Six Questions With John Bogle

An Interview With John C. Bogle

Article Highlights

- To maximize long-term wealth, save, diversify, limit trading and don't look at your account statements.
- Among the mistakes individual investors make are being overconfident, not controlling costs, and simply not capturing the market's return.
- Setting up an investment account for grandkids and discussing it with them is a great way to get them interested in investing.

AAII awarded John "Jack" Bogle, the founder of The Vanguard Group of mutual funds, the Cloonan Award for Excellence in Investment Education at our 2015 Investor Conference. Jack was unable to join us at the conference, but graciously recorded two videos for us. The first was aired at the conference. For the second one, we sent him six questions about investing. An edited version of his answers to our questions is below. Both videos can be viewed on AAII.com.

—Charles Rotblut, CFA

***AAII:** What is the best recipe individual investors can follow to maximize their long-term wealth?*

Jack Bogle (JB): Well, the best recipe for the individual investor, I think, is simple but not easy to do. But you have to do it. Save you must, is the first rule, because if you don't save anything, you will end up at retirement with nothing. And none of you want to do that. So that's the number one rule.

When you start to invest, make sure you're very broadly diversified. Make sure you keep costs out of the equation. Trade the absolute minimum. Trading is ultimately a losing game, so the more turnover you have in your portfolio, the less well you're likely to do. And keep at that.

I've often said, also, when you get those regular retirement plan statements—IRA statements, your own personal retirement plan, 401(k) statements—don't open them. Don't peek. And when you do peek—which you're only allowed to do when you get your final retirement statement—be sure you have a cardiologist standing by. Because you will be so amazed at how much money you've accumulated over 20 or 30 or 40 or 50 years that you won't believe it. You'll probably faint, or something worse, and there will be a doctor there to revive you.

You should definitely start with a base of equities. And by far the best way to own equities is to own them through either a Standard & Poor's 500 index fund or a total U.S. stock market index fund. Hold it forever—Warren Buffet's favorite holding period—and you will win.

Doing those things really works in the long run. You will do better than your neighbors. There's no way around the math, because you will capture the stock market's return less about five basis points—five one hundredths of one percent. You get almost all of it. The money goes to you, not to the managers, not to the salesmen, not to the brokers, not to anybody else, but to you. So that's the tried and true formula and it will work. It has worked.

So, do all those things. And then, as I've often said, stay the course.

***AAII:** Do you think there are any advantages individual investors have over professional investors? If so, what do you think they are?*

JB: Well, individual investors can chart their own course, number one. Now, that means it's a curious way of looking at things, because professional investors are often running individual investors' money. But that need not be; you can run your own money. But don't do things like buy individual stocks or even individual funds, because you're subject to a lot of risks out there.

I've talked a lot about the index fund, but what it does is eliminate the risk of picking individual stocks. It eliminates the risk of picking managers that fail, and it eliminates the risk of various sectors. Is growth going to do better than value, for example? With index funds, you don't have to worry about those three principal risks of equity investing. In index investing, they're all eliminated, so it just plain makes sense to do it that way.

John Bogle's Advice for Individual Investors

John Bogle gave several guidelines for how individual investors can achieve long-term success. Among them are:

- **Save:** This is the first rule. If money is not routinely set aside for investing, a person will end up in retirement with nothing.
- **Stay Broadly Diversified:** An index fund eliminates the risks of incorrectly picking individual stocks, selecting managers and choosing sectors.
- **Keep Costs Low:** Investing is not a zero-sum game with winners and losers, since the investment industry keeps a share of investors' returns through fees and other expenses.
- **Keep Transactions to a Minimum:** Doing so will help keep costs low.
- **Don't Look at Your Statements:** If you don't open your investing account statements until retirement, you'll be amazed at how much money you have accumulated throughout your working years.

***AAII:** What are the most common mistakes you've seen investors make? And can you give suggestions on how investors can try to avoid repeating them in the future?*

JB: Let me count the ways. Let me count the ways that investors make mistakes when they invest. First, all of us go into investing like we do everything else. We think we're above average: We're above-average drivers, and we're smarter than our neighbors. That's not true. In the world of investing, we're all average. We all divide up the stock market's average. Some of us can do better, but for each one that does better, somebody else does worse. It's a zero-sum game.

But it's not a zero-sum game once the croupier, the broker, the salesman and the money manager gets into it, because their costs come out of those returns. So the stock market is a loser's game. For all of us together, as investors, there's no way around this so you might as well lose the absolute minimum. So keep costs down as much as you can. Keep fees down as much as you can. Keep sales loads down. Basically, I would say to eliminate them.

