



**MASON ROAD
WEALTH ADVISORS**
A Registered Investment Advisor

To Our Clients

Re: Common Sense Rules on Investing in Mutual Funds

In the 2010 update of his book entitled “Common Sense on Mutual Funds,” John C. Bogle, founder of the Vanguard Funds, has given us a tremendous wealth of knowledge. I believe it is important to share with you observations he has made regarding our investing philosophy that should be kept in mind.

Most investors believe the last several years have been extremely volatile for the stock market. Measured by standard deviation, the annual stock volatility was 20.8% during the period 1998-2009 compared to 20.5% for the period 1926-2009. The message is that stocks have always been volatile and will continue to be volatile but really weren’t much different in their behavior during the most recent period compared to the last 84 years. However, it did *feel* worse due to the huge decline over a seven month time period in 2008 & 2009.

In 2009, the portfolio turnover of the average equity mutual fund ran at an annualized rate of 105%, compared to 85% in 1997. This means that the average stock in an active mutual fund is held for less than one year. Many in the industry have abandoned the wisdom of long-term investing in favor of short-term speculation. This is in sharp contrast to what we do at Mason Road Wealth Advisors which believes in a buy, hold, and rebalance approach. John says to stay the course and that this is his most important single piece of investment wisdom he can give to anyone. He emphasizes the point that we should not let short-run fluctuations and market psychology of false hope, fear, and greed get in the way of good investment judgment. Many of us got sick and tired of being told to stay the course in 2009, but John was correct.

With numerous charts, he shows that the dividend yields plus earnings growth constitute the driving force for stock returns. The sum of real dividend yields and earnings growth generated from 1871-1997, adjusted for inflation, equaled 6.7% in real terms. In other words, the total long-term real return on stocks derived from dividend yields and earnings is almost

identical to the 7% real return actually provided by the stock market itself. The only other factor influencing stock prices besides the dividend yield and the growth in earnings is the change in price-earnings ratio during the period of investment, which is fueled by investors' speculation based upon fear and greed. Speculation is typically the only reason for these sometimes astonishing weekly, daily or even hourly swings that we witness in the stock market. Never forget that *anything* can happen in the stock market.

John made a prediction in 1999 that the next decade would have very small returns due to the fact that the previous 17 years had seen an unprecedented bull market. He was surprised that the actual return on the S & P 500 index, which was the first index fund he created, showed a negative return for the years 1999-2009. He states with remarkable confidence that the yield on the long-term Treasury bond was at 4.5% in mid-2009, and he expects a bond return within a range of 4%-6% during the coming decade. This does not signal huge inflation as anticipated by many economists. We must remember that the goal of the long-term investor is not to preserve capital in the short run, but to earn real, inflation-adjusted, long-term returns. He gives a rule of thumb that an investors' bond position should equal his or her age. This is similar to the axiom we have quoted that the amount you should have in the stock market should equal 100 minus your age. We have often seen the number 100 increase to 120 due to the fact that people are living longer lives.

He states that asset allocation and expenses in the mutual fund are two of the most significant factors in determining investment returns. Not only does the average mutual fund incur a 1.5% expense ratio for management fees, but the high turnover results in an additional 0.5-0.8% cost per year.

This book indicates that in the long run, approximately one out of every five actively managed funds will out-pace the market in a given year, and that after taking into consideration taxes, the number becomes one out of seven.

Several rules are listed to be considered when investing:

- Select low-cost funds with low-turnover.
- Consider the added cost of active management advice.
- Can advisors and stock brokers identify in advance the top-performing managers for the future? It is *not* possible and you should avoid those who claim they can do this. The best advisors help you develop a long-range investment strategy and an intelligent plan for implementation.
- Do not overrate past fund performance. Funds with past relative returns that have been substantially superior to the returns of their benchmark index will regress toward, and usually below, the market mean over time. I have previously written about reversion to the mean, which states that the law of gravity in the financial markets causes funds that are up to go down and funds that are down to go up and

this is fairly inevitable. For the years 1984-1999, 95% of all equity funds failed to beat the return of the Standard & Poor's 500 Stock Index.

- Use past performance to determine consistency and risk. Look for a fund that has had a consistent performance.
- Beware of stars. Be aware of the fact that the few who have fit into this category were never identified in advance of their accomplishments.
- Beware of asset size. Funds can get too large, refuse to close their fund to new invested dollars and basically become a closet index fund. Broad based market index funds can grow without size limits.
- Do not own too many funds. The returns earned by fund investors substantially lag the returns reported by the funds themselves because most investors put their money into the funds after they have had a good performance.
- Buy your fund portfolio - and hold it. 3% of all equity fund assets were invested in index funds in 1995. The percentage grew to 6.4 in 1998. By mid 2009, fund assets in index funds had soared to \$460 billion, representing 11% of all equity fund assets. Warren Buffett commented in his 1996 annual report of Berkshire Hathaway Corporation, "Most investors, both institutional and individual, will find that the best way to own common stocks is through an index fund that charges minimal fees. Those following this path are sure to beat the net results, after fees and expenses, delivered by the great majority of investment professionals." Peter Lynch, the former manager of the Fidelity Magellan Fund, who was one of the most brilliant stock pickers of his age, stated, "Most investors would be better off in an index fund." Charles Schwab stated, "Only about one out of every four equity funds outperforms the stock market. That's why I'm a firm believer in the power of indexing."

