Report from the Bogleheads 9 (BH-9) Reunion

Philadelphia, PA
13-15 Oct 2010

By: Bill Bernstein, Victoria Fineberg, Alex Frakt, Kevin Laughlin, Mel Lindauer, Paul Stratton, and Ed Tower

Issue Date: 26 October 2010

Table of Contents

1 Introduction

The 9th Bogleheads reunion (BH-9) took place in Malvern PA on 13-15 October 2010. The Forum and reunions are named in honor of **John Clifton "Jack" Bogle**, the founder and former CEO of The Vanguard Group[1] and President of the Bogle Financial Markets Research Center[2].

In addition to this report, BH-9 is discussed in the Bogleheads Forum[3], in discussions:

- Snippets from Bogleheads 9[4]
- Bogleheads 9 Photos[5]
- Laura's Forbes Column on Bogleheads 9,[6]

and the Boglehead Wiki section "Boglehead Convention Meetings and Local Chapters[7]" including Bogleheads 9 Videos[8].

---

[1] http://www.vanguard.com/
[2] http://www.vanguard.com/bogle_site/bogle_home.html
[3] http://www.bogleheads.org/forum/index.php
[4] http://www.bogleheads.org/forum/viewtopic.php?t=61490
[5] http://www.bogleheads.org/forum/viewtopic.php?t=61909
[6] http://www.bogleheads.org/forum/viewtopic.php?t=61907
[7] http://www.bogleheads.org/wiki/Boglehead_Convention_Meetings_and_Local_Chapters
[8] http://www.bogleheads.org/wiki/Bogleheads_9_Videos

2 ***Day-1 - 13 Oct 10 - Registration and Reception***

The registration took place from 2:00pm to 4:00pm. It was followed by the *Welcome Wine and Cheese Reception* where the Bogleheads saw old friends and met new ones.

3 ***Day-2 - 14 Oct 10***

3.1 Introductions and Forum Operations

Mel Lindauer introduced some notable Bogleheads, and then the participants went around the room stating their names, locations and interesting facts of their Bogleheads life. After that Mel provided a recap of the history of the Bogleheads reunions.

In 2000, **Taylor Larimore**, one of the founders of the **Morningstar (M*)** Vanguard Diehards Forum, made a post on the Forum thanking Jack Bogle for the "house that Jack built" for him. Taylor explained that tremendous opportunities provided by the low-cost index funds created by Jack had enabled Taylor to manage his finances effectively and buy his home in Miami overlooking Biscayne Bay. Jack saw the post and responded asking if there was any interest in getting together when he was visiting Florida. And so the first Bogleheads get-together took place at Taylor's beautiful condominium. 22 people flew in from all over the United States and Canada for this meeting. It was a great success. Mr. Bogle asked attendees to call him "Jack" and charmed all participants in a thoughtful discussion.

The next day when Jack was making a presentation at a conference, he pointed to Mel Lindauer and Taylor Larimore in the audience and said that the M* Financial Forum was the best place to go to for financial advice.

There was a lot of buzz on M* after the first meeting. Many people could not make it because of the short notice, and they were asking when the next meeting would take place. Upon coordinating with Jack, BH-2 took place in Philadelphia, and the tradition was born. BH-3 was held in Chicago hosted by M*, BH-4 in Denver, BH-5 in Las Vegas, BH-6 in DC, BH-7 in San Diego, BH-8 in Ft. Worth, TX, and now BH-9 in Philadelphia.

Almost everybody who has attended a meeting wanted to do it again, and every year the crowd was increasing. The organizers decided to cap the attendance at a level that would provide participants with personal experience. And so the attendance list filled up very quickly. In 2010 the event was sold out in 3 weeks, and some checks had to be returned to those who registered too late to make the cut.

For Jack's convenience and to reduce his travel time, future reunions will be held on the East Coast, alternating between Philadelphia and D.C.

Question: How did the relationship with M* dissolve?

Alex Frakt: M* had some user interface issues. Alex made some suggestions to M* on how they could make things easier to use. After receiving no response, he wrote a small program to index the Forum conversations and hosted it on his own website. **Larry Auton (mingstar)** contacted Alex, mentioned that he was archiving all of the Vanguard Diehard M* discussions and suggested to create a new website to host the improved Forum index and an improved search engine to the Forum's conversations. When Alex looked up Larry on the web, it turned out he was an Internet pioneer who had been a system administrator since the time when the Internet consisted of a dozen computers. Together Alex and Larry created the new site named diehards.org in around two weeks, and it quickly became the primary way people accessed M*'s Forum.

Later M* had a serious problem with trolls that they were unwilling to manage. Many good posters were leaving the Forum, primarily because one particular troll was intruding on nearly all of their discussions. A Forum member named **Phoenix** set up a new web site that was meant to provide an alternative to what was going on at M*. When he set up the site, Phoenix suggested that diehards.org could take it over since he had neither the time nor the server resources to run it if it became successful. Alex contacted Phoenix and within a couple of weeks had transferred the site to diehards.org, which was later renamed bogleheads.org[9].

M* inadvertently helped to popularize the new forum. M* acknowledged that there was a problem with trolls, but instead of human moderators they added software that enabled participants to rate posts by popularity. A few posters started gaming the system to further undermine the discussions, and so people started migrating to the new forum in droves. The membership went from 1,000 to 3,000 almost overnight.

Question: How can we contribute to support the Forum?

Alex: The Bogleheads site is non-commercial, but its maintenance costs real money for servers and bandwidth[10] as well as a lot of time, e.g., about 3 hours a day for Alex. And so the Forum accepts voluntary donations either directly or via Amazon.com purchases[11].

Question: Who are Bogleheads members?

Alex: The Bogleheads Forum has over 21,200 registered users, some 12,700 of whom have at least one post. Our users have made over 840,000 posts in over 60,000 threads.

[9] Here is the inaugurating message "A port in a storm" by Phoenix, dated 19 February 2007, http://www.bogleheads.org/forum/viewtopic.php?p=3.

[10] Read, for example, http://www.bogleheads.org/forum/viewtopic.php?p=237109 about migrating to a new facility.

[11] http://www.bogleheads.org/forum/viewtopic.php?t=54100 describes the donation process.

Around 14,000 people visit the site each day. We serve around 40,000 pages a day which comes to 6.5GB downloaded daily.

Mel: I look every day at new people who have just signed up and at people who just started posting. We have about 20 people signing in daily, and of these about 7 make a post. However, we have to deal with a lot of spammers. We see spammer IP addresses from the Philippines, China, Vietnam, India, Bangladesh, etc. These people are paid to register and post their [spam] links.

Question: What about the Bogleheads policies?

Alex: The rules for the Forum are trying to replicate the civil discourse that Taylor set up when he first started posting.

Mel: When M* hosted our 3rd reunion we visited the M* headquarters. They were very good to us and provided us with anything we needed. Our M* Forum had a large number of unpaid moderators. Taylor and Mel could easily spot troublemakers. They would ask M* to check it out, and they would keep the forum clean. However, subsequently M* went public. Different people came to moderate the forums, and they had a different set of principles. Also, as M* became accountable to their shareholders, there was some concern that M* might shut down the forums, since they could not justify losing money on the forums. Mel started wondering what would happen to the community if M* decided to pull the plug on the Forum. How would we operate? How would we get in touch with all the folks who posted on the Forum? The Forum needed a contingency plan.

The initial thought was that the Bogleheads.org site would serve as a backup in case anything happened to the M* Forum. For a while we ran both sites on split screens. However, as the troll situation at the M* Forum deteriorated, and M* failed to do anything about it, it became hopeless to operate both sites simultaneously.

Vimba Edgars: I am from Morningstar, registered as **M*_Edgars**. I am new here having joined M* last August. I want to thank Mel and Taylor for all your posts and work on organizing the Forum. If I can do something at this point, please let me know. Come to me. We will have a chat.

Comment: People who are not moderators should also read posts critically. If you see a post that violates Forum policy, do not respond openly but send a Private Message (PM) to Mel, Alex or Taylor.

Alex: We are relying on posters for identifying trolls and spammers.

Comment: You [addressing the room] have no idea how much time the Moderators spend on the Forum. They are giving valuable time. If you can help in any way, please do. Larry and Alex spend their own money to keep the Forum going.

Alex: Last year was the first time when Larry broke even financially thanks to the donations that started coming in. But after the initial enthusiasm, we are now mainly receiving donations via Amazon.com purchases, about $200-$300 a month. We don't want to be intrusive and we don't want this Forum to have a commercial flavor.

3.2 Q&A with Jack Bogle

At 10:20 Mr. Bogle entered the room. Everybody stood up and greeted Jack with a long round of applause.

Jack was touched by this reception, "Good morning. How many people get this welcome coming into a room?![12]" Jack then said that the Bogleheads Forum site is so popular that he does not have the time to read everything. He also mentioned some personal details including several heart attacks he had over the course of the last fifty years and a heart transplant he received nearly fifteen years ago.

Jack stated that it was quite rewarding to have seen so many things he had been predicting actually come true in the last fifty years. Buttonwood, an economics and finance columnist for *The Economist*, recently wrote about the advantages of low-cost index funds. The article did not mention Vanguard by name, but it clearly promotes the principles on which the Vanguard Group is built[13].

Jack introduced his two assistants, Emily Snyder and Kevin Laughlin, who have worked for him for twenty-two and eleven years, respectively. "This is remarkable considering how tyrannical I am. Last year, when the Bogleheads met I was in Bryn Mawr Hospital. Now I have a little less energy and work less without actually retiring. I used to work at the 150% effort level. And now what is it? 80%? 90%? 105%? Things are good. I don't worry what will happen next," Jack said.

Jack continued, "Recently, I have been very comfortable at Vanguard. The new President is succeeding in restoring old Vanguard values and human relationships. I want you to know very clearly that my relationship with Vanguard is very good. Vanguard is the leader in the new trend after 37 years. Other funds are run for the benefit of their management. What is unique about Vanguard is that it is run for the benefit of the investors. Our fundamental strategy is still the same: low-cost investing wins, long-term investing wins."

---

[12] This and other Jack's statements are *not* precise. They reflect the *essence* of what Jack was saying. See the video of the reunion for Jack's exact words and how he said them. Also, as this entire section was presented by Jack, we omitted most quotation marks except where Jack made some personal remarks.

[13] The article is probably "Paying the price: Time to reassess how fund managers are rewarded," *The Economist*, Jul 29th 2010, http://www.economist.com/node/16702073?story_id=16702073.

I prepared some slides which I call "Bogle Welcomes the Bogleheads."

Figures 1 and 2 show Vanguard's share of the mutual fund industry assets and how it compares to Fidelity. The Vanguard share is growing, whereas the Fidelity share started declining after it peaked in 1999. The slight difference in the numbers on the two slides is due to the Figure 2 focus on the *long-term* assets. Vanguard manages approximately $1,225B in assets, whereas Fidelity manages approximately $725B, a $500B difference. The only area where Fidelity is ahead of Vanguard is earnings. In 2009, Fidelity earned $2.5B, and Vanguard had $0 in earnings. Vanguard is shareholder owned!

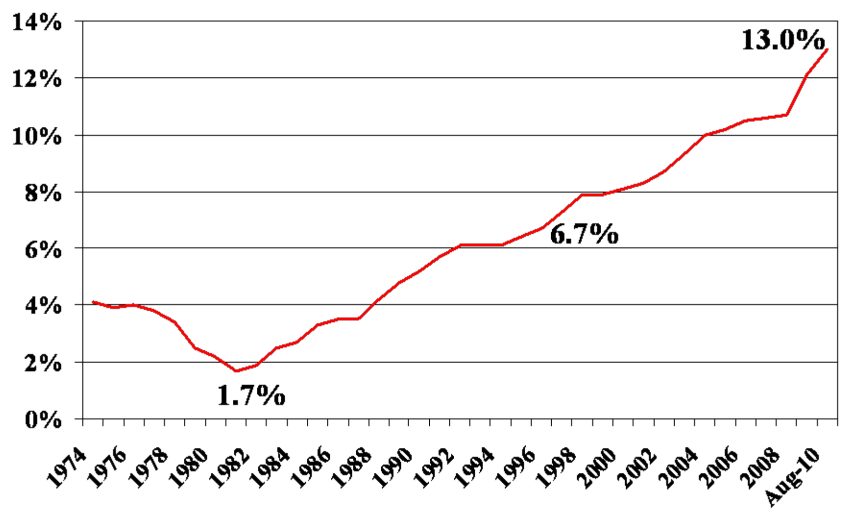


Figure 1. Vanguard Share of Mutual Fund Industry Assets.

