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John Bogle R.I.P.

Since beginning On Course Financial Planning 14 years ago, I have been a disciple of the investment philosophy of John Bogle, who died last month at the age of 89. Broad diversification, buy and hold investing, keeping investing simple, maintaining a long-term focus and minimizing costs and taxes are my foundational investment principles. As he said: *"Avoid complexity and rely on simplicity and parsimony, and your investments should flourish."*

Called the father of indexing, he was the founder of Vanguard and in 1976 created the first retail index fund - the Vanguard 500 Index Fund (VFINX) – to match the return of the S&P 500 Index. Vanguard's competitors mocked the idea that investors would buy a fund that would only yield average returns; ridiculing it as "Bogle's Folly". But Bogle believed that few managers could consistently outperform their benchmark index net of management fees and trading costs. As he said: *"You want to be average and then win by virtue of your costs…Cost is a handicap on the horse. If the jockey carries a lot of extra pounds, it's very tough for the horse to win the race...The index fund is a sensible, serviceable method for obtaining the market's rate of return with absolutely no effort and minimal expense...Index funds eliminate the risks of individual stocks, market sectors and manager selection, leaving only stock market risk…Don't look for the needle in the haystack. Just buy the haystack!"* An index fund doesn't yield average returns; it yields market returns that most of its actively managed competitors will fail to match over the long-term.

The best place to become familiar with John Bogle's investment ideas is in his book: "The Little Book of Common Sense Investing". In it he wrote:

"The way to wealth for those in the business is to persuade their clients, "Don't just stand there. Do something." But the way to wealth for their clients, in the aggregate, is to follow the opposite maxim: "Don't do something. Just stand there."

"Most fund managers, once focused on long-term investment, are now focused on short-term speculation."

"The stock market is a giant distraction…It is economics that controls long-term equity returns; emotions, so dominant in the short-term, dissolve."

"When there are multiple solutions to a problem, choose the simplest one."

"Buying funds based purely on their past performance is one of the stupidest things an investor can do."

"Owning the stock market over the long term is a winner's game, but attempting to beat the market is a loser's game."

Bogle spent much of the past two decades crusading against what he considered to be a predatory investment industry that too often looks at its clients as sheep to be sheared instead of individuals over whose life savings they have a fiduciary obligation. *"The financial system, alas, won't be fixed for a long time. But the glacial nature of that change doesn't prevent you from looking after your self-interest…You don't need to participate in its expensive foolishness."*

Fund companies are incentivized to keep profits as high as possible and keep external shareholders happy. Incredible as it seems today, when Bogle introduced the Vanguard 500 Index Fund, some mutual funds charged front-end sales loads of up to 8.25%, had annual expense ratios of up to 2% and charged commissions to reinvest dividends. Instead of using his fame and position with Vanguard to amass a personal fortune, Bogle chose instead to enhance the wealth of millions of investors by structuring Vanguard to be owned, not by external shareholders, but by the shareholders of Vanguard mutual funds. Thus, there was no need to charge high fund management fees since the company's profits would just be returned to its funds' shareholders. In 1977, Vanguard eliminated sales commissions on its funds. Today, the annual expense ratio of the average actively managed domestic stock fund is about 0.8% while the average annual expense ratio of a Vanguard domestic stock fund is 0.1%. In a 2006 speech, Bogle said: "*The mutual fund industry is now dominated by giant, publicly held financial conglomerates run by businessmen hell bent on earning a return on the firm's capital, not the return on the capital invested by the fund shareholders.*"

When Bogle spoke, everyone listened – even if they'd heard it all before. His most ardent fans call themselves Bogleheads and the Bogleheads website is a place where advocates of indexing gather to discuss various facets of passive investing. The only person in the investment business whose words commanded similar attention is Warren Buffett. In his 2016 annual report to Berkshire Hathaway shareholders he wrote:

"If a statue is ever erected to honor the person who has done the most for American investors, the hands-down choice should be Jack Bogle. For decades, Jack has urged investors to invest in ultra-low-cost index funds. In his crusade… Jack was frequently mocked by the investment management industry. Today, however, he has the satisfaction of knowing that he helped millions of investors realize far better returns on their savings than they otherwise would have earned. He is a hero to them and to me."

