Vanguard's Bogle: Indexing Has Gone 'Too Far' by: Paula Vasan

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Quiet and peaceful Valley Forge-Pa. is not a place where one would expect to find one of the most successful financial businesses in history — a far cry from the hurry and shuffle of Wall Street. But Vanguard's home there speaks volumes about its ability to maintain its reputation as the lowest-cost provider of mutual funds and ETFs since John Bogle founded the company in 1974, operating on a low-cost basis in a financial world motivated and dominated by profit.

There, 84-year-old Bogle sits signing hundreds of copies of his new book: The Man in the Arena, which just hit bookshelves on Dec. 4, his office desk completely covered with a mounting pile of papers, portraits and pictures of his family on every wall, still energized by the purpose of his work. Be careful not to put down a glass of water on any magazine resting on the coffee table — it's probably a collector's item.
This edited transcript is part one of a series, with a more in-depth version of each conversation online. It came out of a nearly 90-minute chat, partly over PB&Js, his lunch of choice.

Q: You've made a name for yourself arguing about the advantage of index funds over traditionally managed mutual funds. Given the proliferation of indexes, many with slight but meaningful differences, what should money managers and advisors consider as they weigh various index funds against each other?

I think it's gone much too far. Most of them are not worth the powder to blow them to hell. I think there are 1,500 ETFs in the U.S. It doesn't work in the long-run. I can't think of a worse way to invest. All that leverage doesn't work over the long term.

Commodity ETFs also have a big problem with contango. Roughly speaking, the funds can't always deliver the returns an investor would expect based on the value of the underlying commodity. For example, oil prices might be rising, but an oil ETF could still lose money. And they are a bunch of those narrow market segments — particularly in international markets, which I think are risky in a way the U.S. is not.

One of the original ETFs is called Emerging Cancer. I wrote about it in a Wall Street Journal op-ed and I got a nasty letter from this company saying, "look you had your chance to do what you wanted to do and it worked fine so let us do what we want to do and see how that works." The Emerging Cancer ETF is now gone. The fact that it was dealing with cancer research and genetics was just too narrow.

It's 1,450 out of 1,500 ETF funds that I just wouldn't touch because they're not diversified enough. Or they have some huge speculative twist to them that if you can guess the markets right you will do very well for a day or two but who can do that? Nobody.

When I came into this business, institutions owned 8% of all stocks and now they own 70% of all stocks. And all those smart people are of course average. It's all mad and people don't understand this. They all think they can win when obviously only half of them can win.

Q: You say that it is a mistake for actively managed mutual fund managers to expect their performance to surpass a well-run index fund over a long period of time. Where is there opportunity for active management?

You've got to think you can pick above average funds and the way you can do that is by looking at performance. In my last book The Clash of the Cultures: Investment vs. Speculation, chapter nine presents a series of eight charts depicting returns for the great mutual funds of the modern era versus the stock market: Magellan, Janus Capital, Windsor, Ivest (the fund I made the horrible mistake of taking on with the merger back in 1966). Each fund hits a high relative to the market, then reversion to the mean sets in and they never hit their high again. You can find this pattern in a lot more funds. People look back and they saw this great performance and they said the past is prologue and unfortunately in this business the past is probably anti-prologue. The better you've done yesterday the worse you'll do tomorrow. It's almost written in the cards.

So if you want to feel good: I tell people to put 95% in a serious money account (a big index fund in one form or another) and 5% in your "funny money" account. You'll see this in my book — I call them TIFs (traditional index funds) to differentiate from ETFs. The problem with ETFs is that they are traded like a fury. There's nothing wrong with buying Vanguard Total Stock Market Index Fund either as a TIF or as an ETF. They both charge five basis points. And they both have the same tax efficiency, which is very high. People will talk about tax efficiency as a reason for these ETFs but indexing is inherently tax efficient so they're low cost (no difference), they're tax efficient (no difference) and the third quoted advantage is the ability to trade all day long in real time. "Now you can trade the S&P 500 Index in real time" was the slogan in the newspapers for the first ETF. What kind of nut would do that?

Q: Let's talk about alternatives, which seem to be a buzzword in the financial world. Is the hype justified?

I think most of them are silly. First they're faddish. When an alternative comes up as a diversifier, advisors say you need to diversity the different asset classes. But it's always the asset class that's done well recently. So gold is popular now. The problem with anything to do with commodities or gold is that they have no internal rate of return. What protects you from a bad judgment on an individual investment if your timing is bad in stocks or bonds is that in the long-term the income bails you out. Bonds are supported by the interest coupon. And stocks are supported by those growing dividend yields and earnings and will be for a long time I think. So what's the internal rate of return with gold? There is none.

What there is, however, is hope that you can sell it for more than you paid for. That's what we call rank speculation. So if you want to speculate on gold, be my guest. But understand that it's not really an investment. Real estate is supposed to be a separate asset class. It gets popular, the prices get bid up, without people realizing that real estate in securitized form is different from real estate itself. In other words, you buy an apartment building and collect rents and so on, and you're there. You're participating. But you put it in securitized form and the valuation of that apartment going up and down in value every day while the income stream remains the same to you.

Let’s talk about your financial views from a more personal perspective. Do you have grandchildren?
I have 12.

What are their ages?
The youngest is going to be 17 in February and the oldest is 29.

What do you tell your grandchildren when it comes to saving and investing?
I do try to help them out by putting money away for them, but I’m not going to help them now or with any significant amount. I put it in a balanced income fund: 60% in U.S. stocks, 40% in U.S. bonds. I don't really try to teach them investment lessons. They look at things differently. And of course at that age the idea of saving anything is not so easy. Some of them have reasonably high paying jobs. Some of them do not. But I tell them to start save now. But four or five of my grandchildren are barely entering the workforce or not even that. Just one left to go to college, three in college. And the others know when I’ve been doing — they know the index story.

How should money managers and advisors support college savings plans?
For my grandchildren I use, and have been putting up for a long time, Vanguard’s balanced index fund: 60% stock market index, 40% bond market index. Since I was able to help, along with their parents, to pay the bills I never had to take any money out so they have a nice little nest egg there. I put a little money away every year for them as I can.