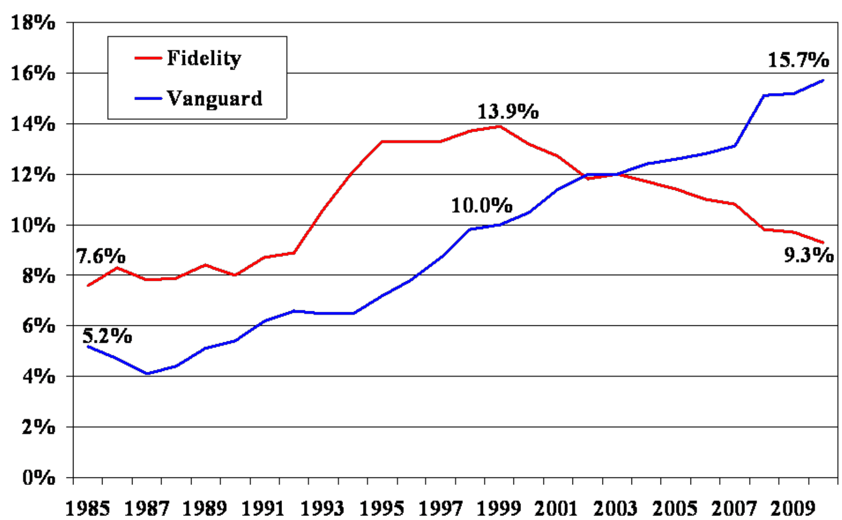


Figure 2. Vanguard and Fidelity Share of Long-Term Assets, 1985 – 2010.

Figure 3 shows how the lead in the fund market share has evolved in the last sixty years. In the 1950's MFS was the leader, in the 1960s it was IDS, which later became American Express, then Ameriprise, and recently Columbia. In the 1980's Fidelity assumed the lead. In the 2000's Vanguard became the leader, whereas Fidelity dropped to the 3rd place. Vanguard achieved this because of investors' trust.

1950
Industry TNA: $2.5 b

Firm	Share
MFS	15.3%
Columbia	9.3%
Keystone	8.8%
Wellington	6.1%
Affiliated	4.6%

1960
Industry TNA: $17.0 b

Firm	Share
Columbia	14.7%
MFS	11.1%
Wellington	6.7%
Waddell & Reed	5.1%
Inv. Mgmt.	4.6%

1970
Industry TNA: $47.6 b

Firm	Share
Columbia	12.6%
Fidelity	7.3%
MFS	6.6%
Waddell & Reed	5.1%
Dreyfus	4.7%

1980
Industry TNA: $55.1 b

Firm	Share
Fidelity	9.1%
Columbia	8.9%
American	7.8%
T. Rowe Price	5.4%
MFS	4.8%

1990
Industry TNA: $566.9 b

Firm	Share
Fidelity	9.1%
Merrill Lynch	8.2%
Franklin	7.3%
Vanguard	5.9%
American	5.4%

2000
Industry TNA: $5.1 tr

Firm	Share
Fidelity	11.7%
Vanguard	9.4%
American	6.4%
Putnam	4.5%
Invesco	4.3%

2010
Industry TNA: $7.9 tr

Firm	Share
Vanguard	15.7%
American	10.8%
Fidelity	9.3%
BlackRock	6.5%
PIMCO	5.6%

Figure 3. Mutual Fund Market Share Leaders: 1950 – 2010 (long-term assets).

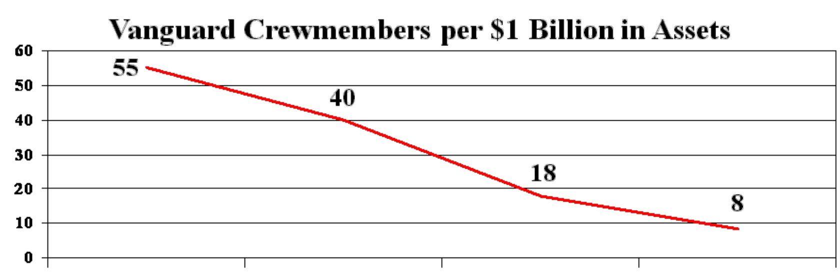
Figure 4 shows how the share of the leading mutual fund companies has changed by 2010.

Year	Firm	Share	2010 Share	Change
1950	MFS	15.3%	0.9%	-94%
1960	Columbia	14.7%	1.8%	-88%
1970	Waddell & Reed	4.8%	0.7%	-85%
1980	T. Rowe Price	5.4%	2.8%	-48%
1990	Franklin	7.3%	3.9%	-46%
2000	Fidelity	11.7%	9.3%	-20%

Figure 4. "Uneasy Lies the Head that Wears the Crown."

You can see that Fidelity is down 20% from the level of its dominance, so far. There is no room for complacency.

Vanguard also moved ahead because it continuously improves its efficiency, as Figures 5 and 6 show. Take for example the expense ratio. We wondered if anybody would even notice a difference between 0.23% and 0.24%. However, I cautioned Vanguard and the industry to stop thinking in terms of basis points and think in terms of dollars. With today's Vanguard's assets at $1,400B, a basis point is $140M, a third of the basis point is almost $50M! This is what Vanguard spends on advertising. We save expenses by using telecommunications and the Internet. The ideas of keeping expenses down and differentiating by price work.



	1980	1990	2000	2010
Assets	$3.0 b	$55.8 b	$564 b	$1,400 b
Expenses	$8.2 m	$130 m	$1.4 b	$3.1 b
Exp. Ratio	0.59%	0.35%	0.27%	0.23%

Figure 5. Increasing Efficiency, 1980 – 2010.

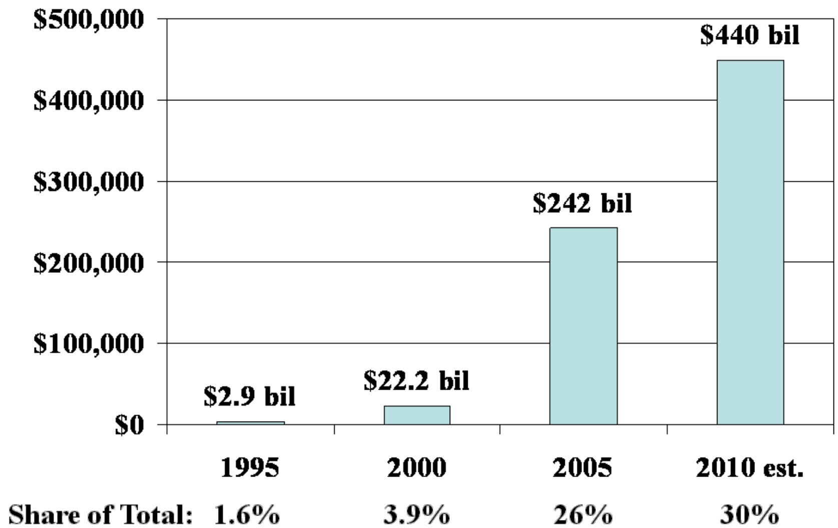


Figure 6. Assets in Admiral Class Shares.

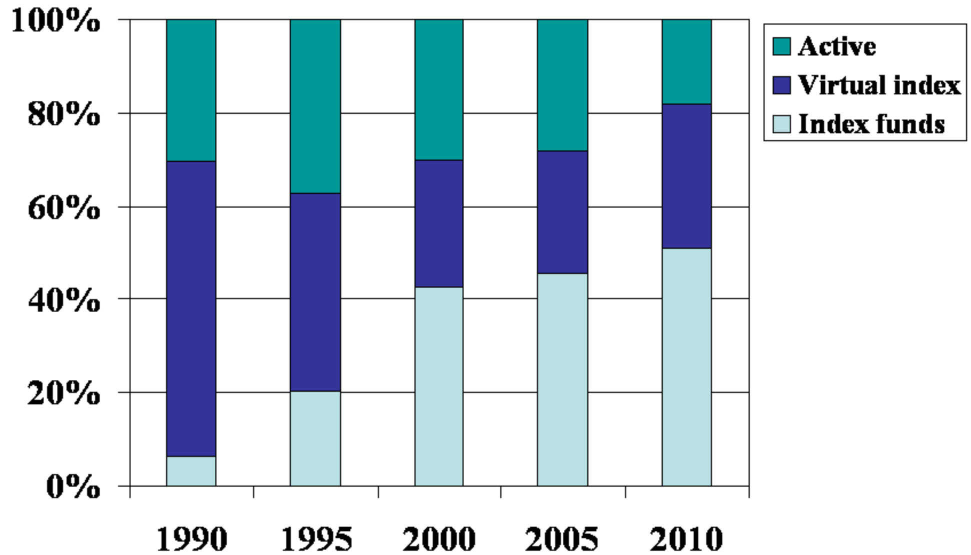
After a recent change in the Admiral qualification minimums, an estimated 30% of the Vanguard assets will be in the Admiral shares. It is a simple idea, but nobody has thought of it except Vanguard. We expect more large investors coming in.

Vanguard addresses two 'sacred cows' that people thought a fund manager would never do. I thought that our competitors may drop their expenses below Vanguard's, but nobody ever did. I also expected that after Vanguard introduced Admiral shares to capitalize on the economies of scale for our largest investors our competitors would follow. Again, we are unique in this, too.

The recent reduction in the Admiral share class minimums is our way to fire a shot across the competitors' bow. It was a wonderful decision by the Vanguard management; I had nothing to do with it. But is not a 'gift' to investors. It is a reflection of Vanguard's low costs. It is a smart reallocation of costs that will make us stronger in the future.

Now, let's talk about Index funds. Figure 7 shows the changing composition of the Vanguard assets over the last twenty years, with the index fund share growing. Figure 8 provides some details of selected Vanguard funds. Virtual Index Funds, technically, are not index funds but they operate like them. We have several funds in this category.

I like multi-manager funds. It is statistically impossible to hire all above-average managers. If we have five managers, and we did a good job selecting them, we will be average. I picked managers who favor a low-turnover approach. For example, Explorer has six managers. If you win by 0.5% a year, you win by 10% over a decade.



	1990	1995	2000	2005	2010
Active Share	30%	37%	30%	28%	18%
Index/Virtual Share	70%	63%	70%	72%	82%

Figure 7. Composition of Vanguard's Assets, 1990 – 2010.

Index Funds	Correlation (R^2)	Expense Ratio	Turnover
500 Index	100	0.07%	12%
Total International	98	0.32%	12%
Total Bond Market	99	0.12%	80%
LT Bond Index	100	0.22%	69%
Virtual Index Funds			
LT Tax-Exempt	98	0.12%	15%
LT Treasury	100	0.12%	77%
STAR Fund	99	0.37%	21%
High-Yield Corporate	96	0.15%	21%
Actively Managed Funds			
Wellington	98	0.23%	28%
Windsor II	96	0.27%	41%
Strategic Equity	99	0.30%	60%
PRIMECAP	95	0.37%	4%

Figure 8. Index Funds, Virtual Index Funds, and Actively Managed Funds.

In some trading firms traders hold a position for an average of 11 seconds! They don't look at it as long-term investing. An average mutual fund holds a position for a year. Index funds hold positions forever.

In 1972 I wanted to start a bond fund. Everybody said I was crazy, but I knew it was right. Management did not support me, and so we started Wellesley as 2/3 bonds and 1/3 income-producing stocks. What is going for Vanguard bonds is our service and that we deliver what we promise. There is no point in building a firm so big that you cannot manage its assets, and I knew that we *will* get big. This is what has happened to Columbia, they got too big. But with the index funds the size is not an issue. Cost is incredibly important as the measure of performance.

Figure 9 shows the percent of peers we outperform. You see our clear lead, particularly after expenses. And you can see the advantage of our low expenses.

	% Outperforming Peers		
	Before Expenses	After Expenses	Expense Advantage
Stock Funds	42%	61%	+19%
Bond Funds	57%	100%	+43%
Balanced Funds	78%	89%	+11%
Money Mkts.	40%	100%	+60%
Overall	51%	82%	+31%

Figure 9. Vanguard Fund Outperformance, Gross and Net.

