 1995, and doubling again to 40% in 1998. It reached 50% in 2005, 60% in 2010, and topped 70% in 2014.

**Index Funds as a Percentage of Vanguard’s Stock and Bond Fund Assets (1974-2014)**

Much of that growth came when I recognized that the index fund wasn’t just a mutual fund. It was an investment strategy. If it works in the stock market, why not the bond market? (We started the first bond index fund in 1986.) If the S&P 500 wasn’t quite the entire U.S. stock market, why not index the remaining “extended market” (1987)? Why not combine them into a total U.S. stock market index (1992)? Why not separate the market into growth and value segments (1992)? How about the small-cap segment (1989)? If indexing works in the U.S. markets, what about non-
U.S. markets (1990)? Why not the maturity segments of the bond market (1994)?

These funds reflected my growing conviction that leadership in indexing represented the fate of our firm. The decisions I made to create these index funds were lonely. I had no confidence in market surveys (nor did Steve Jobs). I just decided — pretty much spur-of-the-moment — which sectors would be appropriate to index, and when it was time to launch them. (I’m not sure that this story has ever been told before.)

Now I’ll turn to the recent drivers of the dominance of index funds. In our current low-yield environment, people are starting to recognize they can retain more of their fund returns by just investing in a low-cost index fund. It consumes much less of what the market is now offering, namely low returns. Competitors to Vanguard are therefore struggling with a really huge problem.

Bond funds are a good example. Our peers are charging 50 to 90 basis-point expense ratios for bond funds when the going yield is, if you want to be generous, 3% (mixing longer maturities and some corporates with the 10-year Treasury note). So, that cannot hold. In bond funds, the elementary mathematics of investing are going to come into play, just as they do with stock funds . . . but more visibly.

I’m not entirely comfortable with the idea of Vanguard dominating the industry this much. I’ve always thought it would be great to have another strong competitor. But the conversion of an existing firm, ultimately, to a mutual structure from a profit-seeking structure is going to be very difficult. I’ve twice tried to get a fund manager to make the conversion and I’ve failed. Even the so-called “independent” directors just don’t dare deprive the management company owners of a company worth billions.

Sullivan: What are the characteristics of a well-run, successful firm?

Bogle: Poor management is not everywhere. So, what are the characteristics of “good” firms? Well, they are run by managers, not marketers. They have reasonable expense ratios and low portfolio turnover. They have self-imposed limits on size. They have interim returns that may vary from the market’s return. Finally, investment professionals own and operate the management company.

**EXPECTED RETURNS**

Sullivan: What was the investment environment like when you first started and what were the important lessons for you?

Bogle: Well, the stock market was quite cheap when I first started in the investment business in 1951. Bond yields were very low and stock yields were very high. Stocks were yielding 8% and the market was going nowhere. The war was over in 1945 and everybody was waiting for the post-war depression. It had not come by 1951 and, of course, it never did come. So, the investment environment was, as all investment environments of this type are, very generous in providing prospects for future returns higher than historical norms.

Sullivan: I believe the last time you and I sat down for an interview was in the late summer of 2008, and you had written a paper called...
Black Monday and Black Swans. Though you advise against individuals’ trying to time the market, better instead to set a long-term strategic asset allocation and stick to it, you are remarkably prescient in your ability to predict markets. Discuss expected-return modeling.

**Bogle:** Well, it’s amazing, really, how easy it is to look ahead over 10 years with a high level of accuracy. Back in 1991 in an article for the *Journal of Portfolio Management (JPM)*, I described a model for establishing reasonable expectations for decade-long returns on stocks that has worked out extremely well. I reviewed it again in the 40th anniversary issue of JPM in 2014. In that issue, I also focused on how Paul Samuelson inspired me to start the first index mutual fund. We became very good friends over time — he being brilliant and I being, well, let’s say, not brilliant.

**Sullivan:** How about “modest”?

**Bogle:** Well, that’s the best I can do for myself this morning. Anyway, the model starts with the entry dividend yield and then adds the earnings growth rate on stocks, based on the historic rate over the previous 10 years. Just adding the two gives you the expected investment return. (I know that we are supposed to use a multiplicative approach rather than simple addition, but it doesn’t change their dimensions much at all. So, I go for the simple addition.) Finally, I arrive at the total nominal expected market return by adding in speculative return, or the likely annual rate of change in P/E over the period (based on reversion to the P/E mean of the previous 30 years).

We recently reviewed my projections for the markets in 10-year increments, and the correlations are really quite high between my projections and reality. Below, I show the expected investment returns derived from my model, along with the stock market’s actual return.

**Actual Equity Returns vs. Predicted Returns: Moving 10-Year Periods, 1990-2014**

![Graph showing correlation and R-squared]

Source: Bogle Financial Markets Research Center

Although the change in P/E over 10 years is really a guess, based on history, we do know a lot more about this than we tend to think. We know that over the last 100 years, when the market P/E was above 20, it was lower at the end of a decade 70% of the time. When the P/E was below 12, 84% of the time it was higher at the end of the decade. Assuming this historical reversion to the mean

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8 Bogle (2008).
10 Bogle (2014).
continues in the future (which I do), you can make some remarkably good predictions over a long horizon with this simple model.

