SERVO

A Smarter Approach For Serious Wealth

FACTORS IN FOCUS

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Building on Bogle

by Eric D. Nelson, CFA

We've lost an investing legend. John Bogle, the founder of Vanguard, the largest mutual fund company in the world with over $5 trillion in assets, passed away last month. Bogle was best know for starting the first index mutual fund for retail investors in 1976, the Vanguard S&P 500 Fund. He changed the way we invest with an outspoken emphasis on capturing market returns, minimizing expenses, and staying the course (avoiding market timing). Hardly a month goes by that *Factors In Focus* doesn't mention one or all of these principles.

Bogle contributed significantly to the process of successful investing through the example he set at Vanguard and the thoughts he laid out in his many books and speeches. With that said, I think it's possible to build on Bogle's ideas, to more clearly define a framework for making smart decisions in pursuit of investors' most important lifetime financial goals. What follows are a handful of core concepts that recognize Bogle's contributions but also builds on them in a way all investors can embrace.

Absolutely No Active Management

John Bogle was relentless in his admonition of high fees. For Bogle, fees even trumped implementation. He was largely indifferent to the choice of index funds or actively-managed funds (he started both types of funds at Vanguard) as long as the expenses were low. I don't think investors can afford to be so fixated on fees or as cavalier about active management.

There is plenty of evidence that lower-cost investments outperform higher cost ones, all things being equal. But this doesn't mean simply opting for low costs results in a successful strategy. In DFA's 2018 Mutual Fund Landscape report, they reviewed all actively-managed stock and bond mutual funds from 2003-2017. Even after sorting the universe of funds by expense ratios and isolating the lowest quartile of costs, they found that 75% of actively-managed *stock* mutual funds and 83% of actively-managed *bond* mutual funds produced lower returns than their respective indexes. No matter how much of the fees you strip away, trying to beat the market through timing and security selection is a bad idea.

The Less Bonds The Better

After the essential decision to avoid active management, you need to determine an appropriate mix of stocks and bonds based on your goals, return requirements, time horizon, and tolerance for losses. Bogle's asset allocation advice was simple: hold your age in bonds (with the rest in stocks). But this ignores that most investors have long-term (in many cases multi-generational) goals and would likely benefit from a relatively high percent in stocks and the additional potential growth. It also misses the point that stock market losses have tended to diminish as the time horizon gets longer.

Stocks are volatile on a month-to-month and year-to-year basis, as we've all been reminded of recently. What happens to stock returns if we look at them over longer periods, such as 10 years? Since 1928, the S&P 500 has averaged +10.4% per year over all decade-long stretches, **outperforming bonds 82% of the time**! Bond (Five-Year Treasury Notes) returns, at just +5.4% a year over the same periods, were significantly less. 5% might not seem monumental but consider at these rates of

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return, the average 10-year growth of $1 in stocks was $2.68 versus just $1.69 for bonds. *That's quite a difference*.

Adopt Asset Class Diversification

Bogle introduced the Total Stock Index Fund in 1992, which was supposed to be a more diversified index fund than the S&P 500 because it included about 2,500 more stocks. But both indexes hold stocks in proportion to their overall size, which means both strategies are basically large cap *growth* funds. This would be fine if all stocks had the same returns, but long-term market data indicates otherwise.

Once again looking at all 10-year periods since 1928, we find that large and small *value* stocks have had consistently higher returns than the S&P 500. A 60/40 mix of DFA US Large Value and Small Value Indexes averaged +13.7%, beating the S&P 500 by +3.3% per year across decade-long stretches. $1 in value stocks over the average 10-year period has grown to $3.61, far more than bonds or the S&P 500. What's more, the Value Index beat bonds **94% of the time** and the S&P 500 **during 81% of 10-year periods** (about the same as stocks over bonds).

Diversifying internationally, especially with large and small cap *value* asset classes, can further improve portfolio outcomes. Over all 10-year periods since 1990 (inception of DFA Int'l Value Index), a 60/40 split of the DFA International Large Value and Small Value Indexes outperformed the MSCI International EAFE Index **94% of the time** by an average of +3.7% per year.

If higher returns and the increased consistency of those returns is important, it's clear that adding large and small cap value stocks in US and international markets to your portfolio is important.

Clarify the Course

Bogle's advice on portfolio management was also simple —*stay the course*. This is excellent advice but to implement it properly we have to define what the course is and how to navigate it.

For accumulators, those trying to achieve future growth and who also may be adding to their portfolios, the key is to rebalance as different asset classes behave randomly and unpredictably in the short run. Understanding the long-term tendencies of the core asset classes outlined above makes it easier for investors to sell holdings that have had above-average recent returns and buy more of the assets that have underperformed. As a general rule, no holding should be allowed to deviate by more than 20% from its initial weight. Contributions can be used first to bolster lagging positions, as can ongoing dividends and capital gains. When those options are exhausted, selling and buying shares will be required.

Retirees and investors needing ongoing cash flows will want to reverse-rebalance their portfolios by selling the asset classes that are the most overweighted from recent outperformance. In bull markets this will typically be the stock side of the portfolio. In bear markets, a short-term bond fund will tend to hold up better than stocks and can often be relied upon for liquidity while stocks trade at temporarily depressed prices. Selling from the most overweighted parts of the portfolio also serves to rebalance it back to the initial weightings, maintaining the agreed upon risk profile and expected returns.

These mechanical approaches remove a lot of the emotions of investing. Near-term future returns are less meaningful if you have a strategic approach to deploying your savings or generating income. Investing becomes less a process of *prediction-based forecasting* and more of one based on *balance and responsiveness*.

John Bogle will be sorely missed and his contribution to the field of finance cannot be understated. But there is much more work to be done to demystify investing, educate investors about how to make smart decisions, and reduce the unnecessary stress and anxiety of managing a portfolio and achieving your financial goals. That has been the mission of Servo and this newsletter since its first issue seven years ago and I expect the best is yet to come.

Source of data: DFA Returns Web

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