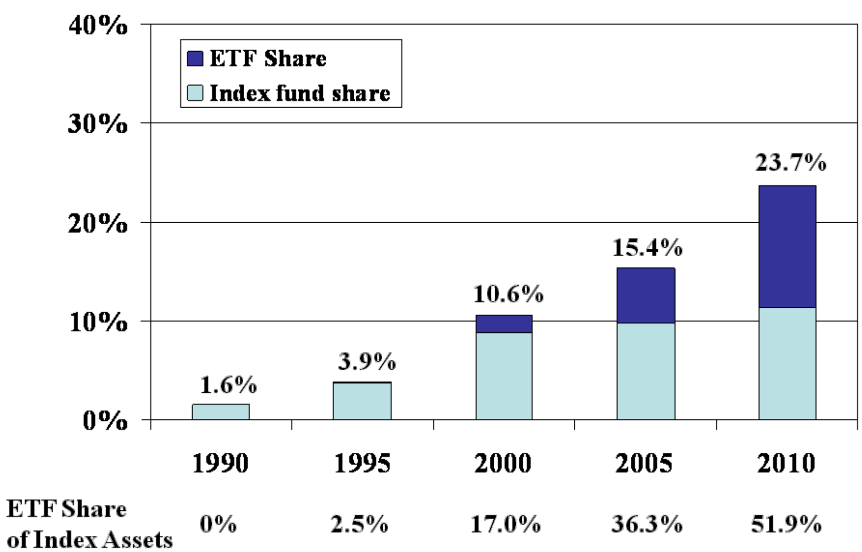


Figure 10. Indexing's Share of Equity Fund Assets.

In Figure 10, note the proliferation of ETFs. There is now more money in ETFs than in conventional index funds, and it is *not* good. There is no reason why many of these ETFs could not be owned by long-term investors. The problem with ETFs is their high turnover. I observe a paradox: active management is becoming more and more like indexing, and with ETFs indexing looks more like active management.

In Figure 11 you can see how rapidly the ETF market share has changed. In the case of Vanguard, it grew from 0% in 2000 to 4% in 2005 to 14% in 2010. In Black Rock the ETF growth is even more dramatic.

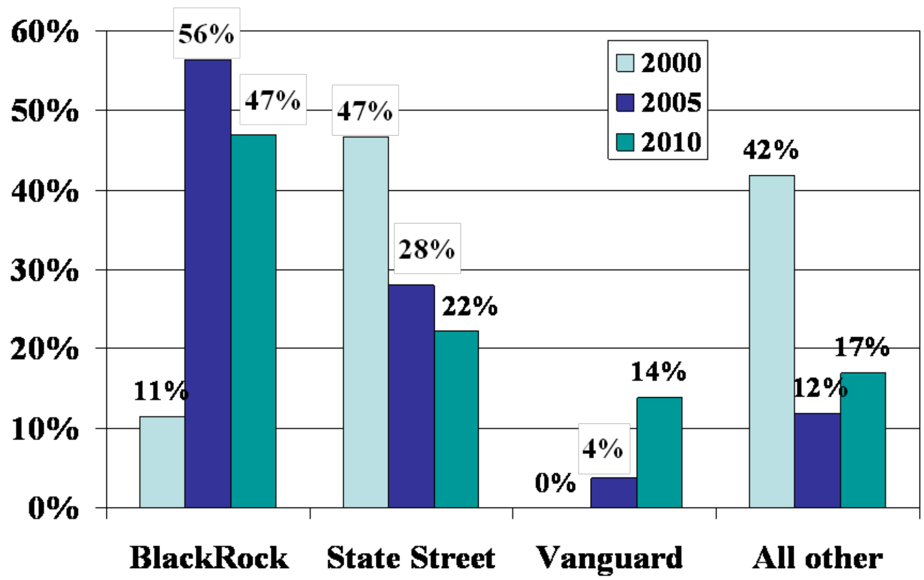


Figure 11. ETF Manager Market Shares.

With ETFs, people are speculating hour-by-hour about what they think the markets will do or, say, what Brazil will do. Some people even invest in ETFs with active managers! The industry preys on innocent investors.

Figure 12 shows shareholder turnover in leading ETFs. And so in Figure 13, I am asking the question ‘Do ETFs provide any value for investors?’ You can see the results. For example, the iShares Hong Kong Index ETF had 5-year annualized returns of 9.8%, but the investors made only 0.5% lagging the ETF by 9.3%.

Vanguard ETFs did not do much better. For example, the Vanguard Emerging Markets ETF had 5-year annualized returns of 12.2%, but the investors made only 2.8%, lagging the ETF by 9.4%.

You can see now why I am concerned about the way investors use ETFs.

Fund	Ann. Turnover	Holding Period (Days)
SPDR S&P 500	10391%	3.5
iShares Russell 2000 Index	10346%	3.5
SPDR Dow Jones Industrial Average	3932%	9.3
iShares MSCI Brazil Index	3892%	9.4
SPDR S&P MidCap 400	2262%	16.1
iShares FTSE/Xinhua China 25	2129%	17.1
iShares MSCI Emerging Markets	1506%	24.2
iShares MSCI EAFE Index	1183%	30.9
SPDR Gold Shares	1119%	32.6
PowerShares QQQ	1005%	36.3

Figure 12. Shareholder Turnover of Ten Leading ETFs.

	Annualized 5-Year Returns		
Extreme Examples	**ETF**	**Investors**	**Investor Lag**
iShares Hong Kong Index	9.8%	0.5%	-9.3%
iShares Global 100 Index	1.0%	-10.1%	-11.1%
iShares Emerging Markets	11.6%	5.3%	-6.2%
Vanguard Emerging Markets	12.2%	2.8%	-9.4%
Vanguard Financials Index	-8.7%	-14.7%	-6.0%
Sectors			
Emerging Markets	12.0%	2.8%	-9.2%
Large-cap	0.8%	-4.6%	-5.4%
Small-cap	1.6%	-1.6%	-3.2%
Foreign	5.2%	-2.8%	-8.0%
All ETFs	2.8%	-2.7%	-5.5%

Source: Strategic Insight

Figure 13. Do ETFs Provide Value to Investors?

It is difficult in this industry to get people interested in corporate governance. The Supreme Court has made an outrageous decision in February 2010, to allow corporations to make political contributions. I wrote a proposal that would prohibit corporations from making political contributions without 75% shareholder approval.

They find ways to influence policies. New corporations were established, so that even the former requirement for a disclosure has disappeared, and they can make contributions virtually anonymously. I will keep fighting this.

Let's talk briefly about my new book *Don't Count on It!* It is endorsed by Paul Volcker, Arthur Levitt, Nassim N. Taleb, Henry Kaufman, Jeremy Grantham, and Jean-Marie Eveillard. Alan Blinder, a former Vice Chairman of the Federal Reserve Board wrote the Foreword.

The BH9 participants will each receive a copy of this book as my gift to you.

All numbers in the book are real. The corporate governance is an agency system, corporations are owned by agencies instead of shareholders.

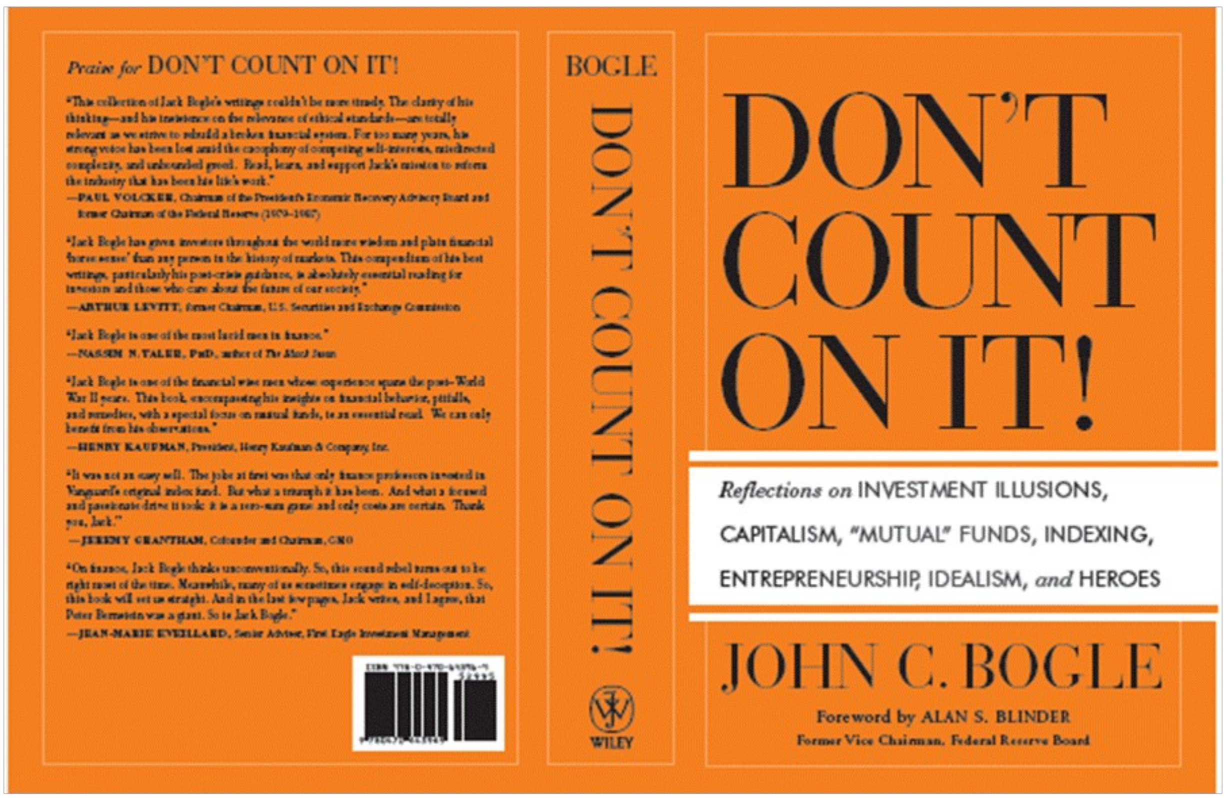


Figure 14. Don't Count on It!

Figure 15 provides the major themes of the book. Each chapter stands by itself.

1. **Theme: The Perils of Numeracy**
2. **A Tome!**
3. **An Anthology**
4. **Foreword by Alan Blinder, includes endorsements by Messrs. Volcker, Levitt, Kaufman, Taleb, and Grantham**
5. **New text on Heroes; 7 commencement speeches ("Idealism"); new introductory material; some updated essays ("The Telltale Chart")**

Figure 15. Highlights of "Don't Count on It!"

Now, let's talk about the financial markets. We lost the focus on the long term and are focusing on the instantaneous prices. Our system is a mess. I worry about the future of stocks and bonds in these speculative markets when we can have a spectacular crash like the 'flash crash' in May 2010. Over the short term, returns are dominated by changes in the speculative premium, how much people will pay for a $1 in earnings. But over the long run, 100% of returns come from corporate America, and the impact on changes in the market's price/earnings ratio is minimal. As I wrote in *The Little Book of Common Sense Investing*, the stock market is a giant distraction from the business of investing.

Figure 16 provides some interesting indication of the investors' sentiment in various decades. It is taken from Keith Ambachtsheer who is using data from *Triumph of the Optimists* by Elroy Dimson, Paul Marsh, and Mike Staunton.

You can see how the sentiment changed from decade to decade, alternating between pessimism and optimism. The last decade was pessimistic because of the double bubble. Should the next decade be optimistic?

Era	Investor Mindset	Time Span	Div. Yield Change	Eq. Risk Premium
WWI	Pessimistic	10 yrs	5% to 7%	-5%
Roaring 20s	Optimistic	10 yrs	7% to 4%	+12%
1930s/40s	Pessimistic	20 yrs	4% to 7%	0%
Pax Americana I	Optimistic	20 yrs	7% to 3%	+8%
Scary 70s	Pessimistic	10 yrs	3% to 6%	-3%
Pax Americana II	Optimistic	20 yrs	6% to 1%	+9%
Double Bubble Blues	Pessimistic	10 yrs-to-date	1% to 2%	-6%

Source: Keith Ambachtsheer, using data from *Triumph of the Optimists*

Figure 16. "Seven Coherent Eras in the Last 100 Years"

Now let's look at the investment returns in Figure 17.

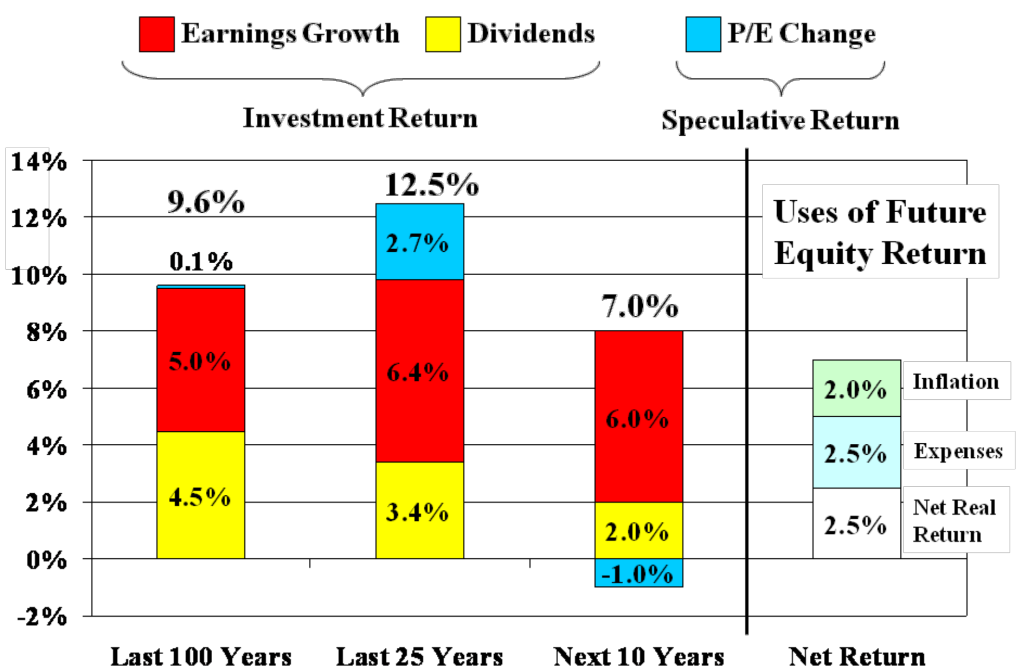


Figure 17. Total Returns on Stocks, Past and Future.