In January of 2000, I gave a speech called “The Bagel and the Doughnut,” to the Sunday Breakfast Club of Philadelphia. There I discussed, in part, the outlook for the stock market. You know, most strategists were looking for 10% to 15% expected return on stocks during the 1999–2009 decade. (The previous two decades had seen a 17% annual return on stocks.) I took the audience through my model, but unfortunately, I cheated. I projected earnings growth of 8% at a time when the dividend yield was 1%. This was just unwise. (The average earnings growth over the previous decade was 7%.) I think I was afraid of showing them too low a return. A 5% earnings growth might have been more reasonable, and that’s what I should have chosen. I apologized for this mistake in my 2012 book.¹¹ I think I’m pretty good at being honest about my mistakes.

But I used an expected earnings growth of 8%. Adding to that a 1% dividend yield suggested a 9% total nominal investment return. I predicted then that the P/E would go from 30 to 20 for a 33% drop, roughly a 4% negative annual return. So, I predicted total market return over the decade would be about 5% per year. I used bad judgment there. I should have used a more reasonable and rational 5% earnings growth. Then we’d expect a 6% investment return, less a 4% speculative return.

Sullivan: So, a 2% expected market return per year.

Bogle: Yes, and over the next decade the market return was actually minus 1%. But still that was a pretty good prediction. Sometimes the problem was the 10-year time period. In 1990, for example, I predicted that the total return over the following decade would be 10% per year.¹² And it was actually 17%. But less than three years later, in June 2003—after the “New Economy” bubble had burst—the annual return since 1990 had fallen to 10% per year. While I was off on the timing, my prediction proved to be right on the mark; it just took time to develop.

Sullivan: Yes, agreed. Did you do similarly for more recent periods?

Bogle: In The Little Book of Common Sense Investing, I included the model’s predictions for the 2007 to 2017 period. My colleague Mike Nolan just recently looked at how it has worked with just two years to go. He found that market equity returns from 2007–2015 have been 6.8% per year, right in line with the model of 7%. So, really good … so far. Nothing is perfect in this business. The model is just a reflection of the reality that a corporation generates earnings, and then it returns dividends to its shareholders, and reinvests the remainder in the business so that it grows over time. It’s a very good way to look at things, I think.

Sullivan: Can you discuss what you’re thinking now in terms of the market looking ahead?

Bogle: Well, you can’t look at the numbers today without having some concern about the future. The dividend yield is currently around 2%, and we’ll probably get something like 4% or 5% earnings growth. Let’s be optimistic and use 5%, which gives a 7% total investment return. As for speculative return, the P/E is now 20, though there are a lot of different ways of calculating it. (Wall Street uses 15, but they’re looking at forward operating earnings, I’m looking

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¹¹ Bogle (2012)
at trailing reported earnings.) So, if you go from a P/E of 20 to a long-term average P/E of 18, that’s a 10% decline or about 1% a year. So, a reasonable—if conservative—expectation for the total return on stocks for the next decade would be 7% less 1%, or 6% per year. One could reasonably expect the P/E to decline even further, lowering the annual return over the next decade to, say, 4% per year. Either way, the message is clear: expect lower stock returns over the coming decade.

We’ve also shown how the market returns would be slashed by the costs of the typical actively managed mutual fund, and how a low-cost index fund would compare. Result: net returns after costs for active funds 2%; for index funds 3.95% — almost double the return.

Ilmanen: We view expected returns in a similar way and agree fully with your expectations for low future long-term returns as compared with history. In our analysis, we use smoothed trailing earnings, like the Shiller P/E. We also agree that it’s interesting to look at mean reversion in P/E, or the expected change in valuation, but we don’t rely on that reversion as part of our baseline long-term forecast. We see expected returns in the range of 4.5% to 5% real, which is roughly equivalent to your 7% nominal reasonable expectations [before the impact of negative speculative return].

Bogle: I should also point out that using my formula for short-term return expectations is a total failure.

Ilmanen: Yes, indeed. Over 10 years, it is a good model. Although, one interesting point is that we may stay in this low-yield environment for a long time, which could sustain the higher P/E ratios.

**IMPROVING RETIREMENT PLANS**

Ilmanen: Can we turn now to discuss the challenges facing defined-benefit (DB) pension plans today?

Bogle: Sure. I think one of the most serious problems confronting our corporations, our state and local governments, our economy and our financial markets today is the reliance on high expected returns in the range of 7.5% to 8% by public and private DB plans. Corporations have a vested interest in assuming a high return, because a high assumed return allows them to put less money into the plan. State and local governments have an incentive to do the same, otherwise they will have to either cut benefits or raise taxes. Neither will be easy.

The bias of the system toward overstating that return is profound. Just as an example, we chose one corporate pension plan portfolio that is invested 56% in bonds, 25% in stocks and 19% in hedge funds and private equity. So, for the plan to get the 8% or so annual return that they assume requires, in one example, a 3.75% annual return on their bonds, a 13.6% return on their stocks, and an 18.5% return on their alternatives.

What’s the reasonable assumption for this portfolio looking ahead? Breaking it down, bonds, 3%, a little generous, but OK if you use some corporates and go out a little bit in maturity beyond intermediate term; stocks, as just discussed, about 4%; hedge funds, I’m going to be generous and...
say 10% per year. Therefore, the reasonable expected return for this portfolio is about 4.6% per year. Then take out 1% for expenses and the total nominal return would be 3.6%.

So, they are targeting 7.5% for their funds, but are more likely to get 3.6%; maybe they’ll get 4% or even 2%, who knows? However, the possibility of getting 8% nominal return from today as a starting point is just absurd. Pardon the strong language, but I think it is insane for plans to expect these higher returns.

We should worry a lot about that mismatch, particularly at the state and local levels. We saw what happened in Chicago recently. One solution is to reduce costs through index investment strategies. A local county here in Pennsylvania recently converted from active to passive. They have a great incentive to go to indexing because they can demonstrate bird-in-the-hand savings. They were paying, say, $2 million in management fees, and now they’re paying about $600,000.