Keep portfolio turnover down as much as you can, because activity is the enemy of the investor. It costs money, and it's often, because of your behavior, counterproductive. For example, we know in this industry, the mutual fund industry, that investors look at fund performance and think it's a prologue to the future. So when a fund is hot, if you will, they pour their money into it. Then the fund cools off, because all funds revert to the market mean. Then they get out of the fund and get into another hot fund. That's a way to guarantee that you will not have very much money by the time you retire. So that's yet another mistake, relying on past performance, because the past is not prologue to the future.

But you should try not to react, because the stock market is a giant distraction to the business of investing. How do you solve these behavioral problems? Well, the way to solve them is not to engage in them. Don't engage in trading. Here, again, obviously, the index fund comes into play. It's the one fund that you don't need to trade.

Still another mistake is listening to tips and rumors, and all those kinds of things.

Another mistake is, I think, the feeling that we need to take action in a very different way than I was just talking to you about. And that is, we react to events in the marketplace. We react to the idea that the Federal Reserve is going to do something, or China is going to do something, or Russia is going to do something. Or the Republicans and Democrats have a debate, whatever it might be.

Our promise, here at Vanguard, is that you will have the same non-manager that you have today when you retire 50 years from now. That's what the index fund is. People are not aware of this, investors are not aware of this. But in other funds, the typical fund manager changes every eight years. Typically, half the funds in business now will probably be gone a decade from now. There's a lot of noise in the fund business that you can't capture.

Eugene Fama and Kenneth French, the academics at the University of Chicago and Dartmouth, tell us that a money manager has a 3% chance of beating the market over 50 years. Well, if you own two managers or three managers, that 3% drops to 1% and then probably, finally, 1/10th of 1%. I hardly need to tell you that those are terrible odds. So do the simple thing: Capture the market return and, if you can, just keep that in mind.

Another rule is don't peek. Don't look at your statements when they come in each month: your statement from your IRA, or your 401(k), your personal retirement account. Don't look. It's just distracting. It will grow; just be patient. And don't open any of those envelopes until the day you retire. When that day comes, as I said earlier, my strong recommendation is that you have a cardiologist at the house, because you are probably going to have a heart attack when you see how much money you've accumulated.

You won't believe it because the miracle of compounding returns—if it's not overwhelmed by the tyranny of compounding costs—just produces remarkable returns. Albert Einstein called compounding the greatest economic miracle of all time, or something along that vein.

***AAII:** If you could share one lesson with individual investors, what would it be?*

JB: Don't worry about the complexity of investing. This is put out as a complex business. You hear opinions all day, every day—newspaper, television, magazines, the media generally—talking about the stock market. Ignore it. Do your best to ignore the noise and just go about your own path of investing.

Because this is not a game about the markets; it's a game about the productivity of American business—the dividend yields that you receive and the earnings growth that follows when the rest of the company's earnings are reinvested in future opportunities. So right now stocks are fairly highly valued, I don't think dangerously so. It may take time, if we get a revaluation in stocks, measured by a price-earnings multiple. But over time, it will take care of you. The market will take care of it, just by its internal rate of return.

***AAII:** Many AAII members are near or in retirement. Is there advice you could give them about getting their grandchildren interested in investing?*

JB: Well, I've done it the easy way. I have 12 grandchildren. And I'm not sure I'd recommend this to anybody reading this, but what I do is put money away for them every year in a Vanguard balanced index fund: 60% total stock market and 40% total bond market. That's very conservative, because I'm a conservative person. And I've been doing that for a long number of years and it's amazing.

I'm going to have to have it tied up in some kind of trust so that they don't get it too soon. But they will be nicely taken care of. I mean, it'll be enough to help them buy a new house or something like that, when the time comes. Or start a business. Whatever they want to do.

I talk to them about it, just once a year. Talk about how simple it is. Talk about the principle of balance. If the stock market has a very good year, I'll say, "You know, I would've been better off having all the money in an S&P 500 index fund, or a total stock market index fund." And they don't dwell on it. I don't tell them the value of their accounts, by the way. Everybody has a different feeling about that.

But, essentially, the way to get children interested is to have stock-picking contests and that kind of thing. I think that's very unhealthy, because that's not what investing is all about. They should be thinking about compounding of returns. Show them what a compound interest table looks like. It might be a little complicated for some of them, but just show them the difference between a 5% return and a 1% return and a 7% return or 8% return over a long period of time. Their eyes will bug out, as the kids might say.

Everybody has to do this their own way. If I had to do it all over again, I probably would've picked a total stock market or S&P 500 index fund with no bonds. And that's maybe what you want to do, depending on the age of your children. A lot depends on that. It's your decision, but it's basically an asset allocation decision and the decision to totally diversify the portfolio. Keep them posted on the returns of the portfolio (personally, I don't reveal the actual amounts in their accounts) once a year or something like that.