You can see in Figure 17 that in the last 100 years the average annual return on stocks was 9.6%. In the last 25 years, it was 12.5%. But what we should really care about is what it will be in the *next* 10 years. I expect to see 6% earnings growth and 2% dividend rates. The P/E is likely to decline a little, e.g., by 1% for the total return of 7%. The P/E factor represents the market's speculative return, or a speculative *decline* as the case may be in the next 10 years. Earnings growth tracks the Gross Domestic Product (GDP) growth, and it is pretty stable over time. But note that the dividend component is reduced dramatically from the 4.5% 100-year average to the 2% currently.

And so you should not expect the last 100-year average returns to carry into the next 10 years. A 7% return is more realistic. Now, let's look at the right-hand side of Figure 17 for how this 7% return will be distributed. 2% of the return will account for inflation; let's assume that inflation will be low. 2.5% are fund expenses, including trading expenses, but we're not even talking about taxes here. And so an investor is left with 2.5% of the net real return [7% - (2% +2.5%)]. If you want to do better than that, lower your expenses now.

And now let's look at the *future* bond *returns* which are linked to the *current yields* as shown in Figure 18. LT stands for Long-Term and IT stands for Intermediate-Term bonds. Note that the current IT TIPS yields are close to 0%.

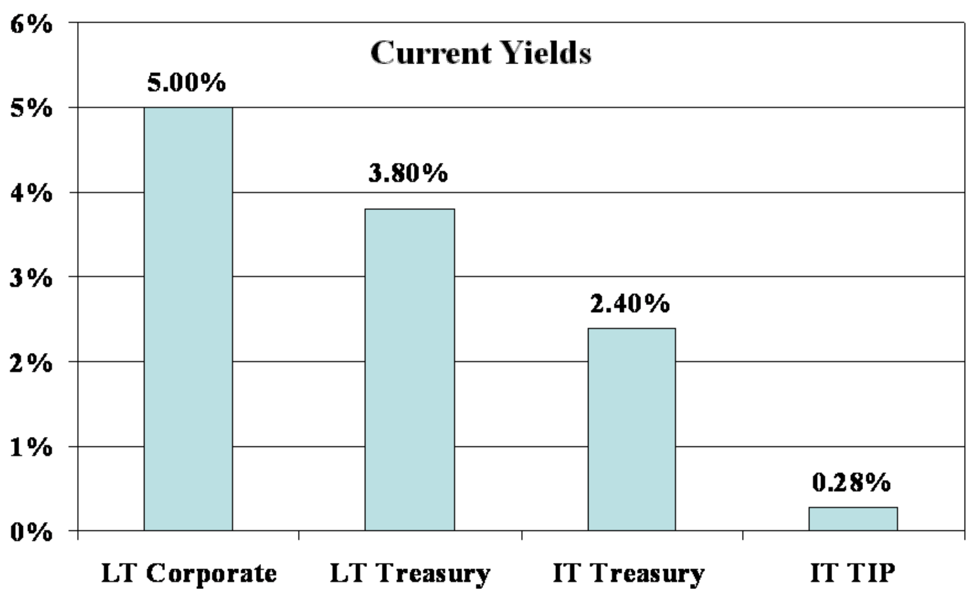


Figure 18. Future Bond Returns are Linked to Current Bond Yields.

The expected bond returns are 3.5%. Of these, 2% will go towards inflation and 1% will go towards expenses. The investor will get a 0.5% *net real* return on bonds. That is why expenses matter tremendously, for stocks and bonds; expenses take out a huge part of the return. Figure 19 summarizes my projections of the stock and bond returns in the next 10 years, breaking them down into their respective inflation, expenses and *net real* return components.

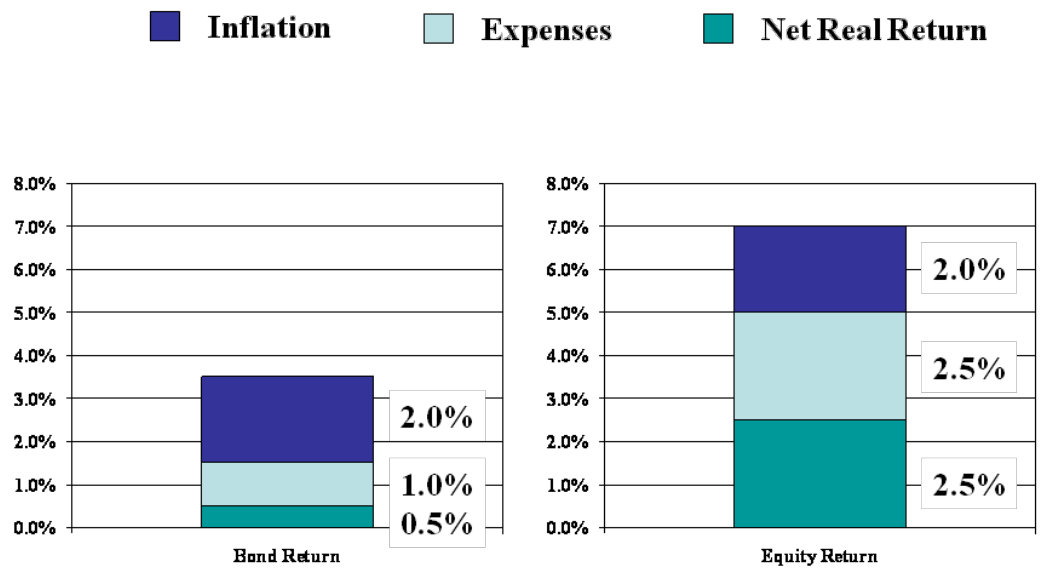


Figure 19. Uses of Future Stock and Bond Returns.

Now, I want to share my thoughts on asset allocation in the context of the topics summarized in Figure 20.

- **Risk to economy, financial markets**
- **Bonds provide a poor alternative to equities**
- **Caution is the watchword (Opinion!)**
- **International?**
- **Commodities?**
- **Gold?**
- **Hedge Funds?**

Figure 20. Thoughts on Asset Allocation.

Vanguard's economic and capital markets outlook[14] is too optimistic in terms of their expected returns. For example, in Figure 13 [of the publication] they show a 25%

[14] https://institutional.vanguard.com/iam/pdf/ICRECM.pdf

probability that the broad U.S. stock market will return 8%-12% annualized over the next decade. In the Figure, the returns show wide symmetric tails, and thus there is a 22% probability of 4%-8% returns and 20% probability of 12%-16% returns. Note how much larger these projections are than my estimate of 7%.

Figure 9 [of the Vanguard publication] provides projections of the total bond market returns. The center of the distribution is 23% probability of 3.5%-4% returns. The graph shows a 21% probability of 3.0%-3.5% returns and a 19% probability of 4.0%-4.5% returns.

But I don't believe it. Monte Carlo does not work. Companies are now different, dollar values are not credible. When you visit Vanguard this evening, ask them 'Should not dividend yield be a part of the equation?' For example, Vanguard projects 5% probability of over 20% U.S. equity returns [Figure 12 of the Vanguard publication]. Start with 2% dividends and you have 18% left to go. Where will this 18% come from?

Bonds provide a poor alternative to equities. But be cautious. Caution is the watch word. I may be wrong. I hold 80% in bonds.

Now, let's discuss international investments. Vanguard's projections for international equity returns are similar to those they have for the U.S. equities [Figure 13 of the Vanguard publication]. I don't know that, I don't know if the international returns will be the same as the U.S. returns. You might ask them about this in a non-contentious way during your visit, how did they arrive at these projections?

Commodities. I hate commodities. You buy a commodity hoping to sell it at a higher price than you paid for it. With stocks, you build your capital over years. With commodities, there is no growth. There will be a sucker who will buy gold at its highest price.

Hedge funds. I would not even know how to pick them. Vanguard has managed payout funds, but I don't believe it when funds put percentages next to their names.

The U.S. financial system is a mess. The pension system is bankrupt. We are facing unknowns, Black Swans. Wall Street is sickening, and they keep making more money for themselves, not for their shareholders. We have lost some values.

I will do my best to bring the values back to the system. I want to make even a tiny difference, to bring us to a nobler vision of society, to bring value to the investors and not to Wall Street. I brought a motto to Vanguard that even a single person can make the difference.

Mel started reading questions, and Jack responded.

Question: You are my financial hero. In your book you write about the responsibility of the Boards of Directors. Why doesn't Vanguard use its institutional power to withhold votes?

Jack: That has to come. I tried to influence governance as far as I was able to. I value professionalism over business; others value business over professionalism. In the corporate governance, nobody wants to irritate their shareholders.

Vanguard got to where it is now by being outspoken, critical, raising hell as appropriate. I always commented on what was good (or not) for the shareholders. Other companies voted on what was good for their business. That is why some people perceive that I am "negative" in comparison to others. I don't know how Vanguard votes. Ask them about it this evening.

I am not critical of Vanguard, despite what some people think. I was once on Lou Rukeyser's show. Lou looked into his teleprompter and said "I understand you disagree with Vanguard." And I responded "No." Lou stopped, he was not ready for this answer. I then continued "Vanguard disagrees with me."

Question: Tell us about rebalancing.

Jack: *Not* rebalancing is a better strategy than rebalancing; this is what the data say. This is because over time, stocks do better. Thus, if you don't want to bother, don't worry about it. However, if you *want* to do rebalancing, do it. Rebalancing may not be the best strategy for a long term, but it may be good short-term. But don't do it very often, do it only if the deviation is significant. Rebalancing from 52/48 to 50/50 is not worth it. I don't do it. It was *done to me*, because in the past 15 years bonds did well.

Comment (in the room): About corporate governance: it takes money to investigate companies, and Vanguard may not want to spend money on this.

Jack: The cost of research should not be that high. A third of our basis point is $50M, more than enough to have a research department. Chris Davis was interviewed about this and he asked 'Why not to leave it to Adam Smith's invisible hand?' This is not about cost, this is about inertia.

Question: I attended your book event when *Enough* was published where you expressed concerns about democracy in this country. Please comment on that.

Jack: I was concerned about a financial reform and campaign council. We made progress on one but not on the other. The campaign reform went backwards. The impact of the campaign contributions in Washington is disgusting. Earmarks. It's vicious, nasty, selfserving. I don't like how the Congress runs, e.g., spending time investigating Roger Clemens on dope and not addressing the issues of the utter importance for the country.

As for the financial reform, Sheila Bair, the Chairman of the U.S. Federal Deposit Insurance Corporation (FDIC), will talk about it. There will be a huge impact on shareholders, but we will not know much before the regulation is done. If it were up to me, I would bring back the Glass-Steagall Act and take banks out of the business of investing.

Question: Mr. Bogle, you recommend including pensions and Social Security into asset allocation. For a 50-year old this may mean going 100% into stocks. Can you comment on this?

Jack: A 50-year old is not drawing Social Security. Take a 62-year old. By the way, fixing Social Security is an easy thing to do. There are several small things that could be done, but they are politically charged. In retirement, you are concerned about sources of income. One source of income is dividend producing stocks. I talked about this in my book *Bogle on Mutual Funds*. Dividend producing stocks generate an income stream. However, we had the greatest dividend cut in history.

Another source of income is bonds. But if you have Social Security it could replace bonds. Thus, a retiree could have income 50-50, a half of which would come from the Social Security and the other half from a 100% allocation to stocks.

However, if stocks go down you may panic. We tend to think in terms of compartments. For example, if we have a balanced fund that invests 50% in stocks and 50% in bonds, and it is doing well we are fine. But if we have an equivalent in the form of two funds, one of which is in stocks and the other one in bonds, and one of them goes down (while the other one is doing well), we panic. And so I would not recommend putting 100% in stocks for behavioral reasons.