“Fellow taxpayers, I have good news for you. We just saved $1.4 million.” But they’re in index funds. That means the chance of an above-market return is zero. I just hope they understand that they are unlikely to achieve the expected 7.5% return assumption that they rely on for funding.

**Sullivan:** With the challenges for defined-benefit plans in meeting obligations, there’s been a big move toward defined contribution plans. What should Defined Contribution (DC) plans do to be successful over the long run?

**Bogle:** Well, it’s actually pretty easy to describe, but it would take a dictator like Mussolini to make it happen, to make the trains run on time. In the ideal, you would allow only low-cost, broadly diversified stock and bond index funds in the plan. We also need to convince retired people that the only thing that’s important to them is a regular check in their mailbox each quarter. This would come from some combination of Social Security and a check from their mutual fund. A reasonable payout for a lifetime today might be 4%, but not likely more than that. There’s also no reason for older people to go to the poorhouse in order to leave an estate for their children, none that I can think of, anyway.

I’ve also recommended that we have a federal retirement board that would establish standards for admission into the 401(k) and the IRA market. I believe this board would require consideration of index funds and very low-cost active funds. Additionally, as we know, all retirement account investments as a group currently own virtually the entire market, and are therefore equivalent to being indexed, but at a far higher cost.

In other words, take all the accounts of all kinds and put them together, and you will find an index portfolio, or maybe a quasi-index portfolio, inevitably. If the overall portfolio doesn’t have an $R^2$ say, 96% or 97% relative to the total stock market, I would be astonished. This means a correlation something like 99%. That’s the rational way of looking at this issue. I’ve never done the empirical test, but it comports with common sense, which is the first thing we all need. When you look at a bunch of data, does it make sense? If it doesn’t, well, the data are probably wrong.

Oh, I’ve got such a chip on my shoulder. It must be getting close to lunch time!

**Sullivan:** There is a lot of discussion about what role, if any, annuities should play in retirement planning and decumulation.

**Bogle:** Well, the defined-contribution plan was designed as a savings plan, not a retirement plan. Annuities were an option, an add-on. Now, by force of the marketplace, the 401(k) plan has
morphed into a retirement plan, and therefore has great structural weaknesses. The weaknesses include investor choice, investor ignorance, inadequate investor education, and excessive flexibility (for a retirement plan) in terms of savings and withdrawals.

For instance, you can take your money out, pretty much whenever you want. You can also borrow against it. If you lose your job, you have the opportunity to take everything you’ve accumulated, leaving nothing for retirement. These all create problems for investors based on their emotions and behavior. We need better rules and regulations, and tougher standards. There is, I would argue, a fiduciary duty on the part of the advisor or broker to make sure that s/he’s giving advice that fits the investor, and not the firm. The problem with the financial business, the brokerage business, the markets, is that ultimately, the salesman has to sell something to earn a living. But buying and selling are the exact opposite of what most investors need, which is “don’t do anything; just stand there” and “stay the course,” to cite familiar phrases of mine. The idea is best encapsulated by Upton Sinclair — I’m paraphrasing here — “It’s amazing how difficult it is for a man to understand something if he’s paid a small fortune not to understand it.”

I don’t like government interference in the markets, but the odds of success in building sufficient retirement wealth are so bad that we need to regulate how the system works. Cliff Asness, are you there? I don’t like government interference. I favor the free market, Cliff, but I know of no other way to fix what’s clearly broken.

There must be much more stringent limitations on getting loans or withdrawing money from your DC plan, and much more stringent requirements to continue to invest when you have the option to take it all out upon your retirement. As I say to people, if you have a retirement plan, don’t take out your money. If you take out half your assets, then you cut your retirement income in half; if you take all of it out, you’ll have no retirement income at all.

So, we need more interference in the free market system than I would like, and, certainly, than Cliff would like. There should be some governing principles to allow anyone to even offer a 401(k) plan. There’s a higher level of fiduciary duty when you’re talking to an uninformed investor. I want a simpler system, a more disciplined system, a lower-cost system, a more diversified system, a system focused on long-term investing, a system in which investors are more knowledgeable about the perils of trading and about the importance of costs.

Interestingly, the more stringent the requirements are for a defined contribution plan, the more successful an investor should be. So, the less switching allowed, the less temptation to pick the winners, the less attention paid to the momentary moves in the market, the more successful investors should be. This is the lesson from Benjamin Graham: “The stock market resembles a huge laundry in which institutions take in huge blocks of each other’s washing.” A great metaphor. This is the opposite of what we tend to believe in America — the more choice, the better. But, in the case of DC plans, more choice is actually appears to be worse, not better.

Proponents of active management say, “You wouldn’t hire an average brain surgeon, so why hire an average (index) manager?” Well, talk about a misplaced analogy! If you knew the manager was going to be above average in the future, of course, you’d hire him. But you have no data on which...
to base that belief. It’s a total speculation as to who’s going to do well tomorrow. If you look at reversion to the mean, probably the best way to speculate is to speculate on the worst managers, because they will likely revert to higher relative performance. And yet, it’s an erratic thing.

So, what is the best approach to investment success? In my opinion, less choice. Low cost. Don’t look at your portfolio values very frequently. Don’t peek! It’s a bit hyperbolic, but I tell people that every time they get a statement, throw it in the waste basket. Do not look at it. And only when you retire, open the statement. But before you open it, have a cardiologist in the room, because you’re probably going to have a heart attack. You simply won’t believe how much money you’ve accumulated over all those years. It’s the compounding. The phrase I use is this: “Enjoy the magic of compounding long-term investment returns without the tyranny of compounding long-term costs.” It goes back to what I suggested earlier, the index guarantee is that you will have the same non-manager when you retire as you did when you started investing 50 years, 60 years earlier.