If three of the most brilliant investors of our time are telling you to index, why is it that so many investors are still trying to find the manager with the hot hand? The largest index fund is called "The Spider" and it is based on the S&P 500 Index. It currently has about 700 million shares outstanding and trades 8 billion shares a year, a turnover of more than 10,000%. This is not the purpose of owning an index fund.

Over the past five years, the return earned by ETF investors (Exchange Traded Fund), have lagged the returns earned by the sectors in which they have invested by 4.2% per year, a cumulative loss of 20% of their capital, due to the fact that most investors still do not realize that to be successful, they must buy and hold. The net rate of return earned by mutual funds as a group and over the long run has tended to lag the market by 1.5 - 2.5 percentage points annually. This is the result of management fees and turnover cost. These differences in annual returns, if extended over long periods of time, make a huge difference in your final capital. The numbers in the accompanying chart overstate, to some degree, the returns of regular mutual funds because the underperforming mutual funds drop out of the race and are not counted in the overall calculations. Only 26 tax-managed U.S. equity funds existed as of

2009. Several of those are represented by the Dimensional Fund Advisor family of funds, the fund family used by Mason Road Wealth Advisors. These are referred to by John Bogle as the funds that *should* be utilized, which makes me proud that these are the funds chosen to be used by Mason Road Wealth Advisors.

S&P 500 Index Fund and Average Mutual Fund

	Rate of Return			
	Fifteen Years Ended 6/30/98		Fifteen Years Ended 5/30/09	
	Before Taxes	After Taxes	Before Taxes	After Taxes
Index fund	+16.9%	+15.0%	6.7%	6.1%
Average mutual fund	<u>+13.6</u>	<u>+10.8</u>	<u>5.4</u>	<u>3.7</u>
Index fund advantage	+ 3.3%	+ 4.2%	1.3%	2.4%
Funds outpaced by index fund	94%	97%	52%	72%

In the updated version of his book, the major trend has been the rise in the use of index funds by investors. At the end of 2009, they accounted for 22% of equity fund assets, more than double their 10% share from a decade earlier. Index funds usually outpace about 60% of their peers in a given year, closer to 80% over longer time frames. Although the S&P 500 Index produced only a 3.3% return from March 1997 through June 2009, it performed better than 60% of all large-cap mutual funds. Too many investors and advisors treat mutual funds as if they were stocks and trade them as if they were stocks. For the five years ended June 2009, the typical ETF had a 0% return but the investors in these funds lost an average of 4.2% per year, more than 20% of their capital over five years, because of their propensity to trade. Since 1999, \$546 billion was added to index funds of which 23% of that money was invested in classic index funds and the rest into exotic index funds. The vast majority of the investments in Exchange Traded Funds, 77%, are being used for speculation instead of investment, a fact that is reflected in the tremendous lag between the returns earned by the average ETF investor and the returns earned by the funds themselves.

The element of cost is magnified by time. When investors make this discovery, John Bogle believes the industry will have to give increased attention to the heavy cost of funds, portfolio turnover, and excessive taxes and to the inherent advantages of market indexing. Investors who get badly burned by a long period of equity underperformance or a significant plunge in stock prices may not soon return to the industry's fold, as predicted in 1999 and certainly apparent as a result of what happened in the stock market in 2008-2009. In spite of these warnings, the vast majority of mutual funds have increased their internal management fees as the dollars of assets invested in their funds have grown.

In the Appendix, John states that his guess is that at the current levels of stock prices, there should be some combination of slightly higher earnings growth and/or slightly higher PEs and/or a swift recovery of corporate dividends that could bring the nominal return on equities, including investment return and speculative return, to 7%-10% during the decade that will end in 2019. Considering how conservative his estimate was for the time period 1999-2009 and how his conservative estimate turned out to be better than reality, this is certainly a projection worth considering.

In conclusion, our goal is to steer you toward a careful course and a balanced investment program, seeking the lowest cost, relying on highly diversified asset class funds that offer tax efficiency, and trade infrequently. We pay no attention to the performance of hot fund managers, attempt to rebalance dollars out of the hot performing sectors, and keep a long-term prospective. Although many of us, including myself, felt that the advice of "stay the course," which is what we were told in 2008-2009, seemed trivial, the advice certainly turned out to be correct.

This book was full of comments and ideas that if put into practice will certainly help an investor obtain higher returns. The rules he has listed are ones that we follow every day at Mason Road Wealth Advisors.