Lunch with Jack Bogle
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Along with about 500 other CFAs, I attended lunch with Jack Bogle at the Willard Hotel in Washington, DC. Below are my notes from lunch with one of our investment heroes who thought aloud with us about what lies ahead for investors.

"Thinking About What Lies Ahead for Investors"

Sources of Stock Returns

Simply put, there are two sources of stock returns: fundamental and speculative. Common stocks are themselves merely *derivatives*- a share of the returns derived from the firm, the present value of expected cash flows, a share of the intrinsic value of the company.

Ben Graham's description of the stock market as an imperfect voting machine in the short run and a weighing machine in the long run bears endless respect, according to Mr.Bogle. In the short run stock prices are based partly on emotion and partly on reason. In the long term, however, the stock market prices are driven by fundamentals. The stock market, driven in the short-term by speculators, is a big distraction to the business of investing. Short-term speculators are crowding investors out of the market. This is not good for investors.

Culture Clash

The mutual fund industry is a very different industry than the one that Jack Bogle entered 60 years ago. While not pleased with the change, he loves the mutual fund industry and wants it to live up to its potential to serve investors. In that sense, he has a "lover's quarrel" with the industry. He has six areas of culture clash concerns.

1. Speculators vs. Capital formation

Capital formation once was the purpose of the stock market. Providing fresh capital to business- capital formation-was once accepted as the principal economic mission of Wall Street. The process of allocating investment capital to the most promising industries, companies and innovators who seek to provide better and better goods and services was the market's core mission. Today, annual stock trading volume runs about $33 trillion. Speculators now account for 99.2% of annual trading volume. Capital formation account was about $250 billion or just 0.8% of total trading volume. *That* is a sizable imbalance.

2. Double Agency

Institutional money managers are often owned by corporations or large banks. Therefore, there is an inherent conflict of interest for money managers between making money for owners of the firm (often through high fees) and maximizing returns for their clients (helped by low fees). Today, 41% of the 50 largest mutual funds are owned by another institution, presenting a "no man can serve two masters" conflict for most mutual funds managers.

3. Ownership Society to an Agency Society

Since 1950, direct ownership of U.S. stocks by individual investors has plummeted from 92% of all shares to 30%, while indirect ownership by institutional investors has soared from 8% to 70%. Our old ownership society is gone, and it is not going to return. In its place we have a new “agency society” in which our financial intermediaries now hold effective control of American business. But these new *agents* haven’t behaved as agents should. While investing “Other People’s Money” should be based on trust and stewardship, our corporations, pension managers, and mutual fund managers have too often put their own financial interests ahead of the interests of the *principals* whom they are duty-bound to represent—those 100 million families who are the owners of our mutual funds and the beneficiaries of our pension plans. Some 200-plus years ago, Adam Smith described this “agency problem” in these simple terms: Managers of other people’s money (rarely) watch over it with the same anxious vigilance with which . . . they watch over their own . . . they very easily give themselves a dispensation. In the recent era, negligence and profusion have prevailed among our money manager/agents, even to the point of an almost complete disregard of their duty and responsibility to their principals. Too few managers seem to display the “anxious vigilance” over other people’s money that once defined the conduct of investment professionals. Our agency society has led to the deterioration of corporate governance.

4. Mutual Funds

The mutual fund industry has moved from management to marketing, from stewardship to salesmanship to the detriment of investors.

5. Index Funds

ETFs now account for about $18 trillion in annual transactions. The Spider ETF turns over 7,900 times annually without any benefit to capital formation. Indeed, the net impact of those transactions was zero minus all the transaction costs. When the capital development of a country becomes the by-product of the activities of a casino, the job of capitalism is likely to be ill done.

6. Under-Funding of Retirement Plans

Many pension plan sponsors hope for unrealistic investment returns of 8%. This bodes ill for future retirees and taxpayers.

Diving Deeper into the Culture Clash

Mr. Bogle began explanation of his concerns by pointing us to Chapter 12 of Keynes’ *General Theory*, noting that Keynes do not focus on historical returns, but rather, he focused on the two broad sources that explain the returns on stocks. The first was what he called *enterprise*—“forecasting the prospective yield of an asset over its entire life.” The second was *speculation*—“forecasting the psychology of the market.”

[Chapter 12 of Keynes’ General Theory describes the action of rational agents in a market using an analogy of the “most beautiful” contest. Contestants in the fictional newspaper contest were given pictures of faces and asked to pick the six most beautiful faces. Those who picked the most popular face were eligible for a prize.