Sullivan: Do firms that offer DC plans have a greater obligation to provide education to their participants?

Bogle: Yes. They do some education now, but I don’t think it’s nearly enough. The evidence is not good that participants understand the basic principles of investing. Successful investing is about understanding. It is taking all this data that’s flying around and turning it into knowledge, and then turning that knowledge into wisdom. Sadly, investment wisdom is far too often lacking among the individuals in these plans.

Corporations can help their employees, and I think they should help even more. It’s a complex story on many levels. For instance, you have to distinguish between a little corporation and a big one. A small corporation is not going to have the resources of a large one. All investors would benefit by understanding those points that I mentioned earlier: simplicity, getting the costs down and some sensible wisdom about long-term investing, asset allocation and balance. It will happen eventually, because investors are not going to ignore these facts forever. The awful thing is that learning from personal experience in the investment field is really painful.

Ilmanen: You’ve recently discussed your belief that investors don’t really need much, if any, international exposure in their stock and bond portfolios, can you expand on that?

Bogle: There are always arguments about how much international is appropriate in investors’ portfolios. I don’t think it is a necessity, and I’d limit it, probably, to 20% exposure. Everybody seems to recommend the global stock portfolio (almost 50% non-U.S.). But I wouldn’t recommend it. We Americans save our money in dollars; we spend our money in dollars; we earn our money in dollars; and so we should invest our money largely in dollars.

It was in my first book, *Bogle on Mutual Funds*, published in 1993, that I mentioned my recommended allocation of 0% to 20% in non-U.S. investments. Since then, the U.S. market has generated a total return of 595% (9.4% per year), and the non-U.S. market had a return of 201% (5.2% per year). So it was good advice that served investors well. Will the past be prologue? We cannot know.

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13 Source: Vanguard, Bogle Financial Markets Research Center. U.S., is represented by the Dow Jones U.S. Total Stock Market Index (formerly known as the Dow Jones Wilshire 5000 Index) through April 22, 2005, the MSCI US Broad Market Index through June 2, 2013, and CRSP US Total Market Index thereafter. International is represented by the Total International Composite Index through August 31, 2006; MSCI EAFE + Emerging Markets Index through December 15, 2010; MSCI ACWI ex USA IMI Index through June 2, 2013; and FTSE Global All Cap ex US Index thereafter.
Also, I believe that U.S. corporations will be able to hold their own in generating investment return against Japan and the U.K., the two largest market caps in the world defined by weighting in the FTSE Developed Market index behind the U.S., with Canada, France, Switzerland and Germany not far behind. So, to each his own — and there will be debates — and you should probably consider an international segment as an option, but with some limits on how much exposure should be allowed in a retirement plan.

Ilmanen: There was a paper a few years back from some colleagues that showed the benefits of international diversification. So, I wonder, does your advice for a U.S.-centric portfolio apply to U.S. investors only? Or would you give the same advice to say European and Japanese investors? Is there value in protecting yourself, say, from the kind of experience Japanese investors had over the last 20 years by diversifying?

Bogle: No, I would not give the same advice to non-U.S. investors. They should balance their home country investments with both U.S. and non-U.S. equities. We in the U.S. have the broadest economic base compared with the entire Eurozone. We have the spirit of innovation. Most important of all, we have strong shareholder protections and institutional structures for investing. Therefore, in my opinion, the U.S. should be an important part of the investment portfolio of investors worldwide. I can’t say those same things about Australia or Japan. And we have a pretty open society. I think you get value out of that too, in the long run.

Ilmanen: What about valuations in U.S. versus others — Europe, for example?

Bogle: I do realize that dividend yields and P/E’s reflect lower valuations outside the U.S. Now, whether that’s because they’re bargains, or because they’re reflecting higher risk in the market’s own inimitable way remains to be seen.

Some call my view on international a betrayal of indexing by not using a world index, and instead focusing on the U.S. index. I know I could be wrong on this, but I don’t think I can be badly wrong. Some might feel the need to invest 50% of their equity portfolio outside of the U.S., which is, in very crude terms, the world cap weight instead of the 20% maximum that I have suggested. If the non-U.S. side earns, say, 2 percentage points a year more than the U.S. over the next decade (unlikely in my view), then for the extra 30% of your portfolio, that’s 60 basis points of return improvement. So in making your allocation decision, you have to look at your own wealth, the extent to which you want to build it, the extent you want to protect it, and the amount of volatility you can tolerate on that portion of your portfolio in return for a possible 30 basis-point improvement on your total 50/50 portfolio. But simply relying on low-cost index funds rather than high-cost active funds increases your return by many times that amount — maybe several hundred basis points per year.

But as I’ve often said, this is a challenging time to invest in anything!

Ilmanen: A challenging environment, indeed.

Bogle: Yes, reasonable expectations for future returns on bonds and stocks are not attractive. If we use 2.5% return for bonds, and my earlier-cited 4% for stocks, that’s only a 1.5% equity risk premium. On a historical basis, that’s pretty low. I think the historical number is about 4.7%. So,

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14 Asness, Israelov and Liew (2011).
investors are captives of higher valuation levels. Yet you cannot fail to invest if you want to accumulate a nest egg for your retirement.

