Principle 9: Invest with Simplicity

[Applause]

Jim Dahle: All right you guys are in for a treat because you get Mike Piper back up here if we can tear him away from the drinks. There in the back, he's back there serving drinks. But let's get him back up here. He's going to talk about investing in a simple manner.

And the best thing about this with Mike is that he practices what he preaches, and the thing I love about Mike is I am still learning stuff from Mike. I sent him an email just last week to clarify something I did not understand. He sent me back an email filled with algebra. He totally understood it and so it's great to have Mike as a resource. Luckily he's not going to be talking about algebra, I hope, in this presentation. But it should still be well worth your time and attention.

Mike Piper: All right. Invest with simplicity. Back in 2008, or Alan can you correct me if I'm wrong, in 2009 perhaps, in his book, *How A Second Grader Beats Wall Street*, he outlined what he called The Second Grader Portfolio, and this was a portfolio that consists of a Total Stock Market Index Fund, a Total International Stock Index Fund and a Total Bond Market Index Fund. And you keep hearing about this portfolio. Now we just call it the Three Fund Portfolio, and it's become largely a default investment recommendation among the Bogleheads community.

And the reason it's become so popular is because it's really simple and it's extremely well diversified. Just like you know Alan and Christine were showing you it includes thousands of stocks from around the world and the diversified collection of bonds with just three mutual funds.

And in some cases, for some people, it can make sense to go one step simpler. You can use a One Fund portfolio that would include something like a Target date fund a Vanguard LifeStrategy fund-- that's what I use-- or a balanced fund. A lot of fund companies offer those. They're very straightforward. They typically just have a fixed 60 stock/40 Bond allocation.

But if you're considering using a One Fund portfolio it's important to keep a lot of different things in mind before making that decision. Number one is that it's still important that the fund has a low expense ratio. That matters with these funds just as much as with any other mutual fund. High expenses are going to eat into your returns. Number two, it's really important to take some time to check the actual asset allocation for the fund, as well as the glide path which is how the allocation is supposed to change over time. Look into that rather than just relying on the name of the fund.

So for example, if your 401-k has a 2040 Target date fund and you're planning to retire in 2040 that fund might not be a good fit for you. Your personal risk tolerance could be much higher or much lower than whatever this fund company assumes is typical for somebody retiring in that year. Because there's more to risk tolerance than just what year you plan to retire.

So it's important to just look it up on the fund company website or Morningstar or wherever and see what the actual asset allocation is and see if that's a good fit for you because maybe again, using the 2040 example, maybe the 2030 fund or the 2050 fund is going to be a better fit for your personal risk tolerance.

And finally, the last important thing to keep in mind about all-in-one funds is that they aren't a good fit for taxable accounts. We were just talking about using tax efficient funds in a taxable account all-in-one funds are not tax efficient. There's a few reasons for that. Reason number one is that they use taxable bonds whereas for some people tax-exempt municipal bonds would be a better fit.

Reason number two is they get in the way of asset location. Remember asset location, the whole idea is to make sure to only own tax efficient things in your taxable accounts. Well with an all-in-one fund the whole point is to own everything. So it's going to include some tax inefficient stuff in that taxable brokerage account which isn't ideal.

And number three is that the third reason they're tax inefficient is that this fund-of-funds structure. So a Target date fund that owns underlying mutual funds. It adds another layer of turnover, right. If you imagine, for example, the Vanguard Target date funds, they've got four underlying mutual funds: a U.S stock fund;

international stock fund; U.S bond fund; international bond fund. And each of those four underlying funds has its own level of turnover and so that creates some taxes. But then the target date fund that owns those funds has its own turnover because it has to rebalance among those four underlying mutual funds and that creates some additional tax costs for you as well.

And sometimes you'll see a case, not going to name names, but a particular fund company this year switched one of the underlying funds in a significant way. It created a huge capital gain distribution for shareholders. It was really expensive. So these again, Target date funds, LifeStrategy funds, they're neat, they're great in a lot of cases, but they're not a good fit for a taxable brokerage account.

But why do we talk about investing with simplicity at all? Like why did this make it onto the list of Bogleheads principles, because rebalancing isn't frankly all that hard if you can use a spreadsheet. You can even do it with pencil and paper and a calculator, if you're inclined to do that sort of thing. But simpler portfolios do save you time. They take less time to rebalance, and if you're using an all-in-one fund like a Target date fund they completely eliminate the job.

So the example I always use is I compare it to doing the laundry, right. It's not like that's a really challenging job but it would be nice to never have to do it. That's what a Target date fund does. It just removes this chore from your life. And that's nice, but really that's not the most compelling reason, in my opinion that's not the most compelling reason to use a simpler portfolio.