Perhaps, you could count Social Security as 50% of your fixed income and then rebalance 75% (i.e., 25% representing the remaining half of the fixed income and 50% representing equity-based income).

People also ask about corporate pensions, but these are not reliable.

Mel: Weren't dividends cut for tax reasons, because dividends are taxed higher than capital gains?

Jack: It *should not* be that way. IRA, 401(k), pension funds, etc., are not taxed. Taxation should not be a big deterrent here. Also, think about it. Most funds have high turnover which generates more taxes. That's why Vanguard has tax-managed funds. Fund managers get paid regardless of taxes. In my most recent *Wall Street Journal* article I pointed out that fund expenses consume the lion's share of the income their stock investments produce. You'd think that somebody will do something about the things that are important.

They should tax inheritances. Andrew Carnegie was in favor of punitive inheritance taxes. He used his fortune to create libraries around the country. When people tell me they are self-made men, I ask them 'Oh? How did you arrange to be born in the United States?' This country provides the greatest opportunities; do we really *not* owe anything to this country for being born in the U.S. and taking advantage of them?

Question: What do you think is the future of a dollar?

Jack: There are many financial forces. We want to strengthen the Chinese Yuan. Interest rates will have to go up. The Chinese own $2 trillion of our debt, this is a large number. This number will go down when interest rates rise. I am surprised that the European crisis did not get worse, particularly among the so-called PIGS countries, Portugal, Ireland, Greece, and Spain.

You go short. Not short-selling, but short in maturity. You can go gold and commodities and I wish you well [laughs][15].

Question: When you go to sleep do you think about the millions of people you benefited by creating Vanguard?

Jack: I will give a whimsical answer: before I go to sleep I do a New York Times crossword puzzle. Socrates taught that one should wait until the evening to enjoy the day. It is not my evening yet. It is a good time to be looking for new ideas. Lately, I don't watch TV except Phillies games. Perhaps later I will have time for introspection. I think about what I haven't done that was obvious.

Question: In your book *The Battle for the Soul of Capitalism* you talked about costs, about expense ratios. What is shelf space?

Jack: This is what is *not* included in the expense ratio. First, portfolio transaction cost (turnover). We don't know its contribution. Perhaps 100% turnover is about 1% of the portfolio. I'd rather be approximately right than precisely wrong. Second, sales charges such as 12(b)-1 fees. Third, taxes. That is why I use 2%-2.5% as the overall cost. The industry uses 1.4% as the cost, but I use 2.5% to cover all these costs. But something like paying for shelf space – in which, for example, the fund manager pays to be part of Charles Schwab's mutual fund supermarket – is included in the fund's expense ratio.

---

[15] This statement has been extensively discussed in the Bogleheads Forum right after Jack's presentation. We highly recommend that those interested in what Jack actually said – and *how* he said it – order the BH-9 video.

Question: Corporate governance in the U.S. is a mess. Abroad it is probably even worse. How can investors reduce their risk of investing abroad?

Jack: As far as I know no mutual fund group is heavily involved in corporate governance. Governance has nothing to do with the daily, monthly, yearly market fluctuations, i.e., the criteria that the mutual fund companies care about the most. However, governance means *everything* in the long run. Dividends matter a lot. Bill Miller wrote about skill vs. luck. If you are lucky and you want to fail you cannot do it, your luck would not let you. Luck seems to dominate the business of investing. It is a vicious business, and I respect money managers who are trying to do honest job.

Mel thanked Jack on behalf of all Bogleheads and presented him with a replica of the Liberty Bell as a symbol of Jack liberating investors from high costs, thus allowing them to enjoy financial freedom. There was a long applause as Jack was leaving the room.

3.3 Fireside Chat: Jack and Bill

After lunch, Jack Bogle and Bill Bernstein held their traditional Fireside Chat. Most questions were from the audience.

Bill: Why there is no mean reversion in bonds?

Jack: Dividend yield causes reversion to the mean in stocks. In bonds, if you are holding to the end, then there is no mean reversion; you get exactly the bond yield. I don't like long bonds.

Bill: If you buy a fund, rates go up and return goes down.

Jack: There are compensating factors: lower return-higher yield and vice versa. People pay too much attention to the short term. I don't know if the rates could go to 10%; use your best judgment. We may be over-thinking this. Even if we are right, it is difficult to guess.

Bill: What fascinated me was your chart about optimism and pessimism. In the airport I walked into a bookstore and could not find anything that would look like an investment book. Nothing by you, nothing by Suze Orman, nothing by Jim Cramer. ☺ . Perhaps, there were one or two of Nassim Taleb's books. There is no interest in investment among the public.

Jack: People seem to be interested only in "making money," not in investing money. People buy old books, many of which are wrong.

Bill: I look at bookshelves at people's homes and I see "Dow 36,000."

Jack: Dow 36,000 is an exercise in marketing. Dow may reach 36,000 – eventually – with a lot of bumps on the way.

Bill: Are the gaps between index funds and ETFs you talked about greater for non-Admiral investors?

Jack: We have not looked at it yet, but your intuition is right. The gap should be smaller with the Admiral shares. It is hard to estimate. We have daily volumes in ETFs, but we don't know if these are sales or purchases. Some of these people may be market makers; but there is no doubt that investors in the vast majority of ETFs earn returns that lag those provided by the funds themselves.

Bill: Should investors worry that their strong hands are weakened by the ETF weak hands?

Jack: No, this is noise. There was the "flash crash" in May. Most people should not have even noticed it. On the other hand, I worry about Emerging Markets, one of our largest ETFs. 33% of mutual fund holders are ETFs. ETF holders are traders. If something happens in Brazil, traders will get out poisoning the market.

If ETF investors get out, the entire market may be affected. Vanguard should be very careful about these speculative funds. It is not good for people to make 25 trades per month. Normal should be perhaps 25 trades in a lifetime.

Bill: What do you think about mutual funds dealing only with advisors?

Jack: There is an inverse relationship with economic growth. The market is about return, not risk. In the past 10 years, emerging markets lost more than 60%. During lunch, Steve Dunn asked me what the "flash crash" was. This is the proper response; one should not worry about daily happenings.

Bill: I see in your calculations [referring to Figure 19] that we can count on 1.5% yield if we are lucky. Add to that 2% dividend yield and we are looking at 3.5% returns.

Question: What about bonds?

Bill: Bonds I worry about. We may see real inflation even if we forget about budget imbalance. My position in bonds is very short. You may end up with a nominal 4% return if you hold a bond for 10 years, but you won't be happy if the inflation is 7-8%.

Jack: I use 2% inflation, because this is what the spread is between TIPS and nominal bonds. If things are bad, it may be 1%. When you start looking at these numbers in real terms, expenses are really big. If the *nominal* equities return is 7% and expenses are 2%, expenses are roughly one-third of the returns. But if you are looking at the 5% *real* returns, then 2% expenses are almost a half. The impact of cost is magnified. Taxes are murder. You are paying taxes on 7% whereas you are getting 2%. Probably we should spend more time looking at real returns.

<u>Bill</u>: It has always bothered me calculating inflation as the difference between nominal bonds and TIPS. I recently read that this calculation assumes the same liquidity in nominal bonds and TIPS, which is not the case. In 2008-2009 TIPS dropped ~25%. When the liquidity differences are taken into account, the estimate of inflation is higher.

<u>Jack</u>: How accurate is the Consumer Price Index (CPI)?

<u>Bill</u>: With respect to computers it is OK. But with healthcare, insurance, etc., good luck.

<u>Jack</u>: I read that Social Security will have no Cost Of Living Adjustment (COLA) next year.

<u>Bill Schultheis</u>: I have a question for Jack, Bill and the gentleman in the audience who helped started the TSP (Thrift Savings Plan), the federal government employees' equivalent of a 401(k). Isn't it ludicrous to think that an average intelligent person can successfully invest over 30 years and then successfully de-cumulate over another 30 years? How about the forced savings system they have in Chile?

<u>Bill</u>: I could not have said it better. Defined Contribution (DC) plans are a social experiment that failed. My opinion is that the more choices we give people the worse they do.

<u>Bill Schultheis</u>: People would sign for this [Chilean-like system] in a heartbeat. They want to know how much they need to save, not how well the Emerging Markets will perform.

<u>Jack</u>: 401(k) plans have a number of problems. First, you are allowed to borrow from them. Second, you can cash them when you are changing jobs. Third, you can stop contributing at anytime. Fourth, you get no guidance. Fidelity Magellan used to be the most popular 401(k) choice. With this attitude, how could people possibly succeed when they were entering retirement? It is basically a privatized retirement plan where you have your own account without all the flaws. The known flaws in the system are high-expense 401(k) plans.

<u>Bill:</u> A survey among 60 to 64 year old pre-retirement people showed that the average retirement account value was $70k, the mean value was $25k. The average cost of healthcare in retirement is $0.25 million. How are they going to make it?

<u>Steve Dunn</u>: I want to follow up on the mean reversion, focusing on nominal bonds. Bonds will not go up with inflation, but stocks *may* increase with inflation. And so I agree with Bill.

Jack: I also agree with Bill. I did not calculate it the same way he did. It is very difficult. That's why I don't like Monte Carlo simulation. People treat is as if it were an actuarial table. There is *no* correlation between stock returns and inflation. There *was* a high correlation between corporate dividends and the Consumer Price Index (CPI).

Bill: In early 1980s people turned away from stocks because they earned only 6%. But that was *real* 6%.

Comment: But not all stocks give out dividends.

Jack: The long-term value of stocks is the discounted value of the dividends. There used to be a company that committed never to pay dividends. They are out of business now. Corporate mergers are performed for the ego.

Bill: I cannot think of one large corporate merger in the last 10 years that worked out. Chief Executive Officers (CEO) *have* to say that they will grow 10%-20% per share. In truth, the economy, and aggregate corporate profits, cannot grow at more than a real rate of 2%, and perhaps another1% due to the population growth. In the past four years, Real Estate Investment Trusts (REIT) had returned 1%-1.5% higher than the overall market, because REITs have to distribute 90% of their earnings.

Jack: Investors, bankers, the Wall Street crowd – they are all looking for deals. Synergies never happen the way they'd like it.

Bill: Sophisticated investors do not realize this when they research companies.

Comment: It is easier to produce capital by acquisition.

Rick Ferri: "Diworsify." Google goes into the wind turbine business to do good for the economy. They have cash on hand, but instead of paying dividends they are getting into a business they have no business being in.

Mel: It is time to go to the book signing. This session is adjourned.

3.4 Vanguard Panel

This session took place on Thursday evening at Vanguard. Gus Sauter, Vanguard Managing Director and Chief Investment Officer (CIO), introduced the panel which included senior Vanguard staff as follows:

- John Ameriks, leads Vanguard's Investment Counseling & Research group.
- Catherine Gordon, helps oversee Vanguard's Institutional Asset Management group, which provides policy consulting, portfolio recommendations, and investment management to Vanguard endowment, foundation, and defined benefit clients.

- Chris McIsaac, heads the Vanguard Portfolio Review Department, which oversees the performance of Vanguard active fund managers.
- Sandip Bhagat, a principal at Vanguard and head of equities.
- Ken Volpert, head of Vanguard Taxable Bond Group.

Gus: You are the most sophisticated group of investors. I read your posts. Some of them are remarkably insightful. What you do is a great service to all investors. I cannot comment in the Bogleheads Forum, but when I do see something that I'd like to respond to, I know the correct answer will be there within a few posts. We frequently discuss your comments at Vanguard internally.

As you know, Jack left Wellington and started Vanguard, both fired with enthusiasm. It is good for Vanguard that he was fired with enthusiasm. Thank you to Mel Lindauer and Kevin Laughlin for helping organize this session.

We will now have a discussion with our five crew members – you know that we at Vanguard are crew members, not employees.

Question about TIPS being an active fund, i.e., *not* an index fund.
Ken: We started the TIPS fund with generally illiquid securities as an actively managed fund to overcome transaction costs. The transaction costs are an outcome of illiquidity and spreads. An index fund could work, but note that the capital market is $25T-$30T, whereas TIPS are only $500B. We do some active things to offset transaction costs. The Treasury will be issuing $120B next year.

Question about Vanguard in Canada - institutional.
Catherine: We are not making any announcements about Canada today. We are looking for good fit. Canada has a lot of appeal -- including similarities to the U.S. investment practices and interest in Canada in our funds -- but we cannot cross-register.

Question about Vanguard in Canada - personal.
Sandip: My response on whether we will have funds in Canada or Australia is similar to Catherine's. Single-country choices pose an enormous amount of risk. Canada is resource-rich. China and India are hypergrowth vehicles. But there is risk.