Yes, you could hold a substantial cash position until the outlook improves, but who will ring the bell when the time comes to get back in? Market timing is a very hard business. Even if you can correctly determine when to get out, it’s very difficult to know when to get back in. “Being right twice” is hardly a proven formula for investment success.

Ilmanen: Would there be some valuation level or some other signal that would lead you to suggest an actionable market timing strategy?

Bogle: Well, I measure valuations primarily by the fundamental return (dividend yield plus earnings growth), not by the speculative return (P/E expansion/contraction). I believe that today’s fundamentals continue to be OK, though not great. So, what would be a high level? If we got back to a 1% dividend yield and a 30 P/E — as we witnessed around the year 2000 — I’d be scared to death. That’s a condition that cannot prevail indefinitely. But we’re not there — yet.

I evaluate the stock market on a long-term basis only, as we discussed earlier. I just don’t do market timing and all of my 64-plus years in this crazy business reaffirms the value of that stance.

Ilmanen: You mentioned that you have given your grandchildren balanced portfolios, as opposed to equity-only or some glide-path approach with equities starting near 100%?

Bogle: Yes, I use a balanced index fund, partly for my own peace of mind. It may not be a brilliant investment decision, but I’m happy to live with it. That allocation also helps to protect me from being scared to death, as I was in February of 2009. Then, I got a knot in my stomach, which is usually a sign of a stock market bottom; a very good sign. Even a veteran investor like me needs to invest in a way that tempers our instinct for bad investment behavior.

I’m not really arguing these points. They have worked well for me. But an investment portfolio has to suit the needs of the investor (or the giver, in the case of this particular grandfather). I didn’t want it to be all in equities. I certainly didn’t want it to be all in bonds. So, 60/40 was the number I picked for our balanced index fund when it was formed in 1992. It’s been around for 22 years now, and has done fine. It operates at very low cost and high tax efficiency. So, I’m not going to beat myself over the head saying, “You could have done better, you chump.” Being comfortable with your investments is a really nice thing.

Sullivan: On a different topic, you mentioned to us that the recent Bloomberg article that posed the question, “Who will be the next Jack Bogle?” caused you some frustration. Why?

Bogle: Bloomberg quoted me as saying, “Nobody could be the next Jack Bogle.” Well, I didn’t say that. What I said was, “I don’t think anybody has the passion to create a new and controversial (mutual) structure for funds, and a new and controversial (index) strategy, and to reform the mutual fund industry in the way that I do.” But, if you’re there, fellow, stand up! Be passionate! Lead!

But all human beings are ultimately replaceable. Who are the candidates that should have been on their list? Well, there is BlackRock’s Larry Fink, who spends a lot of time discussing governance and other issues. Certainly Yale’s David Swensen is another. He makes me seem like weak tea in his criticism of this industry. Vanguard’s Bill McNabb may rise to the challenge. There are not a lot of candidates.
Ilmanen: Swensen makes a distinction between the advice he gives for most investors versus what they can do at Yale.

Bogle: Yes, at Yale he can do things that individual investors cannot. Whether he and his many acolytes can be proved right on this strategy forever — focused on private equity, real estate and hedge funds — is an open question. I am thinking less of his own investment approach than of his willingness to stand up and be counted in a very forceful, vigorous way, about the sins of the investment industry, particularly mutual funds.

Ilmanen: Do you enjoy the role of provocateur?

Bogle: I must say that standing alone and speaking up for what one believes is actually rather enjoyable, and I like a good fight. But it would be nice if there were a dozen people like me doing this. Nice for society, and ultimately nice for the investment community.

I’m not embarrassed about the principles that I’ve stood for during my long career. I’m actually pleased about them. No one can fault the consistency of my message, and it all goes back to that idealistic college thesis, which is now being republished in a new “classic edition” of my 2001 book, *John Bogle on Investing: The First 50 Years*. The thesis, alas, is not particularly well written, I’ll say that. But it’s not bad for a kid just a year out of his teen age. My 10 books have been potent weapons in our education efforts here at Vanguard, but not just for us, potent weapons for investors everywhere. So, I feel good about where I am. I wish I had 86 more years. I think that’s unlikely. Well, it’s impossible, but I like the word “unlikely” better.

To be clear, I’m not a miracle worker — just a guy with a couple of interesting ideas, and the willingness to be passionate about their value and the creation of a new fund industry that is in business, first and foremost, to serve investors. Actually, I wrote these very words in my 1951 Princeton thesis: “The principal role of the mutual fund should be to serve its shareholders.”

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**EXCHANGE-TRADED FUNDS AND HIGH-FREQUENCY TRADING**

Ilmanen: So, your primary focal points being governance, cost in the system, and long-term investing versus short-term speculation?

Bogle: Yes. These are pretty obvious things to take on, for we in this profession can do so much better for our investors. Consider, for example, the new wave of speculation in exchange-traded funds (ETFs). In 2014, the largest one hundred stocks in the U.S. turned over at about 180%, and the largest 100 ETFs turned over at about 1,400%, almost 10 times as much.15 The State Street SPDR S&P 500, the largest ETF, with $180 billion in assets, turned over at 2,700% in 201416, and just about every day is the most widely traded stock (in dollar volume) in the world.

The ETF business is peppered with what Henry Kaufman would call “financial buccaneers” — opportunists in the business seeking to create wealth for themselves. Our industry now sells anything that investors will buy. We used to sell what we made. Now many of us in this business make what will sell. But I acknowledge that sensible ETFs can be put to sound use by their investors, if not by traders.

