Notes from the Diehards VII Reunion

San Diego, CA
23-24 September 2008

By: Paul Globerson, Mel Lindauer, Ed Rager, Paul Stratton, and Victoria Fineberg

Issued on: 07 October 2008

Table of Contents

1 Day-1 – 23 September 2008

1.1 Mr. Bogle's off-the-record remarks

Jack Bogle: I prepared an outline for today's discussion, but the events have interfered, and so I will start with recent events. Some parts of this discussion are off-the-record. I am on the record a lot, for example, I had eight shows recently. Sometimes I answer some questions before an interview. On one such occasion I said that "the government is punch drunk." And the press made a big deal out of it. The press does not have tolerance for nuances.

I don't have anything dramatic to say, and if I say something that sounds funny please check with me. What's on everybody's mind is the financial crisis. I started to write this book ten years ago and I used the word "crisis" a lot. But even what was not true then is true now – we do have a financial crisis. A little humor is due. I received a card on Saturday (20 September 2008) that said "Some companies help in a disaster. We help to avoid a disaster all together." Signed "AIG." [Laughing in the room].

Henry Paulson is applying a tourniquet to various events. Here are some examples.
1. The ban on short selling.
It is an outrage. Let the markets clear, and sooner or later the markets will clear.

2. Money market insurance.
It is ok to protect money markets from short term rate spikes. I approve of it. But …

3. I don't want the Federal government to bail out Bruce Bent[1] who was bragging that he was running the highest yielding money market fund. There are only two ways to have a high yielding MM fund: (a) decrease quality and (b) decrease cost. Only one company does the latter – and you know which company that is.

4. Mortgages.
I prefer Paul Volker's approach. Paulson, Bernanke and Cox have put a deal together in 72 hours with few details, and I am skeptical. Homeowners need to get some help. Sometimes it was greed, sometimes innocent people got hurt by the small print. Investment bankers have caused this, and they are not paying for that. Any time when a system privatizes loss and socializes risk, there is a problem.

5. Bail out.
Paul Krugman suggested yesterday that instead of accepting these "bad merchandize" securities, the Federal government should give the banks more capital[2]. However, the government has to gain ownership of the banks, just as they did it in Dubai, Hong Kong and Singapore. In other words, if the government is helping banks, it should have some equity in their ownership. Banks don't want us to have this ownership, but we should.

33-times leverage means that when the market drops 3% you are bankrupt. Banks were recently 33x leveraged, and markets were recently dropping 4-5% a day.

In my book "The Battle for the Soul of Capitalism[3]" I urge the Congress to bring back the Glass-Steagall Act[4], which was effectively repealed by the Bush administration. And so now no investment banks are left. The writing was on the wall for a long time for all this to happen. My articles, such as "Black Monday and Black Swans[5]" providing my version of "black swans," predicated this a long time ago. I told you so.

6. My approach.
My assets are 31/69 (equities/fixed income), and I did not change my allocation since last spring. It may have changed since due to the market fluctuations, I have not checked. Remember that probabilities could be right but the consequences could be wrong. And also remember that this too shall pass. But in the mean time, what the investor shall do?

This concludes my "off-the-record" remarks.

---

[1] Bruce Bent, the founder and chairman of a cash management firm The Reserve. Their Primary Fund broke the buck: http://www.forbes.com/finance/2008/09/22/reserve-primary-bent-pf-ii-in_ms_0922money_inl.html
[2] Possible reference: http://krugman.blogs.nytimes.com/2008/09/22/ stating "if Treasury buys assets, it gets warrants that can be converted into equity if the price of the purchased assets falls."
[3] http://www.amazon.com/Battle-Soul-Capitalism-John-Bogle/dp/03001
[4] http://en.wikipedia.org/wiki/Glass-Steagall_Act
[5] PDF http://johncbogle.com/wordpress/wp-content/uploads/2007/10/risk_mgmt.pdf

1.2 Mr. Bogle's planned discussion

What I'll be talking about this morning . . .

1. The Economy
2. The Markets
3. Vanguard
4. Personal
5. "Enough"
6. Q&A

1.2.1 The Economy

If you are a speculator, I'll tell you to get out and to get out now. For an investor I don't have any advice rather than to stay in with their asset allocation that relies on low-cost index funds and minimizes taxes. This is my tenth market decline. It is smaller, but it is different, because previous declines stayed within the financial industry. My article on the "black swan" quotes Hyman Minsky that all speculatory problems start in the financial markets and usually stay there. It is difficult to speculate with manufacturing. However, this current decline has spread from the financial industry to the rest of the economy. It is easier to bail out a large institution than 5 million home owners. Large institutions are too big to fail, and homeowners are too numerous to bail. Some of them speculated.

Real economy and stock markets are different. The $14T GDP economy is distinguished by innovation and entrepreneurship. But the U.S. dominance is ending. In the year 2020, China's GDP will be greater than that of the United States.

1.2.2 The Markets

The book value of the stock market tracks the GDP, no surprise here. There is a very strong reversion to the mean; labor and capital tend to even out over time.

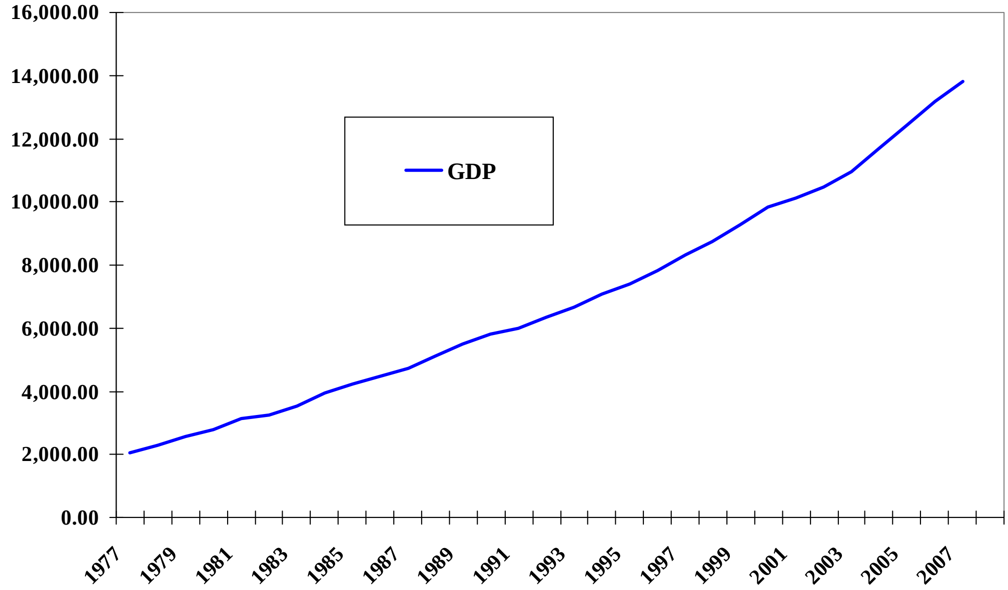


Figure 1-1[6]. The Economy.

But in the short term the value of the stock market fluctuates.

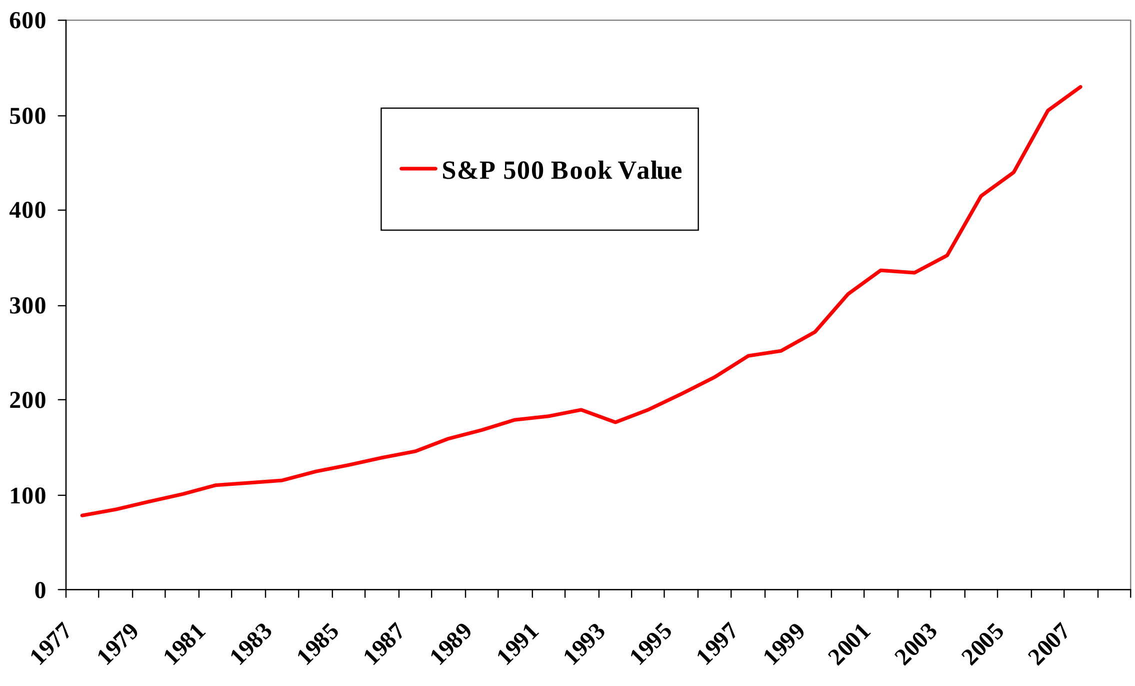


Figure 1-2. The Stock Market's Value

[6] All figures are cut-and-pasted from Mr. Bogle's presentation slides provided by Kevin Laughlin.