The index fund, reviled and ridiculed at first, is the most significant investment product of the past 40 years. It is no exaggeration to say that John Bogle permanently changed how we invest and did more good for the individual investor than anyone else during his lifetime. He revolutionized the way we invest, promoted the interests of the small investor, and railed against corporate greed and the excesses of Wall Street. Because of John Bogle, nearly all Americans have access to index funds in their 401(k). He has earned the gratitude of millions of investors who have never heard of him. Farewell, John Bogle. You will be missed, but the truths you espoused will live on. They will be echoed by financial advisors who promote the ideas you advocated. Thanks for everything.

Desert Musings

My wife and I are enjoying the warm Phoenix weather. That means it's time for my annual desert musings.

The only way to receive the long-term return of stocks is to be permanently invested in them. Unfortunately, the long-term growth of the stock market is not apparent in the short-term; it occurs in fits and starts. If you had the "misfortune" to buy the Vanguard Total Stock Market Index ETF (VTI) at the height of the stock market in Oct. 2007, just before the financial crisis, you gained 111.5%, or 7.1% annually, through 12/31/2018, according to Morningstar. All you had to do was follow John Bogle's advice and ignore the noise, stay disciplined and reinvest the dividends. When you own a total stock market index fund, you own the US economy and the human ingenuity that drives it. VTI cannot go to zero unless all economic activity in the US ceases – in which case you'll have bigger problems than a declining 401(k) balance.

You've probably received mail requesting your attendance at a free dinner investment seminar. Free investment advice costs nothing; at least until you act on it. Be on your guard when someone representing a for-profit investing or insurance firm offers you something for free. The last time I looked, the only free thing in this world is the grace of God.

There are two main reasons why most investors who own individual stocks underperform a simple index fund –

- They sell their winners too soon.
- They hold losers too long because they don't want to admit they made a mistake.

It is during bear markets that the seeds of your future wealth are planted but few investors realize it at the time.

Just because something has never happened doesn't mean it can't happen. Just because something has happened doesn't mean it will happen again. Wise investors never treat the unlikely as impossible or the likely as certain. That's why diversification is so important. Diversifying your portfolio doesn't guarantee that you won't lose money at times, it increases the odds that you won't lose most of your money in a very short period of time.

The surprising thing is not the number of financial crises that have occurred in my adult lifetime. It's how quickly they are forgotten as we continue to blunder along on our merry way.

A S&P 500 index fund is a commodity but not all S&P 500 index funds are the same. The T. Rowe Price Equity Index 500 Fund charges a small 0.21% annual management fee. But the Schwab S&P 500 Index Fund charges just 0.02% - one-tenth the cost. No surprise then that in 2018, the Schwab fund outperformed the T. Rowe Price fund by 0.16%. If the S&P 500 yields an annualized average return of 7% over the next decade, $10,000 invested in the Schwab fund will grow to $19,635 and to $19,289 in the T. Rowe Price fund. Both investors will take the same market risk, but one will leave a $346 tip.

Whenever investment results seem too good to be true – assume fraud until genius is proven.

The stock market's short-term movements follow what is called a "random walk." Stock prices change in response to news. Since the next piece of news about a stock has a 50/50 chance of being better or worse than expected, the next price move of a stock is unknowable and random. When engaged in an activity that yields random outcomes, practice and experience do not improve your chances of picking winners. Practice has the potential of making you a better chess player or a better golfer, but it won't make you a better investor. This is why most successful fund managers eventually underperform the market; usually after attracting huge sums of new investor money.