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15 Bogle Financial Markets Research Center, FactSet.
16 Source: Bogle Financial Markets Research Center, Morningstar Direct.
So, we’re at a time of great change. Investors must have their eyes opened to the truth about the limited ability of active management to win, the importance of investment costs on a long-term basis, even a lifetime basis. The evidence mounts, of course, with each passing year on the compound interest table.

Chasing the will-of-the-wisp of performance will never go away, I’m sure. But I believe it will ultimately be a fraction of what it is today, which is probably half as much as it was 10 years ago, except for ETFs. But we may never get equity fund redemption rates — now about 25% per year — back to the 6% level of my early years in this business. That would take some doing, beyond my capacity to do at this stage of my life. Beyond my energy level — which remains great after two hours and 26 minutes (so far!) in this interview.

Ilmanen: What are your thoughts on costs and high-frequency traders (HFT)? Do you believe that they have, on net, reduced costs for investors?

Bogle: I recently wrote an editorial for JPM on HFT. I found the Michael Lewis book *Flash Boys* to be good reading, but unpersuasive intellectually. While there are plenty of problems connected with high-frequency trading, speed in our markets is not going to leave, ever. Once you get enough speed, whether it's on the Internet or in the markets or in automobiles or airplanes or trains, whatever, there's no going back. So, speed is with us in the markets, and it provides certain economic advantages, economies that are created by being able to get from one stock to another at a remarkably low price.

Certainly high-frequency trading has reduced the cost of investing, the cost of trading, and, yes, the cost of speculation. As some, like Cliff, have said — and they are right — the cost of price discovery is reduced by rapid trading. Price changes happen much quicker, and so you have to be more agile, and that means more competition and more speed.

But the SEC has a list of things they want to know about HFT, and they’ve got it pretty much right. Although market makers are in business to make money, I too would like to see the earnings of these firms disclosed, to learn how much of that trading going on is enriching the middlemen. In other words, if one trader is smarter than the other, and they can do a better buying job and the selling guy pays the price, that’s just the way markets work. But if that gap — let me call it two cents a share — is totally eaten up by high frequency trading costs, then what’s really the point? So, it’s where the money goes. “Follow the money,” is a good way to understand what’s going on.

These HFT firms seem to do trading very efficiently. Yet I was astonished by the thought you could put an enormously expensive high-speed cable from New York to Chicago and make money doing it. But the main thing I make out of high-frequency trading and price discovery is that the typical investor should neither engage in them nor pay attention to them. As I said earlier, my rule is: “Don’t Peek.” Don’t check the prices of your funds and stocks, and the value of your portfolio every day, even every year. Ignore your retirement plan statements. Just keep adding savings until you retire, then peek! Don’t worry about what the market does today. Don’t worry about the next...
flash crash (another concern with ETFs!), even though it’s coming. As you gentlemen know, we haven’t seen the last one.

So, is the system working in favor of investors, or are the benefits going to the market makers in the great casino of investment activity, where we swap stocks with one another, inevitably a zero-sum game before costs? That’s the nature of the so-called auction market.

Ilmanen: What is the impact on investors of the high turnover in ETFs?

Bogle: For individual buy-and-hold investors, it just doesn’t matter much. But institutional traders dominate the ETF business, and we have data that show the returns earned by shareholders in S&P 500 ETFs are some 250 basis points behind the returns that the S&P index delivers for the year. As many studies have shown, the greater your activity as an investor, the worse you do. What we have some obligation to do in this business, as fiduciaries, is protect the interests of the investors we serve, and we’re not protecting them when we offer them a whole bunch of complex, often speculative, products.

Almost all the innovation in the investment business has been driven by the interests of the seller, rather than the interests of the buyer. Looking for something new to sell is what drives innovation in this business.

I recently wrote what I thought was a totally balanced article about ETFs for the Financial Times, talking about how ETFs are useful if you want to buy and hold a broad-market fund forever (but not very many ETF investors seem to do so). At the end of my op-ed, I mentioned that I banned the word “product” at Vanguard many years ago. (It’s back now.) I don’t like anything called a new product, nor a hot product. So, you can imagine what I think about a hot, new product! I wrote that the investor will be enriched if he never buys a hot product, nor a new product. On the front page, there was a news article about my op-ed piece, for it was deemed newsworthy: “John Bogle renews attack on exchange traded funds.”

But I wasn’t attacking, I was just setting down the facts. I guess people love to speculate. They’re down on actively managed mutual funds. They’re down on trading stocks. Now many people fulfill their desires by trading ETFs. The initial ad for the SPDR proclaimed, “Now you can trade the S&P 500 all day long, in real time.” What a wonderful thing (for marketers)!

I expect to carry on the battle, to fight to develop a federal standard of fiduciary duty. My position on this is not a particularly complex one. I say, if you touch a dollar of somebody else’s money, you’re a fiduciary and you must put their interests first. I’ve also written about what I call our “double-agency” system. One in which agents for the company’s shareholders — that would be the management — are confronted by agents for the company’s investors — that would be the institutional money managers. When agent meets agent, they’re too often looking after their own interests, and not the interests of the people they’re supposed to be representing, the shareholders of the corporation on the one hand, and the shareholders of the mutual fund on the other.

Concluding Thoughts

Ilmanen: Any regrets, something that you got wrong?
Bogle: Let me count my failures ... at least most of the big ones. The 1966 merger of Wellington Management Company (which I led from 1965 to 1974) was an enormous failure. I had stupidly accepted the notion that the “go-go” era in the fund industry was here to stay (it wasn’t), and that the four managers of Thorndike, Doran, Paine & Lewis, the merger partner I selected, were outstanding investors (they weren’t). Yes, I have described it as the worst merger in history, even worse than AOL-Time Warner (no mean standard). But out of it came two pretty good firms that, after early struggles, have endured: Wellington and Vanguard.