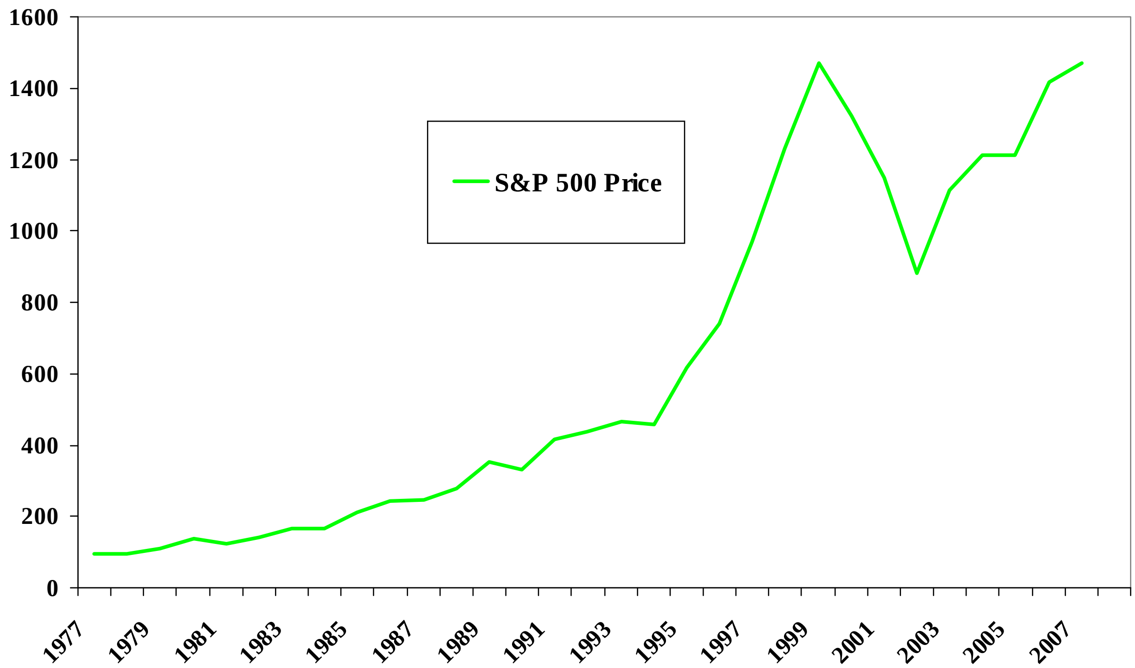


Figure 1-3. The Stock Market's Price

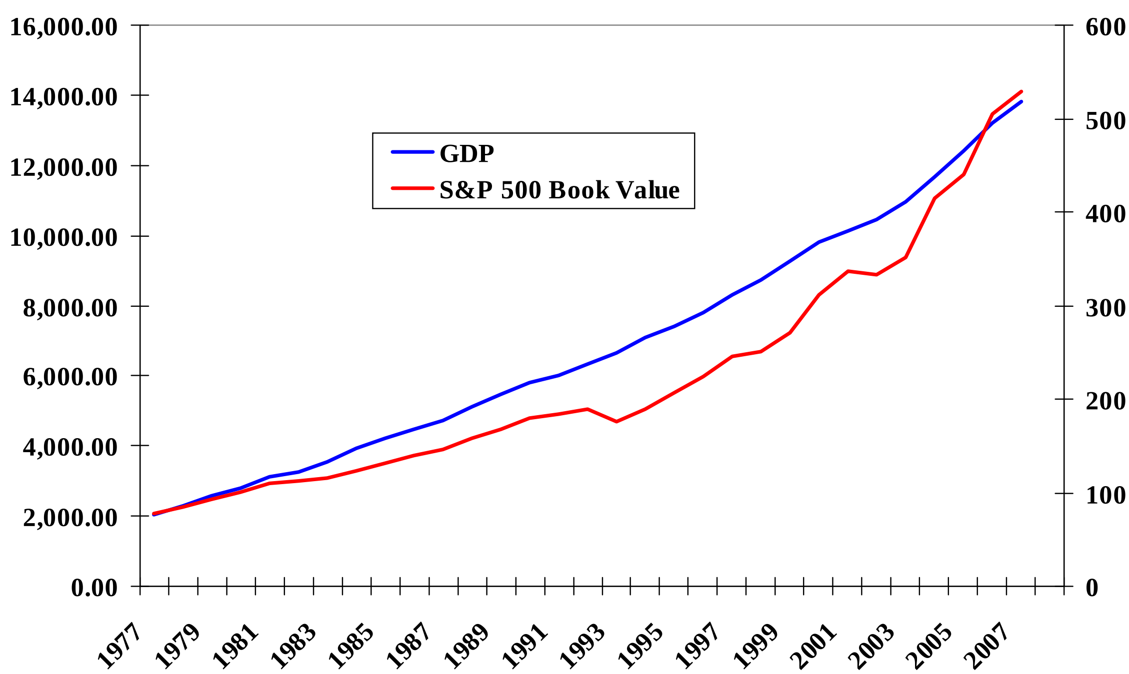
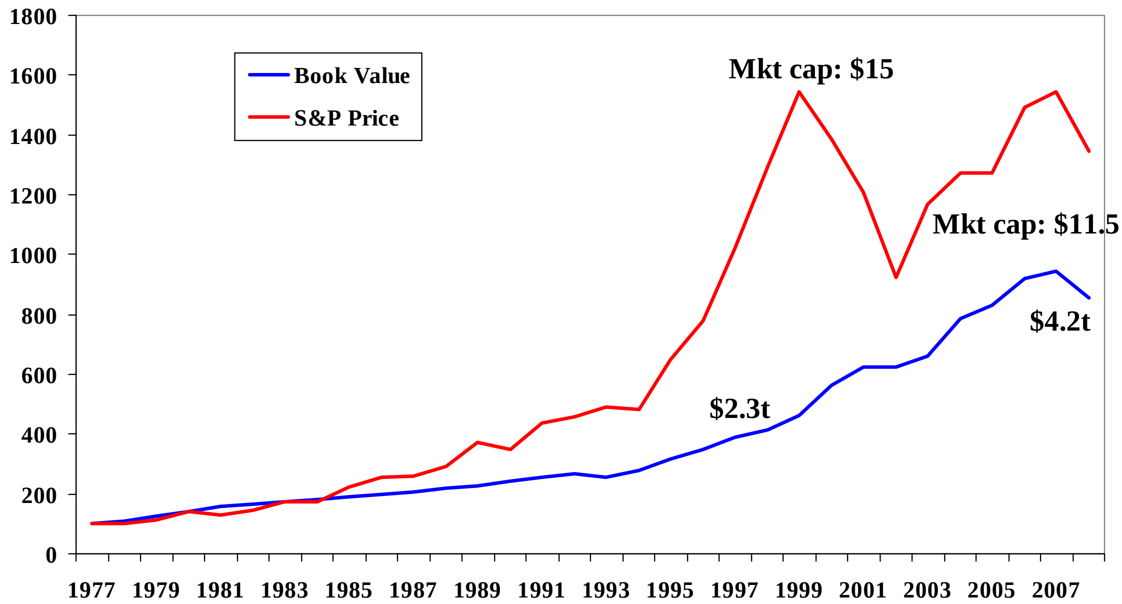


Figure 1-4. The Economy and the Stock Market's Value



2008 book value is estimated, as of July 2008.

Figure 1-5. S&P 500 Book Value and Price Level 1977 – 2008
(base 100)

From Figure 1-5, you can see that in the year 2000, the market cap was $15T, and the book value was $2.3T, at the ratio of $15T / $2.3T = 6.52. Today, the market cap is $11.5T, and the book value is $4.2T (after the 7% growth), with the cap-to-book ratio of $11.5T / $4.2T = 2.74. In other words, the ratio has dropped from 6.52 in 2000 to 2.74 in 2008.

Remember that stock markets are a distraction from the business of investing. Last week, the markets dropped by $1T. Do you think our business has dropped $1T during one week? Investing is about the Discounted Cash Flow (DCF). Speculation is betting on price. Speculators do not care about the value. Let's take the S&P 500 stocks. Assume that the speculators own a half of each stock, and that investors own the other half. Speculators sell to each other, investors stay invested. So why do we have the most speculative market?

When I came to this business, the normal turnover was about 25%. Before that the peak was reached in 1929 when the turnover was 140%. Last year, we had the turnover of 280%, or twice of what we had during the Great Depression. And after the recent weeks it will be even higher; I am guessing 320% for 2008. A lot of this turnover comes from the Exchange Traded Funds (ETF).

In the last 13 months, the markets moved 37 times more than 2% per day. In fact, 70% of S&P is owned by speculators. We have futures and options on S&P that cost $25T, i.e., betting on the price going up and down. When you short futures on the investment you have, it is a defense strategy. But if you short futures of a stock you do not have, it is speculation.