Naïve contestants would choose six faces that, in the opinion of the entrant, were the most beautiful. A more sophisticated contestant, wishing to maximize his chances of winning the prize, would consider the majority perception of beauty, and then make a selection based on their knowledge of public perceptions. This strategy can be carried further to take into account the fact that other entrants would each have their own opinion of public perceptions. In the strategy’s next level, the contestant would attempt to predict the eventual outcome of the process based on the reasoning of other rational agents. “It is not a case of choosing those [faces] that, to the best of one’s judgment, are really the prettiest, nor even those that average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practice the fourth, fifth and higher degrees.” (Keynes, General Theory of Employment Interest and Money, 1936).]

Keynes conceded that competition between expert professionals, possessing judgment and knowledge beyond that of the average private investor, should correct the vagaries caused by ignorant individuals. Yet, Keynes predicted that the energies and skills of the professional investor would come to be largely concerned, not with making superior long-term forecasts of the probable yield of an investment over its whole life, but with foreseeing changes in the conventional basis of valuation a short time ahead of the general public [the “beauty contest]. Keynes described the market as “. . . a battle of wits to anticipate the basis of conventional valuation a few months hence rather than the prospective yield of an investment over a long term of years.”

In Mr. Bolge’s 1951 Princeton senior thesis on the mutual fund industry, he cited Keynes’ conclusion and had the temerity to disagree with the great economist. Rather than professional investors succumbing to the speculative psychology of ignorant market participants, Mr. Bogle argued, experienced pros would focus on enterprise. Portfolio managers would “supply the market with a demand for securities that is *steady, sophisticated, enlightened, and analytic*, essentially on the intrinsic performance of the corporation rather than the public appraisal reflected in the price of its shares.” Sophisticated and analytic focus on enterprise that Mr. Bogle had predicted from the industry’s expert professional investors has utterly failed to materialize. In fact, the emphasis on speculation by mutual funds has actually gotten worse since 1951. The score… Keynes 1, Bogle 0.

Putting Numbers on Keynes’s Distinction

By the late 1980s, based his own first-hand experience and research on the financial markets, Mr. Bogle concluded that the two essential sources of equity returns were: (1) *economics*, and (2) *emotions*. What Keynes had described as enterprise Mr. Bogle called “economics.” What Keynes termed“speculation,” Mr.Bogle found well-defined by “emotions.”

Economic returns were defined as *investment return*—the initial dividend yield on stocks plus the subsequent annual rate of earnings growth. Emotional returns were defined as *speculative return*—the change in the price investors are willing to pay for each dollar of earnings. Essentially, the return that is generated by changes in the valuation or discount rate that investors place on future corporate earnings.

Simply adding speculative return to investment return produces the *total* return generated by the stock market. For example, if stocks begin a decade with a dividend yield of 4 ½ % and experience subsequent earnings growth of 4 ½ %, the *investment* return would be 9%. If investors are willing to pay $15 for each dollar of earnings (the price-earnings ratio) at the beginning of the decade and $20 at its conclusion, that 33 % increase, spread over a decade, would translate into an additional *speculative* return of about 3 % annually.

Simply adding the two returns together, the total return on stocks would come to 12%. It's not very complicated!

This remarkably simple numeric approach of separating enterprise and speculation—i.e., investment return and speculative return—has been borne out in practice. Indeed, once again Mr.Bogle has the temerity to suggest that Lord Keynes would respect this mathematical extension of his concept. Decade after decade over the past century, we can account, with remarkable precision, for the total returns actually earned by U.S. stocks.

Investment Return and Speculative Return

The *investment* return on stocks has proven to be remarkably susceptible to reasonable expectations. The initial dividend yield—a crucial, but today underrated, factor in shaping stock returns—is a known factor at the moment one invests. The steady contribution of dividend yields to investment return during each decade over the past century has always been a positive, only once outside the range of 3% to 5%. The yield was only 1% when the year 2000 began, a red flag that investors should have heeded.

The long-term rate of earnings growth, on the other hand, while hardly as given to precision as the current dividend yield, is relatively stable. The fact is that after-tax corporate earnings have historically grown at about 5% in nominal terms, roughly the same rate as the growth of our economy. Earnings have rarely represented less than 4% of our annual GDP, nor have they represented more than 8%. Today, corporate profits, at an all time high at more than 9.5% of GDP, could be a warning sign. Though there are reasonable explanations for this anomaly including the high percentage of earnings derived from overseas, the weak dollar and accounting chicanery.

