



## **John Bogle: Fixed Income Indexing and his 2008 Market Forecast**

**In response to our [interview](#) with John Bogle last summer, one of our readers (who asked to remain anonymous) posed the following questions:**

I have read this and other past interviews with John Bogle. There are some points that are never raised.

Mr. Bogle is a proponent of indexing, but it is always in reference to equities, not fixed income. In a past interview he referenced Vanguard's bond funds as quasi-index. (To me that was a cop-out). The same evidence supports indexing fixed income, yet the Total Bond Market is likely the fund that most closely follows the index. I don't think it is fair for Mr. Bogle to walk both sides of the line on this issue. On the bond funds that I monitor, Vanguard occasionally will even change the fund benchmark, which is not fair to investors. (I realize this will help their performance comparison). There should be a permanent primary benchmark. They can add a secondary active benchmark. Unfortunately, one gets the impression that he is simply building in wiggle room to his story with regard to indexing and fixed income. This issue really needs to be brought into light. Mr. Bogle should press Vanguard to change this.

On the discussion of ETFs and traditional funds, I believe there are several points in favor of ETFs over traditional funds:

1. As an advisor it is difficult to manage a client's overall fixed income portfolio when each of Vanguard's component funds is not following a specific mandate. You cannot effectively manage duration or credit quality.
2. Vanguard like other fund companies will arbitrarily close a fund to new investors. If an advisor is managing a client base and brings on new clients, this is a nightmare.
3. Finally, Vanguard has put advisors at a disadvantage to their clients going direct to Vanguard because they can buy in a lower expense ratio share class (Admiral) with a \$100,000 minimum, but an advisor must meet a \$5 million per fund to obtain the same expense ratio.

### **Mr. Bogle responds:**

I'm happy to respond to your reader's questions. I'll take them on in the order in which they were asked.



1. It's just not true that I have been a proponent of stock indexing and not bond indexing. See chapter 13 of my Little Book, and other chapters in 50 Years and Common Sense (1999), as well as my 2007 speech to Fixed Income Analysts Society (on my website). Essentially, I argue that bond indexing is even more certain of success than stock indexing--no mean claim!
2. While the taxable (corporate and U.S. government) bond index funds that I created all those years ago were--and remain--"pure" index funds, I have referred to our tax-exempt (municipal) bond funds as "quasi-indexed," simply because that's what they are. Why? Because in that market, the number of issuers is vast, with few single issues dominant, and issues differ greatly in their attributes (i.e., diverse call provisions) As a result, no reliable, trackable indexes exist. So we hold maturities in each portfolio relatively constant, diversify broadly, keep quality high and turnover low, and slash expenses to the bare bones. That's a pretty good definition of indexing. But I call it quasi-indexing so as to be technically accurate.
3. I know of no changes in the benchmarks for our bond index funds. And it would be, well, stupid (as well as unethical) to change benchmarks to improve performance comparisons--after all, it is future performance that we seek, and yesterday's pushover benchmark may be tomorrow's unbeatable paragon.
4. As far as I know--of course I no longer run this place--all of our fixed-income funds follow specific mandates. For the record, in my (tax-deferred) retirement plan here, I'm indexed to the tune of about 90% of my bonds, and in my personal (taxable) holdings 100% in our quasi-indexed munis. I'm completely satisfied with these choices.
5. Your final two questions will need to be addressed by my successor, Mr. Brennan. I have nothing to do with our decisions to close funds (although, even knowing the hazards that creates for advisers--and investors--I closed down many a fund in my day. Something about not wanting "to kill the goose that laid the golden egg.") And while I introduced the Admiral concept (lower expense ratios for larger investments) some 15 years ago, I also have nothing to do with our later decisions on when and where to apply these breakpoints. I'm pretty sure that Mr. Brennan will respond to you promptly on these two issues. [Ed. Note: Mr. Brennan's response was not available as of our publication date, but we will print it once we receive it.]

Maybe I'm getting too sensitive in my later years, but I totally resent and disclaim the suggestion that I'm "copping-out" and "walking both sides of the line." My principal remaining objective of a long lifetime can be said to be "to get out of this world with my reputation intact," and I'm astonished that anyone even remotely familiar with my work could suggest the opposite.



Happy New Year, to you and your anonymous client. I may be wrong, but I think 2008 will be a year for investors to be especially careful.