Credit Default Swaps (CDS). There are $2T in the credit default market, and $62T in the CDS, i.e., 31 times more people are gambling with the credit defaults than there is value. If you insured your house at 31 times its value, the insurance company would be on the watch for arsonists! The long term return of speculations is zero minus cost.

If you are optimistic, the current markets look somewhat depressed. But remember that if we double the earnings (E) and P/E drops by half, we do not gain. Some reductions in P/E will take away from future earnings, i.e., if we double current earnings we will reduce future ones. Wall Street Journal, etc., report earnings casually. But there is a difference between "reported earnings" and "operating earnings" after the write-offs.

	2006	**2007**
Discretionary	**$52.3 bil**	**$ 8.9 bil**
Staples	**60.2**	**67.9**
Energy	**122.2**	**123.5**
Financials	**215.1**	**123.7**
Health Care	**63.5**	**66.3**
Industrials	**80.1**	**79.4**
Technology	**80.6**	**85.3**
Materials	**28.0**	**23.1**
Telecom	**21.5**	**-7.0**
Utilities	**24.0**	**26.1**
Total	**$745.8 bil**	**$594.2 bil**

Figure 1-6. S&P 500 Earnings by Sector

Note significant declines in the financials (and telecom), while others stayed about the same.

Jeremy Siegel said that we should not worry about the future of the financial services. The financial services industry should operate at a lower cost. They should create fewer products and services[7]. We should not speculate but focus on the corporate reality.

First bonds. Bond returns are predictable to a fault. The odds are 9 out of 10 that the returns on the intermediate-term bonds will be 4-5%.

[7] We could not locate the exact quote, but here is a recent interview with Prof. Siegel http://knowledge.wharton.upenn.edu/article.cfm?articleid=2052

Vanguard Fund	12/99 Yield	Avg. Ann. Return 12/99 – 8/08	Current Yield
ST Bond Index	6.5%	5.1%	3.4%
ST Tax-Exempt	4.1	3.2	2.2
IT Bond Index	7.0	6.7	4.9
IT Tax-Exempt	5.0	4.8	3.5
LT Bond Index	7.2	7.7	5.5
LT Tax-Exempt	5.5	5.6	4.1
Ltd Term Tax-Ex	4.5	3.9	2.8
HY Tax-Exempt	5.8	5.4	4.5
Total Bond Market	6.9	5.9	4.6
500 Index		0.0	
Total Stock Market		0.9	

Figure 2-1. Bond Yields and Returns

Stocks are similar. In January 2000, I gave a speech where I said that the future returns of stocks will be 5%.

Components of Return	1979 – 1999	1969 – 1979	1999 – 2009 (?)
Initial Div. Yield	4.5 %	3.4 %	1.2 %
Earnings Growth	5.9	9.9	8.0
Investment Return	10.4 %	13.3 %	9.2 %
Speculative Return*	7.3 %	-7.5 %	-4.0 %
Total Return	17.7 %	5.8 %	5.2 %
Initial Earnings	$14.90	$5.78	$47.00
Initial P/E Ratio	7.3x	15.9x	30.0x
Final Earnings	$47.00	$14.90	$101.50
Final P/E Ratio	30.0x	7.3x	20.0x

*Impact of P/E change

Figure 2-2. Jack Bogle's Outlook, circa January 2000

I was not far off. But I was too aggressive in estimating corporate profits. Here is how it turned out.

Components of Return	1999 – 2009 (?)	Actual, thru 08	If trends hold
Initial Div. Yield	1.2 %	1.2%	1.2%
Earnings Growth	8.0	4.9	4.9
Investment Return	9.2 %	6.1%	6.1%
Speculative Return*	-4.0 %	-6.0%	-5.1%
Total Return	5.2 %	0.1%	1.0%
Initial Earnings	$47.00	$47.00	$47.00
Initial P/E Ratio	30.0x	30.0x	30.0x
Final Earnings	$101.50	$72.11	$72.11
Final P/E Ratio	20.0x	17.3x	17.3x

*Impact of P/E change

Figure 2-3. Jack Bogle's Outlook, circa January 2000

Here is my current outlook for the future.

Components of Return	2008 - 2018
Initial Div. Yield	2.5 %
Earnings Growth	7.0
Investment Return	9.5 %
Speculative Return*	-2.8 %
Total Return	6.7 %
Initial Earnings	$72.11
Initial P/E Ratio	20.0x
Final Earnings	$141.85
Final P/E Ratio	15.0x

Figure 2-4. Jack Bogle's Outlook, September 2008

The total return on stocks is 6.7%, which is about 1.5 times the expected return on bonds. Take the 6.7% return, and subtract from it 3% inflation and 1.5% taxes. You will get (6.7% - 3% - 1.5%) 2.2% real return.

It is not a good idea to abandon the stocks. I have the 69% allocation to bonds (my age minus 10) and 31% in stocks. There is no way to time the markets. Let this turmoil clear a bit and then decide on your allocation. Follow Pascal's advice[8]. Look at the probabilities and circumstances. If staying in the market may get you bankrupt, get out of the market now. Otherwise, consider that the U.S. stock market is the strongest market in the world. Look what happened in other markets.

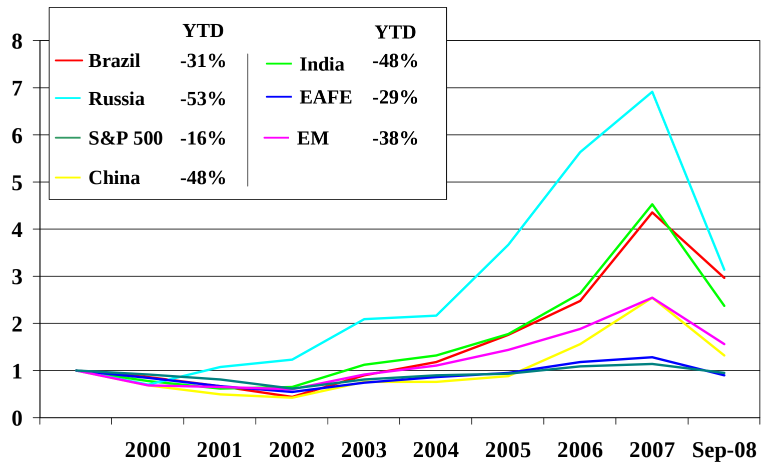


Figure 2-5. The Boom and the Bust . . . so far

China is -48%! Russia is -53%!

I may have been a bit stupid not to get into Europe, but people do not understand the risks of international investing. If I were to make international investments, I would put 10% into the developed international markets (Europe, Australasia, and Far East, or EAFE) and 10% into emerging markets (EM), because they are different. But many investors are duped by the recent performance. When stock markets were soaring, money were flowing into international funds.

	Avg. Annual Return 2005 – 7/2008	
	iShares EAFE	**iShares EM**
Fund Return	**9.1%**	**11.2%**
Investor Return	**4.9%**	**8.9%**
Investor share of fund's return	**54%**	**79%**

Figure 2-6. Performance of iShares EAFE and EM Exchange-Traded Funds

[8] Pascal's Wager http://en.wikipedia.org/wiki/Pascal's_Wager

However, on the long run there is reversion to the mean. EAFE is going up and down. Sometimes, EAFE is outperforming S&P 500; sometimes, S&P 500 is outperforming EAFE. But the average annual returns for the period of 1970-2008 are about the same.

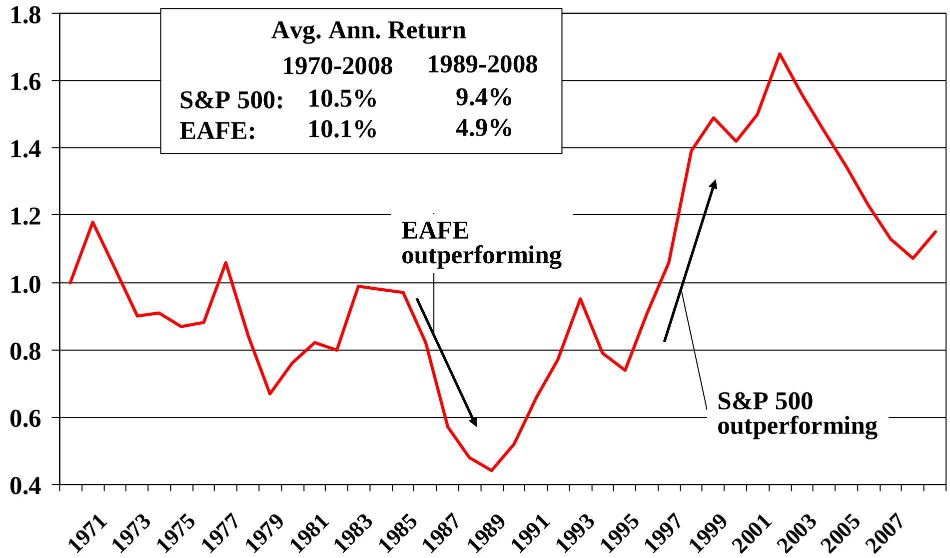


Figure 2-7. Cumulative Returns of S&P 500 / MSCI EAFE, 1970 – 2008

1.2.3 Vanguard

Let's talk about Vanguard. It has emerged as a dominant company. Vanguard is mathematically correct and ethically correct. All my money is in Vanguard. In 2002, I saw that the Vanguard Total Bond Market Index trailed its benchmark Lehman Aggregate Bond Index by 200 basis points[9]. It is not my business as a manager, because I am not a manager, but it is my business as a share holder. Now, Vanguard's quality standards are the best in the industry.