I started too many funds for marketing reasons (a rookie error if there ever were one!). But out of them came several funds that became quite successful—our Health Care Fund and Capital Opportunity Fund. I also restructured the strategy for Wellington Fund in 1978 and started PRIMECAP Fund and Windsor II (a great story, too long for today). In the process, I’ve learned what works for investors and what doesn’t.

Mistakes, by the way, are never clear-cut. I’m sure that there are those who believe that my quick rejection — without consultation — in 1992 to offer our Vanguard 500 Index Fund as a trading vehicle for what would become the SPDR ETF was really stupid. If I’d accepted the offer of the ETF innovator Nathan Most to partner with him, today we’d surely be the largest ETF firm around. But I’d also have betrayed my firm principle that our S&P 500 fund was designed for long-term investors, not for traders and speculators. So I don’t rue that “mistake.” I celebrate it.

Earlier, I made a couple of comments about where I was wrong, such as my prediction for stock market returns in 1990, and my faulty earnings growth prediction for the 1990s. But these failures, I think, have been vastly outweighed by the soundness of the investment principles I have stood for. I guess, pride goeth before a fall. To be honest, I don’t know how many books published on investing — and there are a lot of them — are going to be collectors’ items, but most will be collectors’ items not for their wisdom, but for their stupidity. But my books have met the test of time.

Sullivan: Any concluding remarks?

Bogle: You know, I’m a little embarrassed with all this self-assurance. But, yes, the fact is that my core ideas in founding Vanguard — mutuality, low-costs, indexing, relative predictability — were solid, even industry-changing ideas. Yet, as I so often say, “Ideas are a dime a dozen, but implementation is everything.” And the implementation of those ideas by our Vanguard crew — 28 at the outset, 15,000 today — has been spectacular. This is a crew of loyal, committed and skilled human beings who are proud of our values and our heritage, and who like the human beings with whom they work. I rely on our veterans to reinforce those values with our newcomers. I care about them, and as I wrote in Enough, Rule 1 on leadership is to “make caring the soul of the organization.”

Overall, I’m pleased that my investment principles initially spelled out in detail more than 20 years ago in my first book, Bogle on Mutual Funds: New Perspectives for the Intelligent Investor, have also stood the test of time. I reiterated those principles in greater depth in Common Sense on Mutual Funds: New Imperatives for the Intelligent Investor, published in 1999. Ten years later, I put them to the ultimate test, republishing the original edition verbatim in a Tenth Anniversary Edition in...
2009, with all of the data brought up to date as well as some additional commentary about the events of the preceding decade. The first edition was published near a major stock market high, the second edition shortly after a major market bottom. Yet the principles I had communicated remained intact, and my conclusions were reaffirmed. The late Peter Bernstein wrote the foreword to the first edition; Yale’s David Swensen did the same for the second edition. I hardly need to tell you how much the forewords from these two investment giants have meant to me.

So I’ve lived a life that’s full. I planned our charted course, and each careful step along the highway. I’ve laughed and I’ve cried, and had my share of losing. Regrets? I have but few, but then again, too few to mention. There’s a song about the story of my career, and, as some of you may remember, it ends, “I did it my way.”

Sullivan: Thank you, Jack, for sharing of your time and wisdom with us. We are looking forward to your upcoming books, research, and speeches, and are grateful for your many and lasting contributions to our profession.
Antti Ilmanen and Rodney N. Sullivan of AQR talk with celebrated investor and author John C. Bogle about the people who most influenced his long and celebrated career in finance. This supplements a question-and-answer session with Mr. Bogle about how investors can manage today’s investment challenges.

Rodney Sullivan: You’ve discussed mutual fund firm ownership, can you touch on that?

John Bogle: I recently talked to the SEC about this issue. I believe we have a serious problem with the outside ownership of fund managers. In the early days of the mutual fund industry, management companies were owned and operated by their investment managers and trustees. But today, 39 of the largest 50 fund groups are owned by financial conglomerates (28) and public shareholders (11). These firms must serve two masters. One master is the owner of the management company (the shareholders of the management company), and the other master is the mutual fund shareholder. "No man can serve two masters."18 But if the fund is essentially a corporate shell, and receives from its manager substantially all of the resources that it requires in order to exist, I don’t think I have to tell you which master gets served. If you’re working for the management company, they’re paying your salary and so you’re going to do whatever helps the management company.

This external management structure has been the industry’s dominant modus operandi since it began, and it has never been seriously challenged … until now. But the idea of putting the client first — of putting the fund shareholder in the driver’s seat — is an idea whose time has come. No, it is not easy. And while Vanguard’s fund-shareholder-owned mutual structure was the best I could do 40 years ago, it is hardly conflict-free. Finally, a mutual structure requires a spirit of mutuality, and that depends on the values of the people who are running the firm.

The need to serve two masters, sadly, helps to explain the stupid merger I championed back in 1966, a merger that derailed my career. At Wellington Management in 1965, when I was 35 years old, I was charged by Mr. Morgan to “do whatever it takes” (his exact words) to fix the serious problems faced by the company — essentially holding to a conservative investment strategy in an increasingly risk-seeking field. That meant saving the management company, and the only way to save a management company in a go-go era is to have a go-go fund. (As the kids would say, “duh.”) I also believed — wrongly — that the merger would serve the Wellington Fund shareholders by bringing in new investment managers. That’s what I did, and our new partnership worked fine for a while. And then it turned disastrous, absolutely disastrous for both the management company and the Wellington Fund shareholders.

