



Responses to Our Interview with John Bogle

Our [interview](#) last week with John Bogle elicited many responses. Most were complimentary, including one from an individual investor who said that he was firing his broker and putting all his money in index funds. A number of readers took issue with some of the points Mr. Bogle made, and below is a sampling of those responses:

Dear Editor,

Your recent interview with Mr. John Bogle on “Active Management, Diversification, and the Future of the Mutual Fund Industry”, was very interesting. However, with all due respect to Mr. Bogle, I believe his prediction that “We will unequivocally move to a greater emphasis on passive investing indexing” will prove incorrect. To begin with, there are two very powerful emotions that have always and will always play a significant roll in driving investment decision making. These two emotions are fear and greed. The latter is what drives investors toward active portfolio management, in search of higher returns. There will always be a sizeable group of investors who will be attracted to the potential or promise of higher returns. I just don’t see this ever going away. Whether it is hedge funds or alternative investments, there will always be a “better mousetrap” that will attract the masses.

More importantly, the overall benefits of active management go well beyond generating relative portfolio returns. While historical data does support Mr. Bogle’s view that most active managers trail the benchmarks after fees on a long-term basis, this misses an important point of how fear and greed impact investment decision making. Historical money flow analysis illustrates that the vast majority of investors are most bullish at market tops and most bearish at market bottoms. Again, fear and greed drive decision making with destructive effects at both ends of the spectrum. In reality, very few investors can hang in there during tough times nor can they remain well grounded during the boom periods. They invariably risk too much close to the top and risk too little close to the bottom.

Herein is where professional active managers earn their additional fee by guiding their clients through the emotional rollercoaster of each market cycle. This fee is justifiable as long as it is a reasonable fee (more on this later). The most important value-added service an active manager brings to the table is not achieving a high relative return, but preventing clients from making harmful emotional decisions that destroy portfolio value. A passive investment strategy rarely involves a long-term personal relationship with an experienced investment professional who can provide unemotional counsel when it is needed most. Part of the active management fee pays for the relationship that is so critical during turbulent times in the market. Passive investing works for Mr. Bogle



because he has the wisdom and discipline to avoid emotional decision making. Unfortunately, few investors have this ability.

At the same time, I do agree with Mr. Bogle that there will be continued pressure on fees in the money management business. Archaic business models involving over-diversified, manager of manager, or fund of fund approaches, resulting in total costs to the client from these layers of fees and expenses of 2-3% will be increasingly threatened, especially if future market returns are more in-line with historical averages.

While a business model based on total costs to the client of 2-3% is unsustainable, an active management fee around 1% is reasonable and sustainable in the context of the total value added that the active portfolio manager can bring to the table. The total value added equation includes fees and performance, but also the ability of the manager to protect the investor from making emotional decisions.

In today's market place there is a huge opportunity between low-cost passive investing which requires the investor to have the wisdom and discipline to withstand the never ending emotional pressures of fear and greed, and the high cost manager of manager model. This void will be filled by RIAs who manage assets internally in a cost-effective manner using individual securities. The market can sustain fees around 1% using this separate account management approach.

The relationship and trust that active managers have with clients is critical during the extreme periods of fear and greed. Investors would be well-served by paying a management fee around 1% for this wisdom and counsel.

Michael Kayes, CFA
President
Willingdon Wealth Management

Dear Editor:

I really enjoyed the interview with John Bogle in the most recent newsletter, although I can't disagree with him more about some of the points on ETFs...

Bogle: I have the same doubts about tax efficiencies. How efficient can you be if you are a trader? The SPDR is no more tax efficient than the traditional Vanguard index fund.



This gets bandied about a lot with ETFs. Because traders use ETFs and create taxable issues for their own account does not make ETFs less tax-efficient in their own regard. The structure is sound and the SPDR is more tax efficient and this has been proven in a study by Morgan Stanley. It has only paid one capital gain in 13 years of operation. Vanguard 500 cannot match this claim nor can the average S&P 500 Index Fund. This is erroneous on Mr. Bogle's part.

Bogle: I don't believe that ETFs have either tax efficiencies or lower costs. The costs of the Vanguard ETFs are around 8 or 9bp, as compared to a regular index fund, which is 11 or 12bp with a \$100k investment. But you must pay a commission when buying an ETF, and this will erase the difference. There are a lot of ETFs with costs of over 100bp, so they are not uniformly low cost alternatives, especially once you add in those commissions.

There are not "a lot" of ETFs with over 100bp expense ratios. A lot of people have brokerage accounts in this world where they have to pay commissions for no-load funds, too. In fact, I have to pay \$9.99 to do an ETF trade in my account and \$19.99 for a mutual fund. Yes, this cost would go away if I opened up an account directly with Vanguard, but I prefer not to do that. It's definitely not an accurate description, to be sure.

Thanks a bunch and I really enjoy the newsletter. Keep up the good work.

Regards,

Jeff Brainard, CFS
Regional Sales Manager
The Select Sector SPDR Trust

Dear Editor:

At our firm, my exhaustive body of research concludes that, assuming one has selected the optimal index against which to measure investment performance and, if an appropriate peer group has been parsed, about 20% of actively managed funds will indeed have beaten their index in most periods during the trailing 3-year rolling period when examined quarterly. Further, we have shown that one can safely forecast, with statistical significance, the continuation of index and peer group beating results based on prior behaviors. The correlation of a fund's kurtosis, positive alphas and significance of excess returns (T-stat) is implicit in the recognition of traits that provide the ability to forecast superiority. The funds that continue to beat their peers and indexes exhibit risk controls as evidenced by lower betas and lower standard deviations. While the lower



beta facilitates a positive alpha, the context we believe is better managed risk and therefore absence of high highs and low lows

The biggest problems with the current thinking about index funds, and with Mr. Bogle's arguments in particular are:

- The conversation talks about beating the "market". That is nonsense. Any investment manager must be measured against a correct index and peer group not the S&P 500 (unless appropriate) and not for one year at a time.
- In our view, Morningstar and others do not select optimal indexes, nor do they parse optimal peer groups, for measurement.
- Only funds or asset pools that manage one asset class at a time can ever be accurately measured with predictability.
- Index funds do make sense for most people because the industry, in general, doesn't want to identify the only 20% of funds worth owning, it wants to sell whatever sells. A consumer wouldn't pay for a car repair if the problem was not corrected. Why do so many consumers pay asset management fees for fund managers that produce negative alphas? Because they don't know any better.
- It isn't just about cost. Dumbing down an example of "if both funds earn 7% the cheaper one leaves you with more money" is painfully obvious and not the point. The fact is, all things are not equal.

There are reasons some managers are creating excess returns and exhibiting added value through their management process (positive alpha). Our research conclusively shows that expense ratios don't materially affect that. Also, we calculate all fund returns net of all expenses including trading costs - because we can. So, taking those bogeymen out of the equation we do in fact identify funds worth owning, funds that "beat" their correct relative index and peer group (not the ethereal and ridiculous "market"), and exhibit a high likelihood of continuing to do so through a unique and replicable process which is ingrained in their particular philosophy.

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