Morningstar ratings do not have any more predictive value than just looking at the fund expenses. Morningstar values should not be used to predict, but they are an excellent source to measure past returns. No rating system is perfect, but there is none better in measuring past returns than Morningstar's.

In the speech I gave at Georgetown University[10], I used the "Bogle score" defined as a "percentage of funds rated 4/5 stars minus funds rated 1/2 stars." Another way to measure fund company's performance is a "loyalty score," i.e., asking people of they would recommend their funds to their friends and relatives. On the scale from 1 to 10,

[9] In 2002, the Lehman Aggregate Bond Index returned 10.26% and the TBM returned 8.26%. See Vanguard web site for Vanguard Total Bond Market Index Fund Investor Shares (VBMFX) performance.
[10] PDF http://johncbogle.com/wordpress/wp-content/uploads/2007/05/Georgetown_2007.pdf

the scores of 9-10 signify supporters, 6-8 correspond to ambivalents, and 1-5 are for detractors. Here are the scores.

		Bogle Score*	Loyalty Score			Bogle Score*	Loyalty Score
1	Vanguard	54.1%	44	16	AIM Investments	-13.2%	-48
2	DFA	50.0	n/a	17	Columbia Funds	-14.2	-47
3	T Rowe Price	44.6	21	18	Federated	-16.1	n/a
4	Janus	38.2	-30	19	Lord Abbett	-22.2	-5
5	American Funds	25.6	12	20	MFS	-22.5	-9
6	NeubergerBerman	19.4	-1	21	Delaware	-24.3	n/a
7	PIMCO/Allianz	13.5	-27	22	Evergreen InvMgmt	-24.9	-48
8	Franklin Templeton	8.6	1	23	Pioneer	-27.0	n/a
9	OppenheimerFunds	8.1	-6	24	DWS Scudder	-27.8	-41
10	BlackRock	5.2	-18	25	VanKampen	-29.2	n/a
11	American Century	4.7	-21	26	State Street Glbl	-35.0	n/a
12	Morgan Stanley	1.8	-18	27	Goldman Sachs	-39.6	-32
13	Fidelity	-3.0	12	28	Dreyfus	-40.4	-45
14	AllianceBernstein	-5.7	-33	29	John Hancock	-43.1	-10
15	Principal Funds	-8.4	-7	30	Putnam	-58.7	-54

***Percentage of funds rated 4/5 stars minus funds rated 1/2 stars.**

Figure 3-1. Major Mutual Fund Managers: Fund Performance and Shareholder Loyalty (**All** Long-Term Funds)

If Vanguard was “alpha” Putnam was “omega.” Look at Janus with -30% in the “loyalty” score. A lot of the Vanguard high ratings are because Vanguard’s bonds are without equal. When people ask me about bonds, I cannot recommend anybody better than Vanguard. Even though Pimco is ok.

If we look at stocks only, Vanguard is #4 on the Bogle score. But remember that new funds appear, and managers change. Managers are by and large average. You *want* to be average and win by the way of low costs. When people say that they pick good managers I don’t believe it. It’s a difficult business.

		Bogle Score*	Exp. Ratio			Bogle Score*	Exp. Ratio
1	DFA	64.7%	0.33	16	Morgan Stanley	6.6%	1.23
2	TIAA-CREF	51.2	0.37	17	American Century	6.5	1.37
3	Janus	44.1	1.21	18	Principal Funds	4.6	1.37
4	Vanguard	41.1	0.23	19	Russell Invst Grp	2.4	1.45
5	T Rowe Price	38.6	0.93	20	AllianceBernstein	0.9	1.34
6	American Funds	33.6	1.06	21	Fidelity	0.0	1.31
7	Waddell & Reed	30.1	1.71	22	Franklin Templeton	0.0	1.48
8	Schwab	21.7	1.08	23	OppenheimerFunds	0.0	1.53
9	NeubergerBerman	20.7	1.12	24	Van Kampen	-2.5	1.53
10	Columbia Funds	15.8	1.41	25	Lord Abbett	-2.7	1.48
11	BlackRock	15.3	1.62	26	AIM Investments	-5.4	1.59
12	Prudential Finl	13.7	1.68	27	Barclays Global	-6.5	0.41
13	The Hartford	12.5	1.49	28	Evergreen InvMgmt	-9.2	1.43
14	PIMCO/Allianz Glbl	10.7	1.39	29	MFS	-9.6	1.53
15	GE Asset Mgmt	7.3	1.05	30	Eaton Vance	-10.0	1.74

***Percentage of funds rated 4/5 stars minus funds rated 1/2 stars.**

Figure 3-2. Major Mutual Fund Managers: Fund Performance and Expenses (**Equity** Funds Only)

Here is how Bogle scores compare with Professor Ed Tower's.

		Tower Score*	Bogle Rank			Tower Score*	Bogle Rank
1	DFA	1.12	1	16	BlackRock	-1.62	11
2	Franklin Templeton	0.60	22	17	T Rowe Price	-1.72	5
3	Lord Abbett	0.50	25	18	Morgan Stanley	-1.74	16
4	American Funds	0.39	6	19	Delaware	-2.10	46
5	Vanguard	0.21	4	20	Janus	-2.16	3
6	PIMCO/Allianz Glbl	0.18	14	21	State Street Glbl	-2.25	37
7	American Century	-0.33	17	22	Principal Funds	-2.37	18
8	Fidelity	-0.54	21	23	Putnam	-2.79	50
9	Federated	-0.82	38	24	Evergreen InvMgmt	-2.85	28
10	OppenheimerFunds	-1.11	23	25	Pioneer	-2.87	45
11	DWS Scudder	-1.38	42	26	AIM Investments	-2.93	26
12	Goldman Sachs	-1.39	48	27	AllianceBernstein	-3.01	20
13	NeubergerBerman	-1.48	9	28	Dreyfus	-3.14	44
14	VanKampen	-1.50	24	29	MFS	-3.43	29
15	Columbia Funds	-1.54	10	30	John Hancock	-3.54	47

***From "Ranking Mutual Fund Families," Ed Tower and Wei Zheng, August 2008.**

Figure 3-3. Major Mutual Fund Managers: Fund Performance and Expenses (**Equity** Funds Only) (different view)

In terms of the quality standards, Vanguard is next to none. I am pleased with the Vanguard management. A big challenge for Vanguard is not investing but organizing the crew. It is important to keep some aura of humanity in the midst of bureaucracy.

1.2.4 Personal

Personally, I don't have to worry about bureaucracy. I just finished a new book "Enough: True Measures of Money, Business, and Life[11]." I worked on this book with Kevin [Laughlin] and Sara [Hoffman], trying to use time efficiently. I am at the stage in my life where I have a sense of urgency to have the things done that I feel need to be done. Kevin came with me in 1999 after the publication of the "Common Sense[12]." Little we knew that five more books would follow, and two more are underway now. We are getting to 2 million of my books read.

[11] http://www.amazon.com/Enough-True-Measures-Money-Business/dp/0470398515
[12] "Common Sense on Mutual Funds: New Imperatives for the Intelligent Investor," http://www.amazon.com/Common-Sense-Mutual-Funds-Imperatives/dp/0471392286/ref=sr_1_5?ie=UTF8&s=books&qid=1223212952&sr=1-5

Some people believe that I am a hard person to work with. I am sure this is true. But there are people with whom I worked for years. I had some fantastic relationships as the President of the Financial Markets Research Center[13] and serving on the Board of Trustees of the National Constitution Center[14]. Joe Torsella [Joseph M. Torsella President and CEO of the National Constitution Center] ran for Congress, I brought him back. The former President and CEO Richard Stengel[15] is now the managing editor of Time magazine. I am very happy helping these two great institutions going [Financial Markets Research Center and National Constitution Center], these are great causes.

I had a terrific decade at Vanguard, some publicized challenges notwithstanding. Even now I am visiting the galley every day for lunch.

Finally, my crusade to reform the financial services sector has not succeeded. I am a lonely voice with a certain image crying in the wilderness. I proved to be accurate. Stating the obvious, this sector has blown by its own dynamite. Somebody had to say these things, and the luck fell on me.

Fidelity, DFA are accumulating the capital, by and large privately held. They are in the business to make money for themselves. In the past 10-15 years indexing has become a household word. All these new developments are investor-centric changes.

1.2.5 Enough

"Enough" is my new book endorsed by Bill Bernstein, Peter Bernstein, David Swensen, and others. David Swensen is probably the finest investor and a human being. His blurb on the cover is the most touching

> "Jack Bogle challenges each of us to aspire to become
> better members of our families, professions, and communities.
> Rarely do so few pages provoke so much thought. Read this book.
> David F. Swensen, Chief Investment Officer, Yale University"

This is a wonderful endorsement from Swensen, it brought tears to my eyes, even though I am a veteran.