***AAII:** Are there any personal achievements that you are most proud of?*

JB: Well, you know, yes, there are. First of all, I'm proud of my family. I will have been married 60 years this coming September to my wonderful wife. We're the parents of six children and the grandparents of 12 and various in-laws—grandchildren-in-law or whatever we call them—and we're happy to see them get through life as good citizens. They're all doing very different things. Some of them are struggling a bit; everybody has those things in the family. But the idea, I think, is to produce good citizens in this country, and I believe we've done that.

Of course, I'm proud of starting Vanguard. There's a song from Miss Saigon telling about one of the orphans over in Vietnam. "Conceived in hell and born in strife," is the way they describe it in the song. And that's the way Vanguard started. It was a very messy start. It took a lot of determination to bring it around. I'd been fired from my previous job. I was basically at sea, disgusted, disappointed, tearful, but I knew I had to find a new way in life.

And that led to starting Vanguard. That led to two of my very best ideas, which are the two I'm certainly the most proud of. One is our structure and number two is our strategy. The Vanguard mutual structure, where we operate the funds for the benefit of shareholders and at cost, is one of the great ideas of all times. And it's so popular in this industry that after 40 years of leadership we have no followers. Think about that one for a minute.

As to strategy, we immediately focused on the index fund. We had a lot of managed funds in those days—a number of them, maybe half a dozen. But the future was always going to be with the index fund. It was going to take a long, long, long time for the index fund to get anywhere, so we made the other funds as index-like as we could with relative predictability of their portfolios compared to their peers. They have correlations of 98% or 96% with their peer groups, so they don't depart very much and win on cost.

Those are good ideas. Those are sound ideas. Those are ideas that conform with the relentless rules of humble arithmetic—you know, two plus two equals four. They're very simple ideas, and they're very inexpensive ideas, and they're ideas that are very easy to implement. They, with the help of a few other

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opportunity that any form of stop order does not offer.

There are two reasons why the sale of the put would be at a profit. First, put options are contracts designed to profit from a decline in the price of an asset, which is the most obvious feature of the scenario described above. Second, a less obvious benefit is that declines in stock price are often associated with a change in the perception of the volatility of the stock. Perception of greater volatility in the stock price is always a positive for the value of an option on that stock. A full explanation of why this is true is beyond the scope of this article, but the positive relationship between perceived stock volatility and option prices is well-known and firm. Widely used textbooks in derivatives, such as John Hull's "Options, Futures, and Other Derivatives" (9th Edition, Prentice Hall, 2014) or Don Chance and Robert Brooks' "An Introduction to Derivatives and Risk Management" (South-Western College Pub, 2012) provide detailed coverage of the phenomenon.

Working against the above two positive effects is that the passage of time, all else being equal, has a negative effect on option prices. However, if the decline in stock price occurs over a relatively short time frame (a week or two), then this "time decay" effect will be weaker than the other two effects described.

Therefore, the opportunity to actually profit from a temporary setback in the price of an investment is unique to the protective put and a major benefit of the strategy. However, note that the decision to exit the put position (by selling the contract) and continue holding the stock is a major judgment call on the part of the investor. As mentioned previously, some may argue that the discipline of being forced to exit a position when the price moves against the investor is the whole point of protective strategies and that the investor should stick to the original plan to exit the position once a price level has been crossed. The profits from selling the put option following a stock price decline would obviously be eroded if the stock price continued to fall instead of recovering as the investor expected.

Conclusion

The relative strengths and weakness of stop orders versus protective puts can be very quickly summarized as: buying puts has the disadvantage of costing money but the advantages of guaranteeing the worst-case desired price and providing greater flexibility with regard to exiting the stock position. It is an open question as to whether the cost of the put option is justified by the two advantages outlined; this is likely to be influenced by factors including potential volatility in the stock price and the cost of the put options.

Viewing the cost of the put option as a percentage of the stock price helps the investor appreciate the cost. In the Apple example, the put options cost $2.80 for the $90-strike put and $1.40 for the $85-strike put. These amount to approximately 3.0% and 1.5% of the $93.44 market price of Apple. This cost is certainly not trivial, although we will note that these option prices were taken from a time of greater-than-usual market volatility and that option prices are lower during less volatile markets. This underlines the importance of setting up protection before periods of price declines and high volatility, when the cost of protection is relatively low. ➤

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funds in Vanguard, are basically changing the nature of the fund industry. And I'm proud of the company we have here, proud of the people that work here.

I also have two other totally different achievements that I'm also proud of, and that will end my list. That is, I helped lead the rebuilding of a school I went to, Blair Academy. It's now one of the strongest independent schools in America. I'm also proud of helping to build the National Constitution Center down in Philadelphia, which has the lofty purpose of trying to make the average American, people like you, understand the meaning and importance of our United States Constitution.

When you get to improve the educational system, in a little way; increase awareness of our national heritage; start a good company with good values, strategies and structure; and have a good family, what else is there? ➤

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