My partners, who were responsible for the investment side, were behind that aggressive approach. It failed. Yet the ironic thing is that it was they who fired me. They had many more votes on the management company board than I did. Wellington was then publicly held, and I could have had a proxy fight and I think would have won. But I didn’t want to destroy the company. Out of that catastrophe, in which I made a really stupid mistake — I’m the first one to admit it — and paid a terrible price, came Vanguard.

I should note that it took the independent directors of Wellington Fund and its sister funds to come to the rescue, led by independent director/chairman Charles D. Root, Jr. — the unsung hero of my creation of Vanguard. The firm was incorporated on September 24, 1974, following a seven-month epic battle whose outcome was in doubt until those incorporation papers were filed, creating the first truly mutual mutual fund enterprise in the industry’s history. So, without the determination to struggle through that hard life lesson, there would be no Vanguard today.

18 The reference is to Matthew 6:24. “No man can serve two masters: for either he will hate the one, and love the other; or else he will hold to the one, and despise the other.”
Antti Ilmanen and Rodney N. Sullivan of AQR talk with investment veteran and author John C. Bogle about his long and celebrated career in finance. This supplements a question-and-answer session with Mr. Bogle about how investors can overcome today’s investment challenges.

Antti Ilmanen: You are a role model to so many, who are your role models or heroes?

John Bogle: Of course I begin with the remarkable Walter Morgan, fund pioneer and founder of Wellington Fund in 1928. He was my mentor, and in 1965 he entrusted me with the responsibility to lead his firm. What’s to be said about him? Integrity, intelligence, multifaceted interests, visionary — a good human being to whom I owe, well, everything.

Then I’d turn to Paul Samuelson, the greatest economist of the 20th century, by all accounts. I also have a great relationship with Paul Volcker, surely one of the giants of the American financial system.

I admire Warren Buffett. (Who doesn’t?) Yes, he does his own thing, but his bet that a certain hedge fund will underperform versus the S&P 500 was great. He’s so far ahead in the contest now that I don’t think the hedge fund can ever catch up. Last March, he was kind enough to endorse my Little Book of Common Sense Investing (2007), in which I discussed the philosophy I’m advocating to you. Warren’s endorsement gave me a great month of book sales!

I like Steve Galbraith. I admire him as an investor. I greatly admire Cliff Asness as well. These are guys who run large pools of capital with non-traditional investment strategies. They’re smart, savvy, can keep their perspective, and understand both sides of an issue. They’re far more knowledgeable from an investment standpoint than I am, and are great additions to my large group of heroes.

Peter Bernstein is another. We had a great relationship. I criticized him a couple of times, and he didn’t like it too much, but we made up. In a 2003 paper, he argued that the policy portfolio was dead and that it was time for a different way of looking at investing, urging investors to be opportunistic in their asset allocations, a major departure from his original premise that the 60/40 balanced portfolio was the best policy. I publicly challenged this (I think unwise) change.

William (Bill) Bernstein, another hero, is greatly respected as an advisor, a deep thinker, and an author of a number of outstanding books on investing. David Swensen is also on my list of heroes.

Rodney Sullivan: Yale endowment Chief Investment Officer.

Bogle: Yes, David changed the rules of the game for endowment fund investors. Andy Golden at Princeton, another hero of mine, was one of David’s disciples, and he’s done almost as good a job at Princeton as David has at Yale over the past 15 years. They’re both class acts, people of high integrity and great candor, and they know the business.

Alan Blinder is another hero. I love his gifted writing and the irreverence that often turns up in his regular op-ed pieces in The Wall Street Journal.

I’ve been a friend and admirer of John Gunn, leader of Dodge & Cox for many years, and Merrill Lynch’s former investment leader Arthur Zeikel — two more heroes.

I also admire what my son, John, is doing. He meets all those standards for investment success that I mentioned earlier. He is very conscious of costs, and of asset size. He doesn’t want his small cap growth fund to grow to more than $400 million. And he’s a lot smarter than his father.

Ilmanen: Am I right that he’s doing something quantitative?

Bogle: Totally quantitative. Totally automatic. His firm may be executing transactions all day long without his even knowing it.

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Ilmanen: Warms our hearts.

Bogle: I am sure I will inevitably forget to mention some names. Princeton’s Burton Malkiel would be another hero—brilliant author (A Random Walk Down Wall Street), academic yet pragmatic. I’m still very close to him.

Who am I forgetting? Oh, of course, Benjamin Graham. His timeless wisdom puts him in the upper reaches of my list of heroes. Common sense. The power to see what others miss. Breadth of knowledge about finance. (What would he think about these crazy markets of the recent era?) The later writings of Benjamin Graham clearly marked him as an indexer. When he described the defensive investor, he was probably describing 99% of Vanguard investors.

But I remain an indexer, pure and simple. But very few investors seem to hold the index fund as their only investment, and even I don’t do that. I kept my legacy investment in Wellington Fund, which I started building when I joined Wellington in 1951, right out of college. I can’t bear the thought of liquidating my holdings of this conservative balanced fund, having been, basically, the architect of its revival — its renaissance — in 1978. Since then, Wellington Fund has thrived, in investment performance and in investor acceptance. With assets up from $450 million in the dark days of the late 1970s to almost $90 billion today, it is again the largest balanced fund in the nation. With all that’s changed in the world of investing, Wellington Fund remains its old conservative self — just as founder Walter Morgan would have wanted. That’s the very least that I could do to repay my debt to this remarkable man and mentor.
References


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