---

[13] http://www.vanguard.com/bogle_site/bogle_home.html
[14] http://www.constitutioncenter.org/
[15] http://en.wikipedia.org/wiki/Richard_Stengel

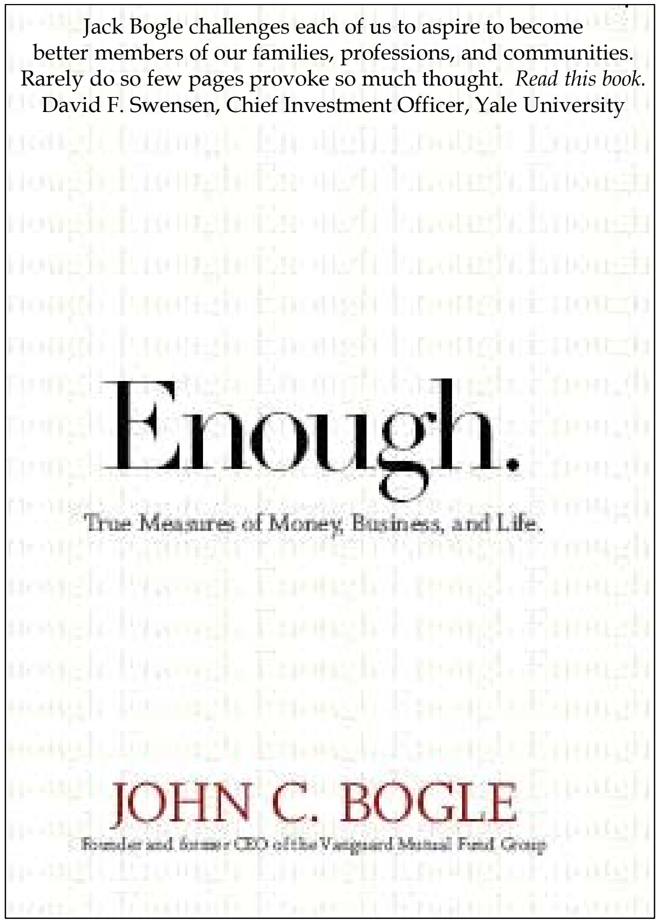


Figure 4-1. Enough

The book is the expansion of the May 2007, commencement speech I gave at Georgetown university[16]. I quoted Kurt Vonnegut and Joseph Heller's discussion at a party given by a billionaire hedge fund manager. Vonnegut noted that the host made more money in a day than Heller from his novel Catch 22 over its whole history. To this Heller replied that he had something the billionaire did not, he had *enough*.

Expanding a 7-minute speech into a book was a challenge. This book is a combination of searing criticism and sophomoric idealism. It is intended not only for people interested in finance but also for people interested in the humanity.

The book's table of contents is as follows:

[16] PDF http://johncbogle.com/wordpress/wp-content/uploads/2007/05/Georgetown_2007.pdf

Table of Contents

Figure 4-2. Table of Contents of "Enough"

The end of the book is from my Yale speech[17] [Yale CEO Leadership Summit] where I give a 10-point list of "Why do I bother to battle?"

> "While I simply can't imagine that my own soul and spirit will ever fade, I'll continue to fight the battle until my mind and my strength begin to fade. Only then, I hop many moons from tonight, will I take the time to reel in the memories of all the wonderful battles I've fought during my long life. After all, as Sophocles reminds us, *one must wait until evening to see how splendid the day has been*."

[Ovation]

1.3 Questions and answers with Mr. Bogle

Mel Lindauer asked questions that had been submitted online and those by the participants submitted at the conference ("Q"), and Mr. Bogle responded to them. Occasionally, somebody from the audience had clarifying or follow-up questions. "A" corresponds to Mr. Bogle's answers. Mel noted that the tone of the participants' questions was somewhat different from those submitted on the Bogleheads site due to the recent events in the world markets.

Q. Are we in a recession?
A. We have an absurd definition of a recession. For example, if the markets go up 0.5% one quarter, and -5% next quarter, +0.5% again, and -5%, etc., the government will say

[17] PDF http://johncbogle.com/wordpress/wp-content/uploads/2007/12/yale_12-07.pdf

that we are not in a recession by their standard. This recession will last 1.5 years, give and take. If you talk to people they feel the recession, and it could get substantially worse. The financial industry has declined significantly. New York City will feel it, bonuses will decline. The stock market usually anticipates recessions quite well. This time is different. Yes, we are in a recession, and measurably so.

Q. Have you changed your opinion about ETFs?
A. The person asking probably does not know what my opinion is. If you have $100,000 and want to by an S&P ETF, there is nothing wrong with that. But narrow-structured ETFs are stupid. Rick Ferri's strategy is not bad. But, en masse, people go for "new things," "new products," and these could be harmful. Investment is not a "product."

There are only about 15 broad-market ETFs such as Total Stock Market and S&P 500. People have huge sales forces to sell ETFs. Some claim that ETFs structured by earnings or dividends are better than those structured by capitalization. We don't know that. People are trading ETFs all the time, they are trading too much. If you work for Microsoft you may want to buy all the ETFs, except the technology ETFs. It is a great strategy, but I don't know anybody using it. With ETFs, there are also brokerage commissions, and brokers live on commissions. Jeremy Siegel has the right to make his living just as non-professionals do.

Q. How can you tell that it is different this time, when there is so much noise?
A. I cannot really know that it is different, but I believe it is different. I make a judgment but cannot quantify it. This bear market may not rebound as quickly as previous bear markets did. I did not mean to worry anyone. Remember about bonds and your age, but not slavishly.

For example, asset allocation funds look at the future growth in stocks and long-term Treasuries as 7% and 4.5%, respectively, and so they invest heavily in stocks. They missed valuations in stocks; even if earning growth is high, valuations still matter. Average fund is down 10.27% this year (as of 22 September 2008).

Q. We talk about U.S. stocks, international stocks and bonds. But what about adding new asset classes such as TIPS and REITs, and how to add them?
A. TIPS are intermediate-term Treasury bonds that give you a coupon that includes inflation protection. They are not a new asset class. Three years ago, I replaced my intermediate-term bonds with TIPS.

REIT may be different or may be not. Real Estate is not the same as REIT, the character of the real estate changes when you buy not a property but a stock of a property.

TIPS are a nice protection against inflation. We can measure the expectation of inflation by subtracting the TIPS coupon rate from the rate of the Treasury bond with the same duration. For example, if the coupon rate for 10-year TIPS is 1.4%, and 10-year Treasuries are earning 3.6%, the spread is (3.6% - 1.4%) 2.2% and it represents the market's expectation of inflation. The expected 2.2% inflation rate may happen in two ways (a) terrible recession (no inflation) and (b) government will say that inflation is 2.2%. They use “core inflation,” i.e., inflation on the things you don’t need.

Q. What is your take on the market black swans?
A. It has been a part of my DNA not to be surprised by much. Everything is possible in the *financial markets*, and it does not really matter. There are no black swans in the *production* parts of the economy. Recessions do not come out of the blue.

Q. When Lehman Brothers and AIG go down that is beyond market point drop.
A. I am surprised that so many firms went under, but I am not surprised that it was coming. What these people did was a disgrace. 2-3 years ago, there were no more municipal bonds left to insure. CEOs were not satisfied with 2% growth, and they started looking for something else to insure. And so they designed Collaterized Mortgage Obligations (CMO). Chuck Price said “for as long as music is still playing, we will keep dancing.”

What we are losing here is the simplicity of the system. Not many innovations benefited investors. Index funds are one innovation that did. Most Wall Street innovations only benefit *inventors*. CMOs, etc. do not benefit *investors*. They can be used only until they explode. I am amazed with the risk they took. If your portfolio is 33-to-1 leveraged in Treasuries you can be euphoric. But not when it is leveraged in CMOs or other inventions.

CNBC quotes are misleading. For example, they may say “everybody is selling their stocks.” And nobody is buying?! Or they may say “no trading on the Wall Street, everybody is satisfied with their position.” Wall Street is a casino where only the croupier wins.

Q. Rich is redesigning his company’s 401(k) plan. Which bonds should he use?
A. Get your funds from Vanguard. Note that mortgage-backed securities in the Vanguard bond funds are GNMA (i.e.., not Freddie Mac or Fannie Mae). GNMA are completely insured by the government. I switched from the Total Bond Market into the Intermediate-term Bond fund. One approach to retirement planning is to move from the intermediate-term bonds into short-term bonds. Never look for extra income, because it always comes with extra risk or with lower quality.

Q. Is there anything wrong with the foreign stock funds that have low expenses and low turnover?
A. There is nothing wrong with foreign stocks. For the next 10 years, international stocks will return about the same as the U.S. stocks. Accounting standards differ. In France, people take the month of August off and work 30 hours a week. Why should their market return more than the U.S. market?

Having said that, there is nothing wrong with holding 20% international. We spend our money in dollars. Sometimes, the correlation is good, sometimes it is poor. Your want a poor correlation, whereas U.S. and international are well correlated.

Q. Why should investors stay the course?
A. Staying the course requires certain stoicism, a good belly. The odds against being right twice are high. But that is a part of the story. You come out of the market and you wait to get back. And the market is so low that you are scared to get back. And you wait … until the market is back but it is now higher than when you got out. Staying the course may not be perfect, but I don't know a better way.

Q. Do you think we are heading towards a depression?
A. I don't know. If consumers stop spending it may get worse. If people don't want to spend, it does not matter whether people have money to spend. Sometimes, it is best to say that I don't know.

Q. What are the long-term effects of bail-outs?
A. We don't know what the bailout terms yet (as of 22 September 2008). I am not happy with the Federal government owning 35% of the American financial institutions. May be they are right for what I know, but $700B blank check without accounting is wrong. So much is not clear, not spelled out.