The historical performance data we have is not the result of a controlled lab experiment from which economists can draw firm conclusions. There's lots of data, but it's the product of human nature and heavily influenced by our collective emotions and random chance, better known as Lady Luck. Databases are constantly updated with new information, so averages are always in flux. Do we have enough data to make firm conclusions? I doubt it. The best we can say is that the data provides a basis for having reasonable expectations about the relative performance of different asset classes.

Most Americans lack even a basic level of financial literacy and too many financial professionals profit from the ignorance of their clients. I agree with Morgan Housel who notes: *"The business model of the majority of financial services companies relies on exploiting the fears, emotions, and lack of intelligence of customers. The worst part is that the majority of customers will never realize this."* There are many books at your favorite bookstore that can give you an understanding of investing basics. So, why do so few of us put in the time and effort to become financially literate? Perhaps the difficulty lies not in understanding what's in the books, but on finding those few that are worth reading. In addition to "The Little Book of Common Sense Investing", those wishing to enhance their financial knowledge should read "A Random Walk Down Wall Street" by Burton Malkiel.

We live in an increasingly trivial popular culture where dumbing down is the norm and most people act as if history began the day they were born. Financial journalism has become trivial by focusing on the short-term and trying to find causes for random events. Every day, there are enough "news" events to give financial reporters something to write about. But instead of enhancing investor knowledge, these reports all too often perpetuate the nation's financial illiteracy. The news of the day influences our emotions far more than the lessons of history. Eventually, what seems so overwhelming today will soon be forgotten or, at best, become dull history for future generations.

In 1900, 40% of Americans worked on farms. By 2000 only 3% of Americans worked on farms. If the average American investor in 1900 had known this, he would have assumed that the America of 2000 would be a third world country populated by starving, unemployed, poverty-stricken citizens.

There is no length of time by which an active fund's historical returns can be used as an indicator of future performance. Nobody knows how long a winning streak will continue or how long the manager will stick around. As John Bogle said: *"Reversion to the mean is the iron rule of the financial markets."* Top performing managers sometimes leave a fund and start a hedge fund. Some start drinking or get divorced or just run out of luck. There are many reasons why performance doesn't persistent, all can be summarized by the fact that we're all human.

Taking more risk is a pre-requisite for the expectation of, not necessarily the receipt of, higher returns. More risk inevitably leads to more volatility and the potential of steeper losses. Studies in behavioral finance reveal that investors don't handle losses very well. Richard Thaler, whose lifetime work in studying investor behavior was rewarded with a Nobel Prize in economics, discovered that we feel the pain of a loss twice as much as the joy we feel from an equal-sized gain. Thus, investors are more likely to react when seeing red numbers on their phone's stock market app than when seeing green numbers. "Recency bias" is a behavioral flaw that causes us to focus on recent past performance rather than on long-term returns. It leads investors to buy what has performed well recently and sell what has recently underperformed. Unfortunately, buying high and selling low is not a strategy that leads to investment success.

You can make the case that the growing popularity of index funds benefits active investors by weeding out unskilled managers. Active fund managers are under intense pressure to outperform their benchmark index. Few can do so, which explains the high rate of attrition of active funds - almost half of domestic stock funds that were available ten years ago no longer exist. One must assume that the most skilled managers are the ones that survived. Today, 90% of trades are done by institutional "survivors" who compete against other surviving managers – the so-called "smart money". The average fund manager today is more skillful than in the past, making it difficult for any manager to outperform the competition on a consistent basis. This is known as "the paradox of skill" and is one reason why "dumb" index funds outperform most of the smart money.

A recent Vanguard research report noted that half of us will never need self-paid long-term care and just 15% are likely to incur costs of $250,000 or more. Concentrating solely on the worst-case scenario sells policies but doesn't help us make prudent decisions. Perhaps you've read reports that claim the average 65-year-old retired couple will have $200,000 in retirement medical expenses, including Medicare and Medicare supplement premiums. But if we average that out over a 25-year retirement, it yields an expense of about $670 per month, an much less newsworthy fact.