Best,

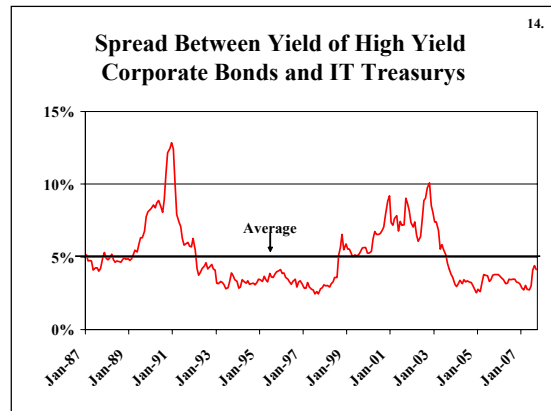
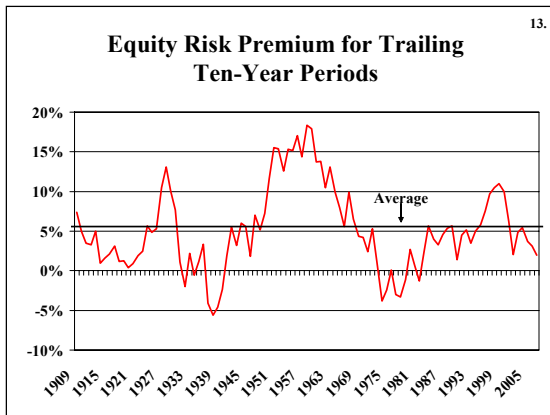
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**We asked Mr. Bogle to elaborate on his forecast for 2008. He provided us with a speech entitled “Black Mondays and Black Swans,” which he gave to the Risk Management Association in Boca Raton, FL, on October 11, 2007, marking the 20<sup>th</sup> anniversary of Black Monday (October 19, 1987), when the market fell 25% in a single day. His speech concludes with the remarks below regarding his outlook for 2008. A complete copy of the speech is available on our website.**

**In the section of his speech preceding the portion below, Mr. Bogle describes the increasingly dominant role the financial sector has taken in our economy, through the growth of derivatives markets and financial transactions. He goes on to describe the mortgage-backed securitization that led to the sub-prime debt crisis as the latest manifestation of our increasingly complex financial markets. This is the ‘systemic risk’ he refers to in the first sentence.**

### **Looking Ahead**

But if systemic risks are increasing, how can it be that risk premiums on stocks are at less than one-half the historic average? Today’s projected equity premium, for one example, is just 2 percent, some 60 percent below the century-long average of 5.2 percent. **(Chart 13)** Bonds, based on the current yield on investment-grade issues, should return about 5 percent over this period. The stock return over the coming decade is projected at 7 percent, based on today’s dividend yield of about 2 percent and prospective nominal earnings growth of about 6 percent, with a shading for the slightly lower price-earning ratio that I expect a decade hence. And while the spread of high-yield bonds relative to U.S. Treasury bonds has risen from 3 percent to about 4 percent after the recent unpleasantness in the mortgage market, it remains below its long-term average of 5 percent. **(Chart 14)**



Our markets, then, seem to be ignoring the warning issued by then-Federal Reserve Chairman Alan Greenspan in 2005: *“History has not dealt kindly with the aftermath of protracted periods of low risk premiums.”* When participants in the financial services field ignore the lessons of history, yet another series of risks are created.

### Other Risks

There are, I regret to say, other huge, seemingly unacknowledged risks beyond the financial sector, out there in our society. The risks presented by the Social Security and Medicare payments committed to by our national government. For that matter, the staggering string of huge (and in fact *understated*) deficits in our Federal budget. Our enormous (soon to reach \$1 trillion) expenditures on war in Iraq and Afghanistan (with more to come, perhaps in Iran), bleeding the resources of our empire; terrorism; and the threat of global warming and the cost of dealing with it.

You all know about these risks, of course, but there are other more subtle risks too. A political system dominated by money and vested interests; a congress and an administration seemingly focused entirely on the short-term, the long-term consequences be damned. The vast chasm between the very wealthiest among us (the top 1 percent of our citizenry holds more than a third of our total wealth) and those at the bottom of the economic ladder. (Did you know that 20 percent of New York City residents earn less than \$8,300 per year?) The implications of



our enormous trade deficit and unfettered global competition. Our self-centered “bottom-line” society, focused on money over achievement, charisma over character, and the ephemeral over the eternal. And finally, the paucity of leaders who are willing to, well, lead, to defy the conventional wisdom of the day, and to stand up for what is right and noble and true.

So the risks are high; the uncertainties rife. Yet perhaps we’ll all muddle through. After all, America has always done just that, all through our 230-year history. Perhaps, too, our society and our economy will continue to reflect the resilience that they have demonstrated in the past, often against all odds. And perhaps we’ll come to our collective senses and develop the courage to take arms against this sea of troubles and by opposing, end them. The stock market, indeed, seems to be saying just those things, and I hope it’s right.

But we’d best not forget Lord Keynes’s warning of 70 years ago: “When enterprise becomes a mere bubble on a whirlpool of speculation the consequences may be dire... When the capital development of a country becomes a by-product of the activities of a casino, the job (of capitalism) is likely to be ill-done.” Whatever the case, some surprising event out there, far beyond our expectations, will surely come to pass, an event that may carry an extreme impact, and one that, once it happens, we’ll quickly concoct an explanation as to why it was so predictable after all. That event, if—perhaps I should say *when*—it comes, will be just one more Black Swan.

<sup>1</sup> Greenspan, Alan, 2005. Remarks at a symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, (26, August).

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