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Six Lessons for Investors

Be diversified and don't assume past performance will continue.

By JOHN C. BOGLE

There is almost no limit to the ability of investors to ignore the lessons of the past. This cost them dearly last year. Here are six of the most important of these lessons:

1) *Beware of market forecasts, even by experts.* As 2008 began, strategists from Wall Street's 12 major firms forecast the end-of-the-year closing level and earnings of the Standard and Poor's 500 Stock Index. On average, the forecast was for a year-end price of 1,640 and earnings of $97. There was remarkably little disparity of opinion among these sages.

Reality: the S&P closed the year at 903, with reported earnings estimated at $50.

Strategists aren't always wrong. But they have been consistent, betting year after year that the market will rise, usually by about 10%. Thus, they got it about right in 2004, 2006 and 2007, but also totally missed the market declines in 2000, 2001 and 2002, and vastly underestimated the resurgence in 2003.

Ignore the forecasts of inevitably bullish strategists. Bearish strategists on Wall Street's payroll don't survive for long.

2) *Never underrate the importance of asset allocation.* Investing is not about owning only common stocks. Nor are historical stock returns a sound guide to future returns. Virtually all investors should keep some "dry powder" in their portfolios in the form of high-grade short- and intermediate-term bonds. Investors who failed to learn that lesson fell on especially hard times in 2008.

How much in bonds? A good place to start is a bond percentage that equals your age. Although I don't slavishly adhere to that rule, my bond position accounted for about 65% of my personal portfolio in early 2000. Because returns on my bond funds since then have totaled 50% and returns on my stock funds were negative 25%, bonds are now about 75% of my portfolio, still close to my advancing age.

With all the focus on historical returns that greatly favor stocks, don't ignore bonds. Consider not only the probabilities of future returns on stocks, but the consequences if you are wrong.

3) *Mutual funds with superior performance records often falter.* Last year was an extreme example. With the S&P 500 off 37% for the year, Legg Mason Value Trust fell by 55%. Fidelity Magellan Fund, after a good 2007, was off 49%. Funds managed by proven long-term pros felt the pain -- Dodge and Cox Stock down 43%; Third Avenue Value down 46%; CGM Focus down 48%; Clipper down 50%; Longleaf Partners down 51%. (Full disclosure: Four of Vanguard's actively-managed equity funds also lagged the market by wide margins.)

Only time will tell whether the disappointing shortfalls experienced by these and other funds will be recovered in the future, whether the skills of their managers have atrophied, or whether their luck has run out. Whatever the case, chasing past performance is all too often a loser's game. Managers of funds seeking market-beating returns should make it clear to investors that they must be prepared to trail the market -- perhaps substantially -- in at least one year of every three.

4) *Owning the market remains the strategy of choice.* Such a strategy guarantees a return that lags the market return by a minuscule amount, and exceeds the return captured by active equity-fund managers as a group by a substantial amount. Why? Because the heavy costs incurred by investors in actively managed equity funds can easily amount to 2% to 3% annually. Typical expense ratios run from 1% to 1.5%; the hidden costs of portfolio turnover often come to 0.5% to 1.0%; a 5% front-end sales load, amortized over a holding period of five to 10 years, adds another 0.5% to 1.0% per year in costs.

As a group, investors are by definition indexers. (That is, they own the entire market.) So indexing wins, not because markets are efficient (sometimes they are, sometimes they are not), but because its all-in annual costs amount to as little as 0.1% to 0.2%.

Indexing won in 2008 by an especially wide margin. Low-cost, low-turnover, no-load S&P 500 index funds outpaced nearly 70% of all equity funds, and (admittedly a fairer comparison) more than 60% of all funds focused on large-cap U.S. stocks. This continues the pattern -- with some variations -- that goes back to the start of the first index fund 33 years ago. The bond index fund did even better. Its return of 5% for 2008 outpaced more than 80% of all taxable bond funds.

In sum, active management strategies as a group lose because they are expensive. Passive indexing strategies win because they are cheap.

5) *Look before you leap into alternative asset classes.* During 2006-07, equity

mutual funds focused on developed international markets and emerging markets provided strong relative returns to U.S. stocks. During that period, U.S. investors made net purchases of $285 billion in mutual funds investing in non-U.S. stocks, and liquidated on balance some $35 billion from funds focused on U.S. stocks.

This extreme example of "performance chasing" at its worst is hardly defensible. But, disingenuously, it was touted by fund marketers as adding "non-correlated assets," or "reducing volatility risk." In 2008 -- with non-U.S. developed market funds falling by 45% and emerging market funds tumbling by 55%, we learned once again that, just when we need it the most, international diversification lets us down.

Commodities were no different. As the global recession developed, commodity funds sank, the largest such fund tumbled 50%. Always keep in mind: When the investment grass looks greener on the other side of the fence, look twice before you leap.

6) *Beware of financial innovation.* Why? Because most of it is designed to enrich the innovators, not investors. Just think of the multiple layers of fees to the salespersons, servicers, banks, underwriters and brokers selling mortgage-backed debt obligations. These new products (credit default swaps are another example) enriched their marketers during 2005-07, only to impoverish the clients who held them in 2008.

Our financial system is driven by a giant marketing machine in which the interests of sellers directly conflict with the interests of buyers. The sellers, having (as ever) the information advantage, nearly always win.

We can't say that we haven't been warned about the perils of ignoring the past. More than 2,000 years ago, the Roman orator Cato noted that, "there must be a vast fund of stupidity in human nature, or else men would not be caught as they are, a thousand times over, by the same snares . . . while they yet remember their past misfortunes, they go on to court and encourage the causes to what they were owing, and which will again produce them."

While the events of 2008 reinforced that message, perhaps these stern and oft-repeated lessons of experience will help investors avoid similar mistakes in 2009 and beyond.

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