The simple, or the better reason for a simpler portfolio is that it improves investor behavior. And to talk about that I want to highlight, the study that has come up--Alan mentioned it also--it's Morningstar's Mind the Gap study. And they do this study every couple of years. And every time they look at the last 10 years of mutual fund performance and they look at all of the different mutual funds that Morningstar looks at. So however many thousands of funds that is. And for each mutual fund they look at two things. First they look at the regular reported performance figure for that fund, right. So that's just the 10-year return figure that you would see on a fund company website or in a prospectus or in a brochure or something like that. And then the second figure that they calculate is what they call the investor return. And this is a dollar weighted figure. So it accounts for the cash flow that's coming into the fund or going out of the fund when shareholders buy and sell shares. And so the idea with this investor return figure is to reflect the actual return that the average investor actually earned in this fund over the period in question.

So if we consider a hypothetical actively managed fund, imagine it's brand new at the beginning of those 10 years, right. And so because it's brand new and that's also say it's from a brand new fund company so nobody's heard of it. It has almost no assets under management. And imagine that for the first four years of the 10-year period it has excellent performance, just incredible returns. And so during those four years people start to hear about it, right. It gets written up in some articles and so on, and so a bunch of money comes flooding into this mutual fund.

And then in our example here let's imagine that over the last six years of the period it has really mediocre performance. Well the regular 10-year performance figure ,the 10-year return figure for this fund, each of those 10 years is going to count the same as the other 10 years so it's going to have a pretty good 10-year return figure because those first four years were so good.

But the investor return figure is not going to be as good because those first four years nobody owned the fund during those first four years so they won't count for very much in the calculation in the last six years with the mediocre returns. That's when most people learned, owned the fund. So that's what will count for most of the calculations. So in this example you'll see a good 10-year return and a really mediocre 10-year investor return. There's going to be a big gap between the two. And that's why they call it the Mind the Gap study because we're looking at that difference.

And the point is that that gap is a measure of how well investors do with the timing of their buying and selling of the fund. So in our example here, this hypothetical fund, this big gap is the result of the fact that investors did a terrible job with the timing of purchases, right. They bought after the first four good years and right before the six mediocre years. So there's a big gap.

Now where I'm going with all of this if we look at the most recent edition of the study. So it came out this year and it looked at the 10 years ending December 31st of last year. These are the gaps for the different categories of funds. And the two things I want to highlight here are that the gap was smallest for allocation funds. That's basically things so that's Morningstar's term it's basically things that include stocks and bonds within the same mutual fund. So balanced funds, target date funds, life strategy funds. And the Gap was largest for sector equity funds. That would be things like a technology stock fund or a healthcare stock fund.

And because they do this study every couple of years of course the exact figures, the exact percentages, change from one edition of the study to the other. But this overall relationship is very consistent. Every time we see that investors do well with allocation funds. And to me that's not the slightest bit surprising because if you think about a target date fund, imagine you're using that in your 401-k. All it is is one fund. You just put money into the same fund. There's no temptation to move your money around. The whole point is to put it on autopilot.And so a lot of people do that. They put it on autopilot and that actually works really well.

And then the other thing we see every time is that investors do really poorly with sector equity funds, and again, to me that's not surprising because when you see portfolios that include sector equity funds they're usually portfolios that have like 30 mutual funds or something insane and so when that's what your portfolio looks like there's a huge temptation to move your money a little bit this way or a little bit that way. Or get rid of this fund and add that fund.

And that's not to say that you personally would do that. But there is very clear, this data from Morningstar makes it very clear that investors do that. And it's generally to their detriment. And they do it more often with funds that represent narrow slices of the market than they do with more broadly diversified funds. And that's true all the way up to the most broadly diversified allocation funds where investors do the best.

So the study also drills down into narrower categories of funds. And here we're looking at the gap for large cap stock funds, meaning funds that invest in stocks of large companies. And the gap for large blend funds--large blend meaning that the fund is not specifically a growth fund nor specifically a value fund, so it invests in growth stocks and value stocks--- he gap for large blend funds was about or exactly three quarters of a percent per year.

The gap for large growth funds was about 1.3% per year and the gap for large value funds was about 1.3% also. It's one of those cases where your intuition could trick you because you might expect that large blend is basically a blend of large growth and large value right so you might imagine that the gap for large blend would be between the gap for large growth and the gap for large value and it's not. It's smaller than either of those other two gaps. You've got investors doing better with the more broadly diversified funds than with the less diversified funds.

So why invest with simplicity. It does save you time and that is, frankly that's nice. I appreciate it but that's not the biggest benefit. The biggest benefit is just that it makes it easier to stick with your plan.

This is a quote from the conclusion of the most recent version of the study. The authors wrote, this is their italics by the way. They recommended that the reader focus on holding a small number of widely diversified funds. They went on to say that as the fund industry has grown asset management firms have rolled out more and more highly specialized funds, but investors have fared far better by keeping things simple and sticking with plain vanilla broadly diversified funds.

And then they went on to write that funds that offer built-in asset class diversification so that's funds that include stocks and bonds in the same fund, so target date funds, life strategy funds, balanced funds, they also excelled in the study. Not only are these funds easy to use but they're also easy to live with. Investors tend to buy and hold them for long periods, or make investments on a regular schedule like in a 401-k.

And that enforces investment discipline and helps them avoid the temptations and pitfalls of trading at the wrong time. So that's it for invest with simplicity.

[Applause]