Gus: Canada and Australia are also an emerging-market play to some extent.

Question about managed payout funds as a retirement income solution.
John: Managed payout funds are funds of funds. They are actively managed. We have a policy benchmark, Commodity Futures exposure. It is intended for investors who seek payout solutions. This is not Vanguard's only solution for retirement income.

Question: What motivated Vanguard to lower Admiral eligibility limits? Was it because of the flow of money from index funds to ETFs?
Chris: You have to recall the history. Originally, the Admiral threshold was $250k. In 2005, we lowered it to $100k. Now we took the next step and lowered limits further, so that now they are $10k for index funds and $50k for active funds. We saw a large inflow of funds into Vanguard and more cost-effective interactions with customers. It just happens that the Admiral and ETF shares now cost the same. We don't want people to make decisions between funds and ETFs based on price; we want them to choose whatever best fits their needs.

Gus: 15 years ago, it cost us $15 to answer each call. Now, people conduct most transactions over the Internet saving us a lot of money. We wanted to share these savings with our customers.

Question: Can Vanguard provide investors with a rebalancing service?
Catherine: We recommend our clients rebalance once a year within ranges. In 2008-2009, we did not see reasons for rebalancing often. Offering rebalancing as a service would be difficult. How could we get a consent form from each investor? We have balanced funds such as Life Strategy and Target Retirement that provide rebalancing *within* funds.

Question: Do you look at company ratings?
Ken: A rating is not an investment recommendation. We do bottom-up analysis and research. It is more reliable than rating agencies. They have their bureaucracies. Our analysts came with experience of working at rating agencies and on Wall Street. This was a good strategy that kept us from making bad but highly rated investments.

Question: Will the operation of rating agencies improve their service to shareholders?
Answer: Some recommendations are strange, e.g., no ratings. Some rating agencies did quite well in the commercial area. We think that something is better than nothing. We would like to see more agencies. If the model changes, there will be a smaller pie and smaller pieces of the pie. That does not seem to us as a good recommendation for improving the quality of ratings. Rating agencies are trying to improve their models.

Question: What criteria did you use to select your nine core funds?
Chris: Not all people are interested in investing details. We wanted to give investors a selection of funds that were broadly diversified and low-cost, so that these investors could construct an effective portfolio. This may not be the right approach for this group, but it works for a certain segment of our investors.

Question: Why do you have two broad international funds?
Gus: This is a historical accident. In 2007 we wanted to offer an international share class (ETF) and could not do it with the Vanguard Total International Stock Index Fund (VGTSX) because it is a fund of funds. We wanted to have an international ETF, because many advisers are interested in ETFs. If we converted Total International into a regular (direct stock) international fund in 2007 we would have created significant capital gains for our investors.

In 2007 we started Vanguard FTSE All-World ex-US Index Fund Investor Shares (VFWIX), which is an actual fund rather than a fund of funds. This enabled us to have a corresponding ETF, Vanguard FTSE All-World ex-US ETF (VEU).

And so we ended up with two similar funds VGTSX and VFWIX, with similar benchmarks, Spliced EAFE+Emerging Markets Index and FTSE All-World ex US Index, respectively.

Some investors wanted specific indexes within Vanguard funds, and we revamped certain indexes. Thus we keep both VGTSX and VFWIX.

Question: Why do you offer both Vanguard Target Retirement Funds and Vanguard LifeStrategy® Funds?
John: Target Retirement is composed of index funds (except the TIPS fund which is managed). LifeStrategy funds have some active funds. You may ask similar questions about several other funds we have. In the foreseeable future Vanguard will be offering several paths to solve investors' requests.

Gus: ETFs are essentially index mutual funds. We polled six advisors, and they all asked for ETFs. I talked with Rick Ferri and asked him why he preferred ETFs. Rick said that it is easier for advisors to deal with ETFs administratively. They make a purchase, and it is there right away.

Question to Sandip: Some people believe that the future is in ETFs. Will the increasing role of ETFs affect costs of index funds? Could you be forced to shut down index funds, because they are too small after they lost money to ETFs?
Sandip: Funds and ETFs are parts of the same pool of money. Shrinking the size of one of the pieces does not impact the other piece as long as the total size of the pool is high enough. Costs are calculated from the total value. We would have *no* reason to shut down mutual funds no matter how small they may get. We are OK with any composition of assets.

Question: As a portfolio manager do you care how money gets in? Whether it is ETF, personal or institutional?
Gus: It does not matter. We only track the index.

Question about bond ETFs.
Ken: We now have bond ETFs. Shares outstanding of ETFs are just like the conventional funds; both are growing. Personally, I don't own the ETF class shares, but the growth reduced my expenses. Our bond index funds work better thanks to ETFs, because the cash flows coming in paid for this growth. There are some discussions of the bond bubble. Currently, [5-year?] Treasury yields are 1.2%. They have already dropped 1.5% this year, and they cannot drop another 1.5% . The 10-year primary benchmark for the Treasuries is probably appropriate. About 70% of our bonds are intermediate, 15% are short, and 15% are long.

Question: Are you planning to offer the Emerging Markets fund in the New York 529 plan?
Catherine: The New York 529 Plan allows tax-deductible contributions of $5k for singles and $10k for married couples filing jointly. The control of the specific 529 investments is with the donor. The New York Office of the Comptroller has selected the Developed Markets Index Fund as the international option for their 529 Plan.

Question: Why is Vanguard not offering Admiral shares in tax-managed funds?
Chris: Tax-managed funds have a minimum of $10,000. Collapsing Admiral on top of tax-managed – we have not done this before. A lot depends on the economics of the fund. Also, somebody asked us earlier, 'Why grow?' There are many investors who are overpaying for their investments, we want to help them. It will be cheaper for you, too. We are not growing for growth's sake.

Question: What is the role of your managers in index funds?
Sandip: There are many venues for order execution. The "flash crash" demonstrates the danger of complete automation. We use technology to get the best execution for you, but we also have portfolio managers who know how to use these sources of liquidity.

Gus: On 6 May 2010, the markets migrated to an automatic marketplace. In the past, people would call in to halt trades. During the "flash crash" people also called in, and the electronic trading proceeded as long as there was somebody who wanted to trade. The Securities and Exchange Commission (SEC) has moved to plug this hole.

Question: Tell us about the Vanguard Annuity Access service?
John: Vanguard has instituted the Annuity Access Program, where our clients with online account access can go directly to Income Solutions to get a quote. We work with eight providers, and the tool provides their live, real-time quotes that enable customers to compare apples to apples in the most transparent way. The 2% transaction fee is already built into the quote the customer receives. In other words, if you purchase an annuity

through this Vanguard service, the cost you will see is the cost you will pay. You can find these quotes outside Vanguard, too, but Vanguard normalizes them for you. The tool also enables you to diversify your annuities over time and over providers.

Question: Money's worth calculator?
John: It is a part of the calculations. Look for what a $0 cost annuity would give you and then compare it to what you can get in the real world. We have a 30-page paper on annuities.

Question: Do you have a tool that shows how bonds react when interest rates change?
Ken: We don't have a tool, but it is an easy formula, and we have tables in the prospectuses. Here is a calculation example. Say, the 30-day SEC yield is 3% and the duration of a bond fund is 5 years. If interest rates go up 1%, the estimated return next year will be: 3% - 1 * 5% = -2%. Here is what will happen to 5-year-duration bond funds [16] if interest rates increase 1%, 2% and 3%, respectively:
1%: 3% - 1 x 5% = -2%
2%: 3% - 2 x 5% = -7%
3%: 3% - 3 x 5% = -12%

We have low-interest bonds and a potential for a drop. This is your answer to "bond bubble" questions.

Question: In case of large-scale redemptions are there tax advantages of ETFs vs. funds?
Gus: We can do in-kind redemption from our regular funds, whether it is an ETF or a regular share class. When we sell stocks we sell the highest cost stocks. In 2000, at the height of the markets, we would have been able to sell 13% of TSM before realizing capital gains.

Question: Why you are not offering a small international fund? Why you are not offering a small international *value* fund?
Sandip: This question seems motivated by the theory of Dimensional Fund Advisors (DFA). We will consider it.

Chris: We need to believe that there is an enduring client need, that there is a sufficient market for such funds.

Question: Two years ago Lehman Brothers collapsed. Why did actively managed funds drop 4% more than Lehman's index?

[16] As of this writing, the duration of the Vanguard Total Bond Market Index Fund (VBMFX) is 4.8 years.

Ken: I recall the period and the experience. I don't recall falling 4% behind the index. Mortgage securities dropped more than corporate securities, but I don't remember the number being that large.

Gus: We also had extraordinary trading cost, because of the redemptions and low liquidity.

Ken: The way the bond market works, it requires banks to be on the other side of a trade, and in 2008, banks did not want to trade. We had to work on the agency basis to find a buyer on the other side. And again, I am not sure about the 4% figure.

Question: Chris, would you consider offering a Virginia tax-free fund?
Chris: We use the same criteria each time we are considering a new fund:

1. The size of the potential market.
2. Market demand.
3. Frequency of new issues coming to the market.

Question: Why there are no Admiral shares for the Star fund?
Gus: In funds of funds we do not collect fees on top of the fees of the underlying funds. The underlying funds have corresponding costs, which we cannot cut at the fund of fund level.

Question: Why don't you kill the U.S. Growth fund?
Chris: Philosophically, we do not believe in killing funds. In this industry, many fund companies kill their underperforming funds to expunge their record. This would be against our philosophy. We are doing everything we can to make funds perform satisfactorily. Active management is difficult.

Question: Is there a "bond bubble"?
Ken: If the rates rise 2-3% from where they are today all bond funds will do poorly. Intermediate-Term investment grade has a lot of corporate bonds, and it would not do badly. If we have a better economy, the spreads will tighten and provide some buffer. Still you would see negative performance if it's a quick rise. TIPS would somewhat benefit from rising inflation. For example, you now have 0.3% real yield. Let's assume that in the next five years, inflation is 4%, and you get 20 points of inflation (5 years x 4%). 0.3% real yield will result in 2.3% real yield. You will lose 18% in price. Strong economy and rising rates -- as well as rising inflation -- will bring us to a more typical environment. But there is also a possibility that we are now in the midst of the "new normal" where interest rates are rising slowly.

Question: Please describe the purpose and results of your recent survey.

Catherine: We have committees that make decisions on hiring and firing fund managers. We sent a survey and received over 100 responses from institutional clients. Typically, our committees make about one change per year. Hiring is more difficult than firing. Performance matters. Fees do not come into the picture. From the survey we learned, for example, that 90% of our respondents are satisfied with our process.

Gus: Thank you again for being here, and for what you do for each other. As you leave, please accept our parting gift.

4 Day-3 - 15 Oct 10 - BH Panel Q&A

Mel Lindauer introduced the panel:

- Bill Bernstein ("**BillB**")
- Laura Dogu ("**Laura**")
- Rick Ferri ("**Rick**")
- Mel Lindauer ("**Mel**")
- Bill Schultheis ("**BillS**")
- Ed Tower ("**Ed**").

Mel: The panel has decided that they don't want to be called "experts." They want to be called "stars." That idea came from Bill Bernstein, who stated that stars are nothing more than "hot gas," so you'll have to argue with him about that. Let's start out with the members of the Star Panel describing their current work.

BillB: I am now working on a book about the communications technology and policy, where I cover the history of the world through the lens of the communications technology.

BillS: I am eternally working on my second book. I want to describe the investing philosophy from the *Coffeehouse* point of view. In 1993 I sent *Coffeehouse*[17] to the publisher; in 1999 it was finally published. The investing philosophy has changed in the past ten years, and I want to capture that change. With *Coffeehouse*, I had a lot of charts and graphs, but my publisher (who also produced *Millionaire Next Door*[18]) told me to focus on the story. And the story became the basis of the *Coffeehouse* success.

Laura: I work with Mel on the *Forbes* column.

Rick: I am writing *Bogleheads' Guide to Investing for Doctors by Doctors*. If there are any doctors here -- any kind of doctors -- please get in touch with me.

[17] "The Coffeehouse Investor: How to Build Wealth Ignore Wall Street and Get on with Your Life" by Bill Schultheis.

[18] "The Millionaire Next Door: Surprising Secrets of America's Wealthy" by Thomas Stanley and William Danko.

Rick: I am writing a book about buying passively managed funds and evaluating the odds of them succeeding or not succeeding. Then I compare them to actively managed funds. Then I talk about fiduciary responsibility. Starting 1 December 2010, I will be publishing papers on my own site: www.RickFerri.com. All proceeds from my books go to charities and veterans' organizations.