The financial advisory profession is rife with noise, nonsense, excitement and self-promoting disinformation. What the profession needs is less talk, more truth, more humility and fewer sales pitches. There's too much talk about market performance, even though the most important function of a financial advisor is modifying investor behavior.

Financially conscientious people usually don't buy things on impulse, overspend or buy things they don't need. Over the long-term, these habits can result in the accumulation of significant wealth. The downside to long-term frugal behavior is that it can make some people uncomfortable with the idea of spending down principal in retirement. Once you have more than enough, it's time to moderate the frugality and enjoy the fruits of your labor. Splurge a little, it won't hurt and you might just enjoy it.

The financial goal of many people is to become rich. Fund companies know this, so they sell the hope of market beating returns in exchange for unnecessarily high fees. But beating the market and getting rich are not legitimate financial goals. You'll never know when you have enough and you'll never be satisfied because you could always have more. The goal isn't to get rich. The goal is to have enough to allow you to retire at the time and in the lifestyle of your choosing and have enough left over at the end to fund your legacy desires.

Daily stock market activity is controlled by institutional traders who have goals that are different from yours. Follow their lead and you'll soon get lost. Financial pros heap scorn on individual investors for repeatedly making predictable, emotional investment mistakes. But institutional traders make similar mistakes - they chase past performance and rarely make portfolio changes much different from their peers.

Averages can be deceptive because they lead us to believe that there's a "normal" return for stocks. The annualized average return of the S&P 500 Index over the past 92 years has been 10%. This has often been mentioned as the return that domestic stock investors should expect. But despite the 10% average, in only four of those 92 years was the return between 8% and12%.

We are approaching that time of year when taxpayers receive scam phone calls from supposed IRS employees telling them they owe money that must be paid with a bank wire or prepaid card. The calls sometimes include threats of arrest, deportation or suspension of a business or driver's license. The IRS does not initiate contact with taxpayers by phone, email, text messages or social media to request personal or financial information. The IRS does not ask for PINs, passwords or confidential information for credit card, bank or other financial accounts. The only way the IRS initiates contact with taxpayers is by US mail.

Most stock market forecasts just take the recent past and extrapolate it into the future in a straight line. While the financial crisis dealt a devastating blow to the retirement dreams of many, it pales in comparison to the daily plundering of assets that occurs when investors act on forecasts uttered by suspicious experts who pretend to have the ability to see what lies ahead. As John Bogle said: "*The idea that a bell rings to signal when investors should get into or out of the market is simply not credible. After nearly 50 years in this business, I do not know of anybody who has done it successfully and consistently. I don't even know anybody who knows anybody who has done it successfully and consistently.*"

Any investment opportunity that I learn about via radio and TV commercials is automatically deleted from my list of potential investments.

Many people talk about a buy and hold strategy. But a better description would be to call it a buy and hold and rebalance strategy. It's not enough just to buy and hold. Periodic rebalancing is necessary to return your portfolio to the allocation recommended in your financial plan.

The S&P 500 Index lost 4.4% in 2018. Yet there were ten companies in the index that were up more than 40% and ten that were down more than 49% for the year. To outperform the S&P 500, all a fund manager had to do was overweight the big winners and underweight the big losers. Yet according to Morningstar, 71% of actively managed large-cap domestic stock funds underperformed the Vanguard 500 Index Fund (VFIAX) in 2018. The large dispersion of returns in 2018 was not unusual, it happens every year. Yet despite this underhanded softball lobbed right over the plate, most active managers strike out in their attempt to beat the index.

Investing tests our intellect and our emotions. Too much investment advice complicates and misleads when it should simplify and clarify. On an ongoing basis, the financial media's relentlessly negative bias causes emotional portfolio tinkering. Successful investing requires optimism, patience and discipline – three traits not found in abundance in our society today. Focus on the basics. This means owning stocks for long-term for capital appreciation and owning US Treasury securities for portfolio stability. Ignore the advice of investing hobbyists - friends, neighbors and co-workers who pretend to know more than they do. Remember the words of John Bogle: "*Time is your friend; impulse is your enemy.*"