Q. Is the capitalization weighted market working against value stocks?
A. It is true, but we don't have a better system. Churchill said that "democracy is the worst form of government except all those other forms that have been tried from time to time[18]." I happen to like the Total Stock Market. It is now bigger than the S&P 500 index fund. If one is starting at ground zero I would recommend TSM. But if you are already invested in the S&P 500, stay with it.

Q. Do you think anyone in attendance here has credit card debt?
A. Paying credit cards provides a guaranteed 17% return; I don't know a better way to get such return.

Q. If the subprime mortgages are only 10% of the total mortgages, why do we have such turmoil?
A. The 10% number does not include the Alt-A loans, neighborhoods with "jingle mail" (keys sent back to the lender), "Ninja loans," etc. There were pyramid schemes between realtors, managers, investment bankers, etc. Some investment bankers were selling to some dumb institutions, some were selling to themselves.

Q. I teach 2nd graders. What lessons can I instill in them?
A. This is a very important work to build a better world, teaching in inner cities. These children have no opportunity, no fighting chance. Our system is too complex, which has nothing to do with investment. All you need to do is own a business. I am appalled by stock picking contests among children.

Q. What are you top 5 suggestions to clean up this mess?

---

[18] http://en.wikiquote.org/wiki/Winston_Churchill

A. The first one is obvious. I would like to be appointed a czar. Jokes aside, I don't have much confidence in Henry Paulson. He is too confident; he needs to be more humble. Paul Volker would be my choice. Volker is a banker, he was a diplomat. He does not care what the others say. But he is older than I am. David Swensen is great.

We live in a society where we think we can count everything. We can measure earnings, salaries, etc. But we cannot measure loan availability to families. Do we know how risky each loan is?

It is a part of our society's flaws that we care less about character. Read David Brooks' column Great Seduction in the 10 June 2008, New York Times[19] on what our society has become and our loss of the 18^{th} century values. We live in a great country that lost the values that made it great. Financial speculation is destroying us.

Q. Are the munies riskier now?
A. I don't think so. New York City and New York State are facing challenges because of the decline in the financial community. You have to invest somewhere. Most of my non-retirement money is in munies.

Q. (follow-up) Are there advantages of muni funds over specific issues?
A. Never buy individual issues, you never know what may happen to them. A fund provides better safety at a lower cost. I don't like long munies, they are riskier.

Q. What do you think about a global bond fund?
A. I guess they are fine. There are only so many ways to slice the global baloney. I don't think they are necessary. I am for simplicity. Some global funds (small amount) would not make much difference. And they are expensive.

Q. Have you invested in the Bogle funds (your son's)?
A. Yes, in his one fund.

Q. Are you happy with what Vanguard does with the Vanguard funds? You are a financial rock star!
A. Vanguard will do what it wants to do. Stay on the index side of Vanguard and don't worry about the rest. If something does not seem to make sense, don't do it.

Q. A few years ago, there was a rule to have one's age equivalent in bonds. Now, target funds for 40-50 year olds have only 14% in bonds, i.e., age-30. Is this a right bond allocation?
A. I was also surprised that they raised the equity allocation. I hope this is not because of the competition.

Q. What do you think about Commodities Collaterized Futures (CCF)?
A. Please, let's get back to the basics. Investment is stocks and bonds. Commodities are speculations. Don't speculate. In 1616, there was a great fire in London, and in 300

[19] http://www.nytimes.com/2008/06/10/opinion/10brooks.html

years until 1916, there was no increase in commodities. I don't believe in speculation. CCF sounds like something that will enrich the Wall Street and impoverish everybody else. Gold, soybeans, pork bellies, etc., do not give dividends. If you need to speculate, do so with no more than 0.5% of your assets.

Q. Can one use Windsor in retirement?
A. Why not?

Q. What we have not asked that we should have asked?
A. When I was giving another speech, the last question was what I thought of Eagle (the proposed join currency between the U.S., Canada and Mexico). I said then as I am saying now "I can see that you have not run out of questions, but I ran out of answers."

1.4 Mr. Bogle and Dr. Bernstein

Dr. Bernstein: I agree with everything Jack says. ☺

I am not much concerned about markets. This is how market bottoms look like. Henry Paulson looks like a deer in the headlights. That is bad news. The good news is that a short guy with a beard coaches him.

If you are 30-40 years old it is a good time to invest. Even if you are retired and markets go down your buying power will still be better than in 2006. The state of the nation is different. We just added $1T debt to the $1T cost of the Iraq war. Add that to the unfunded liabilities of about $30-40T of Medicare and about $15T unfunded liabilities for Social Security. And nobody in the government has the will and maturity to raise taxes. Sooner or later the Chinese will stop buying dollars and we will become like Argentina. The Chinese will be buying Euros, Yen and Swill Franc.

Mr. Bogle: I agree with every word Bill said. ☺

Markets, politics, economics, and national value – we are meeting here at a historic moment when this nation is making critical decisions. When we went to a war in Iraq, the leadership should have said that the war will cost $200B (which actually ended up as $1T) and that the rest of us would have to do our share by paying higher taxes.

It is not just the Wall Street, it is a part of the "me" society. A blurb in my book says "In a society crying for 'more' Bogle is crying 'enough'." We are lacking political will. We are either a Republican or a Democrat, we are just supporting a party. We had higher sense of values when the Republicans supported Harry Truman.

I agree with Bill that Ben Bernanke is the power behind the economic decisions. The SEC Chairman Cox never says anything. The government will most likely require some equity participation in the bailed out entities.

I think the economy will get worse. We have to start thinking as citizens and cut through all that rut. I don't watch Lou Dobbs anymore. I am not telling who I am voting for, but if somebody asks a question... I talk to a lot to students, they are idealistic to a fault, they want a better political system.

Dr. Bernstein: Jack, I will ask you two questions. First "Who are you voting for?" Second, "Do you think there is a bright side where bright young people will stop going to work for hedge funds and become doctors and engineers?"

Mr. Bogle: I will take the easy question first. The financial system is just not worth $400B. It is worth about $2B. There will be no more "Wall Street salaries." Firms will not be able to have any balance sheet they want. People will again start looking at balance sheets. Variable annuities, the most expensive product designed by a man, will disappear. People are asking what will happen when everybody indexes. Let's not worry about it. Let's wait until at least 50% of people index.

The historical stock market return of 9.5% includes the 4.5% dividend yield. Today, the dividend yield is only 2.5%. And so everybody overstates the projected return by 2%. All pension plans overstate their projected returns; it is scandalous. And still it is not as bad as Medicare, which ramps until it will explode. My and your generations take it for granted, but our children do not take it for granted.

Now, the first question. First, a fact. As an American citizen I am interested in the best candidate from each party. I knew that Pennsylvania would select McCain as the Republican candidate, but the situation with the Democratic candidate was not clear at the time. Therefore, I switched my registration for the primaries from Republican to Democratic and voted for Obama. The next day I switched my registration back to the Republican party. I am a "Teddy Roosevelt Republican." I was going to wait until two days before the elections to decide who I was going to vote for. However, some event took place (some candidate appeared) that caused me to decide to vote for Obama.

Dr. Bernstein: I reached certain age and had to renew my driver's license and voter registration. They asked me if I wanted to register as a Republican or a Democrat. I did the same thing as Jack did, but I did not switch back. I don't insist on the reversion to the mean here.

But let's start answering questions.

Question. Why do you feel that the tax rate increase is a good way to go?

Mr. Bogle: Today, I accused the media of not being able to deal with nuances. I probably made the same error. I would lower payroll taxes to stimulate the economy. But the 15% dividend tax has to go. It would affect a small fraction of people. People in this room would hardly feel it if the dividend yield were taxed at your regular rate – you would pay extra 8% at most, because most of your money is tax deferred any way. I don’t see why we cannot have a higher capital gains tax rate. Why do you pay full rate on money markets and bond funds and only half of that on capital gains?

If we could only increase the savings rate in this nation, that would be great. If we could achieve it by taxing the rich that is ok with me, even though I would be paying more taxes. And we should tax inheritance. The exemptions could be higher, e.g., $5M exemption on the inheritance tax. This would have the effect of income redistribution.

Dr. Bernstein: Jack, according to John McCain you are not rich. The theory is that taxes incentivize people. In truth, there is no relationship between the marginal tax rate and the economy. When tax rates increase, one effect is that people have less incentive to work (because they pay more in taxes). The other effect is that you have less money left after paying taxes and you need to work harder. These two effects cancel each other, and the GDP remains about the same regardless of the tax rates. For example, in the 1940-1950s the marginal rate was 90% and the GDP was just fine.

The cost of the increasing inequality in our country is enormous. The more inequality we have the higher the crime rate is. It is also a straight-line relationship between inequality and mortality rates. Cubans have the same mortality as we do, but their GDP is about one-tenth of ours – because they have less inequality. The average Dutch man is 5 cm taller than the average American man; Dutch women are 6 cm taller than American women.

Question. Should we be buying corporate bonds?

Mr. Bogle: Corporate bonds are about 6 ¾% now. The market bets that less than that would send it into a tailspin. One should do the corporate and Treasury bonds together. Also, remember that the Treasury bonds are not callable, and corporate bonds are callable. You may get a great rate on the corporate bonds, and then they will be called. David Swensen is 1000 times smarter than I am, and he says to hold just the Treasuries. I recommend to most people to stick with the Treasuries.