With the exception of the depression-ridden 1930s, the contribution of earnings growth was positive in every decade, usually composing between 4% and 7% per year of total stock returns. If we can but recognize that corporate earnings have, with remarkable consistency, grown at about the rate of the GDP, we can understand that the fundamentals of our economy drive long-term stock returns.

But, in the short-term, it is speculative return that calls the tune. *Speculative* return is speculative, and has alternated from positive to negative over the decades, as price-earnings multiples are highly volatile. Over history, P/Es have generally ranged from 10 times to about 25 times, although as high as 40 times a decade ago! When P/E ratios are historically low, say, below 10 times, they have been highly likely to rise over the subsequent decade. And if they have been historically high, say, above 20 times, they have been highly likely to decline. But in neither case is it given to us to know *when* the change is coming. So, certainty about the future never exists, nor are probabilities always borne out.

But applying reasonable expectations to investment return and speculative return and then combining them has proved to be a sensible and effective approach to projecting the total return on stocks over the decades.

The point is this: over the very long run, it is the *economics* of investing—enterprise—that has determined total return. The evanescent *emotions* of investing—speculation—so important over the short run, have ultimately proven to be virtually meaningless.

In the past century, for example, investment return accounted for fully 9.3% of the 9.5% annual return on U.S. stocks (an average dividend yield of 4% plus average annual earnings growth of 5%). *Speculative* return—the result of an inevitably period-dependent increase in the price-earnings ratio from 13 times to 21 times—accounted for only 0.2% of the total. *Conclusion: Long-term ownership of American business, then, has been a winner's game.*

Bond Returns

Unlike stocks, interest rates have no reversion to the mean, though there is a stable relationship between current yields and returns 10 years into the future. For example, in 1980, the initial yield on intermediate-term government bonds was 14%. Bond returns during the next decade averaged nearly 13%. With current yields on intermediate government bonds below 1%, one can expect, at best, a 3% return on bonds during the next decade.

Reasonable Expectations for Future Returns

Expect equity returns during the next 10 years to be between 6% and 8%. This return consists of dividend yield of 2% and earnings growth of 5%. With the market's current P/E multiple of 16, close to the historical average, speculative return or P/E change is assumed to be 0.

Expect bond returns during the next decade to be between 2% to 4 %. This return is based on current 10- Treasury Notes currently yielding less than 2%. If you blend corporate bonds into the bond portion of your portfolio, some yielding 3.5%, your can expect a 3% return.

The Elusive 8%

A traditional investment policy portfolio with 60% allocated to equities and 40% allocated to fixed-income investments can expect a 5.4% annual return (.60*7% + 40*3%), assuming no alpha is added by investment mangers.. Subtract management fees of 0.06% for the equity portfolio and 0.10% for the bond portfolio and the net expected return is 5.3%, a long way from 8% assumed by many pension plans.

Earning an 8% return in a 5.3% world is an ambitious goal indeed. Especially when one considers that defined benefit (DB) plans are estimated to have a $500 billion deficit with corporate DB plans 80% funded and municipal DB plans 70% funded.

So, how could one get to the elusive 8%?

It would take earning the long-term 9.5% average annual return on a 40% equity allocation, a net-of-fees 3.5% return on a 30% bond allocation plus a 12% after-fee return on a 30% allocation to alternative investments (venture capital and hedge funds), a very tall order given the various sources of expected returns. For a great read in understanding stock returns, Mr.Bogle suggested that investors read an article by Clifford Asness (a very smart man according to Mr.Bogle) titled "Money Masters, Part 5: The Five-Percent Solution" published in the May 15, 2012 issue of Institutional Investor. Cliff accepts yield environment as it is. He suggests that no matter how painful, investors should avoid reaching for yield. Yet, the current rate environment with expected 3% real returns (after inflation) from a balanced portfolio is an iron-clad formula for failure. One can hope there will be a reversion to the mean for equities.

In conclusion, Mr.Bogle sees mid-2012 as a very challenging time though financial markets in the U.S. are not unreasonably valued. Ultimately, stock returns follow GDP growth, which has been subdued. Bond yields are awful. Both Keynesians and classical economists (Hayek) offer economic solutions, government spending to boost aggregate demand for Keynesians and austerity offered by classical economists. Yet, none of these solutions seem to be working. Regulation will be required to right some pieces of the culture clash.