Ed: I wrote a blurb for the back cover of Rick's book. As Rick argues in the book, it is important to steer investors away from actively managed funds. I wrote a paper where I reviewed GMO claims that GMO's managed funds outperform indexes. I compared a set of GMO funds to comparable Vanguard funds. Vanguard outperformed these GMO funds on average from January 1993 through 2009. So, if you don't have the $10 million minimum investment to invest in GMO, not to worry, at least with this set of funds you would have done even better investing with Vanguard.

Folks are paying attention to what we do here. The paper I wrote last year and presented at BH-8 became the 5th most downloaded economics working paper in the world for a two months period. Thanks for providing this Forum.

[Ed then summarized three papers of his that use GMO's predictions and GMO's Benchmark Free Asset Allocation Fund to explore strategic asset allocation. The next section provides detailed abstracts of all four of Ed's new papers.]

Question: What do you think about low-cost financial advisors?

Rick: Financial advisors do not add alpha. You come to them with a problem and pay them by the hour. This is what Allan Roth does. If you need asset management service you pay an on-going fee. Our firm advises over the Internet, and we save costs and pass them to our clients similarly to how Gus Sauter described Vanguard's savings on communications and sharing these savings with investors.

BillS: I read the Bogleheads Forum. People from all over the world connect with me about *Coffeehouse*, and I send them to the Bogleheads. The average *intelligent* investor hardly knows what an index fund is. He watches TV and sees commercial advertisements. We here just do not appreciate the challenges an average investor faces. I rebalanced my portfolio so that my Emerging Markets is now 8%, not 10%, but I will rebalance aggressively when I will be approaching my retirement. In contrast, an average investor is retiring with about 80% of their assets in stocks. People see their portfolios down in the recent market just before they retire. Robert Shiller said on TV that he is much committed to educating people.

BillS: There is a tremendous need for intelligent financial advisors to help baby boomers through the estimated 30 years of their unemployment called retirement. If anybody in this room is willing to pursue this please do. There is a gentleman in Seattle who charges $250/hour. I was sending clients to him, but I stopped because this model does not work. I found out that his wife supports him.

BillB: I agree with everything Rick and BillS said. How do you pick a financial advisor? You can't. If you know how to pick an advisor, you don't need one.

Rick: I have a lot of clients with doctorate degrees and above. They have financial advisors, because they are too busy with other aspects of their lives. They see things in the market that others don't see, because it is *not* there. They hire an advisor who would talk to them when they want to say 'Look at that!' They think that they are better off with an advisor.

BillS: A person working in this field should know what the advisor's role should be. If I were to send a person to a financial advisor, I would tell him, 'Go to an advisor with a few core funds and ask the advisor to manage these funds for you. It should not be the advisor's function to pick best-performing funds for you.' When I first met Ed Rager, Ed said that no matter what your strategy is you will be successful for as long as you stick to your strategy.

Laura: This is also what I see in the Forum. It all comes down to behavior.

BillS: My sister has actively managed funds, but she made money, because she did not touch it in over 20 years. She did better than some index fund holders who bailed out when markets fell in 2008-2009.

Alex Frakt: Perhaps the cut off should be: as soon as the advisor mentions alpha drop him.

BillB: This goes back to my first point, if an investor knows what alpha is he does not need an advisor.

BillS: ETFs are now spreading. Advisers are actively using ETFs, which is not good. Rick wrote a book about ETFs[19]; this is a book I wanted to write.

Question: This question is to Bill Bernstein. In *The Intelligent Asset Allocator*[20] you write about minimizing risk. For example, 7% of stocks increases safety of an all-bond portfolio, 12% of stocks is equivalent to the all-bond portfolio. Are the percentages the same if I hold Treasuries?

BillB: It is not the type of bonds, it is the *duration*. It is hard to improve on a 30-day T-bill, and if you hold it you can add 1% in stocks. If you hold 2-year Treasuries, you would drop stocks to 5%. If somebody in retirement holds a 100% 20-year bond portfolio, he needs his head examined. As interest rates fall, risk for a given duration increases; there is a greater potential for a fall, for a greater loss. Total Bond Market

[19] "The ETF Book: All You Need to Know About Exchange-Traded Fund" by Richard Ferri.
[20] "The Intelligent Asset Allocator: How to Build Your Portfolio to Maximize Returns and Minimize Risk" by William Bernstein.

duration is about 5 years. If interest rates go up 1%, TBM will drop 5%. The current TBM dividend is about 2.5%.

BillS: Corporate bond funds will not drop as much as Treasuries, because for the corporates yield is higher and duration is lower. TIPS are riskless assets for a long-term, but they are a very risky asset on a short term. In 2008, TIPS fell 20%.

Rick: I wrote about this in my Forbes column "The Dark Side of TIPS[21]."

Question from the audience: What about the Thrift Savings Plan (TSP) G fund?

Laura: TSP is the Federal employees' equivalent of a 401(k). We have a gentleman in the audience who created the TSP. You should *not* worry about the G-fund.

Rick: If you have 5-year duration and 3% interest rates expect to receive about $116. If you don't need money for 5 years, you will get close to the duration. You have to wait that long to get it. It does not matter in retirement, you have time.

BillB: It does not matter in the nominal terms. But what if the rates spike? This is what would happen if you had 8% inflation.

Rick: That is why I recommend 20% [of bonds] in TIPS.

Mel: People who are working get Cost Of Living Adjustment (COLA) increases. Retirees do not have COLA in their fixed income investments. TIPS provide them with *real* dollars. For retirees, inflation is the greatest danger, they don't have other protection.

Rick: Equities also give you some inflation protection.

BillB: Yes, you have some other inflation hedges such as stocks (after some period of time) and short-duration bonds.

BillS: I have clients who want a black-and-white bond portfolio. It's been difficult to do it over the past few years, because the yields are not there. I cannot tell my clients "Your asset value may drop, but over years higher yields will compensate for that."

BillB: You tell them that, but you also tell them to buy T-bills and short notes and suck it up.

BillS: What about 2-year bonds?

BillB: They may drop significantly. The NAV of VFSTX dropped 10% in 2008.

Rick: Do your clients have 2 years worth of expenses in short-term funds?

---

[21] http://www.forbes.com/2009/12/04/ferri-deficit-real-interest-rates-personal-finance-dark-side-tips.html

<u>BillS</u>: This is another good approach. I did not do it, because of my funds' minimums.

<u>BillB</u>: CDs are also good.

<u>Rick</u>: CDs are not marked to market. When interest rates go up people see the Net Asset Value (NAV) of bonds change but not the value of CDs. In reality, there is no difference.

<u>BillB</u>: An average person in this room has seen good returns in the past year. What does it matter what the yield was?

<u>Rick</u>: The Federal Reserve is doing quantitative easing in certain markets, including the Treasuries, mortgages, Freddie and Fannie. The Fed is artificially influencing these markets. When they are done, they will start buying corporate, then high-yield; and those will also drop. Eventually, they may start buying munis (municipal bonds), and the munis will drop. But for an investor, buying munis today is not a bad idea.

<u>Question from the audience</u>: What is the effect of interest rate rises on the municipal (tax-free) bonds in comparison to the effect of interest rate rises on taxable bonds?

<u>[Panel</u> has not reached a conclusion on how to respond to this question.]

<u>Question from the audience</u>: Why is everybody so wound up about a potential 10% bond drop? Is not this a double standard in comparison to potential stock declines?

<u>BillB</u>: There is a psychological explanation: bonds are considered a nice, good, safe asset. In a crisis there are only two types of assets: risky assets and riskless assets. There is a fundamental reason why people hold bonds. When the expected returns of risky assets rise in a crisis, I want to have dry powder to buy it; and I want my "riskless asset" to be able to do that.

<u>Question from the audience</u>: What is "dry powder" now?

<u>BillB</u>: T-bills and short notes.

<u>Rick</u>: Gold is a riskless asset ☺.

<u>Comment from the audience</u>: I know retirees who stayed short for the past 10 years, and now they are stuck with 18 basis points. If interest rates linger at these low levels for the next 10 years, people will lose 3% of the income they were used to.

<u>BillB</u>: This is a Pascal's wager. If interest rates stay low for 10 years you lose 2-3% in yield; if interest rates spike you lose much more than that.

<u>Mel:</u> It's not one or the other. You can own some short-term bonds and if you have a longer time horizon, you can buy some intermediate bonds, too.

Comment from the audience: Look at this in the context of the entire portfolio construction.

Comment from the audience: We had some related questions from former employees and we recommend rolling 401(k)s to Vanguard IRAs.

Question: How do you account for Social Security and pensions in the asset allocation?

BillB: One way to look at it is that you have, for example, the need for $60k a year. Your pensions and Social Security provide you with $30k. Then look at your other assets to generate the remaining $30k. If you do that, you cannot count your pension/Social Security as a bond asset. The other way to look at is to consider the value of all your pensions and use the total assets (liquid *and* pensions) to satisfy the need for the entire $60k; in that case, you *can* count your pension/SS as a bond. You can do it one way or the other; you cannot do both. You cannot do as some people do who look at the value of their pensions but then seek to produce income for only $30k a year.

Mel: You cannot control Social Security the same way you can control liquid fixed income assets.

BillB: That's exactly right.

Laura: People react psychologically differently to drops in bonds and the present value of their Social Security and pensions.

Rick: You cannot come to the Social Security office and ask for $300k of your "bond." It is *not* a "bond." Treat it as BillB has described. You have your needs. Pensions and Social Security take care of some of your expenses. Liquid assets cover the remainder of your expenses. This is how you do asset allocation.

Mel: The consensus of the Star Panel is to attribute Social Security to a portion of one's expenses.

Question from the audience: You still have not answered the question on what the asset allocation should be to cover the remaining $30k of one's expenses.

Rick: This depends on the size of your portfolio.

BillS: The bear market provided a stress test on how one's portfolio performs.

Rick: Remember also that stocks provide you with dividends and bonds provide you with interest. See if this income is sufficient for your needs.

Mel: Look at the TIPS and their real yield.

Question from the audience: What if you don't have enough?

Panel: Work longer, buy Single Premium Immediate Annuity (SPIA), leave less to your heirs.

Rick: As people age their burn rate goes down. At the age of 80 or 90, health care cost goes up but all other expenses go down. The Trinity study does not consider that.

BillS: That is a kind of a question you may ask your advisor. When people come to me, the first thing I ask is, 'What is your estimated burn rate in the next thirty years?' People are asking about inflation, but the most important part is "meflation."

BillB: You also cannot rely on the Trinity study, because they used historical returns between 1926 and 1995, which were almost certainly higher than they will be in the future on the stock side.

BillS: Who was it who said that he does not believe in Monte Carlo?

Answer: It was Jack.

Mel: Consider an SPIA. Taylor bought an SPIA to cover his expenses so that he could gift the rest of his assets to his children.

Question: When should one roll assets into an SPIA considering taxes? I am 70 years old, and if I sell my funds to buy an SPIA I will have to pay a lot in taxes.

BillS: If you don't need the money and want to leave it as inheritance, put them in equities. I have a feeling that equities will outperform fixed income in the next 10 years.

Rick: Bill, are you timing the market? ☺

Mel: You may want to take your Required Minimum Distributions (RMD) and put them into taxable equities.

BillS: Let me throw in a question. How long will it take for two people who sit next to each other in an airplane to get into a discussion, and when one of them says, 'I am a Boglehead,' the other would know what he means. How long would it take for this to happen? I would like to acknowledge Bill Falloon for publishing Bogleheads books.

Mel: People should understand though that everything we say here is general guidance, not specific financial advice.

Comment from the audience: I disagree that the burn rate goes down. My mother is 80 years old, and her treatments cost $10k a month.

Mel: People don't realize how much it costs for the supplemental insurance, medications, etc., in retirement, even when people receive Medicare and are healthy as my wife and I are. We still pay close to $10,000 per year in total medical expenses for Medicare Parts B and D, Supplemental Medigap policies, deductibles, etc.

BillB: I agree with Steve. When I look at the economy, Medicare is the greatest threat to the Republic since the Civil War. Social Security is a much more tractable problem.

Question from the audience: What about Long Term Care Insurance (LTCI)?

BillS: People in the audience, please raise your hand if you have an LTCI? [About 25% raised their hands.]

Comment from the audience: I looked at the LTCI a few years ago. At that time, the average cost of care was $80k/year in New York and $115k/year in New Jersey. Now, the average cost is up to $180k/year in New York (and something equally high in New Jersey). I would recommend covering 70% of the long-term care expenses with insurance. Also note that Medicaid is a state program, and there are differences among the states. For example, in New York my IRA and home are exempt but not in New Jersey.

BillB: In a worst-case scenario, cancer immunotherapy/biological therapy in the last few years of one's life may cost $3-5M.

Mel: Some companies offering LTCI may be endangered in the future and unable to live up to their policy commitments.