Dr. Bernstein: The Treasuries hardly earn anything. The Treasuries are good when there is no “day light” between the Treasuries and corporate bonds. But now there is some daylight, and corporate and junk bonds are worth considering. But I may be wrong.

Question. From your remarks it appears that Wall Street does not exist any more.

Mr. Bogle: Brokerage business continues to exist whether we call it “Wall Street” or not. What worries me is that the bankers want to get into the deposit business. Now that they won’t have the ATM of the mortgages they want to get the deposits. Citi, Wells Fargo, Wachovia, etc., are still very powerful institutions. Why would customers move to Goldman Sachs or Morgan Stanley?

Dr. Bernstein: When I go to New York City to meet with the Chairman of Goldman Sachs I will ask him if they will be giving out toasters.

Question. Bill, did you say that when equities fall 25%, the asset allocation to equities should increase by 5%?

Dr. Bernstein: P/E here is about 15, abroad it is in single digits. It is not a bad time to buy. Buy when others are fearful.

Mr. Bogle: Warren Buffet defined three stages of trends as Innovator, Imitator, Idiot. The same is also true of the hedge funds. Every time you feel that you need a higher return from the yields, forget about it. It only works once out of 1000. The financial sector may not grow for a few years. The rest of the sectors may grow a little. I have difficulty computing P/E.

Mr. Bogle: Read Bill Bernstein's "Splendid Exchange."

Dr. Bernstein: It is amazing to share the stage with the historical giant and the moral giant. Read "Enough."

2 Day-2 – 24 September 2008 - Panel Q&A

Panel members:

- Rick Ferri ("**Rick**")
- Ed Tower ("**Ed**")
- "Queen" Laura ("**Laura**")
- Mel Lindauer ("**Mel**")
- Bill Bernstein ("**Bill B**")
- Bill Schultheis ("**Bill S**")
- Sue Stevens ("**Sue**")
- Michael LeBoeuf ("**Michael**")

Question: Do you see the light at the end of the tunnel of where the economy is heading?

Ed: In the 1960s, Milton Friedman wrote an essay on why the American economy is recession-proof. We really screwed up during the 1930s depression, but now policymakers won't allow such declines to happen. As a counterbalance, Germany had horrible inflation in the 1920s, but then they kept inflation under control after WWII. The multipliers are not as great as they used to be.

Rick: The state of the economy is fundamentally strong ☺ Economy has problems, people cannot pay their mortgages, and sometimes people just made bad choices. Some housing markets already turned up. CA, FL, NV may continue to decline. But when prices stabilize, the economy will recover. Watch the Case-Shiller index, and when 13 or 14 or 15 areas turn up the economy will get better (as of now only 11 areas turned up).

Michael: Our unemployment is 5%, in Europe it is 6%. I am from Phoenix, and people there scream that housing prices dropped. But in 2005, they rose 50%. Media tends to be hysterical. We have 200 years of markets, and the trend is always up.

Question: Please comment about Vanguard payout funds.

Mel: We were surprised when Vanguard brought these products out. We will have to wait and see how they work out. I would like to know how Vanguard can promise to pay 5% or 7%.

Bill B: They sometimes do things we may not like.

Bill S: I was uncomfortable, because it locks people into an asset allocation and I would like people first decide on their risk tolerance.

Question: What is your opinion about Zvi Bodie's and Paula Hogan's theory of lifecycle investing?

Sue: Bodie's approach is to use synthetic insurance to some degree to generate a stream of wealth. But I'd not choose insurance for that. Bodie advocates TIPS. I have heard him speaking about insurance contracts – and don't quite like them.

Bill B: Roger Ibbotson, Moshe Milevsky and Peng Chen recommend stocks, bonds and low cost annuities so as not to run out of money. Annuities are ok, but first one needs to trust that the insurance company will not go out of business. Perhaps, the government is a better provider of annuities.

Question to Rick Ferri: Do you recommend ETFs or Vanguard funds?

Rick: If you can do Admiral funds and prefer Vanguard, hold Vanguard funds. If you hold your money at a brokerage, you can buy Vanguard ETFs. Commission to buy a Vanguard ETF is lower than commission to buy a Vanguard fund, e.g., through Schwab. A lot depends on the custodian. Note that with an ETF you also save on the redemption fees.

Ed: Loads for selling Vanguard funds go to fund holders. Do ETF holders also benefit from this?

Rick: That is correct, but it is a small amount.

Ed: So ETF holders rip off fund holders?

Rick: There is a small disadvantage of ETFs. With funds, the dividends are reinvested immediately. With ETFs, it takes on average 10 days. And given that stocks go up as a trend, ETFs are not earning these 10 days whereas funds do. For a client, an open fund showed better performance than an identical ETF, because of the delay in the dividend reinvestment. So this is a slight disadvantage of ETFs that compensates for a slight advantage of receiving the fund redemption fee. These two cancel each other out.

Bill B: This discussion of ETFs vs. open funds is equivalent to the discussion of deck chairs in your yard.

Question: How to do rebalancing in a taxable account?

Bill B: There is a trade off between the cost of rebalancing and lost returns. But the answer is to do as little taxable rebalancing as possible. Do rebalancing in tax-deferred accounts.

Sue: I agree with Bill in general, but this is a special year, because due to the economic situation and despite of what the candidates are saying, it may make sense to take some losses and carry them indefinitely, or even take gains before taxes go up.

Question: What bond funds to hold?

Laura: Intermediate term bond or total bond fund.

Sue: Split between total and intermediate and have some GNMA mortgage bonds. Jack made the same point because Ginnie Mae is not the same as Freddie Mac and Fannie Mae. I like to spread my risks.

Question: Why did the Treasury reduce the amount of I Bonds?

Mel: I had an impression that they wanted to kill I Bonds, because it was too good for investors. The pattern has been down, and now the fixed rate is at zero. A funny thing is that even at zero, I Bonds are a great buy in comparison to other equally safe investments such as money market funds and CDs.

The Treasury may have wanted to see how low they can drop the rates and have people still buying. Remember that some people are buying savings bonds on automatic plans, and they may not even notice that the fixed rate has dropped.

Bill B: Sometimes government does not know how to price new issues, and in the beginning they price them ridiculously low. Astute people like Mel can pick it up.

Mel: They told me that the initial high rates were intended to generate public interest in these new bonds. Market sets TIPS rates, whereas the Treasury sets I Bonds rates.

Question: I want to self-fund long-term care, but I am concerned, especially now that my in-laws went to a high-cost nursing home.

Bill B: Can you afford $100k-$150k per year for several years?

Sue: The long term care insurance is about $3.5-4.5k per year, if you buy it in your 50s. If you have $10M, you can self-insure. Good Long Term Care Insurance (LTCI) providers are John Hancock and GE Capital. You have to go with good solid players. Find some good quotes. I can recommend somebody who can show you various policies.

Bill B: You also have to plan spending $150-180k on medical expenses over your lifetime.

Rick: There is also a difference between a single person and a couple. A single person can sell their house and use the money to go to a home. With a couple you end up essentially running two households, e.g., the husband at the home and the wife at home.

Michael: I looked into the consequences of guessing wrong. What if one of us has stroke in the 60s? I also looked for home care insurance, i.e., the "stay out of nursing home" insurance. Look for inflation-adjusted insurance.

Question: When do you buy LTCI? In your 40s? 50s? 60s?

Mel: It varies based on your personal experience and what happens around you. You look at costs of policies, at the waiting periods, daily costs covered, etc. My parents are in their 90s and healthy. I decided to self-insure, i.e., not to buy it. Michael obviously thinks differently.

Sue: Michael and I bought in our 50s. Women are frequently caretakers in a family. Single women also have to consider it. Prices go up sharply in one's 60s.

Mel: As Sue said, a concern for younger people is that a company may get out of business.

Question: Where can one find good information about various asset classes?

Rick: S&P web site tells both historical data and projections. I have not met anyone yet who could use these data to predict accurately what risk premiums are going to be in the short term. I don't want to take risk.

Bill B: I don't disagree. One month P/E is 22, the other month it is 18. When REITs yield 8% you want to have more of them than when they are yielding 4%.

Question: To Bill B. **–** how to estimate my future longevity and medical expenses considering possible medical advances?

Bill B: You are basically asking how high is high. Some treatments cost $1M a year. Some of these treatments are useful, some are not, and you don't have the means to evaluate them. You will need the 2nd and the 3rd opinion. But as the society do we want to put this money into chemotherapy or to use this money to immunize children?

Question: What to buy, munis or the Treasury bonds?

Mel: The Vanguard muni fund is now paying well (4.05%), outperforming traditional money markets, regardless of the tax bracket. But it is paying so much because of the increased risk.

Rick: You can switch back and forth between money markets and munis.

Question: We have 50%-50% stocks / bonds. Should we also include REITs?

Rick: There is not enough information. Is this in a taxable account? If it is taxable, you do not want to include REITs.

Question: What is potential impact of wealthier baby boomers retirements on stock prices and bond yields?

Bill S: Nobody knows what is going to happen. Don't focus on the things that you cannot control. Henry Dent made all kinds of interesting projections, all of which turned out wrong.

Rick: We live in the global economy; don't look at the U.S. baby boomers in isolation.

Question: What happens when a bank goes bust?

