Bogle: Indexing Has 'Gone Too Far'

BY: PAULA VASAN

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Vanguard has preserved a reputation as the lowest-cost provider of investment options since John Bogle founded the company in 1974, operating on an at-cost basis in a world motivated by profit.

Forty years later, Vanguard is dominates the mutual fund industry, while the 84-year-old serves as president of Bogle Financial Markets Research Center, housed on Vanguard's campus and often described as his personal think tank. He sat down with Financial Planning over PB&Js, his lunch of choice, to discuss the proliferation of indexes, the growth of ETFs and the role of independent advisors. Below is an edited version of the conversation.

The growth in passive investing has greatly benefited Vanguard. What are the implications?

It's a revolution in investor preferences. Since 2008, people have taken over $460 billion out of actively managed funds and invested $540 billion in index funds. That's a $1 trillion shift. And to put that in some kind of perspective, the total assets of equity mutual funds are about $6 trillion. I don't see this trend changing.

People are wising up. Advisors are using index funds much more often. And there's an interesting sub-trend: About half of the growth of indexes are in ETFs.

What's your view on the current state of ETFs?

The problem with ETFs is that they are traded like a fury. The slogan for the first ETF was, "Now you can trade the S&P 500 Index in real time." What kind of nut would do that?

Why don't more money management companies follow Vanguard's model?

Because they want to make money for themselves and for their owners. Forty of the 50 largest mutual fund companies are either publicly owned or owned by financial conglomerates. And when they come into this business, they are seeking what every capitalist firm seeks - to increase the return of their own capital.

Why does Vanguard's strategy work?

You have to understand that when I created Vanguard's mutual structure back in 1974, I had no idea it would grow this large. If we weren't the low-cost provider, we certainly wouldn't be anywhere near $2 trillion. And we'd probably have more competition on the index front.

The low-cost provider will win in this business, because most firms don't really want to be the low-cost provider.

Given the proliferation of indexes, how should advisors 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. There are 1,450 out of 1,500 that I just wouldn't touch because they're not diversified enough. Or they have some huge speculative twist to them.

There 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 early ETFs was called Emerging Cancer. I wrote about it in a Wall Street Journal op-ed and I got a nasty letter from the company. But the Emerging Cancer ETF is now gone. The fact that it was dealing with cancer research and genetics was just too narrow.

What big trends do you see in the advisor world?

We now have a sweeping trend toward advisory fees. There are wirehouse people who are on commission, and then you've got the RIAs who are doing both commissions and fees - which is a very difficult split to maintain. I have the most confidence in fee-only advisors, because I think they have a better sense of fiduciary duty than the people whose duty it is to sell the day's merchandise.

Do investors really need advisors?

Some do. Not that the advisor can help clients with trading - there's no reason why an advisor is a better trader than a client, or a worse one.

I was out in the Midwest many years ago speaking to a group of advisors and I was telling them about the magic of a 65/35 portfolio. One came up to me after the speech and said: "Look, I know you're right, but I have this client: He comes in and I told him to do a 65/35 portfolio. A year later, the client said, 'It looks pretty good. What should I do now?' I told him to do nothing. The client comes in a year later and said, 'I haven't done anything for two years now, there must be something I should do.' So I said, 'Nope, do nothing.' Eventually the client says: 'What do I need you for?'"

I told the advisor that the reason the client needs him is to keep him from doing anything. Maybe it's not worth 1% a year in fees, but maybe it is.

Are advisors getting paid too much?

We have to think very much about it. A fee of 1% is said to be typical. If you think about the return on stocks in the next 10 years, you're going to be looking at maybe 7%. Dividend yield is known - about 2% today. I expect that will grow over time. The other component of investment return is earnings growth, which I think could be about 5% per year over the coming decade.

So a reasonable expectation for stock market returns over the coming decade is 7%. Then take out likely inflation. Let's say we hold it at 2% or 3% - so now we're down to 4% return. Mutual fund expenses run about 2% per year for actively managed funds. That's another 2%. So now if you think about taxes, because mutual funds are extremely tax inefficient, take away another 1%. That gets you down to 1%, and the advisor consumes the rest of your return.

Paula Vasan is a senior editor of Financial Planning. Follow her on Twitter at @paulavasan