Comment from the audience: I have an LTCI policy for which I have already paid. They raised their rates 40%. Should I be happy that they will not go out of business?

Comment from the audience: Perhaps, one should not convert all the money into Roth IRA. If one has really expensive medical treatments, they may offset taxes for the IRA conversion later in life.

Comment from the audience: Along the same lines, I moved my mother into a community and paid a very high upfront expense. It qualified as a medical expense, and we used it to offset taxes on the Roth conversion. The truth is that my mother had to be healthy when we moved her.

Comment from the audience: Move at least some money into Roth now if you have not done so already, so that the 5-year clock will start ticking. Then you will be able to take money out when you need it without waiting for five years.

Question: Would the distinguished Boglehead authors consider writing *Boglehead Guide for Federal Employees*?

Mel: Laura, this is a question to you.

Laura: If you write a chapter (looking at the person who asked the question).

Bill Falloon: Develop a Boglehead brand. Jack's name carries a lot of weight, use his name to the investors' advantage.

Comment from the audience: We all have family and friends who do not want to hear the message.

BillS: Do not spend a minute on those who do not want to know. There are masses of people who are starved for the right information.

Comment from the audience: Quoting Warren Buffett, 'Investing is simple but it is not easy.'

Comment from the audience: My parents taught me about money but not about some important aspects of managing money. For example, they taught me how to balance my checkbook. How can we do a better job with our children?

Rick: I am writing a book *Bogleheads' Guide to teaching your children about money: for children between ages 6 and 60*.☺ Seriously, go electronic with books, do books for iPhone, etc. This is what children read. And go to www.RickFerri.com ☺.

Comment from the audience: Some things work, some things don't. Giving people a lot of numbers does not work. You have to get into a lot of really emotional stuff. 'I don't worry where the markets go. I don't worry about short-term market moves. I am invested in index funds. I am invested for a long term.' As soon as you mention 1% or 2% you'll lose them. They don't know how to calculate 1%.

BillS: There is power in persistence. People tell me that they read me for 10 years until they finally got it.

Comment from the audience: For the young people, you have to get it exactly right. You may say, 'If you don't invest right, this is what you will *not* have, e.g., you will *not* have the iPhone. If you *do well* you will have this fancy car you want so much.'

Laura: When I was writing a column for *Forbes* on teaching children about money, I asked my son for some help. My son then asked me for a cut of my pay from *Forbes*. Of course, I am not paid by *Forbes*.

<u>Comment from the audience</u>: Can we touch a bit the impact of the Federal deficit on investing?

<u>Ed</u>: The deficits are a tremendous source of uncertainty. Nobody knows how governments will respond to them.

<u>Mel</u>: Some are concerned that inflation will go through the roof. I am protecting myself with I-Bonds and TIPS.

<u>BillB</u>: Here is a nightmare scenario. Right now, the Federal government is borrowing $150B/year at next to nothing for an average of 2 years. When interest rates rise, borrowing will be more expensive, and you may get a positive feedback loop. In the 60s, 70s, 80s, and early 90s, Brazil experienced 2,000% per year inflation. However, rich people were making money because they were making 3,000% per year in money market funds. And so this is a real possibility. Then you have problems in Europe. The Southern Europeans (e.g., Italians) are creating problems and the Northern Europeans (e.g., the Brits, Swedes and Germans) are fixing them. As Winston Churchill said, 'The Americans will always do the right thing…after they have exhausted all the alternatives.'

<u>Rick</u>: Now, the government is making money from borrowing money for as long as inflation stays up -- "up" as in "no deflation." So I don't see any reason to stop borrowing money at the current rates. BillB's scenario may happen, but it may not happen for 10 years.

<u>Comment from the audience</u>: Jack said yesterday to put money in gold. Harry Brown thread has over 1 million hits. That portfolio tells one to put 25% in gold. What do you think?

<u>Comment from the audience</u>: Nobody wanted gold when it was $250.

<u>BillB:</u> Harry Brown portfolio is 25% of gold, stocks, money markets, and bonds -- each. In the past 25-30 years such a portfolio did well, because gold had a remarkable run. In five years from now nobody will talk about the Harry Brown portfolio. Read Harry Brown's book. It is a thin book and it's a fun read.

<u>Rick</u>: [Pointing at his wedding band] This is the best gold investment I have ever made. During crisis periods gold goes way up, but then it comes down. Read Peter Bernstein's *Against the Gods*. Gold gives you inflation rate. But this time around, unlike in the 1970s, the price of gold runs well ahead of inflation. The last person to buy gold will be decimated. For long periods between its jumps, gold is a dead asset. As Jack said, gold gives no dividend, no interest. Why hold gold, except for speculation? I am not a speculator.

<u>BillB</u>: We are looking at a simultaneous prolonged bull market in both long bonds and gold. I don't understand it. From experience, when I don't understand something it usually ends badly.

<u>Ed</u>: Actually, I made money off gold. I needed $2k for 2 years to finance publication of a collection of syllabi and exams by leading economists. A friend lent me $2k, and in return I sold him a $2k gold short. Gold went up, then back down to where it was initially. The result was I had an interest-free loan. My assumption was that if my friend who did not know anything about gold thought that gold was going up, gold was bound to go down.

<u>Ed</u>: In thinking about the housing crash it is worth remembering the Hong Kong story. When the UK signed Hong Kong over to the Chinese, real estate crashed and banks became insolvent. The Hong Kong dollar was devalued by close to 50%. All prices, including real estate jumped by roughly that same amount and the banks were solvent without an explicit bail out.

<u>Mel</u>: This question is from Alex. What do you think about having a 60% stock/40% bond portfolio for one's entire career, starting with the first job after college?

<u>BillS</u>: You cannot go wrong with this approach. But my son is out of college, and I recommend that he holds more in stocks. I believe that stocks will do well in the next 10 years.

<u>Alex</u>: **RodC** tested this. It may be easier on one's behavior to start with 60/40 and just not have to worry about changing the allocation, until one is really close to retirement.

<u>BillB</u>: Once you have reached your number, you have won the game, and when you've won the game, you stop playing it.

<u>Rick</u>: This is a good idea if you can stick to it. Age in bonds works well for 20-30 year olds. But by the time you turn 50, you have converted most of your human capital into your assets. Then everybody is different. Some are physicians and are well off, while others are not well off at all.

<u>Mel</u>: You also have a peer pressure problem when your peers are making money with 100% in stocks.

<u>Question from the audience</u>: What do you do once you have reached your number?

<u>BillS</u>: It is a challenge when you don't get 2-3% in fixed income as people used to.

<u>Mel</u>: First of all, make sure that you don't lose it. This is a higher priority than yield. As Will Rogers said, 'Return *of* your capital is more important than return *on* your capital.' Throughout our lives we adjust spending to what we have. Retirement should not be any different.

<u>Alex</u>: People ask whether to pay of mortgage before they retire. They absolutely should.

Rick: I absolutely plan to pay off my mortgage by the time I retire.

BillB: Debt is death. Nothing baffles me more than a 60-year old with a mortgage.

5 Ed Tower's New Papers

Ed Tower summarized four papers prepared for the conference. Here are their highlights. For more, see the papers. They are posted (or will be shortly) on his web page. If you try to access them and have trouble downloading them, contact Ed at tower@econ.duke.edu.

Bogleheads are reluctant to engage in strategic asset allocation except in extreme circumstances. Jeremy Grantham of the mutual fund company GMO is an enthusiastic asset allocator. Here are two quotes which set the stage for a debate over the issue.

"Big moves out of stocks should not be done at all," [John] Bogle told interviewer Jim Wiandt, publisher of the www.IndexUniverse.com site. But "tactical asset allocation — I should say strategic asset allocation rather than tactical — can be done at very rare times, so rare and so difficult to observe, maybe six times in an investor's lifetime, three times when the market is stupidly high and three times when stupidly low."

[Jeremy Grantham]: "The ultimate villain of this [disaster] is the belief in rational expectations – that the market tends to be efficient. People who have anything to do with investing either believe it a bit or believe it a lot. There are only a few of us ornery disbelievers who don't believe that the market is efficient at all. … If you believe in it [market efficiency], then you don't see asset bubbles. And there's nothing as dangerous as an asset bubble. If you even slightly believe in it, you believe in [former Federal Reserve Chairman] Alan Greenspan's idea that markets can control themselves. You believe you should have a fixed asset mix and you should never change it, because why would you? The market is efficient! When you believe in market efficiency, it's like being on the railroad watching the locomotive coming toward you. Then you just stand your ground just for the discipline of not moving. It's ruinously expensive." [References are in paper #4 below]

Ed explored some issues in the debate.

The GMO web page, http://www.gmo.com/America/Library/Forecasts/, argues that its active management allows it to add value for investors. For example, as of July 31, 2010 GMO's value-added predictions were: US equities: 1.8%/year, international equities: 2.3%, emerging equities: 3.7%, US government bonds and inflation protected Treasuries: 0.9%, and US short term government bonds: 1.4%. Paper #1 explores the legitimacy of these claims by comparing GMO's performance with comparable Vanguard funds. The paper finds no support for the claim of value added by GMO on average over the last five years, and over a longer time period the evidence is mixed. Unlike all previous GMO reports, the August 31 and September 30, 2010 reports on GMO's web site do not repeat the claim of value added by GMO's active management for particular asset styles. The GMO web site does not explain why GMO stopped reporting the value-added predictions. Ed wonders if it reflects a loss of confidence based on recent performance.

In a series of papers, which he updates from time to time, Ed has been exploring whether the predicted 7 year real returns for various asset classes on the GMO web page accurately predict short term returns. He has asked whether the GMO predictions predict the returns for investors in Vanguard mutual funds which hold different classes of assets. Paper # 2 is Ed's update using data through July 2010. He finds that the predictions hold well for both equity and bond funds, when examined separately. Also, he finds one would have done well to invest equal amounts in the four asset classes which are predicted to do the best, avoiding the four which are predicted to do the worst. However, he finds that investing in the top four was riskier than investing in the bottom four, as one would expect. Moreover, the predictions are much less accurate recently than they were in the middle of 2000, when GMO was predicting very different returns for various asset classes, something that Bill Bernstein predicted when he looked at the first version of the study in 2007.

GMO has a fund that practices strategic asset allocation, the GMO Benchmark-Free Allocation Fund. How has it done compared with a fixed basket of Vanguard Funds that mimics its style? Paper # 3 finds that it has out-returned the Vanguard basket by 4.6% per year since inception in July 2003. However, if one continually adjusts the Vanguard basket to mimic its changing style, the outperformance is much less (1%/year). Thus strategic asset allocation did work in practice. But over the last half of the fund's life it returned less than the comparable Vanguard basket or baskets. Thus the strategic asset allocation as practiced here has not been reliable. Interestingly enough at the peak of the market in 2007 when GMO's seven year predicted stock returns were low the fund held a higher ratio of stocks to bonds than at the trough in 2009 when GMO's seven year predicted stock returns were high. Thus, the fund does not seem to adhere closely to GMO's predicted seven year returns.

What might be a good way for Vanguard investors to take advantage of GMO's asset class predictions? This is explored in paper # 4. Bill Bernstein in *The Investors' Manifesto* tells two stories with important messages for investors. One is the permanent closure of the Saint Petersburg stock exchange in 1914. It illustrates the need for diversification. Another is the high return on Venetian government bonds for those who bought them when yields were high. But this happened when Venice was fighting with Genoa, and the outcome of the war could have been different. Thus, again, chasing yields, without diversification is risky. In paper #4, Ed presents a model for how to take advantage of predicted differences in asset class returns without deviating too much from the diversified portfolio suggested by Rick Ferri in his *All About Asset Allocation*. Ed demonstrates what the gain in the efficient frontier would have been from following this strategy.

Here are the papers:

1. E. Tower, "GMO versus Vanguard: Assessing the Performance of Comparable Funds" http://econ.duke.edu/Papers/Other/Tower/GMO_Versus_Vanguard.docx
2. E. Tower, "Are GMO's Predictions Prescient? Using Them to Predict Vanguard's Mutual Fund Returns" http://econ.duke.edu/Papers/Other/Tower/GMO_Prediction_October_2010.doc
3. E. Tower, "Strategic Asset Allocation in Practice: Using Vanguard Funds to Clone GMO's Benchmark-Free Allocation Fund." http://econ.duke.edu/Papers/Other/Tower/Strategic_Asset_Allocation_in_Practice.docx
4. E. Tower, "GMO's Predictions as Pilots for Vanguard Portfolios: Are They a Useful Guide for Strategic Asset Allocation?" Not available on line yet. Will be shortly. http://econ.duke.edu/Papers/Other/Tower/Strategic_GMO's_Predictions_as_Pilots.docx .