Mel: I have been in banks that went bust in the 1980s. It is not a big deal; the key is to stay within the FDIC limits. Something happens on Friday, and the following week it is a different bank and you can still get your money.

Follow up: The specific bank is WaMu.

Sue: Check www.bankrate.com/ .

Bill S: I will email to you a link to an article about banks.

Comment: Within a single bank, they consolidate accounts to cover up to $100k per individual / $200k per couple.

Follow up: If my bills are paid out of my account and the bank fails, am I responsible for late payments?

Mel: It is different from my time. I am assuming that in such unique cases the fees would be waved.

Question: Will the Treasury offer stripped TIPS?

Rick: In the past, investment banks were stripping and reselling the Treasuries. The Treasury stepped in, under-priced them, and investment banks stopped offering them. And so now investment banks are less likely to offer stripped TIPS because (a) they know that the Treasury will step in and (b) they are preoccupied with other things. Considering that investment banks are not offering stripped TIPS, the Treasury is not motivated to do so either.

Question: Should one change to the global asset allocation?

Bill B: Even if the global market is 60%, an investor should not have more than 50% international. If you invested 50% in Japan in the 1980s you would lose big way.

Rick: You'd have more with 50/50 EAFE/Pacific and rebalanced, because you would rebalance currency risk without adding risk. You are paying your bills with the U.S. dollars, and so you should have more investments denominated in the U.S. dollars.

Bill B: Rebalancing is the only market timing that works.

Question: about Bill Bernstein's article about value premium.

Bill B: There is a good narrative that there is value premium, because people overvalue growth stocks. Behavioral component is stronger than the value component. If you are buying stocks with P/E = 60, in 6 years it will sell with P/E = 50, and the market will realize that it is not a growth stock and will get rid of it.

Bill S: Can you stay with your allocation when it goes against you? Can you persist with value stocks when it drops? As an individual investor you can have negative returns. Bill and I are managing funds and we cannot do it.

R**ick**: Value stocks do not get as much coverage as growth stocks do, because analysts cover only stocks that invest with them, which are usually growth companies. Also, earnings of value stocks seem to be under-reported, in contrast with the growth stock returns which are over-reported. Very deep small value investors who persist may get a better return than the market.

Bill S: Now that there are no investment banks left around, whom are the analysts going to cover? ☺

Question: Can a non-cap weighted system be devised?

Bill B: There is fundamental indexing by Fama and French to truncate 1/3 of the market. Rob Arnott uses a fundamental metric. These two approaches are equivalent. It comes down to execution, e.g., by DFA or Vanguard.

Rick: It comes down to value tilt. You can have equally weighted small, medium and S&P.

Question: Thank you for co-authoring a book on value averaging. What should I use for "value averaging[20]"?

Bill B: I am not a co-author; I wrote the foreword, because I love this book[21]. Use 7% escalator.

Question: What are your expectations for the CD rates? Will they go up?

Bill S: For the past 3-4 years they went down, but they are not all that bad. 4-5% is not bad in comparison to a diversified portfolio in the past 10 years. Many people underestimate CDs.

Mel: I Bonds pay well; they are a good option to consider until CD returns increase.

Question: Some retirees are saving more than they should based on a report published last year in the Journal of Financial Planning. Apparently, retirees are spending less than they projected in their later stages of retirement.

Rick: I never said that people are saving too much. But it is not a straight line. Some of my clients spend less money as they get older, i.e., at 85 they spend less than they did at 65. Medical and long-term care are major exceptions. The straight-line model is not a good model; we need a curve based on what people actually do.

Mel: My father is 93, my mother is 90, and I have seen some dramatic changes in their spending and travel. What Rick says is very true, it is probably the norm.

Sue: Agree that you don't want to generalize at 4%. But a lot of people don't know what they are spending. One client's children were concerned that father was overspending their inheritance. He thought it was $100k per year, but VISA bills showed that he was spending $300k per year. Factor in what could go wrong, have some cushion.

Bill B: Do the Pascal wager. If you under-spend, your children and your government will get a little more. If you over-spend, you will live on cat food between the ages of 85 and 92.

Michael: Spend more when the markets are doing well; spend less when they are doing poorly.

Mel: Having more than enough gives you peace of mind; you can enjoy life without worrying about running out of money.

---

[20] http://en.wikipedia.org/wiki/Value_averaging
[21] "Value Averaging: The Safe and Easy Strategy for Higher Investment Returns" by Michael E. Edleson, http://www.amazon.com/dp/0470049774/

Bill B: If you are a compulsive saver, you will realize it at some point and will be able to compensate by starting higher spending.

Laura: How about paying off one's mortgage?

Rick: I am paying if off, I want to have it paid off by the time I retire.

Michael: It depends on the interest rate.

Mel: In the 1980s, I bought a building at 12% and was getting 15% on CDs. Now I don't like getting mortgage, and I am paying cash.

Sue: Psychologically, it feels better to have mortgage paid off, especially in the current economic environment. But I agree with Michael's point about the relationship between mortgage and interest rates, and also taxes.

Question: Are munis safe?

Rick: Munies are safe. AA, BB, etc., ratings on munis are much safer than same-letter ratings on corporate bonds. States, Federal governments will bail out municipalities if necessary. Insurance on AAA rated bonds will go down if it reduces to AA, and that is why value went down and the rates went up.

Bill B: The rate of muni defaults was always low. Stay with Vanguard.

Bill S: General obligation bonds seldom default.

Question: Is the same true for the New York State bonds?

Rick: If the Federal government helps companies it would also help the state of New York.

Question: Is 20% allocation to foreign equities risky?

Bill S: Whether you should have 20% or 30% international is impossible to say before the fact.

Ed: As I was listening to Jack's reflections on financial markets, I thought of the Keynes' quote:

> The master-economist must possess a rare combination of gifts. He must reach a high standard in several different directions and must combine talents not often found together. He must be mathematician, historian, statesman, philosopher - in some degree. He must understand symbols and speak in words. He must contemplate the particular in terms of the general, and touch abstract and concrete in the same flight of thought. He must study the present in light of the past for the purposes of the future. No part of man's nature or his institutions must lie entirely

> outside his regard. He must be purposeful and disinterested in a simultaneous mood; as aloof and incorruptible as an artist, yet sometimes as near the earth as a politician. (John Maynard Keynes)

This summarizes my feelings about Jack, Bill and other Bogleheads.

Question: Does Vanguard have any credit default swaps?

Mel: When the Treasury came up with the guarantee of money market accounts, I called Vanguard to find out if they planned to participate. Vanguard said that they have no junk and don't feel the need to take the government insurance. I told them that even if they have no problems, there is still the perception that there might be problems out there.

Question: I am talking about corporate bond funds. If a bond fund holds thousands of bonds they do not need credit default swaps, they can self-insure.

Rick: A swap is when you go to Lehman Brothers and swap the bond return for cash return.

Question: What do you do when somebody asks you where you are investing and tell you that their parents, spouses, etc., do it for them?

Laura: If they are not asking for your advice it would be difficult to help them. I would talk about the benefits **I** receive from low-cost indexing. With a close friend, I would give them a reference and introduce them to investing piece-by-piece.

Mel: I consider *how* people come to me when they ask me for an advice. When people got their brokers via church, etc., I use Laura's approach.

Laura: There is a lot of sensitivity about money and investments.

Bill B: I recommend (a) Random Walk[22] and (b) Common Sense[23].

Sue: Point people to a web site that shows expense ratios.

Bill B: If you want to save the world, volunteer. Otherwise, do as Laura says.

Rick: Individual investors can learn and publish a book. You can hand over the next Bogleheads book to your friends and relatives.

Michael: I put two children through Harvard. My broker's children. I go to Bill Bernstein's site and point to two pages "Bequesting your assets to your broker[24]." I give these two pages to my relatives – it gets their attention. I am trying not to prophesize.

---

[22] http://www.amazon.com/Random-Walk-Down-Wall-Street/dp/0393330338/ref=pd_bbs_sr_1?ie=UTF8&s=books&qid=1223272327&sr=8-1

[23] http://www.amazon.com/Common-Sense-Mutual-Funds-Imperatives/dp/0471392286/ref=sr_1_1?ie=UTF8&s=books&qid=1223272396&sr=1-1

Bill B: 20 years ago I was at a dinner with an older gentleman. He was conservatively invested. I told him about Vanguard, and he could not believe me. He thought I was a snake-oil salesman. Oh, and he lived in Philadelphia.

Mel: I advise people to use Vanguard so much that people often accuse me of working for Vanguard.

Ed: In my undergraduate class in finance I said that expense ratios add up, and that Vanguard is better than any alternatives. The students could not believe me, first. Jack did similar calculations on his web site. Show your friends and relatives these calculations. Some simple calculations are mind-boggling.

Laura: One exception is small children. The public education in this area is not good.

Question: I don't know a single person in this room planning to buy bank stocks. Why cannot a young man buy ETFs of a bank now and take advantage of the opportunity?

Rick: Some long-term investments are short-term investments that did not work out. Sometimes, you just cannot win.

Mel: What do you know that the world does not know?

Bill B: What you are saying is not a bad idea. But remember what Keynes said about markets remaining irrational longer than you can remain solvent.

Question: Is this a good time to buy REITs?

Bill B: REITs are earning about 5%. They are different from home ownership; they are a different type of investment. They are not a particularly good investment now.

---

[24] http://www.efficientfrontier.com/ef/996/broker.htm